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**Shareholder Engagement in Emerging Markets: Institutional and  
Organisational Determinants in Brazil and South Africa**

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M00282844

A thesis presented for the degree of Doctor of Philosophy in Business and Management  
at Middlesex University

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## Abstract

This PhD research analyses the institutional and organisational determinants of shareholder engagement on environmental, social and corporate governance (ESG) issues in Brazil and South Africa. Using an institutional framework, this study investigates the institutional incentives and barriers faced by domestic investors when engaging with companies on ESG issues. It also identifies which types of investors are more likely to engage.

The key research question of this PhD study was investigated using a combination of qualitative and quantitative methods. Statistical analysis was used to identify which types of investors are more likely to engage, and the results were explored in semi-structured interviews. The institutional influences on shareholder engagement in these countries were also explored through semi-structured interviews.

The research findings demonstrate that the engagement strategies most commonly employed by South African investors are individual meetings with companies to address ESG issues, while Brazilian investors mainly use collaborative engagement and appointment of investor representatives onto Boards of Directors of investee companies. As for the determinants of engagement in these countries, legislation and the influence of investor associations are driving local investors to engage with companies both directly and indirectly. Moreover, the influence of the legal and self-regulatory guidelines is encouraging pension funds to question asset managers about their RI practices and, to a lesser extent, to outsource engagement activities. This is because, since most pension funds in Brazil and South Africa are small and lack financial resources, staff and investment knowledge, they are shifting the RI responsibilities imposed on them by mandatory and voluntary regulations to service providers.

In terms of investor characteristics, the statistical data and the interviews show that larger investors and asset managers are more likely to engage with investee companies than smaller investors and pension funds. This is largely because smaller investors and pension funds have insufficient resources available to them, pension fund trustees lack investment understanding, and the potential for smaller investors to influence companies is limited.

In addition, active investors are more likely to engage than passive investors as they are motivated by their goal to outperform the market as well as the remuneration incentives available to active managers. Furthermore, passive investors are unable to divest from companies.

By studying the determinants of shareholder engagement in the emerging markets, this study offers academic and practical contributions. Academically, the study contributes to the literature on shareholder engagement, and particularly on emerging markets where the level of RI and engagement activities is increasing, but on which limited literature is available. Furthermore, the research shows that the institutional frameworks in place in Brazil and South Africa are likely to bring further growth for the practice of RI and shareholder engagement. As practical contributions, the identification of the most common engagement strategies employed and of the determinants of engagement will help investors to develop more effective engagement strategies and will help public and non-governmental organisations develop policies to foster engagement.

**Key words:** shareholder engagement, shareholder activism, Brazil, South Africa, Responsible Investment, emerging markets, institutional investors, pension funds, asset managers, ESG issues

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## **ABBREVIATIONS**

ABRAPP – Brazilian Association of Pension Funds

AGM – Annual General Meeting

ASISA – Association of Savings and Investments in South Africa

CG – Corporate Governance

CME - Coordinated Market Economies

CRISA – Code for Responsible Investing in South Africa

CSR – Corporate Social Responsibility

EMDP – Emerging Markets Disclosure Project

ESG – environmental, social and corporate governance

IFC – International Finance Corporation

IMF – International Monetary Fund

IoDSA – Institute of Directors in Southern Africa

LME - Liberal Market Economies

NGO – non-governmental organisation

POA - Principal Officers Association

PRI – Principles for Responsible Investment

PSPD - People’s Solidarity for Participatory Democracy

RI – Responsible Investment

SIF – Social Investment Forum

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## INTRODUCTION

This study aims to investigate the factors that influence shareholder engagement by domestic institutional investors in the emerging markets. Shareholder (or investor) engagement consists of direct negotiations between investors and portfolio companies regarding the company's strategic and operational matters (Martin et al. 2007). Shareholder engagement can take the form of letter writing, face-to-face meetings, site visits and telephone calls (Becht et al. 2009; Martin et al. 2007; Sullivan and Mackenzie 2006). For the purposes of this research, only shareholder engagement with environmental, social and corporate governance (ESG) concerns will be considered.

This particular research topic was selected because I found a gap in the literature on shareholder engagement in the emerging markets. Although existing academic studies have covered corporate governance (e.g. Ananchotikul and Eichengreen 2009; Claessens et al. 2000; Klapper and Love 2006; Millar et al. 2005; Mueller 2006; Reed 2002; Siddiqui 2010; Paredes 2005; Estrin and Prevezer 2011), Responsible Investment (e.g. Heese 2005; Marlin 1986; Park 2009; Sonnenberg and Hamann 2007) and shareholder activism (e.g. Jang and Kim 2002; Lee and Park 2009) in the emerging markets, studies on shareholder engagement in these countries are virtually non-existent (except for Choi and Cho 2003; Gond and Piani 2013).

Furthermore, this topic was chosen because no study known to me investigates the institutional determinants of investor engagement. Although some literature deals with the factors that drive engagement (e.g. McLaren 2002; Clark and Hebb 2004), there is a need for a systematic analysis of these determinants.

In spite of the limited amount of literature on the topic, the level of shareholder engagement in the emerging markets is growing, thus necessitating a better understanding of this area. Both the number of signatories to the Principles for Responsible Investment (PRI)<sup>1</sup> and the level of shareholder engagement in these countries are growing. As of 26 July 2013, there were 68 signatories in Brazil, 44 in South Africa and 12 in South Korea (PRI 2013a). Moreover, in 2010, PRI signatories

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<sup>1</sup> The United Nations-backed Principles for Responsible Investment is an initiative that aims to encourage institutional investors to incorporate environmental, social and corporate governance issues into their investment decision-making processes.

were reported to have conducted the largest number of engagement initiatives in the emerging markets: 241 extensive engagements in South Africa and 83 initiatives in Brazil (PRI 2010). Besides, foreign investors are increasingly interested in engaging with emerging market companies, as reflected by the number of investors that participated in the Emerging Markets Disclosure Project (EMDP), a coalition of 55 investors who engaged with firms in Brazil, Indonesia, South Africa and South Korea to improve ESG disclosure among companies in these countries (PRI et al. 2012).

Also, identifying the factors that promote or curb shareholder engagement will help predict the presence and extent of engagement in different countries, contributing to the development of policies by public and non-governmental organisations to foster engagement and more responsible corporate practices. It will also help foreign investors understand the constraints of engaging in different environments, leading to the design of more effective engagement strategies. Hence, the results of this research will benefit not only the academic community, but also institutional investors, NGOs and governments.

The following research question and propositions are investigated in this doctoral research:

**Research question:**

What are the factors that influence the level of shareholder engagement in emerging markets?

**Institutional factors:**

Proposition 1 - Legislation does not encourage investors to engage with companies in emerging markets.

Proposition 2 - Investor associations encourage investors to engage with companies.

Proposition 3 - Investor clients do not encourage investors to engage with companies.

**Organisational factors:**

Proposition 4 - Larger investors are more likely to engage with companies than are smaller investors.



Proposition 5 - Asset owners are more likely to engage with companies than are asset managers.

Proposition 6 - Active investors are more likely to engage with companies than are passive investors

This PhD thesis is structured as follows. The first chapter reviews the existing literature on the topic. Later, a set of propositions are developed concerning shareholder engagement in the emerging markets. The second chapter provides an overview of the institutional environment in Brazil and South Africa. The third chapter describes the methodology to be adopted. The fourth chapter presents the results of the statistical data analysis on the organisational determinants of engagement. The fifth chapter presents the findings of the interviews conducted with Brazilian and South African investors to investigate the institutional factors that influence shareholder engagement and to explore the results of the statistical analysis. It also discusses the interview findings in relation to the literature and the statistical findings. The sixth, and concluding, chapter presents the main findings, contributions and limitations of this study and offers suggestions for future studies and recommendations for professional practice.

## 1. LITERATURE REVIEW

**Introduction:** This chapter reviews the extant literature on shareholder (or investor) engagement in the emerging markets. Firstly, it discusses Institutional Theory as a theoretical perspective and the role of institutions in the emerging markets. Secondly, it examines the existing literature on shareholder engagement. Following on from there, it explores the links between Institutional Theory and corporate governance, Corporate Social Responsibility (CSR), Responsible Investment and shareholder activism, concepts which are related to shareholder engagement. It also analyses the firm-level factors that influence these four concepts. Later, a set of propositions concerning the institutional and investor-level determinants of shareholder engagement in the emerging markets is developed.

### 1.1. Institutional Theory

This section provides a brief description of Institutional Theory and analyses the role of institutions in developed and emerging markets.

Institutionalism as a theoretical perspective is rooted in both economics and sociology (Scott 1992 cited in Peng and Heath 1996). While economists (North 1990; Williamson 1985) focus on the efficiency role of institutions, sociologists focus on their effect on legitimacy (Scott 2001; DiMaggio and Powell 1991). Economists argue that the institutional framework of a society serves to regulate economic activities by providing the ‘rules of the game’ (North 1990). Such rules include not only conditions which prohibit individuals from acting, but also those which allow them to undertake certain activities. Institutions are comprised of formal rules, informal rules and enforcement: (i) formal rules are represented by constitutions, laws, policies and formal agreements; (ii) informal rules are comprised of norms of behaviour, conventions and self-imposed codes of conduct, and (iii) enforcement can be imposed by other actors, such as the state or the society. The main aim of the institutions is to reduce uncertainty and create order

through the establishment of a stable structure for everyday life (North 1990; North 1991).

An alternative and complementary perspective on institutionalism is represented by sociologists such as Scott (2001) and DiMaggio and Powell (1991) who focus on the effect of institutions on legitimacy. They address some widely shared beliefs that arise out of cultural and political systems and shape the way people think and behave (DiMaggio and Powell 1991; Scott 1992 cited in Peng and Heath 1996). Scott (1995: 33) defines institutions as “regulative, normative, and cultural-cognitive elements that, together with associated activities and resources, provide stability and meaning to social life”.

Regulative elements are more formal and explicit types of institutions. They include laws, rules, surveillance machinery, sanctions and incentives. Normative elements stress shared values and norms, interpersonal expectations and valued identities. Examples include corporate culture, conventional professional roles and work practices enforced by professional standards. Cultural-cognitive elements take a more informal and tacit form, such as widely held beliefs about the nature of the world. These beliefs are broadly shared and provide vital templates for framing individual perceptions and decisions. Although these three pillars are separated out for analytical purposes, they overlap and influence each other in the real world (Javernick-Will and Scott 2010).

DiMaggio and Powell (1991) also offer a sociological perspective of institutionalism through institutional isomorphism to explain behaviour within firms. Organisations are considered social and cultural systems and, as such, seek legitimacy within the institutional environment. This search for legitimacy converges to create isomorphism, which is generated through coercive, mimetic or normative processes.

Coercive isomorphism is the response to formal and informal pressures that are exerted on organisations by other organisations upon which they are dependent and by societal expectations. Such pressures include force, persuasion or invitation to join a collusion. The most common type of coercive isomorphism is legislation by which organisations must abide in order to operate legally. As discussed later, legislation has proved to be an important factor in driving corporate governance, Corporate Social Responsibility, Responsible Investment and shareholder activism (La Porta et al. 1998; Yang and Rivers 2009; See 2009; Chow 2010; Iliev et al. 2010; Bengtsson 2008; Sievanen et al.

2011). Organisations can also be persuaded to act due to pressures exerted by NGOs and campaign groups (DiMaggio and Powell 1991). One example is the Shell-Greenpeace case. When Shell decided to sink the Brent Spar oil storage facility in 1994 following the dismantling of the platform, Greenpeace led a major campaign against the disposal, which garnered substantial public support. Even though the company believed that sea disposal was the best option in environmental terms, Shell abandoned the plan in light of the insurmountable public opposition (Diermeier 1996).

The second and third forms of isomorphism are more difficult to differentiate (Matten and Moon 2008). Mimetic isomorphism refers to the tendency of social actors to imitate others that are viewed as successful and legitimate. This form of isomorphism draws on conditions of uncertainty. DiMaggio and Powell (1991) cite the Japanese government's efforts to modernise in the nineteenth century which involved sending officers to Europe and the US to study successful structures (e.g. postal, court, navy, army, banking) and subsequently apply them at home. As discussed later, mimetic isomorphism has proved to be essential in driving Responsible Investment in the Scandinavian countries, as observed in the spread of best-in-class investment across these nations and the mainstreaming of RI from Norwegian investor Storebrand to other investors in the region (Bengtsson 2008).

The third mechanism is normative isomorphism. Universities, consultancy firms and professional organisations act as disseminators of appropriate organisational practices, which are then adopted by firms (Abernethy and Chua 1996). Usually, large organisations hire the same few consulting firms, helping spread the same management models. The filtering of personnel also leads to uniformisation. Corporate managers are likely to be drawn from the same universities and are filtered according to a common set of attributes. As a result, they view problems similarly and approach decisions in the same way (DiMaggio and Powell 1991).

According to Djelic (1998), these three isomorphic channels may either operate simultaneously or alternate with each other. Within the different alternatives, the coercive channel may operate concurrently with the mimetic channel or the coercive channel may be replaced later by the mimetic and normative ones.

Comparative research has extended DiMaggio and Powell's neoinstitutional theory by observing how institutional contexts differ across countries (Crouch 2005 cited in

Jackson and Apostolakou 2010; Whitley 1999). While Whitley (1999) calls these specific institutional frameworks ‘national business systems’, Hollingsworth and Boyer (1997) refer to them as ‘social systems of production’ and Hall and Soskice (2001) use the term “varieties of capitalism”. Whitley (1999) provides a framework for comparing the different ways in which countries organise their economic activities. Hollingsworth and Boyer (1997) focus on which institutions render economic activity effective, classifying the economies according to volume (mass production or low production), competition by quality (high or low) and speed of adjustment (flexible or standardised). Hall and Soskice’s (2001) ‘varieties of capitalism’ focus on the firm as the main player in the society and are concerned with incentive structures and efficiency goals (Lane 2003). These varieties of capitalism range from Liberal Market Economies (LMEs), in which supply and demand are regulated by market forces and formal contracts, to Coordinated Market Economies (CMEs), in which firms depend less on market mechanisms and more on the cooperation of the different players in the market.

This discussion is relevant to this research topic because it demonstrates how institutional environments have been analysed and classified in existing academic research. It also indicates the types of institutions which might affect corporate behaviour within countries. These frameworks are helpful in analysing shareholder engagement in Brazil and South Africa, as demonstrated in item 1.8.

### **1.1.1. Institutions in emerging markets**

There are differences in the level of formalisation of institutional arrangements in developed and emerging markets, particularly in the area of regulation. In developed countries, there are often effective judicial systems that include well-specified bodies of law, lawyers, arbitrators and mediators. In contrast, in developing countries, enforcement is usually uncertain because of the ambiguity of legal doctrines as well as uncertainty regarding the behaviour of the enforcer (North 1990).

The Helme and Levitsky (2003 cited in Estrin and Prevezer 2011) typology of informal institutions helps us to understand how formal and informal institutions interact with each other. In developed countries, informal institutions are usually complementary to

formal ones as the latter are considered effective and the formal and informal actors have compatible goals. Informal institutions in the emerging markets are more likely to take the forms of (i) accommodating, (ii) substitute or (iii) competing institutions. Accommodating informal institutions occur when formal institutions are effective, but their goals conflict with those of the informal actors. Brazil's shadow economy offers an example of an accommodating informal institution as it manages to get around the strict rules of business taxation and regulation. Substitute informal institutions occur when formal institutions are ineffective, but the goals of the formal and informal actors are compatible. For instance, in the e-commerce industry in China, telecommunications are considered inefficient, payment mechanisms are inconvenient, products are of poor quality, delivery is unreliable and there are concerns about trust in the legal system. Hence, the Chinese rely greatly on personal trust ('guanxi'<sup>2</sup>), depending on their networks of family, friends and colleagues to guarantee the trust that domestic institutions do not provide (Martinsons 2008). Finally, competing informal institutions exist when formal institutions are ineffective and the goals of the formal and informal actors are incompatible. These types of informal institutions include corruption and clan-like networks. In Russia, the tradition of 'blat', which is a well-developed code of gift-giving and obligation, is an example of a competing informal institution which conflicts with the legal framework.

Besides relying on informal institutions to overcome the lack of formalisation of domestic institutions, many countries are committing to international enforcement mechanisms, such as bilateral investment treaties, international arbitration and multilateral trade commitments (Ginsburg 2005). For instance, the use of international enforcement mechanisms for contracts can be an alternative for countries where local courts are weak. Santhakumar (2003) noted that citizens' actions are also partially replacing less developed formal institutional structures. In economies where there is poor enforcement of environmental regulations and long delays in settling matters through the courts, citizens are being compelled to sue the polluters or take direct actions that are costly to the polluter.

The discussion of the institutional influences on emerging markets is pertinent to this research because it is likely that, as shown in previous studies, formal and informal

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<sup>2</sup> Relationships between two or more people or organisations that rely on each other for help (Martinsons 2008).

institutions influence corporate behaviour differently. For instance, legislation and legal enforcement appear to be stronger in developed countries, while developing markets and emerging economies rely more on international regulations, civil society activism and informal institutions to improve corporate behaviour. This research investigates whether and how these institutions impact shareholder engagement in Brazil and South Africa.

## **1.2. Shareholder Engagement**

This section analyses the literature on shareholder engagement, with particular reference to its definitions, main strategies and recent studies on the topic.

According to Sullivan and Mackenzie (2006: 152) shareholder activism “occurs when shareholders use their unique power as the owners of companies to facilitate change”. One of the many shareholder activism strategies used by institutional investors is shareholder (or investor) engagement, which consists of direct negotiations between investors and portfolio companies regarding the company’s strategic and operational matters (Martin et al. 2007). Shareholder engagement can take the form of letter writing, face-to-face meetings, site visits and telephone calls (Becht et al. 2009; Martin et al. 2007; Sullivan and Mackenzie 2006).

Shareholder engagement can be individual and collaborative. While individual engagement entails the participation of one investor engaging with one or more companies, collaborative engagement involves a coalition of investors. These collaborations may consist of informal arrangements between investors, or more formal structures, such as the Pharmaceutical Shareowners Group, which is concerned with the environmental, social and governance (ESG) behaviour of pharmaceutical companies, and the Institutional Investors’ Group on Climate Change, a coalition of investors that engage with companies and policymakers to encourage a shift to a low carbon economy (Sullivan and Mackenzie 2006).

The literature on shareholder engagement covers various issues, including the drivers of shareholder engagement (Clark and Hebb 2004; McLaren 2002), the link between

engagement and financial performance (Becht et al. 2009; Smith 1996; Strickland et al. 1996; Wahal 1996; Nesbitt 1994), the effectiveness of shareholder engagement (Gifford 2008; Gifford 2010; Piani 2009; Piani and Gond 2013; Hachigian 2011), the role of NGOs in shareholder engagement (Guay et al. 2004; Waygood and Wehrmeyer 2003) and engagement from the company's perspective (Hockerts and Moir 2004; Hachigian 2011; Rehbein et al. 2013).

Clark and Hebb (2004) and McLaren (2002) identified the main motivations for institutional investors to engage with companies on ESG issues through interviews with British and American pension funds and other industry players. Clark and Hebb (2004) identified four main drivers for pension funds to engage: the use of voice over exit that results from the increasing use of passive indices, the corporate governance movement, the growing impact of Responsible Investment and the impact of new global standards. McLaren (2002) found that drivers of investor engagement include reputation, marketing innovation, demand for more detailed information on companies (for screening purposes) and the application of corporate governance expertise.

Becht et al. (2009), Smith (1996), Strickland et al. (1996), Wahal (1996) and Nesbitt (1994) investigated the link between shareholder engagement and financial performance. Strickland et al. (1996), Smith (1996) and Wahal (1996) reported positive financial announcement returns in the sample involving private negotiations, while Nesbitt (1994) and Becht et al. (2009) found that focus lists lead to enhanced returns. For example, Becht et al. (2009) concluded that Hermes' UK Focus Fund produced corporate governance changes in the target companies that generated significant returns for shareholders as a result of its engagement strategy. Although a small number of studies into shareholder engagement are available, evidence that engagement promotes increased financial performance is difficult to measure. As engagement activities are conducted privately, the lack of access to data is a constraint to researching this topic in contrast with voting behaviour (Amalric 2004; Gillan and Starks 2003).

Research on the effectiveness of shareholder engagement has been conducted by Gifford (2008; see also Gifford 2010), Piani (2009; see also Gond and Piani 2013) and Hachigian (2011). Gifford (2008) adopted Mitchell et al.'s (1997) theory of stakeholder salience to analyse the factors that guarantee the effectiveness of engagement from the investors' point of view. He concluded that legitimacy of the investor and urgency-



related factors contribute to an effective engagement. Piani (2009) and Gond and Piani (2013) applied a similar framework to Gifford's (2008) in order to understand the factors that contribute to the effectiveness of collaborative engagement activities in influencing corporate behaviour. She found that company managers perceive that investor collaboration increases the degree of power, legitimacy and urgency of the investor group. Hachigian (2011) built on Gifford's (2008) work to investigate shareholder engagement with Canadian companies. Unlike Gifford (2008), who characterised the policy environment as part of shareholder legitimacy, Hachigian (2011) listed it as a moderating factor in order to examine different jurisdictions and cultural groupings. Hachigian (2011) suggests that cooperation between the state and institutional investors can lead to effective leveraging of the investors' relationship with companies to encourage change in ESG behaviour.

Guay et al. (2004) and Waygood and Wehrmeyer (2003) investigated the role of NGOs in shareholder engagement. Guay et al. (2004) examined how NGOs use shareholder activism to pressure corporations to improve Corporate Social Responsibility (CSR) in the North American context. They found NGOs used three influencing strategies related to shareholder engagement: NGOs may pressure institutional investors to urge changes in managerial behaviour; NGOs may serve as coordinating mechanisms, offering advice and consultation to investors; and NGOs may engage in direct negotiations with companies as a shareholder. Waygood and Wehrmeyer (2003) found that NGOs in Britain played similar roles in order to influence corporate behaviour. The first tactic is the macro 'capital redistribution strategy', in which NGOs use their influence to change investment decisions (e.g. call on investors to boycott companies to divert capital to more responsible investments). This is similar to Guay et al.'s (2004) first strategy. The second means of influencing corporate behaviour is the micro 'investor influence strategy', in which NGOs use their ownership rights, or encourage institutional investors to use theirs, to raise concerns within the company. This is a combination of Guay et al.'s (2004) first and third strategies.

Hockerts and Moir (2004), Hachigian (2011) and Rehbein et al. (2013) studied shareholder engagement from the company's perspective, a focus which has received less attention from academics. Hockerts and Moir (2004) found that investor relations department deal with a limited amount of ESG issues at the moment, but demand is

growing. They also observed that investor relations departments are not only responding to investor queries, but also educating shareholders on ESG issues, and even teaching investors how to approach them. Hachigian (2011) found that, unlike investors, who consider the legitimacy of the engager to be a factor for successful engagement, the companies themselves consider that the persistence of the engager is more important to the effectiveness of engagement. Rehbein et al. (2013) found that corporate managers are more likely to engage in dialogue with shareholder activists when the firm is larger, is more responsive to stakeholders, the CEO is the board chair and the firm has a relatively low percentage of institutional investors.

This brief review of the available literature on shareholder engagement demonstrates the relevance of this study into the determinants of shareholder engagement. As shown above, the existing literature on this topic is relatively limited. Besides, although some studies into the drivers of shareholder engagement have been conducted, there appears to be a gap in the literature in terms of a systematic analysis of the institutional factors that influence engagement, which this study addresses.

### **1.2.1. Shareholder Engagement in emerging markets**

There has been limited research into shareholder engagement in the emerging markets. Gond and Piani (2013) and Choi and Cho (2003) are the only pieces of academic research known to me which analyse shareholder engagement in an emerging market. Gong and Piani (2012) examined two case studies involving collaborative engagement in developing countries: one engaging on human rights with companies operating in conflict-affected areas and another coalition engaging on international standards on human rights and workers' conditions with companies that supply steel from Brazil. The findings of this study, built on Gifford's (2008; 2010) framework, are shown in the section above. Choi and Cho (2003) examined the shareholder activism activities of the South Korean People's Solidarity for Participatory Democracy (PSPD) which included private negotiations with the management of the targeted companies. The authors found that the initiative did not improve performance in the target firms, suggesting that

managers and controlling shareholders of the ‘chaebols’ in South Korea are more insulated from discipline by shareholders than those in other countries.

In terms of non-academic studies, the year 2009 saw an increase in the number of publications on shareholder engagement in the emerging markets. Consultancy firm Mercer, sponsored by the International Finance Corporation (IFC), published “Gaining Ground: Integrating Environmental, Social and Governance (ESG) Factors into Investment Processes”, rating the ESG practices of fund managers in China, India, South Korea and Brazil (IFC and Mercer 2009). The survey found that sustainable investing in the emerging markets is over US\$300 billion. However, less than one third of the managers surveyed have a policy or practice of engagement with investee companies.

The IFC also funded individual country reports on Brazil (IFC and Teri 2009a), China (IFC and BSR 2009) and India (IFC and Teri 2009b). In Brazil, shareholder engagement is considered to be in its infancy. The report describes only one engagement activity, which focused on labour standards in charcoal producers associated with Brazil’s iron and steel production (IFC and Teri 2009a). In China, foreign investors come up against some obstacles to engagement with Chinese companies, such as the language barrier, cultural differences and the lack of proxy services (IFC and BSR 2009). In India, only a few foreign investors and NGOs are engaging with multinationals and Indian companies on ESG issues (IFC and Teri 2009b).

There seems to be a major gap in the literature on shareholder engagement in the emerging markets which academic research has failed to address adequately. In this study, Institutional Theory was employed to investigate the factors that influence shareholder engagement in the emerging markets. Institutional Theory is proved to be effective in the analysis of the environmental influences that affect corporate governance, Corporate Social Responsibility (CSR), Responsible Investment and shareholder activism, concepts viewed as being related to shareholder engagement. A brief description of the concepts and related studies are found below.

### **1.3. Determinants of Corporate Governance**

This section will provide a review of existing literature on the relationship between Institutional Theory and corporate governance. Corporate governance has been widely investigated through the lens of Institutional Theory (cf. Aguilera and Jackson 2003; Buck and Shahrin 2005). This section will present a definition of corporate governance and an overview of studies that relate Institutional Theory and corporate governance, including research focusing on the emerging markets.

Parkinson (1994 cited in Solomon 2007: 13) defines corporate governance as “the process of supervision and control intended to ensure that the company’s management acts in accordance with the interests of shareholders”. According to the Organisation for Economic Co-operation and Development (OECD 2004: 11), corporate governance “involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance 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”.

Corporate governance was created to address agency problems that occur when the interests of management (agents) are in conflict with the interests of the shareholders (owners). Agency problems may arise when agents misappropriate firms’ resources, avoid tasks to meet corporate goals or prioritise personal interests over the firms’ needs (Juravle and Lewis 2008; Sapienza et al. 2000). In this context, corporate governance aims to ensure that the firm operates efficiently from the perspective of its shareholders (Fama and Jensen 1983; Aguilera et al. 2008) and shareholder engagement is one strategy that these investors can adopt to reduce agency problems.

### **1.3.1. The Relationship between Institutional Theory and Corporate Governance**

Studies into the relationship between corporate governance practices and institutional factors focus on the classification of systems of corporate governance (e.g. Chizema and Buck 2006; Lee and Yoo 2008; Aguilera et al. 2006; Weimer and Pape 1999; La Porta et al. 1998) and on corporate governance in specific environments (e.g. Chizema and

Buck 2006; Chizema 2008; Chizema 2010; Jackson 2009; Seki 2005; Jackson and Moerke 2005).

Similarly to Hall and Soskice (2001)'s classification, Chizema and Buck (2006) categorise the world of corporate governance into 'market-based capitalism' and 'cooperative capitalism', while Lee and Yoo (2008) and Aguilera et al. (2006) refer to the Anglo-American shareholder system and Continental European/Japanese stakeholder system. Market-based capitalism is represented by countries such as the US, the UK, Canada and Australia, while cooperative capitalism is represented by countries like Germany, Japan, the Netherlands and Austria. The concept of corporate governance in the first group is restricted to shareholders. The governance system in these countries depends on high levels of disclosure to inform investors while the rights of minority shareholders are protected by law. For the second group, the scope of corporate governance is not limited to shareholders, but encompasses all other stakeholders, such as employees, the bank and the state. This model is often characterised by a bank-centred system (Yoshikawa and McGuire 2008) and managers are strongly influenced by the stakeholders (Noteboom 1999).

Weimer and Pape (1999) increased the number of governance types by identifying four governance systems: Anglo-Saxon countries, Germanic countries, Latin countries and Japan. In Anglo-Saxon countries, the influence of shareholders is strongly institutionalised, stock markets are more intensively used to raise capital and the concentration of ownership is widely dispersed. In Germanic countries, salient stakeholders can exert substantial influence on managerial decision-making and the concentration of ownership is higher than in Anglo-Saxon countries. In Latin countries, shareholders enjoy greater influence than in Germanic countries, though not as much as in Anglo-Saxon countries, and stock markets are a less common means of raising capital than in Anglo-Saxon countries. In Japan, the features of Japanese culture, such as family and consensus, have an important role in the governance system. Employees and shareholders are salient stakeholders in managerial decision-making and bank shareholdings acquire more importance than in Germany.

Focusing on legal systems, La Porta et al. (1998) investigated 49 countries and found that the French civil law tradition offers investors a low level of protection, the German and Scandinavian systems offer moderate protection and Anglo-American common law offers the highest degree of investor protection. The common law regime places

shareholders as dominant actors within corporate governance structures, leading to more widely dispersed share ownership, while the civil law system, through recognising the rights of stakeholders to a much greater degree, protects the investor less and leads shareholding to become more concentrated to compensate for the lower level of investor protection (La Porta et al. 1999).

Among the studies that look at specific environments, Chizema (2008) noted that disclosure of individual executive compensation is not suitable for the German environment due to the existence of co-determination (Jackson and Moerke 2005). As boards encompass representatives of the employees, disclosure of individual executive compensation could have a negative outcome such as later use in collective bargaining. Chizema (2010) also found a negative correlation between the length of a company's experience and the adoption of executive stock options (ESOs) in Germany as older firms resist adopting newer practices. Jackson (2009) found that recent changes in Japan led to the adoption of a 'hybrid' set of practices by some Japanese firms that combine greater capital market orientation with a continued commitment to lifetime employment practices. Seki (2005) found that changes in the composition of shareholding in Japan with an increase in foreign investors, coupled with local legal changes are leading to greater awareness of corporate governance issues among Japanese companies.

These studies demonstrate how institutional features, such as ownership structure, legislation, the importance of the stock markets, salient stakeholders, time horizon and business values, influence corporate governance in different contexts. As these factors influence corporate governance, it is likely that they will impact on shareholder engagement as well. The next section investigates corporate governance in emerging markets.

### **1.3.2. Institutional Theory and Corporate Governance in emerging markets**

Sarkar and Sarkar (2000) argue that the corporate governance context in emerging markets/developing countries is characterised by a less developed capital market, a less active takeover market, low investor protection, weak bankruptcy regulations, a greater involvement of government-owned financial institutions in corporate financing, a higher

dependence on external sources of finance and the absence of a well developed managerial market.

A number of studies focus on the relationship between Institutional Theory and corporate governance in the emerging markets/developing countries. The literature concentrates on the inappropriateness of Anglo-American corporate governance models for most emerging markets/developing countries (Reed 2002; Siddiqui 2010; Paredes 2005) and the interplay of formal and informal institutions in the functioning of corporate governance (Estrin and Prevezer 2011).

Reed (2002) and Siddiqui (2010) noticed that emerging markets/developing countries are drawn to adopting Anglo-American models of corporate governance by international organisations. The World Bank and the International Monetary Fund (IMF) imported the shareholder model to these countries by imposing a series of liberalising measures when negotiating loans, including governance reforms with an Anglo-American perspective. However, the Anglo-American model is not always adequate for these countries. Siddiqui (2010) studied the corporate governance system in Bangladesh and found that, while the market-based system is considered more adequate where company shares are owned by dispersed shareholders and managers are freer from close scrutiny and control, Bangladesh is characterised by a high concentration of ownership, the reluctance of firms to raise capital through the stock market and a high degree of bank borrowing. Rwegasira (2000) investigated the African context and concluded that the German governance model may be more appropriate to Africa due to its low degree of stock market sophistication and domination of bank financing.

Besides the structure of the financial market, the lack of strong institutions is another factor which highlights the inappropriateness of the shareholder model in these countries. Siddiqui (2010) suggests that the American model requires the following conditions: a legal system that can uphold contracts, sophisticated investors and qualified personnel to supplement the capital markets. However, as noted by Paredes (2005), the emerging economies lack 'second order institutions', such as experienced investment bankers, lawyers, security analysts and effective judicial systems that enable the markets to work effectively.

Estrin and Prevezer (2011) examined the interplay between formal and informal institutions in the functioning of corporate governance in the BRIC countries (Brazil,

Russia, India and China). Based on Helmke and Levitzky's (2003 cited in Estrin and Prevezer 2011) framework (discussed further above), the authors studied the role of informal institutions in corporate governance. They found that, in Russia, informal institutions are classified as 'competing' against formal institutions as the rule of law and protection of minority shareholders is undermined by lack of enforcement and corruption, which takes the form of arbitrary inspections, asset expropriation and lack of independence of the courts. The results indicate that the interaction of formal and informal institutions may be detrimental in some contexts.

This section demonstrates that though the available literature on institutional influences on corporate governance is relatively broad, it focused predominantly on developed countries. The corporate governance system in the civil law countries seems to be more appropriate for developing nations than the Anglo-American system, in contrast to what has been promoted by the World Bank and the IMF's lending policies. Besides, informal institutions seem to acquire greater importance in the developing/emerging markets. This analysis of the determinants of corporate governance systems in different countries will be employed later in developing propositions concerning the factors that affect shareholder engagement.

#### **1.4. Determinants of Corporate Social Responsibility (CSR)**

This section will discuss the relationship between Corporate Social Responsibility (CSR) and Institutional Theory. Considering that this study is focused on shareholder engagement that targets environmental, social and corporate governance (ESG) issues, Corporate Social Responsibility is a relevant subject due to the social and environmental issues it encompasses. This section will define CSR and then proceed to examine studies concerning the relationship between Institutional Theory and CSR, including research carried out in the context of emerging markets.

CSR is a contested and dynamic concept (Matten and Moon 2008) and there is still no agreed definition (Fisher 2004 cited in Yang and Rivers 2009). Matten and Moon (2008:46) define CSR as "clearly articulated and communicated policies and practices



of corporations that reflect business responsibility for some of the wider societal good”. The European Commission (European 2001 cited in Oberseder et al. 2011: 450) defines CSR as “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis”. Carroll and Buchholtz (2000 cited in Crane and Matten 2006) characterise CSR as encompassing the economic, legal, ethical and philanthropic expectations placed on organisations by society at a given point in time. By economic responsibilities, the authors refer to issues such as dividends to shareholders, fair wages to employees and fair product prices to customers. The legal responsibility demands that firms abide by the law. The ethical responsibility obliges corporations to do what is fair and just. Finally, the philanthropic responsibility is under the companies’ discretion and encompasses activities related to improving the quality of life of employees, of the local communities and of society.

#### **1.4.1. The Relationship between Institutional Theory and CSR**

The relationship between Institutional Theory and CSR has been covered in the available literature. Some authors point to the existing relationship between Institutional Theory and CSR without analysing further how institutional environments impact CSR (e.g. Chapple and Moon 2005; Maignan and Ralston 2002). Other authors (e.g. Campbell 2007; Chih et al. 2010) identified the institutional determinants of CSR while a number of authors (e.g. Doh and Guay 2006; Matten and Moon 2008; Aaronson 2003; Jackson and Apostolakou 2010; Tengblad and Ohlsson 2010) focused on examining CSR in different environments.

Chapple and Moon (2005) and Maignan and Ralston (2002) found that CSR differs across countries due to institutional differences. While Chapple and Moon (2005) researched CSR in Asian countries, Margolis et al. (2002) studied the public CSR commitments made by firms in European countries and the US. However, neither Maignan and Ralston (2002) nor Chapple and Moon (2005) explored the institutional implications of their findings any further.

Campbell (2007) developed a set of theoretical propositions to analyse the institutional determinants of CSR, arguing that CSR behaviour is associated with the level of state and industry regulations, enforcement by state agencies, NGOs and media activism, normative institutions (e.g. business schools' curricula, business publications and business associations) and legal institutions that facilitate dialogue between companies and their stakeholders (e.g. co-determination in Germany). Chih et al. (2010) investigated Campbell's (2007) propositions empirically, analysing 520 firms in 34 countries, and found that more responsible behaviour is associated with strong and well-enforced state regulations, strong levels of legal enforcement, high quality management schools and cooperative employee-employer relations.

In terms of the study of CSR in different institutional contexts, academic literature is largely focused on the US and Europe. Aaronson (2003), Matten and Moon (2008) and Doh and Guay (2006) examined the differences between the US and Europe/UK with regard to various CSR topics, while Jackson and Apostolakou (2010) and Tengblad and Ohlsson (2010) studied CSR in European countries.

Aaronson (2003) found that, although Britain and the US share similar cultural and political contexts, the CSR models are different. While CSR is supported by businesses, the government and civil society in the UK, CSR initiatives are contradictory and unconnected in the US. Matten and Moon (2008) attribute the differences in business systems to the fact that the nature of CSR in the US is more explicit (CSR encouraged by voluntary programmes and strategies that address societal issues), while the approach in Europe is predominantly implicit (CSR driven by mandatory and customary requirements to address stakeholder issues). In terms of the incentives for businesses and interest groups to influence government policies, Doh and Guay (2006) found that, while in the US, the federalist structure hinders opportunities for companies to influence policy, in Europe, the role of the European Union and the more formalised role of interest groups in the public policy process encourage their participation (Wilson 2003 cited in Doh and Guay 2006; Marks and McAdam 1996 cited in Doh and Guay 2006).

As for the study of CSR in European contexts, Jackson and Apostolakou (2010) compared the influence of different institutional environments on CSR policies in Europe, concluding that firms from more Liberal Economies scored higher on most dimensions of CSR than firms from Coordinated Market Economies. This is because CSR practices in Liberal Economies act as substitutes for institutionalised forms of

stakeholder involvement. Tengblad and Ohlsson (2010) investigated how globalisation of business systems affected the framing of CSR in Norway. They found that CSR discourse had changed from a communitarian and national view, in which CSR is mediated by the State, to an international and individualistic view, where CSR is delimited by globalised companies.

This section demonstrates that the literature on CSR is focused on the comparison of the American and European contexts and on how different institutional factors, such as legislation, legal enforcement, quality of higher education and political structure, shape CSR in different countries. These studies will be employed later in developing the propositions concerning the factors that affect shareholder engagement. The next section investigates CSR in the emerging markets.

#### **1.4.2. Institutional Theory and CSR in emerging markets**

Institutional Theory and CSR in both developing and emerging countries is a growing field of research. The literature mainly focuses on the configuration of CSR in various developing countries (Blasco and Zolner 2010; Robertson 2009; Jamali et al. 2008) and the interplay between local and foreign institutional influences on the subsidiaries of MNCs (Muthuri and Gilbert 2011; Amaeshi and Amao 2009; Yang and Rivers 2009; Jamali and Neville 2011).

Robertson (2009) and Jamali et al. (2008) found that CSR is responsive to national differences. Robertson (2009) compared CSR in Singapore, Turkey and Ethiopia and found that, in Singapore, the institutional environment, characterised by the predominance of public companies, good level of corporate governance and openness to international investment, leads CSR to be dominated by MNCs with possible dissemination to small and local companies in the future. In Turkey, firms have their own CSR practices as privately-owned companies predominate. In Ethiopia, the low level of economic development leads firms to partner with NGOs to deliver social services. In Lebanon, Jamali et al. (2008) found that managers perceive little institutional pressure to adopt CSR in the local context, which has generated a situation whereby it remains relatively unsophisticated and has acquired a mainly philanthropic approach. Blasco and Zolner (2010) compared the impact of institutions on CSR in

France and Mexico. They found that, in France, despite an environment that is more conducive to the dissemination of CSR practices, activities are stagnant and there is a marked reluctance among business people in the country to put forward a CSR discourse too overtly. Contrarily, in Mexico, there are an increasing number of companies and organisations practising and advocating social engagement and the CSR discourse takes a more normative approach.

As for the interplay of local and foreign influences on subsidiaries, Yang and Rivers (2009) found that MNC subsidiaries are less likely to adopt local practices when they are strongly annexed to their parent companies and the benefit of gaining internal legitimacy (from parent company pressure) outweighs external legitimacy (from local institutional pressure). On the other hand, subsidiaries are more likely to adapt to local practices (i) to legitimise themselves if they operate in host countries with different institutional environments and demanding stakeholders and (ii) if their parent companies suffer major legitimacy problems at home or abroad.

Amaeshi and Amao (2009), Muthuri and Gilbert (2011) and Jamali and Neville (2011) explored the local and foreign influences on CSR practices when MNCs operate in other countries. Amaeshi and Amao (2009) found that the corporate codes of conduct developed by MNCs operating in Nigeria, to a large extent, reflect the characteristics of the model of capitalism in their home countries, albeit with certain degree of modification. Muthuri and Gilbert (2011) noticed that the nature and orientation of CSR differ between companies which operate solely in Kenya and those headquartered abroad or with international operations. In general, philanthropic responsibilities take precedent over legal responsibilities in Kenya. However, there are a few foreign companies that exhibit a more strategic response to institutional demands in view of increasing international pressure from civil society, industry associations and home governments. Jamali and Neville (2011) employed Scott's (2008) institutional model and Matten and Moon's (2008) CSR model, comparing institutional influences on the CSR of MNCs and local companies in Lebanon. They found patterns of CSR crossvergence as CSR activities undertaken by MNCs were mostly philanthropic with a generic global flavour, revolving around maintaining legitimacy in host societies, while SMEs enacted philanthropic CSR activities with a local flavour, targeting the less fortunate and influenced by cultural and religious values.

The literature on CSR in developing countries shows how the lack of local institutional pressures and the low level of economic development lead to a low level of sophistication in the CSR activities carried out in these countries. However, MNC companies are more likely to employ CSR practices imported from the headquarters and can drive local firms to improve their CSR practices. This area of the literature was analysed to support the development of propositions concerning the factors that affect shareholder engagement.

## **1.5. Determinants of Responsible Investment**

This section discusses the relationship between Responsible Investment (RI) and Institutional Theory. According to the PRI (2013b), “Responsible Investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance factors, and of the long-term health and stability of the market as a whole”. Similarly, Eurosif (2010) refers to Responsible Investment as the consideration of the long-term influence of extra-financial factors such as environmental, social and corporate governance (ESG) issues in investment decision-making (Eurosif 2010). The study of Responsible Investment is relevant to this research because shareholder engagement is one of the strategies available to investor seeking to adopt a Responsible Investment approach (USSIF 2013; Eurosif 2010).

### **1.5.1. The Relationship between Institutional Theory and Responsible Investment**

A number of studies have analysed the institutional determinants of Responsible Investment, focusing on single countries (Jansson et al. 2011; Solomon et al. 2002) or comparing different nations (Sievanen et al. 2011; Bengtsson 2008; Louche and Lydenberg 2006).

Jansson et al. (2011) analysed the drivers of Responsible Investment in Sweden, while Solomon et al. (2002) studied RI in the UK. Jansson et al. (2011) found that, while investors that adopt RI practices are more likely to be influenced by the example of

others, non-RI investors are more likely to be influenced by market regulations and uniform criteria of RI in the investment community. It seems that, in Sweden, RI investors are more influenced by mimetic isomorphism while non-RI investors are more influenced by coercive and normative isomorphism. Solomon et al. (2002) found that the influence of lobby groups, government and society in general were considered to be the most important drivers of RI for pension funds in the UK. On the other hand, the authors found that trustees, fund managers and pension fund members, who are the main parties involved with the investment institutions, are not as interested in Responsible Investment. Solomon et al. (2002) believe that this could be partially explained by pension fund trustees' concern about breaching fiduciary duties when including ESG issues in investment decisions.

Sievanen et al. (2011); Bengtsson (2008) and Loche and Lydenberg (2006) compared the drivers of RI in different countries: Sievanen et al. (2011) focused on European pension funds, while Bengtsson (2008) studied RI in Scandinavian countries and Louche and Lydenberg (2006) focused on differences between the US and Europe.

Sievanen et al. (2011) examined pension funds in 15 European countries to analyse the determinants of RI and found that pension funds from Scandinavian and common legal origin are more likely to adopt a responsible investment strategy. Bengtsson (2008) found that the institutional setting helps to explain the emergence of RI in Scandinavia. First, he noticed that normative and cognitive isomorphic influences shaped the development of Responsible Investment in these countries. As concerns about the environment, international development and CSR grew stronger in the region, Scandinavian investors incorporated environmental issues and international conventions into their RI practices. Moreover, coercive isomorphism acted as an additional push towards Responsible Investment once legislation focused on public pension funds and ESG issues was passed in Sweden, Norway and Denmark. Nonetheless, Bengtsson (2008) found that the most important form of influence on Scandinavian RI is mimetic isomorphism, observed, for example, in the spread of best-in-class investment across the region and the mainstreaming of RI from Norwegian investor Storebrand to other Scandinavian investors. Hence, in Scandinavia, Bengtsson (2008) found that normative, coercive and mimetic forces contributed to the development of Responsible Investment.

Louche and Lydenberg (2006) found that the differences in RI approach between the US and Europe are explained by cultural, historical and political factors. First, the authors found that the regions' definitions of RI differ: while in the US, it is more values-driven, the European definitions tend to be more pragmatic and emphasise the equal importance of social, environmental and financial aspects, a reflection of the influence of the concept of sustainable development in Europe. Second, in Europe, there is greater participation by governments in promoting the concepts of CSR and Responsible Investment, illustrated, for example, by the regulations focused on pension fund investment policy disclosure on ESG issues in the UK, Sweden, and Belgium. Third, in terms of RI strategies, there is a more antagonistic relationship between shareholders and management in the US due to the ability of American shareholders to file resolutions and use proxy voting rights, while Europeans have more behind-the-scene dialogues. In sum, differences in RI between the two regions are largely explained by variations in the role played by the government and public conceptions of sustainability.

Overall, the studies above demonstrate that coercive isomorphism, in the form of legislation and social pressure, and mimetic isomorphism, through herding, are the most common influences on Responsible Investment in developed countries. These studies will be used later to develop propositions concerning shareholder engagement in emerging markets.

### **1.5.2. Institutional Theory and Responsible Investment in emerging markets**

Only two studies (Sjostrom and Welford 2009; Viviers et al. 2008) were found about the drivers of and impediments to Responsible Investment in the emerging markets, demonstrating the need for further research on the topic, which this study addresses.

Sjostrom and Welford (2009) found that the drivers of Responsible Investment that exist in developed countries, such as regulation, the presence of NGOs in the financial arena, the demand from religious groups for RI and legal rights of minority shareholders, are not present in the context of Hong Kong. As a result, corporations are rarely or never targeted by NGOs in Hong Kong, there are no religious groups that are

active shareholders and the local ownership structure disfavours minority shareholders. Sjoström and Welford (2009) further asserted that the market logic that dominates Hong Kong's business and financial sectors is not particularly receptive to the logic of environmental and social protection.

Viviers et al. (2008) analysed the drivers of and barriers to Responsible Investment in South Africa. According to the study, the interviewees viewed fiduciary responsibility as a critical barrier to RI in the country, while legislation and further evidence of RI resulting in improved risk-adjusted returns were viewed as potential important drivers of RI. It is noteworthy that this research was conducted in 2006, thus before the amendment to the Pension Funds Act incorporating ESG issues into the investment processes of pension funds (described in more detail in Chapter 2). The impact of the changes to the legislation is discussed in Chapter 5.

In summary, the dearth of literature on Institutional Theory and Responsible Investment demonstrates that there is a clear need for further research on the determinants of RI in the emerging markets, which this study addresses.

## **1.6. Determinants of Shareholder Activism**

This section discusses the relationship between Institutional Theory and shareholder activism. Sullivan and Mackenzie (2006: 152) argued that shareholder activism “occurs when shareholders use their unique power as the owners of companies to facilitate change”, while Mallin and Melis (2012: 172) claimed that “the role of shareholder activism arises when shareholders decide to hold their shares and try to induce changes within the company without a change in its control”. Gillan and Starks (2007 cited in Mallin and Melis 2012) placed shareholder activism on a continuum of reactions that unhappy shareholders can give to corporate governance concerns. Sullivan and Mackenzie (2006) observed that the activism strategies generally used by investors include dialogue, use of voting and other formal rights, collaboration with other investors, benchmarking, media communications and the ability to influence share price through the buying and selling of shares. This topic is pertinent to this study because



shareholder engagement is one of the many strategies within shareholder activism which can be employed by investors.

### **1.6.1. Institutional Theory and Shareholder Activism**

A limited number of studies analysed the relationship between shareholder activism and institutional determinants (Chow 2010; Iliev et al. 2010; Martin et al. 2007; Mallin 2001; Mallin 2012), the majority of which focused on the regulatory aspects related to activism, as shown below.

Chow (2010) analysed shareholder activism<sup>3</sup> on ESG issues in 13 countries (both developed and developing economies) and found that shareholder activism commitment (measuring the level of activities and interaction between shareholder and investee companies) is higher in common law countries than in their civil law counterparts and has a positive correlation with the level of law enforcement. The results support La Porta et al.'s (1998) findings which suggest that investors are more likely to exercise their rights when they have legal protection and confidence in legal enforcement.

Similarly to Chow (2010) and La Porta et al. (1998), Martin et al. (2007) asserted that common law jurisdictions offer a supportive context for shareholder activism<sup>4</sup> because they provide a firmer basis on which to develop equity markets than their civil law counterparts by protecting the rights of shareholders and the interests of minority shareholders. Such protection is accomplished by common law systems because the judiciary has greater discretion in interpreting precedent, whereas judges in civil law countries are merely agents of state regulation.

Iliev et al. (2010) studied shareholder voting behaviour in different legal regimes, analysing the relationship between country-level and firm-level characteristics and the voting patterns of American institutional investors in non-American firms from 44

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<sup>3</sup> Chow (2010) used the term shareholder engagement as I use shareholder activism in this study because she includes both voting behaviour and private dialogues between investors and companies as part of her definition of engagement. For purposes of standardisation, I used the term shareholder activism in this literature review.

<sup>4</sup> Martin et al. (2007) also used shareholder engagement as I use the term shareholder activism because they included the filing of shareholder resolutions in their definition. For purposes of standardisation, I used the term shareholder activism in this literature review.

different countries. They found that shareholders' propensity to vote against management recommendations when insider control<sup>5</sup> is greater is about twice as high when firms are domiciled in countries with low levels of shareholder protection. Moreover, they found that recommendations made by the proxy advisory firm Institutional Shareholders Services (ISS) have a stronger influence on the propensity to vote against the management of firms from countries with poor governance. The findings demonstrate that the legal environment influences voting behaviour as institutional shareholders are more likely to be interested in shaping the governance of firms in countries with weaker investor protection.

Mallin (2001) compared voting behaviour in the UK and the US. She found that, average voting turnout in the US is higher because voting is seen as a fiduciary duty and because private pension funds are mandated to vote by the Department of Labour's regulations governing proxy voting by Employee Retirement Income Security Act (ERISA) funds. In the UK, at the time of the research, the voting structure was perceived as limiting voting behaviour because electronic voting was not permitted and the existing proxy voting system was viewed as slow and overly complicated. However, a decade later, Mallin (2012) observed that the UK now facilitates voting through the introduction of an electronic system and general improvements to streamline the voting process. She also argued that the government is encouraging institutional investors to increase levels of voting across their investee companies and that, if this does not happen, the government may make voting mandatory (Mallin 2012).

In sum, Chow (2010), Iliev et al. (2010), Martin et al. (2003) and Mallin (2001; 2012) found that the legal tradition and institutional structures in a particular country help to explain shareholder activism and shareholder voting behaviour. In general, common law countries encourage shareholder activism because they offer higher levels of legal protection to investors, while institutional structures facilitate voting behaviour. The limited literature denotes the need for further research, which this study hopes to address.

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<sup>5</sup> measured in terms of the percentage of shares held by insiders as a proxy for expropriation of minority shareholders (Iliev et al. 2010)

### **1.6.2. Institutional Theory and Shareholder Activism in emerging markets**

To my knowledge, there is only one study on the relationship between the institutional environment and shareholder activism which focuses on emerging markets. Adegbite et al. (2012) found that shareholder activism in Nigeria mirrors the dominant corrupt political culture of the country. The authors found that Nigerian shareholder associations make use of massive disruptions and aggressive bullying in annual general meeting (AGM) proceedings, but these activities are perceived as inefficient because, once the association's executives are "appeased" by the company, they stop their activist practices. Such appeasement can take the form of shares and allotments in public offerings or public favours, such as funding or sponsoring the organisation, disseminating the corrupt culture.

As seen above, there is a clear gap in the literature on the determinants of shareholder activism, especially in emerging markets, which this research helps to overcome.

### **1.7. Organisational determinants**

This research also analyses the organisational determinants of shareholder engagement in Brazil and South Africa. In order to develop propositions concerning investor-level variables, I reviewed studies linking firm-level factors with concepts related to shareholder activism (corporate governance, CSR, Responsible Investment and shareholder activism), as shown below.

In terms of corporate governance, a number of authors found that there is a relationship between company characteristics and corporate governance. Studies were found which link corporate governance and firm size (e.g. Kiel and Nicholson 2003; Ragothaman and Gollakota 2009; Black et al. 2006 cited in Braga-Alves and Morey 2012), return on assets (e.g. Ragothaman and Gollakota 2009), company value (e.g. Gompers et al. 2003 on US; Ammann et al. 2011; Balasubramiam et al. 2011; Schmid and Zimmermann 2008), company risk (e.g. Black et al. 2006 cited in Braga-Alves and Morey 2012), a firm's need for equity finance (e.g. Durnev and Kim 2005 cited in Braga-Alves and Morey 2012) and dividend payouts (Mitton 2004). For example, Ragothaman and

Gollakota (2009) found that return on assets and firm size are useful indicators in discriminating the 'best' American governed firms from the 'worst' governed firms. Kiel and Nicholson (2003) found that larger Australian firms tend to have a greater proportion of outside directors and are more likely to separate the roles of chairman and CEO.

As for studies on CSR behaviour, a number of works found a relationship between CSR and firm size (Chapple and Moon 2005; Margolis and Walsh 2001; Amato and Amato 2007; Adams et al. 1998; Cowen et al. 1987; Hackston and Milne 1996; Patten 1991) and industry affiliation (e.g. Adams et al. 1998; Cowen et al. 1987; Hackston and Milne 1996; Patten 1991). Larger companies were found to be more likely to engage in responsible behaviour (Chapple and Moon 2005; Margolis and Walsh 2001; Orlitzky et al. 2003 cited in Campbell 2007) which Waddock and Graves (1997) attribute to slack resources. For instance, Amato and Amato (2007) found that small and large firms give more to the community than medium-sized firms because smaller firms are closer to the community and larger firms benefit from gaining social legitimacy, while medium firms are too large to have close ties to the community, but too small to have the public relations exposure of large firms. Hackston and Milne (1996) found that the size-sustainability disclosure relationship is stronger among companies involved in high-profile sectors (e.g. extractive industries).

In terms of Responsible Investment, a limited number of studies have sought to link RI and investor characteristics. The only article known to me is from Sievanen et al. (2011) who examined European pension funds. They found that the adoption of a responsible investment strategy becomes more common as the size of the pension fund increases in relation to number of staff and number of current pensioners. Moreover, they found that public pension funds are more likely to have a responsible investment strategy than private funds.

As for studies into shareholder activism, several works linking investor characteristics and activist behaviour were found. Research was conducted on investor size (e.g. Choi and Fisch 2008; Rubach and Seborá 2009), type of investment management (Choi and Fisch 2008; Rubach and Seborá 2009); investment horizon (Rubach and Seborá 2009; Martin et al. 2007; Coffee 1991), pension fund sponsor (Romano 1993; Monks and Sykes 2006) and investment strategy (Romano 1993; Black 1990). Choi and Fisch (2008) and Rubach and Seborá (2009) found that investor size is correlated with

activism as larger funds have greater ability to spread the fixed cost of engaging in activism across their asset base (Choi and Fisch 2008) and are likely to possess the power necessary to gain access to, and be attended to by, directors and senior managers (Rubach and Seborá 2009). Regarding investment management, Choi and Fisch (2008) and Rubach and Seborá (2009) found that internally managed pension funds are more likely to engage in activism because funds that delegate more functions (externally managed) have fewer in-house resources with which to do so and are likely to devote less effort and resources to developing in-house knowledge about corporate governance (Choi and Fisch 2008). In terms of investment horizon, Rubach and Seborá (2009), Martin et al. (2007) and Coffee (1991) found that investors with longer investment horizons are more likely to engage in activism which Martin et al. (2007) and Coffee (1991) attribute to the outflows of pension funds, as beneficiaries are less likely to leave the fund than other types of investor clients, giving pension funds the flexibility to develop a long-term perspective on their investments.

As outlined above, a large number of studies have been conducted on the relationship between corporate governance, CSR shareholder activism and organisational factors, while fewer studies have been carried out on Responsible Investment. These studies will be employed to develop the propositions found in the next section.

## **1.8. Determinants of Shareholder Engagement**

This section develops propositions on the determinants of shareholder engagement in emerging markets. The focus of this study will be on shareholder engagement performed by institutional investors targeting listed companies in emerging markets with the aim of changing corporate behaviour related to ESG issues. The propositions and methodology of this research (found in Chapter 3) were developed according to this focus.

**Research question:** What are the factors that influence the level of shareholder engagement in emerging markets?

## 1.8.1. Institutional determinants

### 1.8.1.1. Legislation

Legislation is the most common type of coercive isomorphism, as corporations must abide by domestic regulations to operate legally (DiMaggio and Powell 1991). Academic research found that legislation is an important factor which influences corporate governance (La Porta et al. 1998; Chizema and Buck 2006), CSR (Campbell 2007; Chih et al. 2010), Responsible Investment (Solomon et al. 2002; Bengtsson 2008; Sievanen et al. 2011) and shareholder activism (Chow 2010; Martin et al. 2007; Iliev et al. 2010). Campbell (2007) found that CSR behaviour is associated with the level of state and industry regulation, enforcement by state agencies, and legal institutions that facilitate dialogue between companies and their stakeholders. La Porta et al. (1998) found that different legal systems lead to different degrees of effectiveness in corporate governance: while the common law regime places shareholders as dominant actors within corporate governance structures and offers greater protection of investors' rights, the civil law system, through recognising the rights of stakeholders to a much greater degree, provides less protection (La Porta et al. 1999). Sievanen et al. (2011) found that European pension funds from Scandinavian and common law countries are more likely to adopt a responsible investment strategy, while Chow (2010) and Martin et al. (2007) argue that investors from nations based on common law are more likely to be activists.

Nonetheless, in developing countries/emerging markets, the legal environment is usually characterised by a lack of regulation and/or legal enforcement (Yang and Rivers 2009; Tan 2009). In the sphere of environmental concerns, studies have reported that regulation on these issues is looser and less likely to be enforced by governmental agencies in developing countries (Kusku 2007; Kusku and Zarkada-Fraser, 2004; Lang and Ho, 2000 cited in Ozen and Kusku 2009). Moreover, Estrin and Prevezer (2011) found that BRIC countries either have an ineffective legal system or a well-established legal framework with a low level of enforcement. For instance, while in China, there is a lack of legal infrastructure and weak contract enforcement, in India, there is a well-established legal framework, but marked variations in the implementation of the legal system at the state level.

Besides the low level of legal formality in these countries, developing countries/emerging markets might be encouraged to keep social and environmental standards and the correspondent level of enforcement low so as to attract foreign investment and promote rapid economic development, whilst ignoring long-term environmental and social consequences and stakeholder needs (Marsden 2000 cited in Ozen and Kusku 2009; Ozen and Ozen 2004 cited in Ozen and Kusku 2009; Croucher and Miles 2010). For instance, Mwaura (2005 cited in Muthuri and Gilbert 2011) and Opondo (2009 cited in Muthuri and Gilbert 2011) found that the Kenyan government has been reluctant to impose regulations for fear of discouraging domestic investment. In addition, the fact that the level of societal expectations is low in the emerging markets does not compel local governments to make changes (Ozen and Kusku 2009).

Drawing on the above literature, I posit that the legal framework in emerging markets is generally weak or not well-enforced and, as such, does not have the power to encourage shareholder engagement. Therefore:

**Proposition 1:** Legislation does not encourage investors to engage with companies in emerging markets.

#### **1.8.1.2. Influence of investor associations**

Industry associations and professional organisations are considered mechanisms for normative and mimetic isomorphism (DiMaggio and Powell 1991; Campbell 2007) as these organisations act as disseminators of appropriate organisational practices, which are then adopted by firms (Abernethy and Chua 1996).

Industry associations usually establish their own regulatory mechanisms to ensure fair practices, product quality and workplace safety to which their members are expected to adhere (Campbell 2007). These associations move towards self-regulation for two main reasons: to avoid eventual state regulatory intervention and to protect the industry from itself. Firstly, industry associations believe that it is wiser to control the regulatory process themselves than to be forced to succumb to a process over which they would have little control (Kolko 1963 cited in Campbell 2007; Schneiberg 1999 cited in

Campbell 2007; Streeck and Schmitter 1985 cited in Campbell 2007; Weinstein 1968 cited in Campbell 2007). Self-regulation also arises because corporations are afraid that state regulation is insufficient to protect the industry from itself. Fearing that one firm might ruin the reputation of the whole sector through corporate misbehaviour, industry associations may establish their own regulations, monitor performance and punish companies that do not comply with these regulations (Campbell 1989 cited in Campbell 2007). Moreover, self-regulation is sometimes encouraged by the state so that the latter can displace regulatory responsibilities onto the private sector (Bartley 2003 cited in Campbell 2007; Maignan and Ralston 2002; Streeck and Schmitter 1985 cited in Campbell 2007).

Industry regulations may also include guidelines on environmental, social and corporate governance (ESG) practices, anchoring expectations as to how the industry should behave (See 2009). Companies are encouraged to become signatories to these codes to avoid peer-pressure from other firms within the industry (Lennox and Nash 2003 cited in Yang and Rivers 2009) and to be attractive to company level stakeholders (Yang and Rivers 2009). These codes promote mimetic isomorphism of CSR practices and contribute to institutionalising a normative climate that facilitates responsible corporate behaviour among their members (Campbell 2007). Examples of these codes include The International Corporate Governance Network (ICGN)'s guidelines to improve corporate governance and disclosure (Porter and Kramer 2003) and the United Nations-backed Principles for Responsible Investment (PRI), reported to have accelerated the development of Responsible Investment (Borglund et al. 2008 cited in De Geer et al. 2009). In emerging markets, voluntary practices acquire even greater importance as a means of strengthening a company's position in the market when mandatory regulations are not yet well-established (Millar et al. 2005). In emerging markets, investors feel that their capital is better protected if companies can prove that they abide by high voluntary standards of corporate governance when the legal system does not offer investor protection (cf. Millar et al. 2005). As industry associations can encourage CSR practices, corporate governance and Responsible Investment, I suggest that investor associations can encourage shareholder engagement.

**Proposition 2:** Investor associations encourage investors to engage with companies.



### 1.8.1.3. Influence of clients

Client/consumer pressure is another form of coercive isomorphism (DiMaggio and Powell 1991). Consumers today are increasingly attentive to social and environmental factors when making purchase decisions (Bray et al. 2011). Examples of consumer ethical concerns include environmental/green issues, sustainability concerns, workers' rights, country of origin, the arms trade, fair trade and animal welfare (Carrington et al. 2010). In addition, ethical sensitivity is reported to increase as consumers get older (Hines and Ames 2000 cited in Bray et al. 2011) and as they become more affluent (Barnett et al. 2005 cited in Bray et al. 2011).

Ethical concerns have also been reported among pension fund beneficiaries. According to Hendry et al. (2007), public pension funds in particular have taken the view that the pensioners of the future have an interest in environmental sustainability and ethically and socially responsible capitalism.

Nevertheless, beneficiaries have no 'say' in how their funds are managed (Juravle and Lewis 2008). According to the fiduciary duties of pension funds, trustees need to act in the best interests of the beneficiaries, but do not need to consult them (Richardson 2008). As a result, fiduciary norms reduce beneficiaries to a voiceless and passive status (Richardson 2008). The lack of voice is even more worrying for beneficiaries because, whereas mutual fund clients could change service providers, pension fund members generally have no such choice (Richardson 2008). Furthermore, private-sector defined benefits (DB) pension schemes, which promise members a pension based on years in service and earnings, are increasingly being replaced by defined contribution schemes (DC), shifting the pension burden on to employees as DC schemes depend on the amount invested and the performance of that investment in the market (Kakabadse et al. 2003; Jamieson 2001 cited in Kakabadse et al. 2003; Mallin 2004).

In sum, beneficiaries are far removed from the investment decisions that occur on their behalf (Thamotheram and Wildsmith 2007) and, even though they are often referred to, they are rarely seen in the world of pension fund management (Clark and Hebb 2004). Likewise, it is unlikely that beneficiaries from emerging markets will participate in investment decisions, particularly because beneficiaries from these countries tend to be

less affluent, a factor that has been reported to limit ethical consumption (Barnett et al. 2005 cited in Bray et al. 2011). The literature suggests that beneficiaries do not encourage pension funds to engage with companies.

As for the relationship between pension funds and asset managers, pension fund trustees, who have ultimate responsibility for the way in which the pension fund is invested (Solomon 2010), often delegate such investment responsibilities to fund managers and other service providers, claiming they lack the expertise to make complex investment decisions (Solomon 2010; Richardson 2008). This lack of expertise among trustees has been reported in the literature. Kakabadse et al. (2003) surveyed UK pension fund trustees and found that 74% stated that their background lay in areas other than financial investment and the majority responded that they hold no relevant qualification in financial investment. Kakabadse and Kakabadse (2005) suggest that, although trustees may be capable individuals in their own fields, they may have little of the background knowledge required to run a pension fund.

As a result, the majority of UK pension funds employ the expertise of service providers (actuaries, consultants and investment fund managers) to make strategic investment decisions (Tilba and McNulty 2013). However, delegating investment responsibilities tends not to work in the best interest of beneficiaries (Monks and Sykes 2006). Waygood (2011) and Tilba and McNulty (2013) found that pension fund trustees encourage asset managers to deliver short-term investment returns by evaluating fund manager performance on a quarterly basis and providing incentives and rewards to fund managers to outperform their target benchmarks. As a consequence, fund managers focus on producing short-term investment returns which they pursue through active stock trading (Tilba and McNulty 2013). This, in turn, inhibits long-term investing (Richardson 2008). According to Monks and Sykes (2006), this presents a serious mismatch between the periods over which fund managers are evaluated and the longer periods which would suit most beneficiaries.

Tilba and McNulty (2013) also found little evidence of engaged ownership behaviour on the part of the asset managers. Considering that fund managers are dependent on the companies' executives for information with which to develop their stock trading models and make buy-and-sell decisions, they prioritise maintaining good relationships with the companies instead of engaging with them to change corporate behaviour.

Overall, the literature suggests that there is a disconnect between pension fund beneficiaries, the institutions that hold the shares (pension funds) and the institutions that actually manage the stocks (investment managers) (Tilba and McNulty 2013). Considering that beneficiaries are removed from the investment decisions made by their pension funds and that the funds offer their investment managers short-term incentives for investments made on their behalf, it is unlikely that investors' clients encourage investors to engage with companies on ESG issues. Hence, the following proposition was developed:

**Proposition 3:** Investors' clients do not encourage investors to engage with companies.

## 1.8.2. Organisational determinants

In addition to institutional contexts, organisational factors can also influence corporate behaviour. The literature suggests that the characteristics of investors, such as size, type (asset owner or asset manager) and type of investment strategy (active or passive), can influence their engagement activities, as discussed below.

### 1.8.2.1. Investor size

The academic literature suggests that investor size influences the propensity for shareholder engagement. In the CSR literature, larger firms were found to be more likely to engage in responsible behaviour (Chapple and Moon 2005; Margolis and Walsh 2001; Orlitzky et al., 2003 cited in Campbell 2007) which Waddock and Graves (1997) attribute to slack resources. In the investment field, a number of authors found size to be a significant factor which affects Responsible Investment (Seivanen et al. 2011) and shareholder activism (Choi and Fisch 2008; Rubach and Seborá 2009) because larger funds have greater ability to spread the fixed cost of engaging in activism across their asset base (Choi and Fisch 2008) and are likely to possess the power necessary to gain access to, and be attended to by, directors and top managers (Rubach and Seborá 2009). Larger funds are also more likely to have the resources to recruit and

train in-house staff (Myners 2001; Tilba and McNulty 2013), while smaller funds find it more difficult to achieve best practice due to limited levels of personnel and resources (Myners 2004). The same applies to shareholder engagement: investors with greater resources are expected to engage more with companies than smaller ones.

The literature also suggests that larger investors in terms of share ownership (controlling investors) are more likely to engage with the investee companies. Concentrated ownership has the potential to limit the agency problem (Jensen and Meckling 1997 cited in Hu and Izumida 2008) because large shareholders have greater power and incentives to monitor management at lower cost (Hu and Izumida 2008). First, controlling investors have greater incentives to have the firm run properly (La Porta et al. 2002 cited in Yeh 2005) because the size of their holdings allows them to capture most of the financial benefits of intervention (Grossman and Hart 1986 cited in Hu and Izumida 2008; Martin et al. 2007). Moreover, the proportional cost of gathering information and monitoring decreases as the size of the holding increases (Chen et al. 2007 cited in Sabherwal and Smith 2008). Their shareholdings also provide them with leverage to gain access to and influence the management of investee companies (Martin et al. 2007; Carleton et al. 1998 cited in Sabherwal and Smith 2008; Tilba and McNulty 2013) which helps to offset the costs of intervention. Hence, the financial benefits coupled with lower costs encourage controlling investors to engage.

In summary, according to the literature, larger and controlling investors have greater incentives to engage with companies than smaller and minority investors. Therefore:

**Proposition 4:** Larger investors are more likely to engage with companies than are smaller investors.

#### 1.8.2.2. Investor type

The academic literature suggests that asset owners/pension funds engage more with investee companies than asset managers due to their long investment horizon (Aguilera et al. 2006; Clark and Hebb 2004; Martin et al. 2007). Pension funds, both private and public, tend to have significantly predictable, long-term outflows to beneficiaries

(Martin et al. 2007) who are less likely to leave the fund than other types of clients. This is because pension fund members generally do not have the option to move to another fund (Richardson 2008). On the other hand, pension fund managers, mutual fund managers and bankers face beneficiaries who may redeem their shares at any time, resulting in a much shorter horizon (Coffee 1991; Levinthal and Myatt 1994 cited in Martin et al. 2007; Monks and Minow 1996 cited in Martin et al. 2007). For shareholder engagement, this means that pension funds can rely on longer-term strategies such as engagement to improve fund performance compared to shorter-term investors.

Fund managers may also adopt short-term horizons because of the pressures created by the regular, often quarterly, meetings with the trustees of a pension fund (Coffee 1991; Myners 2001). As discussed under Proposition 3, quarterly appraisal of manager performance by trustees means that internal appraisal and monitoring systems in the fund management firms focus heavily on quarterly performance (Myners 2001; Tilba and McNulty 2013; Waygood 2011). If the pension fund's profitability lags in the short-term, the asset managers might be replaced by a competitor (Coffee 1991). This could potentially encourage managers to adopt an investment approach which reflects neither their clients' wishes nor the long-term interests of the beneficiaries (Martin et al. 2007; Monks and Sykes 2006). Furthermore, investment managers might avoid an activist stance because of their wider business interests (Black 1992; Tilba and McNulty 2013; Mallin et al 2005). In general, investment managers avoid developing what might be seen as an anti-manager reputation because doing so would cause the fund manager to lose business or make it harder to gain new business (Black 1992; Coffee 1991; Mallin et al. 2005). For instance, if the fund manager is part of a banking or financial services group, the targeted company's management might threaten to terminate banking relationships if investment managers have an anti-manager position (Black 1992). In addition, fund managers may avoid acquiring an 'activist' reputation so as not to compromise their ability to gain new pension accounts (Coffee 1991).

In view of the literature, I suggest that pension funds are more likely to engage with companies than asset managers. The next proposition is as follows:

**Proposition 5:** Asset owners are more likely to engage with companies than are asset managers.

### 1.8.2.3. Investment strategy

The academic literature suggests that active investors are more likely to engage with companies than passive (or indexed) investors. In principle, it seems rational that passive investors would place emphasis on activism in order to influence investee firms and to ensure long-term shareholder value for beneficiaries (Hirschman 1970 cited in Clark and Hebb 2004) because, in practice, they cannot divest (Romano 1993). However, passive investors have little incentive to monitor for two main reasons. First, having abandoned attempts to outperform the market, passive investors seek to maximise their returns by minimising operating costs (Choi and Fisch 2008). As a result, passive investors and their service providers avoid engaging in costly activities, such as corporate governance issues (Black 1990) and monitoring companies (Martin et al 2007). Second, passive investors usually hold such diversified portfolios that it is beyond their realistic capacity to monitor and intervene in investee companies (Coffee 1991; Martin et al. 2007). In addition, considering that no single stock is likely to amount to more than a small percentage of the portfolio, expected payoff from involvement with issues at any single corporation in the portfolio is low (Lowenstein 1991 cited in Coffee 1991). The limited benefits in relation to the costs offer little incentive for passive investors to monitor and intervene (Martin et al. 2007). Hence, passive investors are not motivated to engage with companies. The next proposition is as follows:

**Proposition 6:** Active investors are more likely to engage with companies than are passive investors.

**Summary of the chapter:** This chapter provides a review of the literature surrounding the determinants of shareholder engagement. Firstly, this chapter provided a brief description of Institutional Theory, outlined various frameworks with which to analyse institutions in different institutional contexts and showed how formal and informal institutions influence corporate behaviour in developed and emerging markets.

Secondly, the chapter analysed the literature on shareholder engagement, showing that the number of studies is still relatively limited, especially in the context of emerging markets, which academic research has failed to address adequately. Thirdly, this chapter reviewed the literature concerning Institutional Theory and corporate governance, noting how institutional features influence governance and the different ways these institutions impact CG in emerging markets. Next, this chapter analysed literature concerning Institutional Theory and CSR, demonstrating that the studies have focused on comparison of the American and European contexts and on how institutional factors shape CSR in different countries. For emerging markets, the literature is focused on the configuration of CSR in different developing nations and on the interplay between local and foreign institutional influences on MNC subsidiaries. Subsequently, this chapter analysed literature concerning Institutional Theory and Responsible Investment. It shows that coercive isomorphism, in the form of legislation and social pressure, and mimetic isomorphism are the most common influences on Responsible Investment in developed countries. Moreover, limited literature can be found on emerging markets. Next, literature on the relationship between Institutional Theory and shareholder activism in developed countries was found to have a largely regulatory focus, while there is a dearth of literature on emerging markets. Following on from that, the chapter reviewed studies linking firm-level factors and concepts related to shareholder engagement (corporate governance, CSR, Responsible Investment and shareholder activism). Finally, based on the literature review, propositions were developed regarding the determinants of shareholder engagement in emerging markets.

## 2. INSTITUTIONAL ENVIRONMENTS IN BRAZIL AND SOUTH AFRICA

**Introduction:** This chapter will provide a brief overview of the institutional characteristics of Brazil and South Africa, including their economic, social and environmental features. It will also provide background information about companies' and investors' practices with regard to corporate governance, Corporate Social Responsibility (CSR), Responsible Investment and shareholder activism, as well as discuss the drivers of these phenomena in the two countries.

### 2.1. Brazil

**Overview:** Ranked as the fifth largest nation in the world, Brazil covers an area of 8.5 million km<sup>2</sup> and has more than 198 million inhabitants (UNDP 2013). In financial terms, the country is South America's leading economic power and the world's eighth largest economy, with a GDP of over US\$2 trillion (UNDP 2013). The good weather conditions and the availability of fresh water are ideal for producing a variety of agricultural commodities, such as coffee, oranges and soy. Brazil is also rich in minerals, including bauxite, gold, iron ore and manganese. The abundance of natural resources facilitates the production of energy: 85% of the electricity used in Brazil comes from renewable energy sources, particularly hydropower, and the country produces much of the world's sugar-derived ethanol and is increasing the number of biomass and wind power plants (UNDP 2011). Besides, Brazil is expected to see increases in oil output for at least the next ten years (OPEC 2012).

**Environmental issues:** Brazil is one of the world's most biologically diverse countries, hosting nearly 12% of all life forms on the planet, 22% of all vascular plants, 524 types of mammals and over three thousand species of fresh water fish. The country also hosts four of the planet's richest biomes: the Atlantic Forest, Cerrado, Pantanal and the Amazon Forest, the world's largest tropical forest and most biodiverse region. However, deforestation has been prevalent in the country: today, the Atlantic Forest only has seven per cent of its original coverage and Cerrado only 20% (CI 2013). Over



the past few years, the increasing value of soy exports and commercial logging, much of it illegal, have provided the impetus for further deforestation and the violation of the human rights of indigenous people. As a result, even though Brazil has low levels of carbon emissions in per capita terms, if we take into account just the emissions relating to deforestation, the country is one of the largest carbon emitters (UNDP 2007-2008).

**Social issues:** Despite having experienced economic growth, Brazil is far from providing the quality of life found in developed countries. For example, it is estimated that 21.4% of the population lives below the national poverty line and the Gini coefficient of income inequality stands at 54.7%. In terms of education, although the adult literacy rate is 90.3%, only 49.5% of the population had access to secondary education (UNDP 2013). Income and education levels in Brazil are largely influenced by race. According to the 2010 Census (IBGE 2012), the average monthly incomes of white (R\$ 1,538) and ‘yellow’ (represented by Asian and indigenous population) populations (R\$ 1,574) are approximately twice as high as that of the black (R\$ 834) and ‘brown’ (mixed race) (R\$ 845) populations<sup>6</sup>. Moreover, illiteracy rates among the black (14.4%) and ‘brown’ (13%) populations are almost three times higher than in the white population (5.9%). The Brazilian government has been trying to address this inequality by introducing a poverty reduction programme, extending access to education and raising the minimum wage. “Bolsa Familia”, a cash and in-kind transfer programme system, assisted more than 12 million households across the country in 2009 (UNDP 2013).

**Financial sector:** Brazil has a thriving capital market and the world’s fourteenth largest stock exchange (BM&FBovespa), accounting for US\$ 1.2 trillion in market capitalisation and featuring 374 domestic and foreign listed companies (WFE 2013). The stock market is dominated by the financial, oil and gas, mining and steel sectors (IFC and Teri 2009a), while the benchmark Ibovespa index is concentrated and dominated by two companies: oil company Petrobras and mining company Vale (BM&FBovespa 2013a). As for institutional investors, the Brazilian Association of Pension Funds (ABRAPP 2013) has 261 pension fund members holding combined assets of nearly R\$ 642 billion (almost US\$ 237.5 billion), while the three largest pension fund members (PREVI, Petros and FUNCEF) account for 44% of that total

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<sup>6</sup> White, yellow, black and brown are the official categories used to classify race in the official Census in Brazil.

(Abrapp 2012). In addition, funds under management by professional institutions stand at approximately R\$ 2.1 trillion (or US\$ 1 trillion) (Anbima 2013).

### 2.1.1. Corporate governance

The ownership in the Brazilian market is highly concentrated as 74% of publicly traded companies have a controlling shareholder (CFA Institute 2009). Most Brazilian companies are family-owned and this has an effect on the type of management that prevails (Aguilera 2009). Since Brazilian legislation allows companies to issue shares without voting rights up to the value of two-thirds of the total capital stock (Institute of Directors 2005) and 50% for new listed companies (da Silva 2002), it is common for insiders to retain voting shares and issue non-voting preferred shares to outsiders (Black et al. 2010). Hence, holders of non-voting shares are often in a weak position and vulnerable to the whims of controlling shareholders (Mallin 2013).

Corporate governance in Brazil essentially involves a two-tier structure as Brazilian companies have a Board of Directors and a Fiscal Council (Mallin 2013). The Companies Law (Law 6404/1976 amended by Law 10303/2001) establishes that the Board of Directors ('Conselho de Administração') must comprise at least three members and that members have a maximum of a three year-mandate with the possibility of re-election. The company's by-laws may also establish the possibility of employee representation on the Board. The Companies Law does not stipulate a minimum of independent non-executive directors required on a board, and this is directly reflected in the low percentage of independent directors on Brazilian boards. A survey of 85 companies by Booz Allen and IBGC (2009) about the state of corporate governance in Brazil found that, on average, 22% of board members are independent directors, while 30% are non-executive directors representing large shareholders. The relatively large percentage of institutional directors can be explained by the fact that shareholders have legal rights to elect Board members in proportion to their shareholdings. As a result, controlling shareholders tend to have more representatives on the investee companies' Boards (CFA Institute 2009).

The Fiscal Council (“Conselho Fiscal”) is responsible for overseeing the actions of the companies’ administrative bodies and to give its opinion on certain matters to the owners (Mallin 2013). The Companies Law establishes that the Fiscal Council can be temporary or permanent and that it should have between three and five members. When it is not permanently established, it may be instated at the request of shareholders representing at least 10% of the voting shares or 5% of the non-voting shares. The Fiscal Council was created to remedy the agency problem between controlling and minority shareholders as minority and non-voting shareholders have no influence and limited information (Mallin 2013). The Fiscal Council often acts as a substitute for the audit committee (Black et al. 2010).

Given the influence of controlling shareholders in the Brazilian corporate environment, legislation provides a number of rights to protect minority shareholders. One example of this is the concept of ‘tag along’ rights. Under article 254-A of the Brazilian Companies Law, a new controlling shareholder who acquires 50% of the common shares is required to offer to buy all remaining common shares at a set minimum of 80% of the per share price paid for the controlling shares (CFA Institute 2009). Other rights of minority shareholders relate to electing Board members (these are described in more detail in the Shareholder Activism section).

Despite the existence of mechanisms to protect minority shareholders, the low level of legal enforcement may constrain the adoption of these instruments. The Brazilian judicial system is considered dysfunctional and many of its judges are corrupt (Aguilera 2009). Moreover, until recently, Brazil did not have specialised business courts. Today, Rio and São Paulo do, but the São Paulo court is limited to matters of bankruptcy and financial restructuring (Black et al. 2010). Hence, lawsuits dealing with violations of shareholder rights are generally handled by the State Court judiciary, and not necessarily by those courts and judges with specialised knowledge of corporate law. In addition, court proceedings may take some considerable time to reach a financial settlement and a decision which cannot be appealed, delaying legal procedures (da Silveira and Dias 2010; Estrin and Prevezer 2011). These factors may discourage minority shareholders from seeking justice when their rights are violated.

Nonetheless, it is important to acknowledge the existence of minority rights in the Companies Law, especially considering the fact that they had been suspended between

1997 and 2001. Before privatising public companies in the late 90s, the Brazilian government issued Law 9457/97 to amend the Companies Law, thus facilitating the privatisation process. This amendment reduced the rights of minority shareholders, including ‘tag along’ rights, as its objective was to avoid payment of premiums to minority shareholders and to maximise returns for the State (Paschoarelli 2008; da Silva 2002). In 2001, Law 10303 restored some of the rights to minority shareholders, but not always in full. For example, the new ‘tag along’ rights require controlling shareholders to buy common shares at 80% (rather than the original level of 100%) of the price paid for the shares (Paschoarelli 2008).

The temporary reduction of minority rights set out in Law 9457/97 led to a crisis in the capital markets (Paschoarelli 2008). The number of listed companies dropped from 550 in 1996 to 440 in 2001, while the volume of market capitalisation represented on the exchange fell from US\$ 190 billion in 1997 to US\$ 65 billion in 2001. To stimulate capital flows back into the market, BM&FBovespa created special governance listing segments to recognise companies that abide by corporate governance and transparency practices beyond the requirements of the Brazilian Law and of the Brazilian Securities and Exchange Commission (Garcia 2005). In 2001, three governance listing levels were created: Level 1, Level 2 and Novo Mercado, each establishing different corporate governance criteria for a company’s inclusion. In 2005, a new listing level was added for small and medium companies (‘Bovespa Mais’). As of December 2012, 178 companies (or 48% of all listed companies) were included in one of the four listing levels, 127 (or 34% of all listed companies) of which at the Novo Mercado level, which requires the most stringent standards of governance (BM&FBovespa 2013b). Companies listed at Novo Mercado must issue only common shares with voting rights, grant 100% tag along rights to all voting shareholders, maintain a minimum of 20% independent board members and maintain a free float of at least 25% of the shares representing their capital stock (BM&FBovespa 2013c; CFA Institute 2009). The listing segments also improved the level of corporate governance for newly listed companies. Between 2004 and 2008, 78 out of the 110 initial public offerings (IPOs) (71%) were included in the Novo Mercado level (Black et al. 2010).

Two other initiatives to encourage better governance were spearheaded by the Brazilian Institute of Corporate Governance (IBGC) and by the Brazilian Securities and Exchange Commission (CVM). In 1999, IBGC created the Code of Best Practices of Corporate

Governance, now in its fourth edition, while in 2002, CVM issued recommendations under its Corporate Governance Code ('Cartilha de Governança Corporativa') (CVM 2002; Mallin 2012). To the best of my knowledge, no research has been conducted to assess the effectiveness of CVM's and IBGC's codes.

In summary, due to the high level of concentration of ownership in Brazil and the ability of listed companies to issue non-voting shares, minority shareholders are in a weak position. This is further accentuated by the fact that Boards contain few independent directors, Fiscal Councils are not always permanent and the level of legal enforcement is relatively low. To help reduce the disparity in agency problems between controlling and minority shareholders, the Companies Law established a number of legal mechanisms to protect minority shareholders. In addition, good corporate governance practices are encouraged by BM&FBovespa's governance listings segments and by IGBC's and CVM's codes. Considering that 48% of all listed companies are included in these governance segments and that 71% of the recent IPOs were included in the Novo Mercado category, it seems that voluntary mechanisms play a significant role in encouraging the adoption of good practices of corporate governance in Brazil.

### **2.1.2. Corporate Social Responsibility (CSR)**

According to GTZ and Bertelsmann Stiftung (2007), the most important pillars of CSR in Brazil are represented by social investments and philanthropic contributions made by corporations to fill gaps in government capacity. A survey by the Institute for Applied Economic Research (IPEA 2006) indicates that the percentage of companies investing in community development rose from 59% in 2000 to 69% in 2004, totalling R\$ 4.7 billion (approximately US\$ 1.5 billion) in social investments, or 0.27% of the GNP. Even though the majority of the businesspeople surveyed believe that it is the government's duty to take care of social issues, 57% agree that the state alone is not capable of solving all social problems and thus companies have an important role to play (IPEA 2006).

Although philanthropic CSR is the dominant approach in Brazil, there has been a move towards a more strategic CSR approach, largely encouraged by business associations

such as the Ethos Institute, an NGO founded by a group of companies in 1998 with the aim of promoting CSR in the country (Yamahaki and Ursini 2010). The Ethos Institute was responsible for developing the Ethos Indicators in 2000, considered instrumental in disseminating the concept of CSR among the business sector (SustainAbility 2006). The Ethos Indicators consist of a self-assessment questionnaire that measures the companies' CSR performance in relation to a range of sustainability indicators (Ethos 2013).

Recently, two studies have sought to assess the level of CSR adoption by Brazilian companies. The first one was coordinated by the Dom Cabral Foundation (FDC 2012). The survey of 172 companies found that the concept of sustainability is well understood among Brazilian companies and more than 80% of the respondents argued that sustainability improves corporate image and brings competitive advantage. Moreover, 67% of companies have a professional or team responsible for sustainability issues, while 62% have written sustainability policies. The study also identified avenues for corporate improvement as the respondents observed that only a few stakeholders are included in their stakeholder relationship management and that only 31% of companies measure the social impact of their business.

A study of 250 companies by UniEthos (2012) found that 69% of the companies surveyed consider the interests of their stakeholders in the development of their strategic plan and that 60% have some form of impact evaluation for their sustainability initiatives. Regarding plans for the future, 61% of the companies have plans to improve sustainability management, 58% have strategies in place to strengthen relationships with stakeholders and 50% plan to manage risks and impacts. As for areas for corporate improvement, the study found that only 16% of the surveyed companies include sustainability criteria in the evaluation of a directors' performance when calculating executive pay. These two studies demonstrate that many Brazilian companies are embedding CSR as part of their strategy instead of maintaining a philanthropic approach, moving away from the paternalistic approach adopted by the majority of Latin American companies (SustainAbility 2006).

In terms of the incorporation of sustainability issues into the companies' management systems, there are 3,517 Brazilian companies with ISO certification (ISO 2011), certifying plants' environmental management systems (ISO 14001), and 78 companies

certified for SA8000 (SAI 2013), certifying compliance with principles of a decent workplace. Furthermore, reporting has grown substantially in Brazil: the country ranks third in the world for number of companies that publish sustainability reports. In 2010, more than 160 companies adopted the Global Reporting Initiative framework (GRI 2013). FBDS et al. (2010) reported that the drivers for sustainability reporting in Brazil include the growing influx of foreign investment attracting investors concerned with sustainability, multinational Brazilian companies adopting best practices of reporting and the presence of a GRI local representative office encouraging improvements in reporting. FBDS et al. (2010) ranked the top ten best Brazilian sustainability reports, declaring reports by cosmetics company Natura and sanitation company Sabesp to be leaders in the field.

Industry associations have also launched initiatives to promote CSR in Brazil. The Brazilian Chemical Industry Association (ABIQUIM) established a code for the sector called ‘Atuação Responsável’, modelled on the international Responsible Care code, and compliance is mandatory for all members (SustainAbility 2006). In the financial sector, five Brazilian banks adopted the Equator Principles, a risk management framework for determining, assessing and managing environmental and social risk in projects (Equator Principles 2013). In the electrical energy sector, the regulatory agency requires companies to report on their sustainability initiatives (FBDES et al. 2010).

In summary, CSR in Brazil has been growing and acquiring a more strategic approach, driven by business association initiatives and by the company perception of the materiality of sustainability issues. Sustainability reporting has also been growing substantially, which is beneficial for local and foreign investors, as access to corporate sustainability information allows them to incorporate Responsible Investment issues into their investment decisions, as shown in the next section.

### **2.1.3. Responsible Investment**

Since the early 2000s, Responsible Investment (RI) issues have had a prominent place in the Brazilian finance and investment communities (IFC and Teri 2009a). In 2001, Banco Real launched the country’s first Responsible Investment fund, the Ethical Fund,

incorporating financial, environmental, social and governance (ESG) issues into portfolio analysis. Four years later, BM&FBovespa launched a sustainability index, ISE, which served as the basis for the creation of a number of Brazilian RI retail funds. There are now 34 RI funds representing R\$ 1.7 billion (or US\$ 820 million) in assets under management (Anbima 2013). The identification of RI funds by the market was facilitated by Anbima which has included a special category for RI equity funds in the investment fund classification (Yamahaki and Gaban forthcoming).

Investor associations have also been encouraging RI in the country. In 2008, the Principles for Responsible Investment (PRI) established the PRI Brazil Network. As of 26 July 2013, the Network comprised 68 signatories: 19 pension funds, 31 asset managers and 18 service providers (PRI 2013a). Local signatories meet regularly, in person and via conference calls, to share best practice, provide training on selected topics and network (PRI 2011a). The Brazilian Network is organised into four working groups: Integration (to assist signatories with the implementation of ESG factors in their investment processes), Engagement (forum for investors to engage with investee companies to improve corporate behaviour on ESG issues), Recruitment and Awareness (to raise awareness about Responsible Investment and to recruit new signatories) and Investment Policy (to help pension fund signatories to develop RI policies). This fourth group was created largely in response to article 16 of National Monetary Council Resolution 3792/2009, which requires all Brazilian pension funds to make it explicit in their investment policy whether they consider social and environmental issues in their investment decisions. Although integrating ESG issues was not made mandatory, this piece of legislation brought the topics of Responsible Investment and sustainability to the forefront of discussions in the pension fund industry. A study by PREVI in 2010 found that 44% of the 50 largest pension funds included social and environmental criteria in their investment policies, and this percentage is expected to increase (Yamahaki and Gaban forthcoming).

The Brazilian Association of Pension Funds (ABRAPP) has also taken a proactive advocacy position on RI (IFC and Teri 2009a), actively promoting the concept of Responsible Investment and sustainability among pension funds through its Sustainability Committee and annual RI Conferences (Yamahaki and Gaban



forthcoming). Moreover, ABRAPP supports other RI initiatives, both as a CDP<sup>7</sup> sponsor and PRI Network Supporter.

In sum, Responsible Investment in Brazil seems to be encouraged by Resolution 3792/2009, the sustainability index and by a number of investor associations. These factors are further explored later in Chapter 5.

#### **2.1.4. Shareholder activism**

Due to the high level of concentration of ownership in Brazil, voting power in most listed companies is also concentrated, and majority shareholders often elect the majority of the board members. This limits the practice of shareholder activism by minority investors (CFA Institute 2009).

As mentioned earlier, in order to protect minority rights, the Companies Law established a number of legal mechanisms to facilitate the election of Board members by minority investors. Article 141 of the Companies Act states that non-voting shareholders representing at least 10% of the voting shares, and minority voting shareholders representing at least 15%, may elect one Council member each. Besides, the same article gives the option for shareholders representing at least 10% of the share capital with voting rights to adopt the cumulative voting system ('voto múltiplo'). In this case, for each share the shareholder owns, he or she can vote as many times as there are seats on the Board. For example, if there were eleven Board seats, one voting shareholder holding five shares would have the right to vote 55 times (five shares \* eleven seats). This gives minority shareholders a greater opportunity to elect their representative as they can place all their votes for one single candidate. As for the election of Fiscal Council members, article 161 of the Companies Law states that voting shareholders representing 10% of the voting share capital, and the group of non-voting shareholders, may elect one Council member each.

Regarding the effectiveness of minority rights, Saito et al. (2006) found that the majority of Brazilian minority investors were not using the mechanisms provided by the

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<sup>7</sup> CDP is a global organisation that collects carbon, water and climate change information from the larger organisations worldwide (CDP 2013)

legislation to elect directors in the Boards of Directors, while Black et al. (2010) found that 41% of the 116 Brazilian firms they surveyed had one or more representatives of the minority shareholders. This indicates that minority rights have been increasingly employed by smaller shareholders. However, they found that cumulative voting is seldom used as only 12% of the surveyed companies had adopted the system in the last five years. In 2011, in an effort to encourage investors to use their ownership rights, the Brazilian Association of Financial and Capital Markets (Anbima) established guidelines for the investment fund industry on the exercise of voting rights in Annual General Meetings. According to these guidelines, all investors who own more than 5% of a company's shares or who own funds in which the company's participation is greater than 10%, should have a Proxy Voting Policy in place and should vote in this company's Annual Meetings whenever the resolutions refer to issues that are considered relevant by the guidelines, including issues related to election of minority representatives on the Board of Directors and ownership changes (Yamahaki and Gaban forthcoming). Moreover, to improve voting levels, in 2011, Law 12431 amended the Companies Law to permit investors to vote electronically (previously, they could only vote in person at Annual General Meetings). The outcomes of these guidelines and legislation are yet to be assessed.

Overall, given the high level of concentration of ownership, the law offers minority shareholders a number of means of protecting their rights so that they can elect members of the Boards of Directors and Fiscal Councils and have their voices heard. Although provisions for representation have been adopted by minority shareholders, cumulative voting is seldom used. Law 12431 and ANBIMA's guidelines aim to encourage further use of voting. These issues are explored further in Chapter 5.

## 2.2.South Africa

**Overview:** South Africa covers an area of 1.2 million square kilometres and has a population of nearly 51 million people of diverse origins, cultures, languages, and religions (UNDP 2013). Today, South Africa is by far the largest and most developed economy in Africa, generating nearly 40% of the income in sub-Saharan Africa (Reed 2003 cited in Vaughn and Ryan 2006). The country has abundant minerals, including

chromium, diamonds, gold, manganese, platinum and vanadium, coupled with a highly developed mining engineering industry. South Africa also possesses sound communications systems and abundant energy generation capacity (Babarinde 2009). However, South Africa has been described as a “two-tier” economy. In the formal economy, the mining, manufacturing, agricultural, financial services and retail sectors are comparable with those in developed countries. Simultaneously, high levels of unemployment have generated a very large informal sector which provides a range of goods and services in urban, peri-urban and rural areas (IFC et al. 2011).

**Social issues:** Twenty-three per cent of the South African population lives below the national poverty line (UNDP 2013) and the vast majority of the population has inadequate access to basic necessities, such as food, shelter, health care and education (Babarinde 2009). The Gini income inequality coefficient is 63.1%, showing that the country is one of the most unequal in the world (UNDP 2013). White South Africans continue to control the corporate environment, while the vast majority of black South Africans live in townships and squatter camps across the country and have limited access to the most basic amenities (Babarinde 2009). Moreover, South Africa is currently at the epicentre of the AIDS pandemic and the disease is affecting all aspects of South African society (King et al. 2010). The Actuarial Society of South Africa estimates that 5.4 million were living with HIV in 2006 (King et al. 2010), cutting life expectancy to 53.4 years (Bolton 2008; UNDP 2013).

**Environmental issues:** Two main environmental risks affect the country: high levels of carbon emissions and scarcity of water resources. Firstly, South African per capita carbon emissions are among the highest in the world (IFC et al. 2011). This is because the energy sector in South Africa is dominated by low efficiency coal-fired power generation, accounting for over 90% of electricity production (Babarinde 2009). This is exacerbated by the fact that the most prominent sector in the country, the mining industry, is highly energy-intensive. Secondly, South Africa is a water stressed country, largely due to low rainfall and limited underground aquifers (CDP 2012a). The effects of variable rainfall patterns and different climatic regimes are compounded by high evaporation rates across the country and groundwater availability is limited by predominantly hard rock geology. Also, where groundwater is available, it is frequently over-exploited (UNEP FI 2009).

**Financial sector:** South Africa has the nineteenth largest stock exchange in the world, the Johannesburg Stock Exchange (JSE), accounting for nearly US\$ 908 billion and 387 domestic and foreign listed companies (WFE 2013). The JSE has comprehensive regulations and stringent listing requirements. Following the incorporation of the King Report (explained below) into the JSE listing requirements, listed companies are required to issue an integrated report, incorporating financial and ESG information in one single report, or to explain why they are not doing so (IFC et al. 2011). As for institutional investors, there are approximately 14,000 pension funds in the country representing US\$ 250 billion in assets under management. The total assets under management of the investment industry accounted for US\$ 556 billion in 2010, 77% of which is managed by the ten largest South African asset managers (IFC et al. 2011).

### 2.2.1. Corporate governance

Shareholder ownership is highly concentrated in South Africa (Okeahalam 2004). Control of companies accounting for a large proportion of the capitalisation is fairly concentrated in the hands of a number of the founding families of large companies (Okeahalam 2004). Moreover, the South African government holds significant ownership stakes in large public and private companies through the Public Investment Corporation (PIC) (Ntim et al. 2012).

As a consequence of the Apartheid regime, South Africa was virtually isolated from the global economy between 1961 and 1994 (Mathieson et al. 1998 cited in Vaughn and Ryan 2006; Sethi and Williams 2000 cited in Vaughn and Ryan 2006). The United Nations excluded South Africa from participating in international organisations and imposed economic and trade sanctions against the country (Vaughn and Ryan 2006). The international sanctions reduced the ability of South African mining companies to access international capital markets (Arya and Zhang 2009) and led many foreign multinational companies to divest from the country in the 1980s (Arya and Zhang 2009).

After the collapse of Apartheid, South Africa re-entered the world economy, which brought both opportunities and challenges for South African companies in the global

market (Vaughn and Ryan 2006). Companies were compelled to address and embrace improved standards of corporate governance to compete in the new business environment and foreign financial institutions returned to South Africa demanding governance reforms in exchange for an infusion of capital (Andreasson 2011; Kakabadse and Korac-Kakabadse 2002 cited in Vaughn and Ryan 2006).

Shareholder rights in South Africa tend to be strong in comparison with rights in other emerging markets (CFA Institute 2009) and, overall, South Africa is rated among the best performers in corporate governance in the emerging markets (Judin 2003 cited in Vaughn and Ryan 2006; IoD 2009). The new Companies Act was signed into law in 2008 and became effective on 1 May 2011. According to the new legislation, the Board of a listed company must be comprised of at least three directors. The Act does not specify the composition of the Boards of Directors, such as the minimum percentage of independent directors. However, in South African public companies, the average percentage of independent board members is fairly high (51%) (CFA Institute 2009). This can be seen as a reflection of the governance guidelines for listed companies provided by the King Reports, as discussed below. The Board may appoint any number of Committees of Directors, unless the company's by-laws state otherwise. In addition, the Minister of Finance may prescribe that a company establishes a social and ethics committee if it is desirable in the public interest. Furthermore, public companies must convene Annual General Meetings at least once every calendar year and must deliver a notice to shareholders about the meeting at least 15 business days before it is held. Shareholders representing 10% of the voting shares may also convene an extraordinary meeting.

It is worth highlighting the importance of the King Reports in the South African corporate governance context. The first King Report was developed in 1994 as a response to the changing political landscape, a shift in corporate control structures and a desire to be competitive in a global market (Vaughn and Ryan 2006). The main objective of the King Reports was to promote high standards of corporate governance in South Africa. The King Report I was followed by the release of King II in 2002 and King III in 2009. They employ a principle-based approach, a reflection of South Africa's colonial legacy and resultant ties with the UK which ensured that corporate law and corporate practice were firmly rooted in the British tradition (Sarraf 2004 cited in Andreasson 2011; Wixley and Everingham 2005 cited in Andreasson 2011). Although

the King Reports have no force of law, the JSE made it compulsory for listed companies to disclose the extent of their compliance with it or explain their lack of compliance (Malherbe and Segal 2001 cited in Vaughn and Ryan 2006), leveraging the reports' application. Those who do not do so run the risk of damaging their reputations and share prices and, ultimately, of being delisted (Pearce and Kennedy-Good 2009). As a result, the 2011 World Economic Forum Global Competitiveness report ranked South Africa first out of 142 countries for its regulation of securities exchanges (WWF 2013).

The King Report III establishes that the Board should meet at least four times a year (item 2.1.2) and that the majority of Board members should be independent non-executive directors (items 2.18.1. and 2.1.8.2). Public and state-owned companies must appoint an audit committee, comprised of independent non-executive directors, to review financial statements and disclosure of sustainability issues (item 2.23.4). Moreover, the King Report advises that the Board should consider not only financial performance, but also the impact of the company's operations on society and the environment (item 2.1.2) and that the link between the company's reputation and stakeholder relationships should be a regular item on the board agenda (item 8.1.2). In addition, the Report requires companies to report non-financial information in an integrated report (item 9.2) (IoD 2009).

Through the King Reports, South Africa was among the first countries to acknowledge stakeholders in a corporate governance context (Roussouw et al. 2002 cited in Visser 2005), combining shareholder and stakeholder interests in its governance model to address the urgent need to improve social and economic conditions (Andreasson 2011; West 2006). While in the UK, the legitimate interests and expectation of stakeholders should be considered an instrument to serve shareholders' interests, in South Africa, "the interests of any stakeholder may be given precedence based on what is believed to serve the best interests of the company at any particular point", interests which should be interpreted "within the parameters of the company as a sustainable enterprise and as a responsible corporate citizen" (Croucher and Miles 2010: 375). Andreasson (2011: 655) argues that the King Reports "have become notable examples of how an emerging market can devise its own solutions to aligning corporate governance with international best practice while also addressing corporate social responsibility and needs for broad-based development".

In sum, following the collapse of Apartheid, the level of corporate governance in South Africa has improved significantly to meet the demands of returning foreign investors and to compete in the international environment. While legislation regulates some aspects of South African governance, it seems that voluntary governance guidelines in the form of the King Reports together with the incorporation of the guidelines in the JSE's listing requirements are the major drivers of good governance practices in the country.

### **2.2.2. Corporate Social Responsibility (CSR)**

According to GTZ and Bertelsmann Stiftung (2007), the rationale for CSR involvement in South Africa seems to be largely driven by the need to address socio-economic challenges and by limited government capacity to deliver social services effectively.

In South Africa, the context and definition of CSR was found to be significantly influenced by the legacy of colonialism and Apartheid (GTZ et al. 2009). After the fall of the Apartheid regime, the African National Congress (ANC) government has gone much further than governments in many other countries to legislate social issues in company management (GTZ and NBI 2007; Arya and Bassi 2011), seeking to involve corporations in promoting social cohesion and addressing problems arising from the historical exclusion of black communities from the mainstream economy (Arya and Bassi 2011; GTZ and NBI 2007). Between 1994 and 2004, a wave of new legislation was enacted to rectify racial imbalances, such as the Employment Equity Act (1998), requiring companies to adopt affirmative action policies (West 2006), and the Black Economic Empowerment (BEE) Act (2003), requiring companies to take steps to increase black equity ownership (Alessandri et al. 2011). Furthermore, codes of practice have been issued under the BEE Act to promote its objectives and change the racial profile of companies' owners, managers and skilled professionals, increase the ownership and management of companies by the black community and help them access more economic opportunities (Croucher and Miles 2010). Additionally, some industries (e.g. mining, finance, construction) have signed their own charters specifying how companies should meet BEE objectives (Arya and Bassi 2009; McAllister and

Ramjee 2009). Hamann (2006) contends that BEE is a clear indication of how the state can play a crucial role in providing incentives, pressures and benchmarks for CSR.

Besides addressing racial imbalances, South African companies have been adopting CSR practices to address the government's limited capacity to provide social services. Today, many companies seek to tackle immediate human needs like nutrition, health and education. As the government has limited personnel and limited ability to implement policies in an effective way, companies are stepping up to the challenge (GTZ and Bertelsmann Stiftung 2007). Total corporate expenditures on philanthropic activities have grown from ZAR 2 billion in 2000/2001 to ZAR 6.9 billion in 2011/2012 and, in terms of expenditure priority, 93% of the surveyed companies invest in education, 80% support social and community development and 40% contribute to health projects (NGO Pulse 2012). Companies also realise that some socio-economic challenges affect them directly, as is the case of HIV/AIDS (GTZ and NBI 2007). In a survey conducted by South African Business Coalition on HIV and AIDS (SABCOHA) in 2003, more than a third of companies indicated that HIV/AIDS had reduced labour productivity or increased absenteeism and raised the cost of employee benefits. In addition, the Bureau for Economic Research (2004 cited in Bolton 2008) found that more than three-quarters of large companies reported that HIV/AIDS had led to lower labour productivity or higher absenteeism, higher benefit costs and higher staff turnover. As a result, companies are addressing HIV/AIDS to reduce negative impacts on their business: a survey conducted by the World Economic Forum in 2005-2006 found that 94% of the South African companies surveyed have an HIV/AIDS workplace awareness programme, 69% offer voluntary counselling and testing and 37% provide antiretroviral therapy (Bolton 2008). Companies such as Anglo American PLC, BHP Billiton, Zstrata, Eskom, De Beers and SAPREF have introduced programmes to combat HIV/AIDS, ranging from education and prevention, testing, counselling, medical care to the provision of anti-retroviral therapy (Bolton 2008 cited in Croucher and Miles 2010). For instance, the approach taken by Anglo American through cooperation between senior personnel in the company and the unions was successful in enabling a sustained programme to be adopted (Croucher and Cotton 2009 cited in Croucher and Miles 2010).

In terms of corporate transparency, 97% of South Africa's Top 100 companies report on CSR issues, a fact that is widely attributed to King III's requirement that firms publish



an integrated report (KPMG 2011). Moreover, 78 South African companies responded to the CDP questionnaire disclosing their carbon emissions in 2012 (CDP 2012b) and 30 companies responded to the CDP questionnaire on water usage (CDP 2012a). The reporting on these two issues is particularly relevant in a country with high levels of carbon emissions and water scarcity.

Overall, CSR in South Africa seems to be driven by two main factors: the socio-economic challenges related to racial inequality and government incapacity to deliver social services. Both are encouraging companies to develop BEE programs, promote employment equality and invest in education and health programmes.

### **2.2.3 Responsible Investment**

According to IFC et al. (2011), the total volume of assets under management in South Africa that take ESG factors into account is estimated at US\$ 111.2 billion, the majority of which is attributed to investments by the Government Employees Pension Fund (GEPF), the largest pension fund in the country, and in the whole of Africa (IFC et al. 2011).

One of the most pioneering RI initiatives in South Africa was the launch of the Socially Responsible Investment Index by the Johannesburg Stock Exchange (JSE) in 2004. As the first RI index in an emerging market and only the third such index in the world, the SRI index was created in an effort to attract foreign investors to South African companies by highlighting firms that follow best practices in CSR (Vaughn and Ryan 2006). The index is comprised of 76 companies and portfolio review takes place annually (JSE 2012).

Furthermore, the GEPF has been an active disseminator of the concept of Responsible Investment in South Africa. First, with the support of GEPF, the PRI South Africa Network was launched in 2009, serving as a platform for PRI signatories in South Africa to discuss ideas, share experiences and collaborate on a range of ESG issues that are material to investment decision-making. The Network has active groups working on awareness, recruitment and engagement (PRI 2013c). As of 26 July 2013, the PRI had 44 South African signatories: 4 asset owners, 32 investment managers and 8

professional partners (PRI 2013a). Second, the GEPF drove a large number of asset managers to become PRI signatories in 2007 by asking about the PRI status of the candidates in a call to tender for investment managers (Wildsmith 2008 cited in Giamporcaro 2011).

The year 2011 saw a number of changes in the South African environment concerning Responsible Investment. The first one relates to regulatory changes in the Pension Funds Act, as the preamble of Regulation 28 was amended to incorporate ESG issues. The preamble now states that:

“...prudent investing should give appropriate consideration of any factor which may materially affect the sustainable long-term performance of a fund’s assets, including factors of an environmental, social and governance character.” (Republic of South Africa 2011)

The changes to the regulation came into effect on 1 January 2012. Although WWF (2013) argues that it is too early to assess the impact of the regulation, a study conducted by SinCo (WWF 2012) indicates that Regulation 28 has been a powerful driver for increased ESG-integration.

Also in 2011, the Code for Responsible Investing in South Africa (CRISA) was launched, coming into effect on 1 February 2012. The Code was created as a result of the feedback submitted by the PRI South Africa Network to King Report III calling for guidance on governance to be provided to the investor community. The feedback prompted the King Committee to recommend that a separate code be drafted to set out the expectations to institutional investors in this regard. Following on from there, the Committee on Responsible Investing by Institutional Investors in South Africa was convened by the Institute of Directors in South Africa (IoDSA) to develop such a code. CRISA is a set of market-based guidelines encouraging institutional investors to incorporate ESG issues, to be active owners and to consider a collaborative approach. A number of investor associations and other investment players participate in the CRISA Committee, including the Association of Saving and Investment SA (ASISA), the JSE, the PRI, the Financial Services Board, the Takeover Regulation Panel, the POA and the GEPF. According to WWF (2013), the industry-led environment has not been in

operation long enough for its effect or the means of implementation to be properly assessed and understood. Nonetheless, WWF (2013) states that the majority of pension funds have not yet been active in taking up and implementing CRISA.

The third significant event in 2011 concerns the Sustainable Returns Project for Pensions and Society, convened by the Principal Officers Association (POA), the International Financial Corporation (IFC), the GEPF and ASISA. Funded by the Norwegian Government, the Project aims to provide trustees with practical assistance in implementing the responsible investment principles of Regulation 28 and CRISA by developing information, frameworks, training and tools to support trustees (WWF 2013). The Project is expected to draw to a close in late 2013 (POA 2012).

Overall, it seems that Regulation 28, CRISA and the Sustainable Returns Project have significant potential to enhance Responsible Investment in South Africa. The impact and outcomes of these different initiatives are examined in this study, the results of which are shown in Chapter 5.

#### **2.2.4. Shareholder activism**

South African legislation has established a set of investor rights to promote shareholder activism. For instance, according to article 58 of the Companies Act, investors have standard proxy voting rights. This means that shareholders can appoint any individual, including someone who is not a shareholder of the company, as a proxy to participate in and vote at the AGMs. In addition, shareholders have the right to propose resolutions. According to article 65, any two shareholders of a company may propose a resolution concerning any matter in respect of which they are each entitled to exercise voting rights (Republic of South Africa 2008).

As for voluntary guidelines related to shareholder activism, the Code for Responsible Investing in South Africa (CRISA) recommends, under Principle 2, that institutional investors include the topic of voting at shareholders' meetings in their ownership responsibility policies. In addition, Principle 2 suggests that passive investors should also adopt (alongside active investors) active voting policies incorporating ESG considerations. Moreover, under Principle 5, CRISA recommends that investors

disclose their voting records, arguing that “non-disclosure of voting records by an institutional investor and its service providers precludes the investee company the opportunity to engage with the institutional investor or its service providers regarding the vote exercised” (IoD 2011: 11).

Despite legal and voluntary guidelines on activism, institutional investors in South Africa are considered apathetic in regard to voting (Institute of Directors 2005). Even though they have proxy voting rights, they tend not to vote or participate in shareholder meetings and not to disclose voting policies (Institute of Directors 2005). Moreover, electronic voting, accessible either via telephone or the Internet, is not yet widely used (CFA Institute 2009). Furthermore, shareholders rarely present proposals at the AGMs.

It seems that, while South Africa’s legal and voluntary guidelines aim to encourage investors to be activists and exercise their voting rights, in practice, they seldom do. It is yet to be seen whether the new Companies Act and CRISA will incentivise further use of shareholder rights in the near future.

**Summary of the chapter:** This chapter investigated the institutional environment in Brazil and South Africa. In both countries, voluntary governance guidelines seem to have a more positive effect on improving levels of corporate governance than legal requirements do. In Brazil, BM&FBovespa’s governance segment listings have been one of the main drivers of corporate governance as nearly half of the listed companies joined one of these segments and more than 70% of recent IPOs are at the Novo Mercado level. In South Africa, the governance guidelines provided by the King Reports, coupled with the JSE’s decision to make the King guidelines a requirement of the listing process, substantially increased the level of governance in the country. In Brazil, legislation also played a role in protecting rights of minority shareholders as research indicates that minority investors have been using the mechanisms provided by the Companies Law to elect representatives onto companies’ Boards. Nonetheless, legislation and voluntary regulations have not been very effective in improving the levels of shareholder activism in either country. In terms of Responsible Investment, incorporation of ESG issues seems to be encouraged by investor associations and by legislation in Brazil. In the case of South Africa, recent initiatives, such as the amendment to Regulation 28, the launch of CRISA and the start of the Sustainable

Returns Project, are expected to have a substantial influence on RI in the country. The outcomes of these initiatives and drivers are explored in Chapter 5.

### 3. METHODOLOGY AND METHODS

**Introduction:** This chapter describes the methodological approach adopted in this doctoral study to explore the propositions developed in Chapter 1 (Literature Review). It will lay out the philosophical underpinning of this research and the methods employed, followed by issues related to the evaluation of the research, as well as the ethics and limitations of the study.

#### 3.1. Philosophical approach

This research is based on critical realism. This philosophical position emerged from the work of philosopher Roy Bhaskar (1975), providing an alternative to positivism and relativism (McEvoy and Richards 2003; Robson 2002). Under critical realism, attention turns away from the flux of events and towards the causal mechanisms that govern them. Its primary purpose is to enable us to provide causal explanations of phenomena and of the regular relationships that exist between them (Keat and Urry 1978). While positivists align explanation of events with prediction using deductive-nomological forms, critical realists seek explanations based on mechanisms and structures.

For realists<sup>8</sup>, the social structures and causal mechanisms that govern events can be uncovered, described (Fleetwood 2002) and formulated in concepts and theory (Walliman 2006). Social structures and causal mechanisms include conventions, habits, class structure, social and economic institutions and relations of production (Fleetwood 2002). To understand causal relationships, first it is necessary to discover the nature of the underlying mechanisms involved and how they generate or produce a given phenomenon (Keat and Urry 1978). Even though the consequences of particular events cannot be deduced or predicted, once causes that determine actions have been uncovered, they are also seen as tendencies that produce particular effects (May 2001).

For critical realism, ontology is a central feature. Critical realists believe that there is an external reality regardless of whether we have knowledge of it or not (Sayer 1992). This

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<sup>8</sup> Realism represents long-standing positions on ontological matters whereas the term critical realism was first used in the works of Roy Bhaskar (1975). The critical element recognises that explaining social phenomena necessitates a critical evaluation of them (Sayer 1992).

means that nature and its material processes have particular structures and properties which exist independently of our understanding of them (Sayer 1992; Fleetwood 2002). However, unlike positivists, critical realists do not assume that they can ‘know’ the world ‘out there’ independently of a society in which they can learn to think and act (Sayer 1992; May 2001). As posited by Bhaskar (1975: 250), “things exist and act independently of our descriptions, but we can only know them under particular descriptions”. In trying to understand the world, individuals use existing knowledge and skills, drawn from whatever cultural resources are available to them. Therefore, social phenomena are concept-dependent: the meanings of practices, institutions, roles or relationships depend on what they mean to the members of that society (Sayer 1992).

The critical realist approach is appropriate for this study as its main goal is to identify the underlying mechanisms of shareholder engagement behaviour. The causal mechanisms are described using the accounts of the participants in this research who perceive the causal structures of shareholder engagement according to their social and historical worldview. Acknowledging the participants’ lenses is particularly important in cross-national studies since different nationalities have different cognitive, linguistic and material resources with which to set up meanings and practices (Sayer 1992).

As explained in more detail below, the qualitative phase analysed whether institutions influence engagement directly and/or whether institutions work together to encourage engagement behaviour. Furthermore, the quantitative phase investigated whether certain types of investors are more likely to engage with companies than others, while the qualitative phase examined the reasons for why certain investors engage more. I expect that identifying such mechanisms will facilitate the prediction of the conditions under which engagement occurs.

### **3.2. Methods employed**

This doctoral research adopted a mixed methods approach, involving a quantitative phase followed by a qualitative phase. The quantitative phase investigated whether certain types of investor are more likely to engage with companies than others

(Propositions P4 to P6<sup>9</sup>), while the qualitative phase investigated why certain types of investor are more prone to engaging. The qualitative phase also analysed whether institutional factors influence engagement behaviour (Propositions P1 to P3<sup>10</sup>). As outlined earlier, the mixed methods strategy employed combines concurrent embedded design and explanatory strategy (Creswell *et al.* 2008). The concurrent embedded design strategy was adopted as qualitative and quantitative methods were used to address different research questions. The explanatory strategy was also employed as the qualitative phase contributed to explaining the results of the quantitative phase. Further details are provided below.

### 3.2.1. Quantitative phase

The quantitative phase investigated whether investors' characteristics influence their propensity to engage with companies. This section describes the organisations selected for the study, the data collected and data analysis.

#### 3.2.1.1. Sampling and data collection

Obtaining data that measures shareholder engagement behaviour is rather difficult as dialogue between investors and companies takes place 'behind-the-scenes' and without public knowledge (Amalric 2004; Gillan and Starks 2003). The PRI Assessment Survey is one of the few available instruments which provide data on investor engagement. This survey is based on an extensive questionnaire that evaluates the progress of PRI signatories towards implementation of the PRI Principles<sup>11</sup>, including issues such as

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<sup>9</sup> P4 – Larger investors are more likely to engage with companies than are smaller investors.

P5 – Asset owners are more likely to engage with companies than are asset managers .

P6 – Active investors are more likely to engage with companies than are passive investors.

<sup>10</sup> P1 – Legislation does not encourage investors to engage with companies in emerging markets.

P2 – Investor associations encourage investors to engage with companies.

P3 – Investors' clients do not encourage investors to engage with companies.

<sup>11</sup> 1 - We will incorporate ESG issues into investment analysis and decision-making processes.

2 - We will be active owners and incorporate ESG issues into our ownership policies and practices.

3 - We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4 - We will promote acceptance and implementation of the Principles within the investment industry.

5 - We will work together to enhance our effectiveness in implementing the Principles.

6 - We will each report on our activities and progress towards implementing the Principles.



environmental, social and corporate governance (ESG) integration, active ownership and collaborative action. All PRI signatories, except for service providers, must respond to this questionnaire annually to keep their names on the list of members. Although the database is not open to the public, access was facilitated by the organisation for this research.

The sample comprises all of the Brazilian and South African investors that responded to the PRI Assessment Survey in 2011 and that invested in listed equity, listed real estate/property, listed securities held in hedge funds and corporate fixed income<sup>12</sup>. Brazil and South Africa were selected because these countries are leaders in Responsible Investment and shareholder engagement in emerging markets. The two nations have the largest number of PRI signatories and the largest number of reported engagements within emerging markets. As of 26 July 2012, Brazil had 68 PRI signatories and South Africa had 44 signatories, while China had 14 (including Hong Kong signatories), South Korea had 12 and India had 3 (PRI 2013a). In addition, in 2010, the Brazilian signatories reported that they had held 83 extensive engagements, while the South African signatories held 241 engagements<sup>13</sup> (PRI 2010).

In total, there are 43 investors (22 Brazilian and 21 South African investors), in the sample. To investigate whether propensity to engage is related to investor characteristics, five variables were used: shareholder engagement, country of origin, type of investor, investment strategy and investor size. Further details on the variables are provided below.

#### **i. Shareholder engagement**

Initially, I considered that the most suitable variable with which to measure shareholder engagement would be the number of companies engaged by each investor. Data for this

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<sup>12</sup> To check whether investors invest in at least one of these four asset classes, answers to the following survey questions were analysed: Q8a (listed equity – developed markets), Q8b (listed equity – developing markets), Q8d (fixed income corporate), Q8f (listed real estate), and Q9a2 (listed equities within hedge funds).

<sup>13</sup> In 2011, Brazil reported having had 72 extensive engagements, while the number for the South African organisations was not disclosed (PRI 2011a) because the number of signatories that engaged with companies did not reach the minimum number that the PRI judges necessary to maintain the anonymity of the participants.

indicator is collected through Question 39<sup>14</sup> of the PRI Assessment Survey, which requests that investors disclose the number of listed equity and fixed income issuers with which each investor engaged (or were engaged with on the organisation's behalf) on ESG issues over the period concerned. The question addresses both individual and collaborative engagement.

At first, this variable was considered to be the most appropriate for this study as it measures the level of shareholder engagement by calculating the total number of companies engaged by each PRI signatory. However, although the measure apparently reflects the content of the concept in question (face validity), a deeper analysis demonstrates that the variable lacks measurement validity. One of the problems with this indicator is related to how signatories count collaborative engagements. According to the survey guidelines, investors should count the number of companies with which they engage instead of counting the number of initiatives in which they are involved. For instance, when an investor participates in a collaborative engagement that targets ten companies, they should count ten engagements for this initiative. However, a preliminary analysis of the data found that some of the investors surveyed counted each collaborative engagement with different companies as one engagement instead of counting the total number of companies engaged with. This issue led to significant distortions in the measurement validity of the variable.

An alternative and more robust variable for examining shareholder engagement involves building a categorical variable based on survey Question 17c<sup>15</sup>, which asks investors whether they (or their service providers on their behalf) undertake engagement on ESG issues with issuers of listed equity, listed real estate/property, listed securities held in hedge funds and corporate fixed income. When the investor selects the item, the investor is considered to engage with companies. When the investor fails to select the item, the investor is considered not to engage with companies. This indicator is more reliable as signatories do not need to keep an exact count of the number of companies with which they engaged.

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<sup>14</sup> In total, how many listed equity and fixed income issuers did your organisation engage with or were engaged with on your organisation's behalf on ESG issues in 2010, by level of engagement?

<sup>15</sup> Please select any of the following active ownership activities that you, your external service providers or your external investment managers have undertaken in 2010 on behalf of your organisation?

c) Engagement on ESG issues with listed equity or fixed income issuers in the following asset classes: listed equity (developed markets), listed equity (emerging markets), listed real estate/property, listed securities held in hedge funds, or fixed income – corporate issuers.

This indicator may have limitations if some investors lack an understanding of exactly what shareholder engagement entails. This limitation is judged to be offset by a clear definition provided in the survey, which is as follows: “seeking company behaviour changes where appropriate through dialogue with companies specifically on environmental, social and corporate governance issues. This option does not look at how you influence corporate behaviour via voting” (PRI 2011b: 31). All in all, the second variable is more robust than the first one and was therefore adopted for this study.

#### **3.2.1.1.1. Investor characteristics**

As for characteristics of the investors, four variables are used in this study, which were also retrieved from the 2011 PRI Assessment survey. The variables are found below:

##### **ii. Country of origin**

Categorical nominal variable. Only investors from Brazil and South Africa were considered.

##### **iii. Investor size**

Numerical continuous variable, retrieved from Question 7<sup>16</sup>. This numerical continuous variable is measured in terms of assets under management in US dollars.

##### **iv. Investor type**

Categorical nominal variable, retrieved from Question 2<sup>17</sup>. In the questionnaire, investors are classified as “asset owners” and “asset managers”.

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<sup>16</sup> What were your organisation's total assets under management as of 31 December 2010, including the assets of all your consolidated subsidiaries?

Asset owners include non-corporate pension or superannuation or retirement or provident funds or plans, corporate pension or superannuation or retirement or provident funds or plans, insurance companies, foundations or endowments, development bank and sovereign or government controlled funds. Asset managers consist of organisations that primarily invest directly in companies and other asset classes, organisations that primarily perform investment research internally and provide lists of eligible securities (or ineligible securities) to sub-advisor(s), and organisations that primarily provide manager of managers, fund of funds or sub-advised products or investment strategies.

#### **v. Investment strategy**

Categorical nominal variable, retrieved from Question 8<sup>18</sup>. If 50% or more of total assets under management are managed passively, the type of management is considered “passive”. If more than 50% of total assets are managed actively, the type of management is considered “active”. When assets are managed passively (also called indexed or tracker funds), investment strategies aim to replicate financial indices (e.g. FTSE100), whilst assets that are managed actively do not replicate indices.

#### **3.2.1.2. Data analysis**

##### **3.2.1.2.1. Descriptive analysis**

First, descriptive analyses were performed to examine each of the variables individually. All categorical variables were examined according to country of origin and type of investor in search of potential patterns. The numerical variable (investor size) was analysed according to the five-figure summary (minimum, lower quartile, median, upper quartile and maximum).

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<sup>17</sup> What category best describes your organisation?

<sup>18</sup> Please provide an approximation of your average asset mix for 2010 or your most recent count, in %.

#### **3.2.1.2.2. Cross-tabulations**

The relationships between engagement behaviour and the categorical variables (type of investor and investment strategy) were analysed through cross-tabulations. This is the most appropriate method with which to analyse categorical explanatory and categorical response variables.

#### **3.2.1.2.3. Logistic regression**

The relationship between engagement behaviour and investor size was analysed through logistic regression. This is the most appropriate type of analysis as the response variable is a categorical one, while the explanatory variable is numerical (investor size measured by assets under management in US dollars). Before running logistic regression, the numerical variable was logarithmically transformed as it presented an asymmetric distribution. Transforming the data tends to make the distribution of the variable more symmetric and the relationship more linear.

The results are shown in Chapter 4 (Statistical Data Analysis).

### **3.2.2. Qualitative phase**

This phase analysed whether shareholder engagement was encouraged by different institutions, such as legislation and the influence of investor associations and clients. It also explored the results of the statistical data analysis. Critical cases were chosen for interviews and data was examined through thematic analysis.

#### **3.2.2.1. Sampling**

In total, 20 participants were interviewed in Brazil (13 investors and seven non-investors) and 24 were interviewed in South Africa (12 investors and 12 non-investors; for more information on the latter, see below).

The organisations were selected based on whether they provided examples of critical cases (Bryman and Bell 2007). Due to the reduced number of cases that can be studied, it makes sense to choose extreme situations in which the process of interest is more transparently observable (Pettigrew 1988). In this study, cases are considered critical when they involve asset owners or asset managers that demonstrate some commitment to Responsible Investment and/or shareholder engagement activities, or non-investors that work closely with investors on ESG issues. The PRI signatory list formed the basis for selecting critical cases.

An additional technique used to select interviewees consisted of snowballing: when previously selected interviewees indicated a new interviewee of possible interest, and I considered that the suggested interviewee fitted the description of a critical case, s/he was contacted. Out of the 20 interviewees chosen in Brazil, five (one investor and four non-investors) were selected through snowballing. Meanwhile, ten participants (three investors and seven non-investors) out of the 24 interviewees in South Africa were chosen using this method. The categories of participants interviewed in each country can be found in the table below:

**Table 3.1 - List of participants**

<b>Type of interviewee</b>	<b>Brazil</b>	<b>South Africa</b>
<b>Investors</b>	13 investors: <ul style="list-style-type: none"> <li>• 6 asset owners/pension funds</li> <li>• 7 asset managers</li> </ul>	12 investors: <ul style="list-style-type: none"> <li>• 3 asset owners/pension funds</li> <li>• 9 asset managers</li> </ul>
<b>Non-investors</b>	7 non-investors: <ul style="list-style-type: none"> <li>• 1 academic</li> <li>• 1 industry association</li> <li>• 5 investor associations</li> </ul>	12 non-investors: <ul style="list-style-type: none"> <li>• 2 academics</li> <li>• 1 industry association</li> <li>• 4 investor associations</li> <li>• 4 investment consultants</li> <li>• 1 independent activist</li> </ul>

<b>Type of interviewee</b>	<b>Brazil</b>	<b>South Africa</b>
<b>Total number of interviewees</b>	<b>20</b>	<b>24</b>

As for the investors that were part of the sample, 13 Brazilian investors and 12 South African investors were selected for interview. These investors represented a mix of investor types and investor sizes, including engagers and non-engagers.

In Brazil, six pension funds and seven asset managers were interviewed, managing between US\$ 200 million and US\$ 91 billion in assets. Eight out of these 13 investor interviewees engage with companies, according to the 2011 PRI Assessment Survey, while three do not engage and one did not respond to the Survey. As this investor was a new signatory, it had a one-year period in which to begin disclosing its practices. One investor is not a PRI signatory, but is renowned for its engagement practices. The interviews with investors revealed that the three non-engagers now engage with companies, while the new signatory has not engaged yet. Thus, the Brazilian sample totals twelve engagers and one non-engager.

In South Africa, three pension funds and nine asset managers were interviewed, representing assets under management ranging from US\$ 527 million to US\$ 138 billion. Eight out of these 12 investors engage with companies according to the 2011 PRI Assessment Survey, while one does not engage and two did not participate in the survey that year. One investor is not a PRI signatory, but is renowned for its engagement practices. The interviews revealed that the non-engager investor and one new signatory now engage with companies. Thus, the South African sample totals eleven engagers and one non-engager. The low number of pension funds interviewed in comparison to asset managers in South Africa is explained by the low level of interest local pension funds have in Responsible Investment, as reflected by the number of PRI signatories (four asset owners and 32 asset managers as of 26 July 2013). In addition, during the period in which I ‘recruited’ investors to interview, I tried to reach a larger number of investors that do not engage with companies, but they were unwilling to participate in the research.

The interviewees in Brazil and South Africa were usually heads of research, investment/portfolio managers or investment/ESG analysts.

In addition to investors, interviewees that are not investors (namely “non-investors”) were included in the sample to corroborate the responses from investors. They were selected based on their knowledge and experience of working closely with investors on ESG issues. Seven Brazilian non-investors (one academic and six industry/investor associations) and 12 South African non-investors (two academics, five industry/investor associations, four consultants and one activist) were interviewed. In the Brazilian sample, there were no investment consultants as, according to a number of interviewees, pension funds have their own selection processes to hire investment managers and do not use the services of investment consultants. In addition, unlike South Africa, there were no known independent shareholder activists in Brazil.

### **3.2.2.2. Data collection**

Data collection was achieved through semi-structured interviews. This method was chosen because it allows cross-case comparability (Bryman and Bell 2007). The interview guide (Appendix I) helps the researcher to investigate a fairly clear focus, but also provides the flexibility to accommodate other areas of interest which arise during the interview (Bryman and Bell 2007). One-to-one interviews also have the advantage of accommodating the investors’ busy schedules. In addition, invitations to participate in interviews achieve a higher acceptance rate than other methods because of widespread familiarity with the concept and the fact that people generally enjoy speaking about their work (King 2004).

Prior to the data collection fieldtrip, I conducted a pilot study between July and November 2011 to test the propositions developed and to examine whether the interview guide succeeded in investigating these propositions. Eight investors were interviewed: three South African investors (one pension fund and two asset managers), three Brazilian investors (one pension fund and two asset managers) and two foreign asset managers (one American and one British) who have experience in engaging with companies in emerging markets.

As a result of the pilot study, I found that it was necessary to make some amendments to the interview guide to include questions that examined the findings of the statistical data analysis. Considering that the statistical sample is not representative of the whole



investment market (especially the South African sample which has only two pension funds), I felt it was necessary to triangulate the statistical results with the interviewees' perceptions of the impact of investor size, investor type and investment strategy on shareholder engagement. In addition, I believe that exploring the statistical findings by inquiring interviewees as to the reasons for why they believed that the identified types of investor were more likely to engage led to richer research insights. Furthermore, I decided to drop two propositions concerning the impact of civil society and the media on shareholder engagement as the interviewees in the pilot study did not perceive any influence of these institutions on engagement. Moreover, I decided not to include foreign investors in the interview sample of my main doctoral research as they proved to have limited experience in engaging with companies in Brazil and South Africa. Nonetheless, with their permission, the outcomes of the interviews with foreign investors in the pilot study were used to feed a publication produced by the PRI on collaborative engagement (PRI 2013d).

Once the interview guide had been modified, the interviewees received additional questions to complement their interviews so that these could be included in the main doctoral research. Among the Brazilian interviewees, all three pilot interviews were held by telephone and then follow-up questions were sent by email. Among the South African interviewees, two were originally interviewed by phone and one in person (as she was in London at the time) and all three received follow-up questions by email. However, as new Responsible Investment legislative changes took place in South Africa in 2012 (i.e. amendments to the Pension Funds Act), the South African participants were interviewed a second time: two in person and one by telephone. Interviews with the foreign investors were conducted by telephone.

As for the main data collection, I conducted my fieldwork between 6 June and 19 July 2012 in Brazil and between 3 September and 16 September 2012 in South Africa. The fieldtrips were funded by the Chancellor's scholarship which I was granted in 2011 and by the research travel grant offered by the Society of Latin American Studies (SLAS) in 2012.

On average, the interviews lasted 45 minutes. Preference was given to interviewing the participants in their own language to ensure that they felt comfortable with the interview (Cooper and Schindler 2006). In Brazil, the interviews were held in Brazilian

Portuguese and, in South Africa, in English<sup>19</sup>. Preference was also given to face-to-face interviews to enable interviewer and participant to build a rapport (Cooper and Schindler 2006).

In Brazil, 15 interviews were conducted face-to-face and five by telephone so as not to lose interviewee participation due to geographical constraints (Cooper and Schindler 2006). Among the interviews held by telephone, three interviewees were from the pilot study and two interviews were held with representatives of investor associations who had not been available while I was in Brazil. Among the interviews that were conducted in person, 11 were conducted in the interviewees' offices (located in three different Brazilian cities), while four interviews were conducted during the PRI in Person annual event which took place in Rio de Janeiro on 28-29 June 2012.

In South Africa, 19 interviews were conducted face-to-face, four interviews were held by telephone and one interviewee was interviewed both in person and by telephone. Among the four interviews conducted on the telephone, two were pilot interviews and two were with interviewees who had not been available while I was in South Africa. Among the interviews that were held in person, 16 were held in the interviewees' offices (located in Cape Town or Johannesburg), three were held during breaks at various investment conferences/events in South Africa and one interview was conducted in a restaurant.

In Brazil, the number of people who participated in the interviews with investors varied. In six interviews, one person participated, while seven interviews involved more than one respondent (in five interviews, two people took part and, in two interviews, three people participated). In six interviews with non-investors, one person participated, while, in one interview, there were two participants. In the majority of interviews held in South Africa, only one person participated, except for one interview with a non-investor, in which there were two respondents, and another session in which three interviewees from two different organisations decided to be interviewed together.

It was particularly interesting when more than one person was involved in the interviews as it offered an opportunity for participants, especially those from different departments, to engage in a debate with a view to clarifying the organisation's view on Responsible Investment and shareholder engagement.

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<sup>19</sup> Although there are eleven official languages in South Africa, the official business language is English.

All of the interviews conducted in South Africa were recorded and later transcribed. As for those in Brazil, all interviews were transcribed and translated, except for two cases in which the interviewees did not allow the conversation to be recorded and one session where the recording was lost due to technical faults. To overcome the lack of recording, the interviewees were asked to confirm their responses by email.

### 3.2.2.3. Data analysis

Thematic analysis was used to examine the data as it provides a flexible tool with which to analyse qualitative data in a rich, detailed and complex manner. Another advantage of this analytical approach relates to the fact that it is not wedded to any theoretical framework and can be used within different philosophical approaches (Braun and Clarke 2006).

The interviews were coded in the language in which they were conducted (Brazilian Portuguese or English) so as not to lose the richness of the language in translation. The themes were selected based on a combination of deductive and “inductive” processes. The propositions developed in Chapter 1 helped to establish themes (deductive approach), but additional themes were created during the coding process using an “inductive” approach to allow unexpected insights to emerge from the data.

## 3.3. Research evaluation

To ensure that quality of this research, this study was evaluated based on its validity and reliability.

The quality of the quantitative research was evaluated according to:

- a) **Measurement or construct validity:** including reliability. Measurement validity relates to whether the measure of a concept really reflects the concept being studied (Bryman and Bell 2007). As explained earlier, an alternative variable that measures shareholder engagement was adopted to enhance measurement validity. Analysis of the first variable showed that the lack of

clarity in the responses to the survey question compromised the measurement validity of the variable and, as a result, an alternative variable was selected.

- b) **Internal validity:** accounts for the establishment of a causal relationship in which certain conditions lead to other conditions (Bryman and Bell 2007). To ensure greater confidence in the causal/explanatory inferences found in the quantitative phase, the qualitative phase investigated the interviewees' perceptions of the relationships found in the statistical analysis. This step was designed to confirm that there were no alternative explanations for the causal inferences found in the analysis.
- c) **External validity (generalisability):** refers to the degree to which findings can be generalised (Bryman and Bell 2007). To enhance generalisability, the interviewees were asked to share their views about the statistical findings to examine whether the causal relationships were not only a reflection of the PRI signatory base, but also the investment market in general.

### 3.3.1. Qualitative research evaluation

The quality of the qualitative research was evaluated according to Yin's (2009) criteria for research quality:

- a) **Measurement or construct validity:** refers to the identification of appropriate operational measures for the concepts being studied (Yin 2009). To prevent the participants from drawing on their own idiosyncratic understandings of what shareholder engagement entails, I provided a definition of the term at the beginning of every interview: "in this study, shareholder engagement is defined as direct negotiations between investors and portfolio companies regarding the company's strategic and operational matters. For the purposes of this research, only shareholder engagement with environmental, social and corporate governance (ESG) concerns will be considered. Filing resolutions and voting at Annual General Meetings will not be considered engagement". As Brannen (2005) and Hurmerinta-Peltomaki and Nummela (2006) point out, in cross-national studies, it is important that the researcher confirms that all respondents understand the concepts in a similar way. Secondly, I employed triangulation of

indicators by comparing the data collected in the interviews with the results of the PRI Assessment Survey.

- b) **Internal validity:** seeks to establish an explanatory relationship whereby certain conditions are believed to lead to other conditions (Yin 2009). To avoid spurious relationships, the interviews were used to examine whether the institutions under study work together to encourage engagement behaviour and whether other factors not yet identified encourage the practice of engagement or facilitate relationships between the institutions identified and shareholder engagement.
- c) **External validity (generalisability):** defines the domain to which a study's findings can be generalised (Yin 2009). The type of generalisation in this case is analytical, as the results provide strong support for institutional theory. Moreover, to analyse whether the findings are applicable to other contexts, I could employ the same research strategy to investigate other emerging markets, i.e. replication.
- d) **Reliability:** demonstrates that the operations of a study can be replicated (Yin 2009). To allow other researchers to conduct similar studies, a thorough research database was built so as to record all the different types of data collected and produced during the research. These include interview recordings, transcripts and notes as well as corporate reports, catalogued using NVivo.

### 3.4. Ethics

Ethical issues represent the concerns and dilemmas that arise over the proper way to conduct research (Neuman 2006). This research strives to (i) avoid harm to participants, (ii) deal with confidentiality and anonymity issues; and (iii) seek informed consent and voluntary participation.

In general, social research can cause physical, psychological or legal harm to a participant, or damage their career or income (Neuman 2006). This research did not pose a threat of physical harm as the main data collection methods consisted of interviews and secondary sources. To avoid causing participants mental stress, I assured them at the beginning of the interview that their anonymity and confidentiality would be protected in the study. Moreover, as described earlier, I strived to interview most

participants in their workplace and in their own language. The possibility of legal or career harm was not applicable to this study as informed consent was sought and confidentiality and anonymity were guaranteed.

Anonymity and confidentiality were maintained by not disclosing the names of the participants at any point and by not publishing single accounts in case there was a possibility of identifying the participant. Moreover, the fact that data collection did not involve group interviews (unless requested by the interviewees) or focus groups helped to preserve privacy.

To gain the respondents' informed consent, when I first contacted them, I sent each one a document in their own language containing detailed information about the research goals and confidentiality issues so that interviewees could make a conscious decision about their participation (Appendix II). This document made it explicit that participants were free to withdraw from the research at any point and that they were free to refuse to answer certain questions on whatever grounds they felt were justified. I did not request written consent as oral consent is sufficient in most business research (Cooper and Schindler 2006).

### **3.5. Limitations of the study**

There are some limitations to this study, one of which involves the samples used. Firstly, as the statistical sample draws on the PRI Assessment Survey, the data does not reflect the total number of investors found in each country. In Brazil, there are over 260 pension funds (ABRAPP 2012), whereas, in the sample, there are just 14. In South Africa, there were only two pension funds in the sample (no public data is available on the total number of South African pension funds, but, according to IFC et al. (2011), it is estimated that there are 14,000 pension funds in the country). To overcome this bias, interviews examined whether the statistical findings applied to the local investment market as a whole. Conclusions were drawn carefully in order to overcome the sampling bias.

Secondly, considering that the statistical data sample draws on the PRI database and the sample of interviewees is largely made up of PRI signatories, both samples mainly

include investors that, regardless of their level of adoption, value Responsible Investment practices. As a result, this study cannot claim to be representative of all investors in Brazil and South Africa. Instead of using the PRI database, I could have conducted my own survey, including a large number of investors in the sample. Moreover, the interview sample could have included investors that do not adopt or have not made a commitment to adopting Responsible Investment practices, leading to a richer understanding of the factors which influence shareholder engagement, and the barriers to adopting shareholder engagement in particular. However, considering issues of access<sup>20</sup> and time constraints, the decision was made to use the PRI database and to focus on the “RI adopters”. Therefore, the understanding of shareholder engagement generated by this research is particular to the sample organisations.

The third limitation refers to the variable used to measure shareholder engagement. As discussed earlier, there is an indicator that measures the number of engagements performed by each signatory in the PRI Assessment Survey, which would ideally be the most appropriate variable to account for level of engagement. However, problems with the way it is measured led to the rejection of the variable its replacement with an alternative which is more reliable, though less exact, measuring the existence of shareholder engagement practices for each signatory.

The fourth limitation refers to the data collection. Some Brazilian investors, fearing that being interviewed on tape could lead to confidentiality and reputational issues, preferred the conversations not to be recorded. To overcome this limitation, these interviewees were subsequently asked to confirm their answers in writing.

**Summary of the chapter:** This chapter described the methodological approach adopted in this research. A critical realist approach is the philosophical underpinning for the study. A combination of methods was used to test the propositions developed in the literature review. The first phase is quantitative and analyses the organisational characteristics that determine propensity to engagement. The second phase is composed of semi-structured interviews with Brazilian and South African investors and other players to examine the institutional factors that encourage shareholder engagement in

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<sup>20</sup> I believe that the fact that I was a member of the PRI staff as an intern during my pilot study and at the time I was scheduling interviews with Brazilian and South African investors facilitated access to data.

these countries, and to explore the findings of the first phase. The results can be found in the following chapters.



## 4. STATISTICAL DATA ANALYSIS

**Introduction:** This chapter presents the results of the quantitative phase, as described in Chapter 3 (Methodology and Methods). First, descriptive analyses of each variable (shareholder engagement, investor type, type of investment strategy and investor size) are performed. Subsequently this chapter tests Propositions 4, 5 and 6, exploring the relationship between engagement behaviour and investor characteristics through cross-tabulations and logistic regression.

### 4.1. Descriptive analysis

As shown in Chapter 1, the literature suggests that propensity for shareholder engagement varies according to investor characteristics (e.g. Aguilera et al. 2006; Clark and Hebb 2004; Hawley and Williams 2006; Martin et al. 2007; Myners 2001; Myners 2004; Black 1992; Solomon 2010). To determine whether shareholder engagement and investor characteristics are linked in Brazil and South Africa, statistical analysis will be performed. In this section, I will examine these variables separately.

#### 4.1.1. Descriptive analysis of shareholder engagement

This dataset is composed of 43 investors. As described in Chapter 3, these 43 investors represent the total number of Brazilian and South African asset owners and asset managers who responded to the PRI Annual Survey in 2011 and that invested in one or more of the following asset classes: listed equity, listed real estate/property, listed securities held in hedge funds or corporate fixed income. Table 4.1 shows the distribution of engagement behaviour by country of origin.

**Table 4.1 - Engagement behaviour by country**

Country of origin		Engagement behaviour		Total
		Does not engage	Engages	
Brazil		11	11	22
		50%	50%	100%
South Africa		3	18	21
		14.3%	85.7%	100%
Total		14	29	43
		32.6%	67.4%	100%

Overall, the majority of investors surveyed (67%) engage with companies. However, there are clear differences in engagement behaviour between the two countries. While most of the investors surveyed in South Africa (86%) engage with companies, half of the Brazilian investors (50%) have engagement practices. The varying institutional environments in Brazil and South Africa, together with differences in investor profile in these countries, go some way to explaining these figures. This chapter and Chapter 5 (Interview Analysis) will explore how the different institutions and investor characteristics encourage and limit shareholder engagement in Brazil and South Africa.

#### 4.1.2. Descriptive analysis of the investors' characteristics

This section analyses the variables related to investor characteristics: investor size, investor type and investment strategy.

##### 4.1.2.1. Investor size

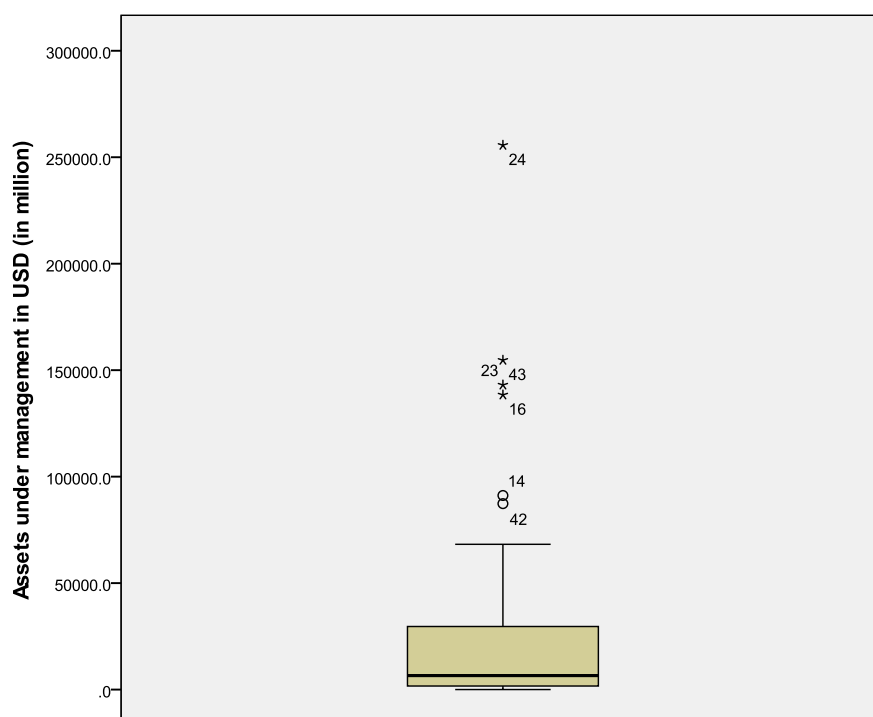
Descriptive statistics on the investor size variable, measured in terms of assets under management in U.S. dollars, are shown in Table 4.2.

**Table 4.2 - Investor size by country**

Description	Total	Brazil	South Africa
N	43	22	21
Minimum (US\$ million)	16.3	16.3	527.7
Lower quartile	1,058.8	381.4	4,332.1
Median (US\$ million)	6,554.2	5,487.4	13,005.2
Upper quartile (US\$ million)	33,157.3	27,862.7	41,595.8
Maximum (US\$ million)	255,633.7	255,633.7	154,684.4

As demonstrated in the box-plot below, the investor size variable is distributed asymmetrically. This means that there are significant differences in the size of investors in the sample. The upper section of the box-plot shows that there are six outliers (four of which are extreme outliers<sup>21</sup>) represented by investors managing assets over US\$ 50 billion, while the median value of assets under management is approximately US\$ 6.5 billion.

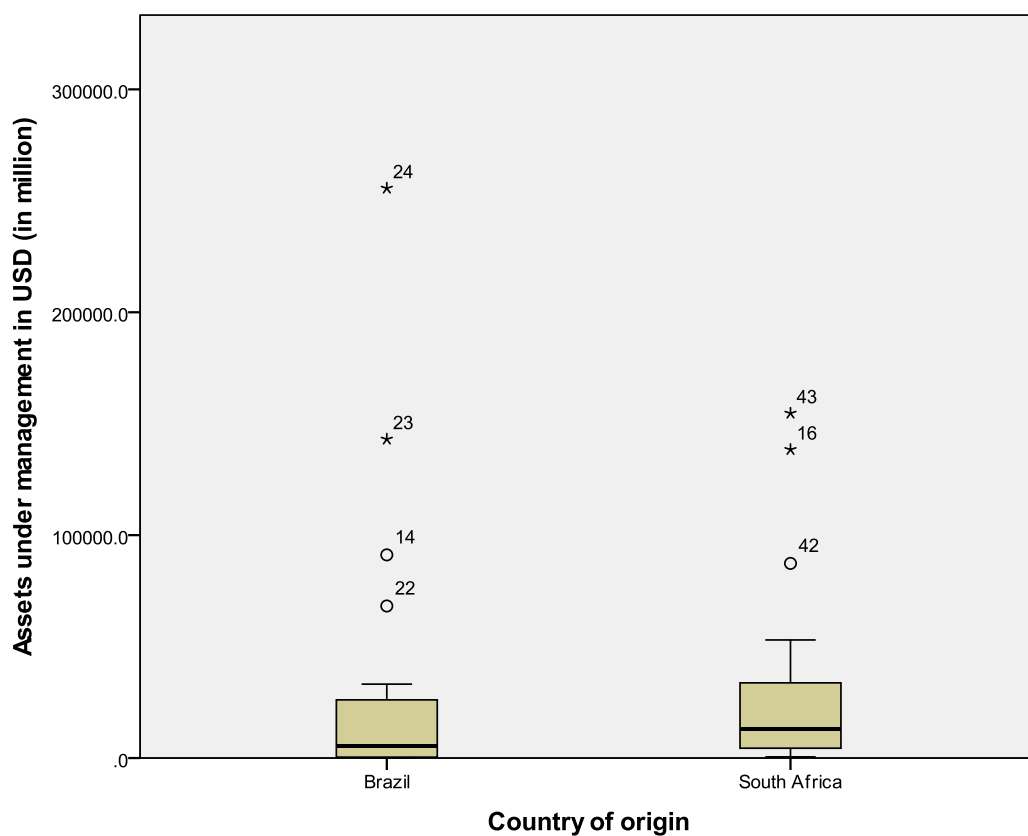
**Figure 4.1 – Distribution of investor size (US\$ million)**



<sup>21</sup> In SPSS, an asterisk represents an extreme outlier (a value more than 3 times the interquartile range from a quartile). A circle is used to mark other outliers with values between 1.5 and 3 box lengths from the upper or lower edge of the box.

In addition, the distribution of this indicator is more skewed in Brazil than in South Africa, as shown in Figure 4.2. In Brazil, the upper part of the box-plot demonstrates that there are four outliers (two of which are extreme outliers) managing assets over US\$ 68 billion, while the median value is US\$ 5.5 billion. In South Africa, there are three outliers (two of which are extreme outliers) managing assets over US\$ 87 billion while the median value is US\$ 13 billion.

**Figure 4.2 – Distribution of investor size by country (US\$ million)**



Such asymmetric distribution suggests that the variable must be logarithmically transformed before running a regression analysis.

### 4.1.2.2. Investor type

Table 4.3 shows the proportion of asset owners and asset managers among PRI signatories, per country of origin.

**Table 4.3 – Types of investors in Brazil and South Africa**

Country of origin		Investor type		Total
		Asset owner	Asset manager	
Brazil		14	8	22
		63.6%	36.4%	100%
South Africa		2	19	21
		9.5%	90.5%	100%
Total		16	27	43
		37.2%	62.8%	100%

Overall, 63% of the sample are asset managers and 37% are asset owners. In this dataset, asset owners are represented solely by pension funds. While there are a large proportion of asset owners/pension funds in the Brazilian sample (namely 64%), these account for less than 10% of the sample in South Africa. Such an imbalance in the South African sample can be explained, in part, by a tender held by the Government Employees Pension Fund (GEPF) in 2007, as mentioned in Chapter 2. In the process of selecting investment managers to manage some of their assets, the GEPF's tender questionnaire asked whether the candidate was a PRI signatory. This requirement prompted many asset managers to become PRI signatories. This issue is explored further under Proposition 3 in Chapter 5.

### 4.1.2.3. Investment strategy

Table 4.4 shows the proportion of investors by type of investment strategy and investor type.

**Table 4.4 – Type of investment strategy by investor type**

Investor type		Type of investment strategy		Total
		Passive	Active	
Asset owner		5	11	16
		31.3%	68.8%	100%
Asset manager		3	24	27
		11.1%	88.9%	100%
Total		8	35	43
		18.6%	81.4%	100%

As explained in Chapter 1, when assets are managed passively, investment strategies aim to replicate financial indices, whereas, when assets are managed actively, investment decisions depend on the investor's discretion. In the table above, investors are considered passive when 50% or more of their assets are managed by following financial indices, while active investors manage more than 50% of their assets using their own discretion.

The majority of investors in the sample adopt a predominantly active investment strategy (81%). In addition, active strategies are more commonly used by asset managers than by asset owners: while 69% of asset owners adopt a predominantly active strategy, the figure rises to 89% for asset managers. This is consistent with the behaviour of pension funds in other countries, such as the UK, where pension funds use index strategies more often than other types of investors (IMA 2011).

Cross-tabulation showing the proportion of investors by type of investment strategy and country of origin will not be shown for confidentiality reasons, as there are fewer than five investors in one of the four categories.

## **4.2. Data analysis**

This section investigates the relationship between engagement behaviour and investor characteristics through cross-tabulations and logistic regression. I examine Propositions 4 to 6 to determine whether investor characteristics influence propensity for engagement.

#### 4.2.1. Proposition 4 – impact of investor size

**Analysis of Proposition 4: Larger investors are more likely to engage with companies than are smaller investors.**

The literature suggests that size affects engagement behaviour. Choi and Fisch (2008), Rubach and Seborá (2009), Myners (2001) and Tilba and McNulty (2013) found that larger funds are more likely to engage in shareholder activism than smaller investors because they have greater ability to spread the fixed cost of engaging in activism across their asset base (Choi and Fisch 2008), they are likely to possess the power necessary to gain access to, and be attended to by, directors and top managers (Rubach and Seborá 2009) and are also more likely to have the resources to recruit and train in-house staff (Myners 2001; Tilba and McNulty 2013).

To determine whether there is a relationship between investor size and the level of engagement by pension funds, I will test the hypotheses below using logistic regression:

**Ho: There is no association between investor size and level of shareholder engagement.**

**H1: A higher proportion of larger investors engage with companies than smaller investors.**

The table and box-plots below compare the average size of engagers and non-engagers.

**Table 4.5 - Investor size by engagement behaviour**

Description	Total	Non-engagers	Engagers
N	43	14	29
Minimum (US\$ million)	16.3	16.3	89.4
Lower quartile (US\$ million)	1,058.8	353.1	4,332.1
Median (US\$ million)	6,554.2	3,660.1	15,076

Description	Total	Non-engagers	Engagers
<b>Upper quartile (US\$ million)</b>	33,157.3	6,175.9	60,602.7
<b>Maximum (US\$ million)</b>	255,633.7	26,097.8	255,633.7

Figure 4.3 – Engagement behaviour by investor size

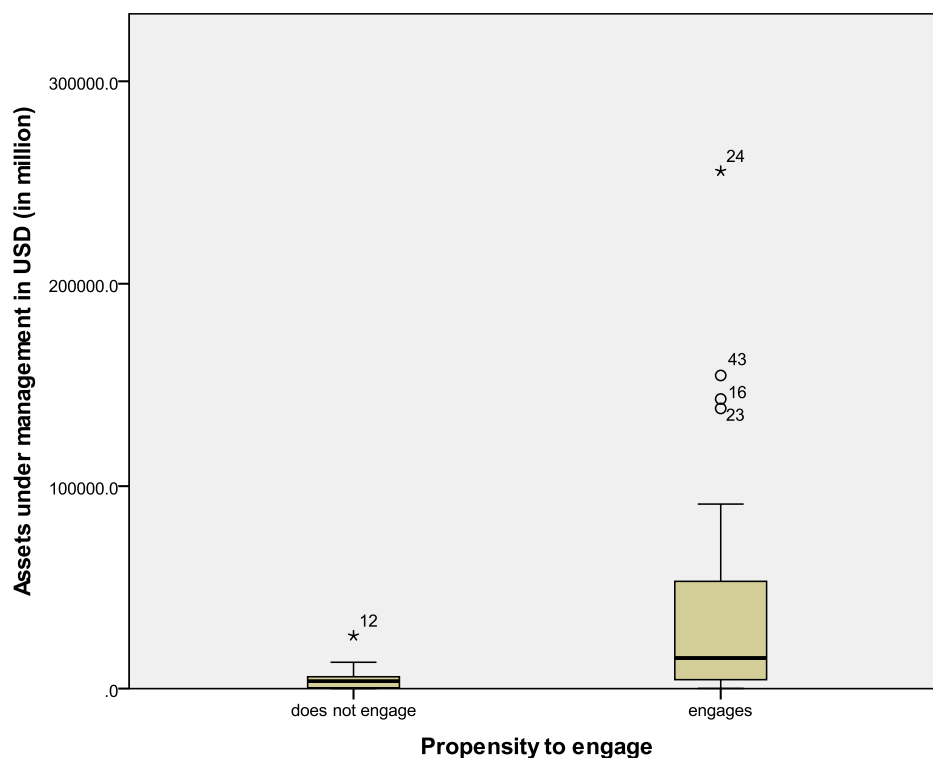


Table 4.5 and Figure 4.3 demonstrate that investors that engage with companies are larger than investors that do not have engagement practices: while the median value of assets under management for engagers is US\$ 15 billion, the median value for non-engagers is US\$ 3.7 million. This corroborates the findings in the literature.

To confirm whether there is a relationship between investor size and shareholder engagement, logistic analysis is run. For the logistic regression analysis, the investor size variable was logarithmically transformed to make the distribution of the variable more symmetric.

The analysis shows that the “prediction” generated by the model is accurate in 70% of cases. There is a relationship between investor size and engagement behaviour as the Cox and Snell R Square and the Nagelkerke R Square (pseudo R Squares) are .183 and



.255 respectively. It appears that investor size is an important factor in predicting whether an investor engages with companies. The relationship between investor size and engagement behaviour is shown in the equation below:

$$\text{Logit}(\text{engagement behaviour}) = -3.383 + (1.123 * \log \text{ investor size})$$

Proposition 4 is supported. The reasons for why large investors engage more than smaller ones will be explored in the interviews with investors, discussed in Chapter 5.

#### 4.2.2. Proposition 5 – impact of investor type

**Analysis of Proposition 5: Asset owners are more likely to engage with companies than are asset managers.**

The literature suggests that pension funds are more likely to engage with portfolio companies than other types of investors due to their long investment horizon (Aguilera et al. 2006; Clark and Hebb 2004; Martin et al. 2007). Pension funds, both private and public, tend to have significantly predictable, long-term outflows to beneficiaries (Martin et al. 2007) who are less likely to leave the fund than other types of clients. In contrast, pension fund managers, mutual fund managers and bankers face beneficiaries who may redeem their shares at any time, resulting in a much shorter horizon (Coffee 1991; Levinthal and Myatt 1994 cited in Martin et al. 2007; Monks and Minow 1996 cited in Martin et al. 2007). For shareholder engagement, this means that pension funds can rely on longer-term strategies such as engagement to improve fund performance compared to shorter-term investors.

To analyse whether there is a relationship between investor type and engagement behaviour, I will test the hypotheses below using cross-tabulation:

**Ho: There is no association between investor type and level of shareholder engagement.**

**H1: Asset owners are more likely to engage with companies than asset managers.**

Table 4.6 shows the relationship between investor type and engagement behaviour.

**Table 4.6 – Engagement behaviour by type of investor**

Investor type		Engagement behaviour		Total
		Does not engage	Engages	
Asset owner		9	7	16
		56.3%	43.8%	100%
Asset manager		5	22	27
		18.5%	81.5%	100%
Total		14	29	43
		32.6%	67.4%	100%

While 44% of asset owners in the sample engage with companies, the figure rises to 82% of asset managers, showing that there is a 38 percentage difference in engagement behaviour for these two types of investors. These results suggest that asset managers are more likely to engage with companies than asset owners in these two countries. This is contrary to what we can observe in the behaviour of PRI signatories overall, in which rates of engagement are slightly higher among asset owners than among asset managers (PRI 2011a). My finding is also contrary to the expectations gleaned from the literature. The reasons for why asset managers engage more than pension funds will be explored in Chapter 5.

#### **4.2.3. Proposition 6 – impact of investment strategy**

**Analysis of Proposition 6: Active investors are more likely to engage with companies than are passive investors.**

The literature also suggests that active investors are more likely to engage with companies than passive investors for two main reasons. Firstly, having abandoned attempts to outperform the market, passive investors seek to maximise their returns by minimising operating costs (Choi and Fisch 2008). As a result, passive investors and their service providers avoid engaging in costly activities, such as corporate governance issues (Black 1990) and monitoring companies (Martin et al 2007). Second, passive investors usually hold such diversified portfolios that it is beyond their realistic capacity to monitor and intervene in investee companies (Coffee 1991; Martin et al. 2007).

To determine whether there is a relationship between investment approach and engagement behaviour, I will test the hypotheses below using cross-tabulation:

**Ho: There is no association between type of investment strategy and level of shareholder engagement.**

**H1: A higher proportion of active investors engage with companies than passive investors.**

Table 4.7 shows the relationship between type of investment strategy and engagement behaviour.

**Table 4.7 – Engagement behaviour by type of investment strategy**

		Engagement behaviour		Total
		Does not engage	Engages	
Type of investment strategy	<b>Passive</b>	5 62.5%	3 37.5%	8 100%
	<b>Active</b>	9 25.7%	26 74.3%	35 100%
Total		14 32.6%	29 67.4%	43 100%

The analysis shows that, while 74% of active investors engage with companies, only 37% of passive investors do, leading to a 37 percentage difference in engagement behaviour between the two types of investor. These results suggest that active investors

are more likely to engage with companies than passive investors, corroborating the findings in the literature.

The reasons for why active investors engage more than passive ones will be explored in the interviews with investors, discussed in Chapter 5.

**Summary of the chapter:** In this chapter, using data from the 2011 PRI Assessment Survey, statistical analysis was performed to investigate Propositions 4, 5 and 6. Corroborating the findings in the literature, the results suggest that larger investors and active investors engage more with investee companies than smaller investors and passive investors. However, contradicting the findings in the literature, the results show that asset managers engage more than pension funds. In total, only two out of the three propositions relating to investor characteristics were confirmed by the statistical data analysis. The reasons for why these types of investor are more likely to engage than others will be discussed in Chapter 5.

## 5. INTERVIEW ANALYSIS

**Introduction:** This chapter will present the results of the interviews held with investors and other investment players in Brazil and South Africa, as described in Chapter 3 (Methodology and Methods). The findings are organised around the research propositions developed in Chapter 1 (Literature Review). This chapter will also investigate the experiences and perceptions of the interviewees regarding the most common shareholder engagement strategies in Brazil and South Africa.

### 5.1. Analysis of propositions

This section will present the findings of the interviews conducted in Brazil and South Africa. The findings are organised around the research propositions. In this section I will analyse both the institutional determinants of shareholder engagement related to Propositions 1, 2 and 3 (legislation, influence of investor associations, client influence), and the reasons for why the investor characteristics identified in the statistical data analysis (i.e. investor size, investor type and type of investment strategy, as shown in Chapter 4) influence engagement.

#### 5.1.1. Proposition 1 – impact of legislation

**Proposition 1 – Legislation does not encourage investors to engage with companies in emerging markets.**

**Not supported**

As shown in Chapter 1, the literature review suggests that legislation does not encourage investors to engage with companies in emerging markets (e.g. Yang and Rivers 2009; Tan 2009; Sjostrom and Welford 2009). To investigate this proposition, the interviewees from Brazil and South Africa were asked whether they agree with the statement. The results are shown in the table below:

**Table 5.1 - Interviewees' perceptions on the influence of legislation on shareholder engagement**

Interviewees claimed that:	South Africa		Brazil	
	n	%	n	%
<b>Legislation encourages shareholder engagement</b>	<b>15</b>	<b>62%</b>	<b>10</b>	<b>50%</b>
Directly only	0	0	2	10%
Indirectly only	13	54%	8	40%
Directly and indirectly	2	8%	0	0
<b>Legislation both encourages and limits shareholder engagement</b>	<b>3</b>	<b>12%</b>	<b>0</b>	<b>0</b>
<b>Legislation does not influence shareholder engagement</b>	<b>3</b>	<b>12%</b>	<b>5</b>	<b>25%</b>
<b>Did not respond, did not have an opinion or were not asked the question (when they were not actively involved with the investment community)</b>	<b>6</b>	<b>25%</b>	<b>5</b>	<b>25%</b>
<b>TOTAL<sup>22</sup></b>	<b>24</b>	<b>100%</b>	<b>20</b>	<b>100%</b>

As shown in Table 5.1, the interview findings do not support Proposition 1 as a majority of the South African (62%) and 50% of the Brazilian interviewees reported that they believe that legislation encourages engagement. Ten per cent of the Brazilian interviewees believe that legislation encourages engagement directly, 8% of the South African interviewees argued that legislation encourages engagement directly and indirectly, and 54% of the South African and 40% of the Brazilian interviewees believe that legislation encourages engagement indirectly. Further, 12% of the South African interviewees maintained that legislation both encourages and limits shareholder engagement.

A minority (12%) of the South African and 25% of the Brazilian interviewees do not perceive any impact of legislation on engagement. Therefore, contrary to the expectations from the literature, the proposition is not supported.

The interviews were also used to investigate the reasons for why the interviewees believe that legislation encourages engagement. The arguments given are shown in Table 5.2.

<sup>22</sup> Total value is over 100% because some interviewees were categorised into more than one alternative

**Table 5.2 – Interviewees’ reasons for why legislation encourages shareholder engagement**

Interviewees claimed:	South Africa		Brazil	
	n	%	n	%
<b>Direct positive impact</b>				
i. Limited investment universe	2	8%	0	0
ii. Protection to minority shareholders	0	0	2	10%
<b>iii. Indirect positive impact</b>				
iv. Awareness of Responsible Investment	10	42%	7	35%
v. More questioning from pension funds to service providers	5	21%	0	0
vi. Inclusion of ESG factors in the trustees’ fiduciary duty	6	25%	1	5%
vii. No reason or other reason given	1	4%	0	0

The majority of interviewees in Brazil and South Africa believe that legislation encourages shareholder engagement directly and/or indirectly. Direct encouragement happens through requiring South African pension funds to invest the major part of their assets domestically and by protecting the rights of Brazilian minority shareholders. Indirect encouragement occurs through raising awareness of Responsible Investment in Brazil and South Africa, increasing the interest of South African pension funds on the topic, and including ESG issues in the fiduciary duties of Brazilian and South African pension fund trustees. These arguments will be discussed below.

#### **5.1.1.1. Legislation encourages shareholder engagement directly**

##### **i. Limited investment universe**

In South Africa, two interviewees (8%) mentioned that legislation encourages pension funds to engage with companies directly in South Africa. The regulation in question is

the Pension Funds Act, issued in 1956, which aims to regulate the activities of private pension funds in the country.

According to Interviewee SAI-1<sup>23</sup>, the Pension Funds Act limits the exposure that a South African pension fund may have to international investments. According to the regulation, pension funds are allowed to invest up to 20% of their assets in investments outside of South Africa (OECD 2011). Hence, the bulk of the pension fund investments must be invested domestically. Interviewees SAI-1 argued that the reason as to why this regulation encourages shareholder engagement is related to the limited investment universe in South Africa. According to Interviewees SAI-1 and SAI-11, there are a limited number of possible investments in listed companies on the Johannesburg Stock Exchange (JSE) that pension funds can make. Interviewee SAI-1 contended that there are between 150 and 200 companies listed in the JSE in which pension funds would invest, which is a different investment universe of American or British pension funds which would invest in nearly 300 companies. Thus, as assessed by Interviewee SAI-11, the option of divesting from companies in South Africa is not a good option given the limited investment universe, while a more viable strategy for improving investment performance would be engaging with companies. Hence, Interviewees SAI-1 and SAI-11 argued that for private pension funds the option of ‘voice’ is more advantageous than the option of ‘exit’.

The statements suggest that the limited international exposure prescribed by the Act coupled with the limited investment universe encourages pension funds to engage with companies.

## **ii. Legal protection to minority shareholders**

In Brazil, two interviewees (10%) argued that shareholder engagement is encouraged by the Brazilian legislation as it protects the rights of minority shareholders. The regulation being referred to is the Companies Law which regulates corporate entities (“Lei das Sociedades Anônimas”, Law 6404/1976, amended by Law 10303/2011). According to

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<sup>23</sup> Coding for interviewees: SA – South African; BR – Brazilian; I – investor (pension fund or asset manager); NI – non-investor (investor association, academic, asset consultant or other)



Interviewee BRNI-3, Brazil offers the most protection to minority shareholders than any other emerging market since, as posited by Interviewee BRNI-5, the Brazilian legislation considers minority shareholders “weak and unprotected”. Therefore, legislation gives minority shareholders a number of instruments so that they can protect themselves from controlling shareholders. For example, in terms of selection of companies’ Board members, legislation gives the option for shareholders representing at least 10% of the share capital with voting rights to adopt the cumulative voting system (cf. article 141 of Law 6404/1976). As explained in Chapter 2, under cumulative voting, for each share the shareholder owns he or she can vote as many times as there are seats in the Board. This gives minority shareholders a greater opportunity to elect their representative as they can place all their votes for one single candidate. Moreover, non-voting shareholders representing at least 10% of the voting shares, and minority voting shareholders representing at least 15%, may elect one Council member each. As for the election of Fiscal Council members (cf. article 161 of Law 6404/1976), the group of non-voting shareholders and minority voting shareholders representing at least 10% may elect one Council member each. Through electing members in the Boards of Directors and Fiscal Councils, minority shareholders can participate in the strategic discussions of the investee companies and engage with management.

However, Interviewees BRNI-3, BRNI-5 and BRI-11 argued that there are instances in which legislation favours majority shareholders. For instance, as pointed out by Interviewee BRNI-5, companies in Brazil are allowed to issue dual shares of classes (voting and non-voting shares). As a result, majority shareholders can keep their voting power by keeping the voting shares, while issuing non-voting shares to the market to raise capital. In addition, Interviewee BRI-11 noted that the regulating bodies, such as CVM (“Comissão de Valores Mobiliários”) - the Brazilian Securities and Exchange Commission - are not particularly responsive to minority shareholders when the latter claim that their rights are violated. Illustrating the lack of protection provided by CVM to minority rights, Interviewee BRI-13 referred to the case of Petrobras. In 2012, an individual with ties with the government (Petrobras’ majority shareholder) was appointed to occupy one of the company’s Board seats legally designated for representatives of minority shareholders. This happened because government-linked organisations, such as the public pension funds, were treated as minority shareholders for the purpose of nominating and electing directors, leading to the election of the

controversial candidate (Hermes 2012). As claimed by Interviewee BRI-13, CVM did not interfere in the decision as they should have, thereby failing to protect minority shareholders.

The statements above suggest that some interviewees believe that the legal protection of minority shareholders in Brazil creates an incentive for engagement by minority shareholders since they can more easily appoint members onto Boards of Directors and Fiscal Councils, and participate in the internal discussions held in the investee companies. However, other interviewees argue that both legislation and the enforcement system do not always protect minority rights.

#### **5.1.1.2. Legislation encourages shareholder engagement indirectly**

As shown in Table 4.1, 62% of the South African and 40% of the Brazilian interviewees claimed that legislation encourages engagement indirectly through encouraging Responsible Investment, thereby creating an enabling environment for engagement. The main reasons offered for this claim are that legislation raises awareness of Responsible Investment, it increases the interest of the pension funds in Responsible Investment and it includes ESG issues in the fiduciary duties of pension fund trustees, meaning that trustees are less wary of violating their fiduciary duties. These will be discussed below.

#### **iii. Awareness of Responsible Investment**

Ten South African (42%) and seven Brazilian interviewees (35%) believe that legislation encourages or will encourage shareholder engagement indirectly because it contributes to improving the level of understanding of investors on Responsible Investment issues.

In South Africa, the interviewees referred to Regulation 28 of the Pension Funds Act, amended in 2011 and effective from the 1<sup>st</sup> January 2012. The Regulation's preamble now states that:

“...prudent investing should give appropriate consideration of any factor which may materially affect the sustainable long-term performance of a fund’s assets, including factors of an environmental, social and governance character.” (Republic of South Africa 2011)

The exact wording of the preamble was suggested by the RI Standing Committee of the Associations of Savings and Investments in South Africa (ASISA). According to Interviewee SAI-4, ASISA was asked by the South African Treasury to comment on the amended draft to Regulation 28, to which they recommended that a Responsible Investment approach be considered by all pension fund trustees when deploying capital into markets.

Interviewee SAI-1 remembered that previously, only a few PRI signatories and non-signatory investors would speak about sustainability issues. However, after the amendment to Regulation 28 and the launch of the Code for Responsible Investing in South Africa (CRISA), the South African market started to speak more openly about Responsible Investment, making the term more commonplace. Interviewee SAI-4 agreed that there appears to be more conversations about Responsible Investment, even though, contrary to Interviewee SAI-1, she argued that it has been mostly driven by Regulation 28, rather than CRISA, because the former is mandatory. Interviewee SAI-9 noted that the regulation significantly helped to clarify what Responsible Investment is. Interviewee SAI-10, SANI-3 and SANI-6 mentioned that pension funds are in the process of understanding the requirements of the legislation and are considering how they can comply with it. Interviewee SAI-5 noticed that not only are the asset owners becoming more aware, but also consultants and asset managers are trying to understand Responsible Investment more broadly to serve their clients.

Interviewee SANI-10 highlighted the extent to which the level of awareness of Responsible Investment has changed in the past five years. She pointed out that the ‘The State of Responsible Investment in South Africa’ report, conducted by the UNEP FI, Noah Financial Innovation and UNISA and published in 2008 (UNEP FI et al. 2008) reported that the level of understanding of Responsible Investment was rather low in 2006-2007, and that Responsible Investment was often confused with philanthropy.

However, a survey conducted by SinCo (IFC et al. 2011) to assess the current state of Responsible Investment in the country reported that in 2011-2012 the majority of interviewees were able to provide a definition of Responsible Investment that was not significantly divergent from the consensus view. Interviewees were able to identify ESG issues and with the view of improving financial returns or risk-adjusted returns. Interviewee SANI-10 considered this consensus a major shift in the investment community.

However, four interviewees noted that the level of understanding of Responsible Investment is still low. Three of them mentioned that investors often confuse Responsible Investment with infrastructure funding or developmental investment, such as financing house and road development. Interviewee SANI-9 explained that the understanding that Responsible Investment refers to soft investment towards social responsibility done for purposes of morality is still prevalent among investors. Two other interviewees argued that the definition of Responsible Investment also varies inside and among different groups. Interviewee SAI-12 pointed out that the definition varies from asset manager to asset manager, while Interviewee SANI-4 mentioned that consultants and asset managers use terminology differently.

Hence, the interviewees perceived that Regulation 28 improved the level of understanding on Responsible Investment, even though it has not yet reached the large majority. Through creating an enabling environment, Regulation 28 indirectly encourages shareholder engagement on ESG issues.

In Brazil, seven interviewees (35%) reported that they also believe that legislation improved the level of awareness of Responsible Investment. These interviewees referred to the resolution issued by the Brazilian National Monetary Council 3792 in 2009 (art. 16, §3, item VIII) requiring of pension funds the following:

Art. 16 - §3 – “The investment policy of each plan must contain, at least, the following items:  
VIII – whether there is compliance to social and environmental responsibility principles.”  
(CMN 2009)

According to the regulation, Brazilian pension funds must state in their investment policy whether they include social and environmental concerns in their investment decisions. Interviewee BRI-1 stated that this resolution has had an impact on investors in terms of driving pension funds to understand the topic of Responsible Investment. Interviewee BRI-6 noted that, even though legislation approaches the issue in a broad manner and does not require pension funds to incorporate social and environmental aspects in their investment decisions, this piece of legislation has encouraged pension funds to pay attention to and be interested in the theme. Similarly, Interviewee BRNI-1 claimed that, because the regulation makes it mandatory for pension funds to consider these issues in their investment policies, the executives of the pension funds are required to discuss the topic at some point in order to rewrite their investment policies, which increases awareness. Interviewee BRNI-4 argued that the legislation had a more focused impact, affecting largely the Brazilian PRI signatories. She posited that the Brazilian PRI signatories understood the resolution issuance as a sign that the inclusion of social and environmental issues in the investment decisions of the pension funds would become mandatory in the future. As a consequence, they created a new working group within the PRI Brazil Network, the PRI Investment Policy Working Group, to assist pension funds to write their ESG investment policies. Interviewees BRI-6 and BRNI-1 also mentioned that the Secretary for Complementary Pension Fund Policies (SPPC) is now in the process of reevaluating the resolution and assessing whether it should make the inclusion of social and environmental aspects mandatory in investment policies of pension funds.

Overall, the South African and Brazilian interviewees perceived that regulation encourages engagement indirectly through improving the level of understanding on Responsible Investment.

#### **iv. More questioning from pension funds to service providers**

In South Africa, five interviewees (21%) representing 56% of all asset managers interviewed, noted that Regulation 28 has encouraged pension funds to start questioning their clients and consultants about their Responsible Investment practices.

Asset Manager X noted that there has been an increase in the number of questions that they receive from asset consultancies and questions in request for proposals (RfPs) around how they are applying Regulation 28. Asset Manager Y mentioned that they have been receiving questionnaires from asset owners inquiring about their approach to Responsible Investment and how they apply both Regulation 28 and CRISA to their investment processes. Asset Manager W observed that their clients have been asking them questions to identify how aware they are of Responsible Investment. Nonetheless, three of these five asset managers noted that the quality of the questions is still rather poor. As stated by Asset Manager X:

*“I would argue that the quality of the questions is often quite bad, people don’t really know what they are asking, so they didn’t really know whether they were looking at a horse or a donkey, you know I mean? They just have no idea.” (Interviewee X)*

Similarly, Asset Manager Z noticed that the level of enquiry from pension funds is superficial. Asset Manager K claimed that, soon after the amendment to Regulation 28, they have started receiving questions on ESG issues, but not of in-depth quality.

However, according to Asset Manager Y and Asset Manager Z, this questioning has not been translated into changes in the mandates. Asset Manager Z argued that pension funds have not yet reached a point where they start revising their mandates. Likewise, Asset Manager Y claimed that pension funds have not yet changed their mandates to request that their service providers vote or that they engage on the behalf of the pension funds in ESG issues. Interviewee SAI-1 claimed that pension funds are still in the process of updating policies related to Responsible Investment before they task service providers to perform these duties on their behalf.

Hence, the South African interviewees perceived that there has been increase in the level of interest of pension funds in Responsible Investment issues, as observed by their service providers, even though the level of questioning has been quite superficial and not yet translated into real implementation. Again, through creating an enabling environment, Regulation 28 indirectly encourages shareholder engagement on ESG issues.

#### v. Inclusion of ESG factors in the trustees' fiduciary duty

Six South African interviewees (25%) and one Brazilian respondent (5%) contended that regulation encourages engagement indirectly by including ESG issues into the fiduciary duties of pension fund trustees.

In South Africa, Interviewees SAI-1, SAI-5 and SAI-8 stated that Regulation 28 includes in the fiduciary responsibility of pension fund trustees to at least consider ESG issues when these issues materially impact the long-term financial performance of their investments. As expressed by Interviewee SAI-5:

*“There has been changes in regulation in South Africa recently which is increasingly bringing a broader consideration of fiduciary issues to the fore of trustees, including environmental, social and governance factors”* (Interviewee SAI-5)

Interviewee SAI-2 argued that Regulation 28 recognises that incorporating ESG issues is not against the fiduciary duty of pension funds and is not against providing financial returns - a perception that, according to Interviewee SANI-1, was fairly common in the past. Nonetheless, the interviews argued that by approaching the topic in the legislation, trustees perceive that it is not against their duties to include ESG issues in their investment decisions.

In Brazil, Interviewee BRI-2 contended that, before Resolution 3792/2009 was issued, pension funds were concerned that the inclusion of social and environmental issues in investment decisions could be perceived as against their fiduciary duties. However, Interviewee BRI-2 claimed that, after the issuance of the Resolution, pension funds were more comfortable dealing with the topic. The interviewee posited that, through listing in the regulation that social and environmental issues be among the important issues they must consider in their investment policies, pension funds understood that the government perceives such consideration as a good practice.

The statements above demonstrate that legislation encourages shareholder engagement indirectly. Through approaching ESG issues in the pension funds' fiduciary duties, pension funds understand that it is not against their duties to consider ESG issues in their investment processes.

#### **5.1.1.3. Legislation both encourages and limits shareholder engagement**

In South Africa, three interviewees (12%) noted that legislation encourages shareholder engagement, but that it also limits collaborative engagement. This is because of 'acting in concert' issues brought forward by the legislation. The legislation that regulates 'acting in concert' issues is the 2008 Companies Act. According to section 440A the Act:

“...act in concert' means any action pursuant to an agreement between or among two or more persons, in terms of which any of them co-operate for the purpose of entering into or proposing an affected transaction or offer.” (Republic of South Africa 2008)

Interviewee SAI-1 argued that investors in South Africa are reluctant to engage collaboratively with one company on specific issues because they are concerned about being deemed to be acting in concert which, according to the legislation, could trigger an offer to minority shareholders. Interviewee SAI-1 then mentioned that, while shareholder initiatives involving engaging with groups of companies on thematic ESG issues are more common (e.g. engagements encouraging corporate disclosure against the Carbon Disclosure Project and improved corporate reporting using the GRI guidelines), they would be wary of engaging with individual companies. Similarly, Interviewee X (not identified for confidentiality purposes) claimed that they have been reluctant collaborative engagers because of the number of collaborative experiences that they have had in the past which led to concert party risks. As an example of collaborative risk, Interviewee SAI-4 cited a court case in which three well-known investment managers collaborated to change the Board of Directors of a listed company, but, due to the significant collective shares that these investors held, there was an



accusation that they had colluded and the company almost had to make an offer to all minority shareholders.

To tackle this lack of regulatory clarity in South Africa, Interviewee SAI-1, SAI-4 and SAI-6 mentioned that a group of investors under the PRI South Africa Network is engaging with South Africa's Takeover Regulation Panel with the aim of bringing more transparency to the regulation, and to encourage more collaborative engagement in the future. This initiative is discussed under Proposition 2.

Three interviewees disagreed that the regulation is limiting to collaborative engagement. Interviewee SAI-8 argued that the regulation gives rules and parameters on how to operate, but she does not believe that it is limiting to collaborative engagement. Interviewee SAI-6 claimed that investors hide behind the 'acting in concert' risk as a reason not to collaborate, while the real reason is the competitiveness of the industry. Interviewees SAI-10, SANI-11 and SAI-1 also agreed that the lack of collaboration is more related to the competitiveness among asset managers rather than the limits of the regulation. As posited by Interviewee SAI-10:

*"I wouldn't really be seeing it being a big issue because sometimes fund managers don't act in concert with each other. Because they are competitors anyway. They hardly sit around the table when it comes to making investment decisions."* (Interviewee SAI-10)

Interviewees SAI-10 and SANI-11 claimed that asset managers perceive the other asset managers as a competitor and, as such, do not collaborate. Interviewee SAI-1 noted that many large asset managers use the relationship they have with a particular company as part of their competitive advantage and this makes them hesitate to collaborate with others who do not possess such relationships. Interviewee SAI-6 suggested that it is going to take some time for investors to start collaborating around issues of common cause given the inherent nature of the investment industry.

Overall, these three interviewees perceived that legislation encourages engagement, but also that 'acting in concert' regulations together with the competitive nature of the asset management industry discourages collaborative engagement among investors.

#### 5.1.1.4. Discussion

The interview findings do not provide support to the proposition as a majority (62%) of the South African interviewees and 50% of the Brazilian interviewees believe that legislation encourages engagement directly and/or indirectly.

In South Africa, the interviewees claimed that shareholder engagement is encouraged directly by the limited international exposure that South African pension funds may have, as prescribed by the Pension Funds Act, together with the small investment universe in the country, meaning that it makes more sense for investors to adopt ‘voice’ over ‘exit’. Given the restricted investment universe, South African pension funds prefer to engage in discussion with the investee companies rather than divest.

In Brazil, the interviewees cited the protection to minority shareholders as encouraging shareholder engagement directly. They argued that the Companies Law gives minority shareholders mechanisms that allow them to appoint their own representatives sitting in the Board of Directors and Fiscal Councils more easily, which facilitates their participation in the strategic discussions of the investee companies. The accounts of the interviewees corroborate the literature. While Saito et al. (2006) found that the majority of Brazilian minority investors were not using the mechanisms provided by the legislation to elect directors in the Boards of Directors, Black et al. (2010) found that that 41% of the 116 Brazilian firms they surveyed had one or more representatives of the minority shareholders. This indicates that minority rights have been increasingly employed by smaller shareholders. In this research, two examples of investors collaborating to elect a representative for minority shareholders were found. As discussed earlier, one of them happened under the AMEC umbrella with the goal of trying to elect a minority investor director at Petrobras. The second coalition, detailed under Proposition 4, refers to an engagement in which one of the interviewees participated involving asset managers representing 20% of the market capitalisation of a Brazilian listed company, succeeding to elect a number of members in a company’s Board of Directors. Although only two initiatives were identified, the fact that one of them was held at AMEC - the main association for minority investors in Brazil - targeting one of the largest companies in the country may be an indication that the

practice of gathering minority investors to elect directors within associations may experience further growth in the near future.

In terms of indirect influence on shareholder engagement, both South African and Brazilian interviewees mentioned that legislation increased the level of awareness within pension funds of Responsible Investment. In Brazil, even though the Brazilian legislation does not explicitly demand pension funds to include ESG issues in their investment decisions, the interviewees perceived that it helped to bring the discussion to the forefront of the Brazilian pension industry. Similar laws requiring pension funds to disclose how social and environmental information is processed in the construction of investment portfolios exist in the UK, Belgium, France, Netherlands, and Germany (See 2009). Solomon (2010) defends the idea that these types of disclosure requirements for pension funds act as incentives for trustees to adopt such policies because they would probably be embarrassed to state in their investment policy that they do not have any type of Responsible Investment concern. Moreover, there is understanding among some interviewees that the Brazilian legislation might change in the future and that investors must be prepared for potential further regulation.

Another indirect impact to engagement that the interviewees recognised is the inclusion of ESG issues in the fiduciary duties of trustees by Regulation 28 in South Africa and by Law 3792/2009 in Brazil. Pension fund trustees have a fear that including ESG issues is against their fiduciary duties and this is a significant barrier to responsible investment - as is shown in the literature (e.g. Sandberg 2011; Martin 2009; Hoepner et al. 2011; Richardson 2011). Institutional investors often interpret fiduciary duties as prohibiting consideration of any factor other than those directly related to maximising shareholder wealth (Hawley and Williams 2006). Nonetheless, a study commissioned by the UNEP FI to the law firm Freshfields Bruckhaus Deringer (2005) to study the relationship between fiduciary duty and Responsible Investment, found that institutional investors may incorporate ESG issues in three situations: when the financial characteristics of two or more investments are equal (ESG issues can be used as ties-breakers); when it is financially beneficial to consider ESG factors; and when ESG incorporation is supported by beneficiaries. Furthermore, some jurisdictions expressly allow trustees to take ESG considerations into account provided that their duties of prudence are met, such as the Ontarian and Manitoban law in Canada (Richardson 2008). In the UK, Shepherd (2007 cited in Richardson 2008) argued that the regulation

of pension fund disclosure led pension funds to acknowledge that ESG issues can be taken into account. Likewise, in Brazil and South Africa, through including ESG considerations in the legislation, the interviewees reported that institutional investors are less concerned about breaching their fiduciary duties towards their beneficiaries.

Furthermore, 12% of South African interviewees perceive that legislation both encourages and limits engagement. The accounts of the interviewees demonstrate that collaborative engagement is discouraged in South Africa by ‘acting in concert’ regulations, as investors are concerned about being deemed to be acting in concert when collaborating. Regulations preventing investors from collaborating are not unlike those of developed countries, such as the UK, Germany and Australia, which could hinder future investor collaboration (Nardhues 2007; EU 2009; Hermes 2009). Both the Green Paper of the European Commission and the UK Walker Review acknowledged the need for clear legislative rules so that acting in concert does not limit effective shareholder cooperation in Europe (EU 2009; Walker 2009).

In general, this section shows that the interview findings, which indicate that legislation encourages shareholder engagement, contradict the literature. According to a number of authors (e.g Ozen and Kusku 2009; Yang and Rivers 2009; Gatamah 2002 cited in Vaughn and Ryan 2006), the legal environment in developing and emerging markets is usually characterised by a lack of regulations and/or legal enforcement that does not encourage responsible behaviour. However, the literature indicates that this is less so in the Brazil and South Africa, particularly in South Africa.

In South Africa, as discussed in Chapter 2, the financial institutional structures and shareholder rights tend to be strong in comparison with rights in other emerging markets (Andreasson 2011; CFA Institute 2009), which is a result of pressures from institutional investors and from the transformation of the South African society (Rossouw et al 2002 cited in Andreasson 2011). When foreign financial institutions returned to the country after the end of Apartheid, investors demanded reform in corporate governance practices to bring their money back in the country (Kakabadse and Korac-Kakabadse 2002 cited in Vaughn and Ryan 2006). Furthermore, South African legislation has been greatly influenced by the country’s historical and social conditions and the South African government has gone much further than governments in many other countries to legislate social issues in company’s management (Hamann 2008 cited in King et al.

2010). After the end of Apartheid, the government sought to develop a number of regulations to reduce social inequality in the countries, including the Employment Equity Act and the Broad-Based Black Economic Empowerment Act (West 2006). Such emphasis on governance and social issues is possibly the reason as to why the government incorporated ESG issues in the Pension Funds Act.

The Brazilian government has also legislated ESG issues in corporate management. In the social remit, a number of regulations were created, reflecting the government's need to tackle social issues with the corporate sector, such as Law 8213/1991 mandating companies employing over 100 people to hire people with disabilities and Law 10020/2000 mandating Brazilian companies to hire young employees for positions demanding professional qualifications (Ethos and Ibope 2010). Legislation also provides tax incentives for companies and individuals that invest in culture (Law 8313/1991) (Yamahaki and Ursini 2010). Moreover, the Brazilian environmental regulations are considered fairly advanced by international standards and the National Environmental Policy establishes that company directors and managers can be held personally responsible and liable to criminal prosecution if they are aware of a criminal act and do nothing to prevent it (SustainAbility 2006). Attention to corporate social and environmental issues by the government may explain why social and environmental concerns were incorporated in the pension fund legislation.

Thus, unlike many emerging markets/developing countries that are characterised by lack of regulations (Ozen and Kusku 2009; Yang and Rivers 2009), Brazil and South Africa have regulations in place encouraging good corporate behaviour. The research findings demonstrate that at least some emerging markets are developing legislation related to ESG issues directed at companies and investors. The research findings suggest that Brazil and South Africa feature characteristics more similar to developed countries in terms of the sophistication of the legislation on ESG issues.

The main challenge in both countries is the low level of legal enforcement. In Brazil, the judiciary system is considered inefficient and many judges are corrupt (da Silveira and Dias 2009). In South Africa, even though there has been progressive legislative reform, government capacity for enforcement remains a concern (Visser 2005 cited in Arya and Zhang 2009). However, this research shows that formal legislation in both South Africa and Brazil can be said to encourage shareholder engagement. Moreover,

measures that the investor associations are adopting help their members to comply with existing legislation or to avoid potential future regulation, as investigated in the next proposition.

Overall, the proposition is not supported.

### 5.1.2. Proposition 2 – influence of investor associations

**Proposition 2 – Investor associations encourage investors to engage with companies.**

**Strong support<sup>24</sup>**

As shown in Chapter 1, the literature review suggests that investor associations encourage institutional investors to engage with companies on ESG issues (e.g. Campbell 2007; Yang and Rivers 2009; Borglund et al. 2008 cited in De Geer et al. 2009). To investigate this proposition, the interviewees from Brazil and South Africa were asked whether they agree with the statement in their countries. The results are shown in the table below:

**Table 5.3 – Interviewees’ perceptions on the influence of investor associations on shareholder engagement**

Interviewees claimed that:	South Africa		Brazil	
	N	%	n	%
<b>Investor associations encourage shareholder engagement</b>	<b>19</b>	<b>79%</b>	<b>16</b>	<b>80%</b>
Directly only	0	0	5	25%
Indirectly only	16	67%	7	35%
Directly and indirectly	3	13%	4	20%
<b>Investor associations do not</b>	<b>0</b>	<b>0</b>	<b>1</b>	<b>5%</b>

<sup>24</sup> Over 79% of the interviewees in both countries agree with the proposition

Interviewees claimed that:	South Africa		Brazil	
	n	%	n	%
encourage shareholder engagement				
Did not respond, did not have an opinion or were not asked the question (when they were not actively involved with the investment community)	5	21%	3	15%
<b>TOTAL</b>	<b>24</b>	<b>100%</b>	<b>20</b>	<b>100%</b>

As shown in Table 5.3, an overwhelming majority (79%) of the South African interviewees and 80% of the Brazilian interviewees believe that investor associations encourage investors to engage with companies. While 25% of the Brazilian interviewees claimed that the influence on engagement is direct, 67% of the South African and 35% of the Brazilian interviewees claimed that the influence is indirect and 13% of the South African and 20% of the Brazilian interviewees argued that the influence is both direct and indirect. Only 5% of the Brazilian respondents claimed that the investor associations have no influence. The interview findings are consistent with the literature review. Hence, the proposition is strongly supported.

The interviews were also used to investigate the reasons as to why the interviewees believe that investor associations encourage shareholder engagement. The arguments given by the interviewees are shown in Table 5.4.

**Table 5.4 – Interviewees’ reasons for why investor associations encourage shareholder engagement**

Interviewees claimed:	South Africa		Brazil	
	n	%	n	%
<b>DIRECT POSITIVE IMPACT</b>				
i. Offer a platform for collaborative engagement	0	0	9	45%
<b>DIRECT AND INDIRECT POSITIVE IMPACT</b>				
ii. Sustainable Returns Project	8	33%	0	0
<b>INDIRECT POSITIVE IMPACT</b>				
iii. Code for Responsible Investing in South Africa	7	29%	0	0
iv. Reduce uncertainties about the ‘acting in concert’	3	12%	0	0

Interviewees claimed:	South Africa		Brazil	
regulations				
v. Promote awareness of Responsible Investment	8	33%	12	60%
vi. No reason or other reason given	4	17%	0	0

These will be discussed below.

### 5.1.2.1. Investor associations encourage investors to engage with companies directly

#### i. Offer a platform for collaborative engagement

Nine Brazilian interviewees (45%) argued that investor associations have been encouraging shareholder engagement directly through offering a platform for investors to collaborate and to engage with companies on ESG issues.

First, five interviewees (25%) mentioned that the PRI has been providing a space for investors to engage collaboratively with companies. Interviewees BRI-2, BRI-3 and BRI-10 cited the collaborative engagement held within the PRI Brazil Network in which a group of PRI signatories engaged with a number of Brazilian listed companies to encourage them to adopt sustainability reports based on the Global Reporting Initiative (GRI) framework. Interviewee BRI-2 claimed that the experience of the PRI Brazil Network demonstrated that collaboration works in Brazil and that minority investors who do not have the necessary ‘clout’ to speak to companies directly benefit from collaborating with other investors. Interviewee BRI-9 highlighted that the PRI has proven a useful space to learn the process of engaging with companies before investors start engaging with companies on ESG issues on their own. Interviewee BRNI-4 noted that, before the PRI Brazil Network was launched, there were no forums where investors could bring engagement proposals and work in collaboration. She reported that she believes that the PRI group is strategically placed to become the main forum for investor collaborative engagement.



Second, five interviewees (25%) argued that the Association of Capital Markets Investors (AMEC) also provides a forum for minority investors to collaborate. Interviewees BRI-12 and BRI-13 cited one case (also mentioned under Proposition 1) in which a group of minority investors gathered at AMEC to collaborate and try to elect a member of the Board to represent minority shareholders at Petrobras. However, the interviewees argued that minority investors failed to elect their representatives. The public pension funds were treated as minority shareholders for the purpose of nominating and electing directors, voting according to the recommendations of the Brazilian government which is a majority shareholder in Petrobras. As a result, they managed to appoint the controversial candidate proposed by the government to occupy one of the board seats legally designated for representatives of minority shareholders (Hermes 2012). The treatment of public pension funds as minority investors was considered contentious. Despite the failure of the minority investors to elect a candidate, AMEC provided the space for them to collaborate and act.

Interviewee BRI-3 noted that ABRAPP's Sustainability Commission might also become an engagement forum. At the time of the interview, she mentioned that the Commission was considering coordinating a collaborative engagement targeting investee companies to disclose information on carbon emissions according to the CDP guidelines. If this is put into practice, ABRAPP could also become a hub for investor collaborative engagement.

The statements above demonstrate that the PRI and AMEC hold forums for investors to engage collectively with companies, encouraging collaborative engagement in Brazil.

#### **5.1.2.2. Investor associations encourage investors to engage with companies directly and indirectly**

##### **ii. Sustainable Returns Pensions and Society Project**

In South Africa, eight interviewees (33%) believe that the Principal Officers Association (POA) will encourage shareholder engagement both directly and indirectly through their Sustainable Returns for Pensions and Society Project.

As described by Interviewee X (not identified for confidentiality purposes), the Project is sponsored by the Norwegian government through the International Finance Corporation (IFC), while the POA and other members of the Project's Steering Committee provide the in-kind work. Interviewee X stated that the Committee is comprised of approximately twenty industry bodies such as the National Treasury, the Financial Services Board (FSB), the Government Employees Pension Fund (GEPF), the Institute of Financial Planning, the Institute of Retirement Funds (IRF), the Government Institution Fund of Namibia (GIPF), the Institute of Directors (IoD) and the PRI.

Interviewee X commented that the Sustainable Returns Project aims to create an "Asset Owners' Guide to Responsible Investing, providing the A to the Z on how do you go about implementing the policy". She argued that the guide will help pension fund trustees to exercise their duties and to choose the best approach for their fund to implement ESG issues. Interviewee SAI-2 asserted that the Project is making "Responsible Investing requirements more locally and understandably applicable" by, as observed by Interviewees SAI-8 and SAI-12, developing a framework for pension funds to implement the requirements of Regulation 28 and the Code for Responsible Investing in South Africa (CRISA).

Interviewee Y (not identified for confidentiality purposes) explained that the Guide will contain a list of global ESG standards and frameworks that pension funds may wish to resource, such as drafts of investment policies. She noted that the Guide will also discuss general issues, including the history of Responsible Investment, its business case and regulatory obligations, so that trustees with low understanding of ESG issues can find a large amount of Responsible Investment information in one single document. Interviewee Y claimed this is necessary because the level of knowledge of Responsible Investment among asset owners is still low. As assessed by Interviewees Y and SAI-12, this is explained by the fact that most pension fund trustees are not professional trustees, working on a part-time basis as an add-on to their daily jobs (further discussion of the level of investment knowledge held by pension fund trustees will be discussed under Propositions 3 and 5). Interviewee X stated that the Guide will also assist the industry in the standardisation of the different Responsible Investment terms. This is because Interviewees SAI-12 and SANI-4 found that, in the consultation with stakeholders, the different investment groups (e.g. asset consultants, asset managers) use Responsible Investment terms very differently from each other (as mentioned under Proposition 1).

Although the majority of the interviewees argued that the Sustainable Returns Project will encourage engagement indirectly through offering a framework to help pension funds to integrate ESG issues into their investments, three interviewees believe that shareholder engagement will also be encouraged directly by the initiative. Interviewee Y argued that even though the starting point of the Project is focused on increasing trustees' awareness of Responsible Investment and assisting them to exert pressure on their service providers to implement ESG factors, pension funds will start considering engagement in a few years time as a natural outcome of their ESG strategy. Similarly, Interviewee SAI-8 argued that the Project will assist asset owners to develop a Responsible Investment policy and related tools, but it will also encourage activism in the future. Interviewees SAI-12 noticed that the Project will encourage engagement because it will help asset owners to implement CRISA's principles and one of them (Principle 2) is related to active engagement.

In sum, the statements suggest that the Sustainable Returns Project is encouraging shareholder engagement indirectly in South Africa by offering a toolkit for pension funds to integrate ESG issues into their investment process. Engagement will also be encouraged directly as the Project will also encompass shareholder ownership responsibilities.

#### **5.1.2.3. Investor associations encourage investors to engage with companies indirectly**

##### **iii. Code for Responsible Investing in South Africa (CRISA)**

In South Africa, seven interviewees (29%) claimed that the Code for Responsible Investing in South Africa (CRISA) has encouraged or will encourage shareholder engagement indirectly through developing an enabling environment for engagement. As explained in Chapter 2, CRISA “gives guidance on how the institutional investor should execute investment analysis and investment activities and exercise rights so as to promote sound governance” (IoD 2011: 3). As Interviewee SAI-4 noted, effective from

the 1st February 2012, CRISA was created to complement King III with corporate governance requirements for institutional investors.

Interviewees SAI-4 and SANI-2 explained how the need for the Code was raised. They mentioned that, when the draft of King Code III was issued for public comment, the PRI South Africa Network submitted a comment to the King Committee suggesting that not only should the Code include governance responsibilities to corporations, but also to the investing community, similar to the UK Corporate Governance Code. As a result of the PRI engagement with the King Committee, the Committee recommended that a separate code be drafted, leading to the creation of the CRISA Committee, convened by the Institute of Directors (IoD).

Interviewee SAI-5 argued that the launch of CRISA ignited a momentum within asset owners and asset consultants that, together with Regulation 28, will catalyse the development of Responsible Investment and ESG implementation in the near future. One investor (not identified for anonymity purposes) mentioned that, after the launch of CRISA, they started providing their service providers with guidelines as to how they should vote proxy on their behalf. One asset consultant (not identified for anonymity purposes) observed that, since the launch of CRISA, asset owners and asset managers have been asking them questions on how they are approaching CRISA. In addition, some of their clients requested that they conduct due diligence on asset managers on their behalf in order to evaluate whether asset managers are endorsing CRISA and to what extent they are implementing its principles. She noted that these behaviours are a sign that investors are aware of the Code and are interested to understand how their service providers are applying it. Interviewees SAI-4, SAI-8, SAI-9 and SANI-6 claimed that CRISA has made investors speak more openly about Responsible Investment and ESG issues. However, Interviewee SAI-9 believes that investor behaviour has not yet changed, while Interviewee SANI-2 claimed that the take-up of CRISA has been slower than expected.

However, Interviewees SANI-2 and SANI-7 highlighted that, in the launching event of CRISA, the Financial Services Board (FSB) made it clear that CRISA's requirements may become mandatory. Interviewee SANI-2 explained that, in the event, the Minister of Finance suggested that even though the FSB prefer the voluntary approach to Responsible Investment via CRISA, were institutional investors to ignore the Code,

mandatory measures may follow. According to Interviewee SANI-7, such announcement was a “wake-up call” for the institutions.

The statements above suggest that CRISA is encouraging or will encourage shareholder engagement indirectly by offering guiding general principles and disclosure requirements on how investors can integrate ESG issues into their investment processes.

#### **iv. Reduce uncertainties about ‘acting in concert’ regulations**

In South Africa, three interviewees (12%) argued that the PRI South Africa Network is encouraging shareholder engagement indirectly by clarifying legislation regarding “acting in concert” issues. As mentioned under Proposition 1, the interviewees claimed that investors are reluctant to engage with companies in South Africa for fear of being deemed to be acting in concert.

To tackle this regulatory concern, Interviewees SAI-1, SAI-4 and SANI-1 mentioned that the Engagement Working Group of the PRI South Africa Network has been engaging with the Takeover Regulation Panel to make the regulation on collaboration clearer. Interviewee SAI-4 explained that a document was prepared with the Executive Director of the Takeover Regulation Panel to guide investors on how they can collaborate and avoid regulatory issues. At the time of the interview (September 2012), the document was being submitted to the PRI signatories for consultation before being released to the public. Interviewee SAI-4 highlighted that the PRI Engagement Working Group thought it was important to develop some guidance on the regulatory aspects of collaboration as many local and global guidelines - such as CRISA, the OECD guidelines, the PRI Principles and the UK Stewardship Code - encourage collaboration. As claimed by Interviewee SAI-4:

*“But if you collaborate, you got to know what the safe path is. You don’t want to suddenly find yourself in conflict with the regulator and suddenly find that you have to make an offer to minorities. So we work with the regulator and we have a document now that clarifies what the safe path is and, if you step off the safe path, what are the consequences and, you know, the risks that are involved with stepping off the safe path.” (Interviewee SAI-4)*

Interviewee SAI-4 claimed that it is important for investors to understand what the safe legal path is in terms of collaborating with other investors to avoid the risk of having to make an offer to minorities. Moreover, Interviewee SANI-1 argued that the investors involved in developing the guidance document hope that smaller asset managers will start engaging with companies in collaboration with other investors, considering that they have more ‘clout’ working collectively.

The statements suggest that the PRI initiative engaging with the Takeover Panel and creating a guidance document on how to collaborate will provide an enabling environment for engagement, encouraging collaborative engagement in the future.

#### **v. Promote awareness of Responsible Investment**

Eight South African (33%) and 12 Brazilian interviewees (60%) mentioned that investor associations are contributing to an increase in awareness of Responsible Investment in the country.

In South Africa, five interviewees (21%) mentioned the work of the Association for Savings and Investment in South Africa (ASISA). Interviewee SAI-8 claimed that ASISA has been promoting Responsible Investment through their Responsible Investment Standing Committee and their sub-committees. Interviewees SANI-3 and SANI-11 argued that ASISA was instrumental in the development of CRISA through participating in the CRISA Committee. In addition, Interviewee SAI-4 and SANI-3 mentioned that ASISA was involved in the drafting of the preamble of Regulation 28, as mentioned under Proposition 1.

In terms of the work of PRI South Africa Network, four interviewees (17%) argued that the PRI has been increasing awareness of Responsible Investment in the country. Similarly, Interviewee SAI-8 suggested that the PRI has been promoting Responsible Investment among their signatories in South Africa. According to Interviewee SAI-1, the PRI has helped to highlight both the importance of integrating ESG issues and the importance of pension funds and asset owners to be active in their ownership practices and to collaborate when it comes to engaging with companies on ESG issues.

Interviewee SAI-4 claimed that the PRI has improved the awareness of Responsible Investment and facilitated dialogue between local investors on ESG issues. In addition, Interviewee SANI-6 highlighted that the PRI helps to disseminate the experiences of other global signatories on how they are integrating ESG issues across asset classes.

Further, Interviewees SAI-1 and SAI-6 mentioned the Institute for Retirement Funds (IRF) and their role in educating and organising conferences for pension fund trustees. Coincidentally, one of these interviewees was interviewed during the IRF Conference's "The Journey to Sustainability", held in Cape Town on 2-4 September 2012.

In Brazil, 12 interviewees (60%) also claimed that Brazilian investor associations helped to improve the level of awareness of Responsible Investment.

Eight interviewees (40%) mentioned the work of the Brazilian Association of Pension Funds (ABRAPP) as increasing awareness of Responsible Investment. Interviewees BRI-1 and BRI-2 explained that ABRAPP's Sustainability National Technical Commission discusses sustainability issues, such as sustainability reporting, CDP and PRI Principles, with the associated pension funds. Likewise, Interviewee BRNI-4 argued that ABRAPP encourages its associates to think about the importance of ESG issues. According to Interviewee BRNI-1, awareness-raising has been done through meetings, seminars and through the ABRAPP's website. Interviewee BRNI-1 also mentioned that ABRAPP is developing a GRI-based sustainability reporting framework for pension funds and a handbook for pension funds to understand how ESG issues can be incorporated in the investment policy. Interviewees BRNI-1, BRI-2 and BRI-6 added that ABRAPP encourages Responsible Investment through supporting other organisations: ABRAPP is a PRI network supporter, CDP's<sup>25</sup> partner and sits in the Board of the Brazilian Sustainability Index.

In terms of the work of the PRI Brazil Network, seven interviewees (35%) maintained that the PRI has contributed to raising awareness of Responsible Investment amongst investors in Brazil. Interviewees BRI-11 and BRNI-4 noticed that the PRI increases awareness of Responsible Investment through attracting new signatories and supporting the existing signatories to implement the PRI Principles. Interviewee BRI-3 claimed that, by participating in the Working Groups of the PRI Brazil Network, institutional

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<sup>25</sup> CDP is a global organisation that collects carbon, water and climate change information from the larger organisations worldwide (CDP 2013)

investors obtain information on how to deal with ESG issues. Interviewee BRI-7 added that it is encouraging for investors to participate in the PRI Working Groups and to discuss Responsible Investment with other investors. Furthermore, Interviewees BRI-1 and BRI-7 observed that the obligation to respond the PRI Assessment Survey annually motivates signatories to improve their ESG practices. As mentioned in Chapter 3, this survey represents an extensive questionnaire that signatories fill out on an annual basis to evaluate the progress of the PRI signatories towards implementing the PRI Principles. By mandating signatories respond the survey on an annual basis, these interviewees claim that signatories are compelled to reflect upon their practices and seek improvements.

The statements above suggest that ABRAPP and the PRI, in Brazil, and ASISA, the PRI and the IFR, in South Africa, have been important in encouraging shareholder engagement through disseminating the concept and the practices of Responsible Investment.

In summary, shareholder engagement has been encouraged indirectly through the Code for Responsible Investing in South Africa; engagement of the PRI South Africa Network with the Takeover Regulation Panel helped to clarify ‘acting in concert’ issues; and awareness raising has been brought by the PRI, ASISA and IRF in South Africa, and ABRAPP and PRI in Brazil.

#### **5.1.2.4. Discussion**

There is overwhelming support for Proposition 2 as the majority of the interviewees in Brazil and South Africa believe that investor associations encourage investors to engage with companies. As shown above, 79% of the South African interviewees and 80% of the Brazilian interviewees claimed that investor associations encourage shareholder engagement directly and/or indirectly. The findings are consistent with the literature review.



As claimed by the interviewees, investor associations in these countries: (i) offer a platform for collaborative engagement; (ii) developed RI principles through the Code for Responsible Investing in South Africa; (iii) are creating a RI toolkit for investors through the Sustainable Returns Project; (iv) are reducing uncertainties about ‘acting in concert’ regulations by engaging with the Takeover Regulation Panel; and (v) promote awareness of Responsible Investment.

With regard to the first argument (forum for collaborative engagement), the Brazilian interviewees cited two investor associations (and possibly a third in the future) where investors can meet and collaborate on engagement. The spread of collaborative engagement in Brazil is probably a result of a number of factors. Firstly, there are no ‘acting in concert’ regulations limiting shareholders’ collaboration, which creates an enabling environment for collaboration. Secondly, the concentrated share ownership that characterises the Brazilian corporate environment favours majority/controlling shareholders to engage with companies as they hold the necessary shares to elect Board members, and to be involved in the companies’ strategic decisions. Hence, to acquire some control, minority shareholders are incentivised to collaborate with other small shareholders to join shares and try to elect members as well. In pooling material resources through collective action, investors can increase their own salience in the eyes of corporate managers (Gond and Piani 2013). In addition, the Companies Law incentivises minority investors to collaborate so that they can make use of the mechanisms stated in the legislation to elect members in the Boards of Directors and Fiscal Councils. As discussed under Proposition 1, while Saito et al. (2006) found that the majority of Brazilian minority investors were not using the mechanisms provided by the legislation to elect directors in the Boards of Directors, Black et al. (2010) found that that 41% of the 116 Brazilian firms they surveyed had one or more representatives of minority shareholders. This indicates that minority rights have been increasingly employed by smaller shareholders. In this research, only two examples of investors collaborating to elect a representative for minority shareholders were found. However, the fact that one of them was held at AMEC, the main association for minority investors in Brazil, targeting one of the largest companies in the country may be an indication that the practice of gathering minority investors to elect directors within associations will grow further in the near future.

Another reason for the growth of collaborative engagement is the fact that the practice of engaging on ESG issues has been presented by the PRI Brazil Network to Brazil as a model that has been used by the PRI globally to assist their signatories to engage with companies worldwide. As a result, legislation, the Brazilian shareholder concentration of ownership and the import of foreign investor practices by the PRI probably contributed to the increase of collaborative engagement in Brazil.

The literature also acknowledges the role of organisations like investor associations as ideal centres for collaborative investor engagement. As posited by Gong and Piani (2012), enabling organisations like the PRI may help to overcome barriers to collective action by identifying ESG issues of interest to heterogeneous investors and by providing an infrastructure for investors to work with one another. Furthermore, an enabling organisation with a good reputation attracts investors who are more likely to cooperate and generates trust among participants (Fehr and Fischbacher 2002 cited in Gond and Piani 2013; Fombrun and Shanley 1990 cited in Gond and Piani 2013). The interview findings corroborate the literature. The forums for collaborative engagement in Brazil are concentrated at AMEC and the PRI Brazil Network - two investor associations that, as suggested by the interviews, provided the infrastructure for investors to collaborate on issues of common interest which Brazilian investors, particularly smaller ones, may not have.

Another industry-led initiative which the interviewees believe has encouraged or will encourage shareholder engagement indirectly through incentivising Responsible Investment is the Code for Responsible Investing in South Africa (CRISA). As reported by the interviewees, the PRI South Africa Network engaged with the King Committee to incorporate governance responsibilities to institutional investors in the King Report. As a result of the consultation, the King Commission decided to produce a separate code directed at institutional investors. This is a similar approach to the one adopted in the UK, as the Stewardship Code was produced alongside the Corporate Governance Code (Mallin 2012). Furthermore, in the launching event of CRISA, the Financial Services Board (FSB) announced in that, even though the FSB prefer the voluntary approach to Responsible Investment via CRISA, if institutional investors choose to ignore the Code, mandatory measures may follow. This assertion demonstrates that currently the Financial Services Board (FSB) have decided to rely on the voluntary adoption of CRISA's guidelines to improve corporate governance in the investment

industry instead of making them mandatory. This governmental approach is also reported in the literature. Streeck and Schmitter (1985 cited in Campbell 2007: 510) argue that self-regulation is sometimes “encouraged and authorized by the state so that the state can displace on to these private associations what would otherwise be its own regulatory responsibilities”. Hence, corroborating the literature, the South African government has decided, at this point in time, to transfer regulatory responsibilities to the private sector by endorsing CRISA in a public event.

An additional initiative in South Africa which the interviewees believe will encourage shareholder engagement directly and indirectly is the Sustainable Returns Project. The interviewees indicated that, through the Sustainable Returns Project, the pension fund industry wishes to define their own approach to how they are going to comply with Regulation 28 rather than expecting the government to define how they would prefer the pension funds to comply with the regulation. As claimed by Interviewee SANI-4, “we don’t want the Treasury and we don’t want FSB three years down the line to take out the carrot and stick approach and say ‘we’ve given you the opportunity, you haven’t applied or explained, we are now going to be prescribing’. The literature demonstrates that, similar to the approach adopted in the Sustainable Returns Project, industry associations usually establish their own regulatory mechanisms to avoid eventual state regulatory intervention. They believe that it is wiser to control the regulatory process themselves than to be forced to succumb to a process over which they would have little control (Kolko 1963; Schneiberg 1999 cited in Campbell 2007; Streeck and Schmitter 1985 cited in Campbell 2007; Weinstein 1968 cited in Campbell 2007; Prakash 2000 cited in Arya and Bassi 2011). Corroborating the literature, the interviewees reported that the South African pension fund industry created the Sustainable Returns Project in large part to comply with Regulation 28. They did this by developing their own guidelines with an enabling approach instead of expecting further regulation from the government and a prescriptive approach on how pension funds should comply with Regulation 28.

Furthermore, the engagement of the PRI South Africa Network with the Takeover Regulation Panel was also mentioned by a number of interviewees as encouraging shareholder engagement indirectly by clarifying the legislation on “acting in concert” issues. The PRI has been discussing with the Panel in order to make the legal requirements clear with regard to how investors can engage in collaboration with other

investors and avoid being deemed to be acting in concert. The literature shows that the experience of an emerging market such as South Africa is not unlike those of developed countries. Other players worldwide are engaging with state regulators to clarify ‘acting in concert’ regulatory concerns in relation to collaborating with other investors. For example, the UK pension fund Hermes, with a number of other investors, initiated an engagement with national and European legislators and regulators (e.g. AMF in France, CONSOB in Italy, CNMV in Spain) on the subject of ‘acting in concert’ so that regulators explicitly state how investors can share information or discuss their view on ESG issues provided they are not aiming to gain control of a company. As mentioned under Proposition 1, the 2009 UK Walker Review and the 2009 Green Paper of the European Commission both acknowledged the need for clear rules so that acting in concert does not hinder effective shareholder cooperation (EU 2009; Walker 2009).

The research findings demonstrate that there is a close relationship between legislation and the work of investor associations in Brazil and South Africa. This research identified at least five instances of active behaviour of private sector associations with regards to government legislation, demonstrating the willingness of the private sector in emerging markets to pre-empt and influence legislative initiatives related to shareholder engagement on ESG issues.

The first example of link between legislation and investor association initiatives is the participation of ASISA in the amendment of the preamble of Regulation 28 in South Africa. The interviewees reported that the South African Treasury requested that ASISA’s RI Standing Committee assist in developing the amendment. As a result of the consultation, the exact wording proposed by the Committee was incorporated in the regulation. Fashoyin (2004) argues that social dialogue between the government and other stakeholders on issues of common interest, such as consultation on proposed government policies, permits key stakeholders to convey their concerns and to have their views incorporated in the formulation or alteration of policies. In South Africa, Arya and Bassi (2011) noticed that the government has been actively involved in consultative processes with industry members to develop industry-specific charters. They cited the example of the Mining Sector Charter on which the government opened negotiation with diverse stakeholders to specify standards for racially equitable behaviour. Fashoyin (2004) acknowledges that social dialogue is particularly important in developing countries as it contributes to further democracy and good governance.

The consultation by the South African government with ASISA is possibly another effort of the industry to improve democratic processes and to listen to the concerns of the industry.

The second example of the link between legislation and the work of investor associations concerns the Sustainable Returns Project in South Africa. As mentioned above, the interviewees indicated that, through the Project, the pension fund industry aims to determine how to comply with Regulation 28 rather than expecting further mandatory rules by the government. The research findings corroborate the literature which indicates that industry associations develop their own mechanisms to avoid eventual future legislation so as to control the regulatory process themselves (Kolko 1963 cited in Campbell 2007; Schneiberg 1999 cited in Campbell 2007; Streeck and Schmitter 1985 cited in Campbell 2007; Weinstein 1968 cited in Campbell 2007; Prakash 2000 cited in Arya and Bassi 2011). Hence, supporting the literature, the pension fund industry decided to develop its own approach to comply with Regulation 28 in order to avoid future regulation.

The third relationship between legislation and the work of investor associations refers to CRISA and the potential mandatory nature of its guidelines. As mentioned above, South Africa's Financial Services Board (FSB) stated that they support the voluntary nature of CRISA's principles, corroborating the literature which indicates that self-regulation is sometimes encouraged by the state to displace their regulatory responsibilities to private associations (Streeck and Schmitter 1985 cited in Campbell 2007). Moreover, the FSB asserted that mandatory measures may follow if CRISA is not adopted by the members of the industry on a voluntary basis. A similar approach with regard to voting was adopted by the British government. Even though the UK government prefers that institutional investors increase levels of voting across their investee companies, if it does not happen, the government may make voting mandatory (Mallin 2012). Likewise, in South Africa, there is a possibility that CRISA's guidelines become mandatory in the future if there is not enough observance to the Code while it is voluntary.

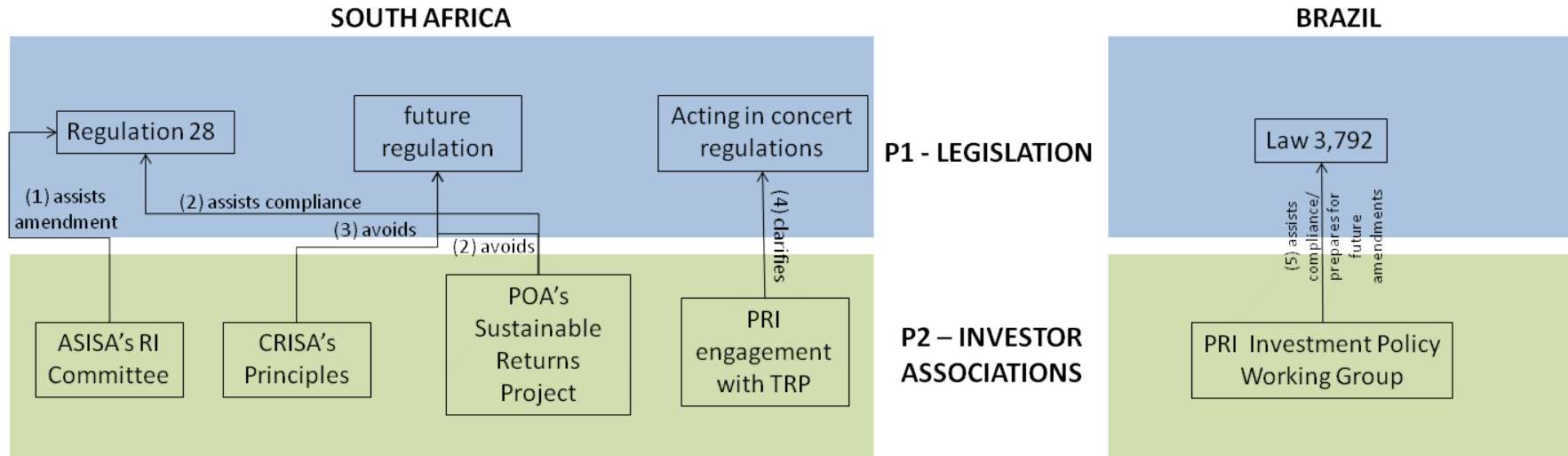
The fourth example of link between legislation and the work of investor associations is the engagement of the South African PRI Engagement Group with the Takeover Regulation Panel. In this case, the work of this investor association in relation to legislation was not about assisting members to comply with current regulations or to

avoid further legislation, but was concerned with clarifying the legal requirements on how investors can engage in collaboration with other investors. As mentioned previously, there are investors in South Africa that are reluctant to engage with others because of the potential risk of being deemed to be acting in concert. The PRI Group expects that the document they produced with the Takeover Regulation Panel will clarify the instances when investors will and will not be considered to be acting in concert and, as a result, will encourage investors to engage in collaboration in the near future.

Finally, the fifth relationship between legislation and the work of investor associations refers to the work of the Brazilian PRI Investment Policy Working Group helping pension fund signatories to comply with Law 3792. As mentioned under Proposition 1, the interviewees reported that the PRI signatories understood the issuance of the regulation as a sign that the inclusion of social and environmental issues in the investment decisions of the pension funds would become mandatory in the future. Therefore, the PRI Group was created not only with the goal of helping pension funds to comply with existing legislation and to develop their investment policies according to the law, but also to discuss how pension funds can effectively incorporate social and environmental issues in their investment processes, preparing for eventual legal requirements.

The different relationships between legislation and investor association initiatives in Brazil and South Africa are illustrated in the figure below:

**Figure 5.1 – Relationship between legislation and investor association initiatives in South Africa and Brazil**



The figure shows that investor association initiatives have been closely related to legal frameworks, assisting their members to comply with and understand current legislation and to avoid or comply with future regulations, and assisting the government to amend legislation. These initiatives are strong indicators that investor associations encourage Responsible Investment and shareholder engagement in Brazil and South Africa.

Overall, Proposition 2 is strongly supported.

### 5.1.3. Proposition 3 – Influence of clients

**Proposition 3: Investors’ clients do not encourage investors to engage with companies.**

#### Partial support

As shown in Chapter 1, the literature review suggests that investors’ clients do not encourage investors to engage with companies on their behalf: beneficiaries do not encourage pension funds to engage with companies (e.g. Richardson 2008; Thamotheram and Wildsmith 2007; Clark and Hebb 2004) and pension funds do not encourage their asset managers to engage with companies (Tilba and McNulty 2013; Monks and Sykes 2006; Richardson 2008). The interviewees from Brazil and South Africa were asked whether they believe that investors’ clients encourage engagement. Both the relationship between pension fund beneficiaries (clients) and pension funds (suppliers), and the relationship between pension funds (clients) and their asset managers (suppliers) were examined. The results are shown in the table below:

**Table 5.5 – Interviewees’ perceptions on the influence of investor clients’ pressure on investors for shareholder engagement**

Interviewees claimed that:	South Africa		Brazil	
	n	%	n	%
<b>BENEFICIARY-PENSION FUND RELATIONSHIP</b>				
<b>Beneficiaries encourage pension funds</b>	<b>2</b>	<b>8%</b>	<b>2</b>	<b>10%</b>



<b>Interviewees claimed that:</b>	<b>South Africa</b>		<b>Brazil</b>	
<b>to engage</b>				
Directly only	0	0	0	0
Indirectly only	2	8%	2	10%
<b>Beneficiaries do not encourage pension funds to engage</b>	<b>12</b>	<b>50%</b>	<b>5</b>	<b>25%</b>
<b>PENSION FUND –ASSET MANAGER RELATIONSHIP</b>				
<b>Pension funds encourage asset managers to engage</b>	<b>18</b>	<b>75%</b>	<b>7</b>	<b>35%</b>
Directly only	1	4%	1	5%
Indirectly only	16	67%	6	30%
Directly and indirectly	1	4%	0	0
<b>Pension funds do not encourage asset managers to engage</b>	<b>1</b>	<b>4%</b>	<b>0</b>	<b>0</b>
<b>Did not respond, did not have an opinion or were not asked the question (when they were not actively involved with the investment community)</b>	<b>3</b>	<b>12%</b>	<b>6</b>	<b>30%</b>
<b>TOTAL<sup>26</sup></b>	<b>24</b>	<b>100%</b>	<b>20</b>	<b>100%</b>

In terms of the relationship between pension funds and beneficiaries, a majority (50%) of the South African interviewees (or 67% of the South African pension funds interviewed) and 25% of the Brazilian interviewees (or 50% of the Brazilian pension funds interviewed) believe that pension fund beneficiaries do not encourage their pension funds to adopt Responsible Investment practices or to engage with investee companies on ESG issues. A minority (8%) of the South African and 10% of the Brazilian interviewees believe that beneficiaries offer some incentive for their funds to adopt responsible practices. Hence, the interview findings corroborate the literature which suggests that beneficiaries do not put pressure on pension funds.

As far as the relationship between pension funds and asset managers is concerned, a majority (75%) of the South African interviewees (or 78% of all South African asset managers interviewed) and 35% of the Brazilian respondents (or 86% of all Brazilian asset managers interviewed) believe that pension funds encourage their asset managers to engage with companies directly and indirectly. Four per cent of the South African respondents argued that

<sup>26</sup> Total value is over 100% because some interviewees were categorised into more than one alternative

pension funds do not encourage their asset managers to engage with companies. In this case, the interview findings are not consistent with the literature, which suggests that pension funds do not incentivise their asset managers to engage.

Considering that the interview results provide support for the literature review of the beneficiary-pension fund relationship, but not for the pension fund-asset manager relationship, the proposition is partially supported.

The interviews were also used to investigate the reasons for the interviewees' responses, as discussed below.

### 5.1.3.1. Beneficiaries do not encourage pension funds to engage

As shown in the table above, a majority (50%) of the South African interviewees (including 67% of the South African pension funds interviewed) and 25% of the Brazilian interviewees (including 50% of the Brazilian pension funds interviewed) believe that funds' beneficiaries do not encourage their pension funds to engage with companies. The main reasons are found in table 5.6:

**Table 5.6 – Interviewees' reasons for why beneficiaries do not encourage pension funds to engage**

Interviewees claimed:	South Africa		Brazil	
	N	%	n	%
<b>No pressure</b>				
i. Lack of investment understanding of beneficiaries	4	17%	0	0
ii. Lack of sense of fund ownership by the beneficiaries	3	12%	0	0
iii. Other reasons				
Perception of future benefits	0	0	1	5%
Perception of guaranteed pension	0	0	1	5%
Lack of business case	1	4%	1	5%

Interviewees claimed:	South Africa		Brazil	
iv. No reason or other reason given	5	12%	2	10%

These arguments will be discussed below.

**i. Lack of investment understanding of beneficiaries**

Four South African interviewees (17%) argued that beneficiaries do not encourage their pension funds to engage because of their low level of investment understanding. Interviewee SANI-1 claimed that most pension fund beneficiaries do not know how their money is being invested. Similarly, Interviewee SANI-10 contended that the average contributor has no understanding of the mechanics of the pension fund. The interviewees also argued that beneficiaries do not have knowledge of Responsible Investment. Interviewee SAI-7 claimed that the average pension is not sophisticated enough to understand ESG issues, while Interviewee SANI-1 posited that beneficiaries do not exert influence on pension funds over Responsible Investment. Interviewee SANI-2 suggested that there is need for more education of the ultimate beneficiaries on Responsible Investment because there is a perception that Responsible Investment is synonymous with sacrificing financial returns.

Interviewees SAI-2 and SANI-10 argued that beneficiaries, especially those approaching the retirement age, would ask questions from a financial returns perspective, such as whether their money is safe, whether they will be able to retire and live with their pension in the long term, how wealthy or un-wealthy they are going to be when they retire, and so forth. However, they would not ask questions on ESG issues. Interviewees SANI-6 and SANI-10 claimed that it is only a small fraction of the beneficiaries who are interested to engage with their trustees around Responsible Investment. Interviewee SANI-10 pointed out that one exception includes Muslim beneficiaries who have specific religious investment constraints. Interviewee SAI-12 also indicated that beneficiaries from pension funds of mining companies are interested to understand how their pension money is being invested. She argued that, given the nature of the industry in which they work and the fact that they are members of the community, these beneficiaries wish to find ways to use their investments to impact the communities positively.

The statements above suggest that, in general, South African beneficiaries have low level of understanding of investment and Responsible investment, leading them not to exert pressure on their pension funds on these issues.

## **ii. Lack of sense of fund ownership by the beneficiaries**

Three South African interviewees (12%) claimed that pension fund beneficiaries do not encourage pension funds to engage because beneficiaries do not feel ownership towards their pension savings. Interviewee SANI-6 argued that most of the beneficiaries do not engage in dialogue with the boards of trustees of pension funds as they often overlook the fact that they are being provided a service and, as such, that they can engage with the board of trustees in order to ensure that their retirement savings are being well-managed. Similarly, Interviewee SANI-9 contended that beneficiaries do not have a sense that they own these funds, while Interviewee SAI-1 noted that beneficiaries are not fully aware of what they could potentially be doing through their pooled savings.

The statements above indicate that the beneficiaries do not feel that they own their funds, leading them not to influence their pension funds to adopt Responsible Investment practices and engage with companies on ESG issues.

## **iii. Other reasons**

A number of other reasons were cited by the interviewees why they believe that beneficiaries do not encourage engagement. As each reason was cited only once or twice, they are aggregated in this section.

First, Brazilian Interviewee BRI-6 noticed that the interest of the beneficiaries in Responsible Investment is low, especially of the active participants as they have a perception that they are contracting a benefit that will take effect in a too distant future (in 30 to 35 years) to be concerned. On a related issue, Brazilian Interviewee BRNI-5 commented that beneficiaries do not worry about pension investments because they have a perception that pension funds

offer them a guarantee that they will receive a reasonable amount of money when they retire – provided the pension fund does not go bankrupt.

Third, Brazilian Interviewee Z (not identified for confidentiality purposes) and South African Interviewee SANI-2 argued that beneficiaries are sceptical about the business case for Responsible Investment. Interviewee Z explained that the PRI Brazil Network has been assisting newly signed pension funds to communicate to their beneficiaries what Responsible Investment is and what the PRI represents, because a number of PRI pension fund signatories observed that they have received complaints from their beneficiaries for becoming PRI signatories and adopting Responsible Investment practices. Some beneficiaries have a preconception that Responsible Investment leads to lower returns. Hence, Interviewee Z argued that it is necessary to raise awareness of the beneficiaries of the benefits of Responsible Investment. Similarly, Interviewee SANI-2 noticed that there is need for more education considering that there is a perception that Responsible Investment is synonymous with sacrificing financial returns.

In sum, perception of benefits in a distant future, a feeling of guaranteed pension returns and lack of perception of the business case of Responsible Investment were cited as other reasons for why beneficiaries do not incentivise pension funds.

#### **5.1.3.2. Pension funds encourage asset managers to engage**

As for the relationship between pension funds and asset managers, a majority (75%) of the South African interviewees (or 78% of all South African asset managers interviewed) and 35% of the Brazilian respondents (or 86% of all Brazilian asset managers interviewed) claimed that pension funds encourage their asset managers to engage with companies either directly or indirectly. While 8% of South African and 5% of the Brazilian interviewees argued that pension funds encourage their asset managers to engage directly, 67% of the South African and 30% of the Brazilian interviewees reported that pension funds encourage asset managers to engage indirectly and 4% of the South African interviewees claimed that pension funds encourage asset managers both directly and indirectly. The reasons given by the interviewees are shown in Table 5.7:

**Table 5.7 – Interviewees’ reasons for why pension funds encourage asset managers to engage**

Interviewees claimed:	South Africa		Brazil	
	N	%	n	%
<b>Direct positive impact</b>				
i. Outsource engagement activities	2	8%	1	5%
<b>Indirect positive impact</b>				
ii. More questions from pension funds	7	29%	4	20%
iii. Influence of the PRI pension fund signatories on asset managers	10	42%	1	5%
iv. No reason or other reason given	5	21%	1	5%

These arguments will be discussed below.

#### **5.1.3.2.1. Pension funds encourage asset managers to engage directly**

##### **i. Outsource engagement activities**

Two South African (8%) and one Brazil interviewee (5%) argued that pension funds encourage asset managers to engage through outsourcing engagement activities or through hiring asset managers that offer this type of service as part of their investment approach.

In South Africa, Interviewee SANI-1 contended that pension funds outsource engagement to asset managers because pension funds do not have the technical understanding of investment or the expertise to engage with companies. Interviewee SAI-1 also claimed that pension funds outsource their investment capabilities, including engagement work, to their service providers due to lack of resources and lack of knowledge. Interviewee SAI-1 posited that, except for the larger pension funds, most pension funds do not employ many staff who would be able to conduct engagement activities. Also, Interviewee SAI-1 claimed that many of the pension fund employee trustees, appointed to represent employees, are not investment professionals

and may not have university education, and therefore lack investment understanding. The background of trustees will be further discussed under Proposition 5.

In Brazil, Asset Manager X (not identified for confidentiality purposes) asserted that their clients, mainly asset owners, expect them to engage with companies. Renowned for an activist approach on corporate governance issues, Asset Manager X claimed that their clients demand an activist approach because this is the main reason as to why they were selected as asset managers by the pension funds. Asset Manager X explained that they adopt a value investing approach, focusing on investing in companies whose equities are undervalued in relation to what Asset Manager X believes to be their inherent value. Asset Manager X then strives to improve the asset value of the investee companies by appointing representatives onto the companies' Boards of Directors and Fiscal Councils and improving corporate practices as an insider. Asset Manager X illustrated the level of pressure their clients exert, observing that, when Asset Manager X invests in large companies in which their share ownership is not significant, their clients question how they plan to have an activist approach as minority shareholders with low voting power and low capacity to appoint representatives for Boards and their Committees.

Hence, the statement demonstrates that the interviewees perceive direct pressure from their clients to engage with companies either through outsourcing engagement activities or hiring asset managers that offer this type of service in their investment approach.

#### **5.1.3.2.2. Pension funds encourage asset managers to engage indirectly**

Two main reasons were mentioned as to why pension funds are offering indirect incentives for asset managers to engage: 29% of the South African and 20% of the Brazilian interviewees argued that asset managers have started receiving more questions on Responsible Investment from pension funds, while 42% of the South African and 5% of the Brazilian respondents claimed that this is a consequence of the PRI pension fund signatories putting pressure on their asset managers about Responsible Investment issues. These arguments will be discussed below.

## ii. More questioning from pension funds to service providers

Seven South African (29%) and four Brazilian interviewees (20%) argued that asset managers have started receiving more questions on Responsible Investment from pension funds.

In South Africa, as discussed under Propositions 1 and 2, five interviewees (21%), representing 56% of all asset managers interviewed, noted that Regulation 28 and CRISA have encouraged pension funds to start questioning their clients and consultants about their Responsible Investment practices. They noticed that there has been an increase in the number of questions that they receive from asset consultancies, questions in requests for proposals (RFPs) on how they apply Regulation 28 and questionnaires from asset owners inquiring how they apply both Regulation 28 and CRISA to their investment processes. In addition, Asset Consultant A (not identified for confidentiality purposes) mentioned that their clients request that they conduct due diligence on asset managers on their behalf to evaluate whether asset managers are endorsing CRISA and implementing its principles. Similarly, Pension Fund W (not identified for confidentiality purposes) stated that they specifically question asset managers on ESG issues when they conduct due diligence and appoint asset managers.

However, as discussed under Proposition 1, three interviewees claimed that the level of questioning has been superficial, while four interviewees argued that this questioning has not been translated into changes in the mandates. Interviewees SAI-6 and SAI-7 alleged that they have not yet seen any asset owners integrating ESG issues into their mandates. Similarly, Interviewees SAI-4 and SAI-5 contended that pension funds have not yet changed their mandates to request that their service providers vote or engage on their behalf on ESG issues. Interviewee SAI-1 argued that this is because pension funds are still in the process of updating policies related to Responsible Investment before they task service providers to perform these duties on their behalf.

In Brazil, four asset managers also argued that pension funds are inquiring about the practices of their asset managers. Asset Manager X (not identified for confidentiality purposes) noted that such questioning by pension funds is fairly recent, having started in the beginning of 2012. Asset Managers X and Y noticed that their clients are not yet putting pressure on them to incorporate ESG issues, but they are interested to understand how they analyse and/or select investee companies based on ESG issues. Similarly, Asset Manager Z claimed that



pension funds wish to be informed about their ESG methodology, how companies' performance is monitored, which companies were approved/reproved for investment and why, and so forth. Asset Manager Q mentioned that they have received due diligence questionnaires from some pension funds asking Responsible Investment questions, even though the level of questioning is as yet superficial. Two of the interviewees argued that the increase in questioning has been largely driven by the PRI signatories.

The statements suggest that there is an increase in the number of questions from pension funds towards their asset managers in both countries on how the latter is applying ESG issues into their investment processes, driven by Regulation 28 and CRISA in South Africa and by the PRI in Brazil. However, asset managers do not yet perceive that there is direct pressure to include ESG issues because mandates have not been revised.

### **iii. Influence of the PRI pension fund signatories on asset managers**

Ten South African interviewees (42%) and one Brazilian respondent (5%) claimed that some pension funds are encouraging their asset managers to discuss/adopt Responsible Investment as a consequence of these pension funds being PRI signatories.

In South Africa, ten interviewees (42%) argued that the Government Employees Pension Fund (GEPF) has been a significant driver to encourage asset managers to start discussing Responsible Investment. Nine interviewees contended that a large number of South African asset managers signed to the PRI because of GEPF's tender requirements. As mentioned in Chapters 2 and 3, Interviewee SAI-4 explained that when the Public Investment Corporation, GEPF's main asset manager, invited tenders to manage GEPF's US\$ 12 billion in assets in 2007, one of the questions for qualification was whether the asset manager had signed up to the PRI. Interviewee SAI-7 pointed that a large number of asset managers became PRI signatories soon after the announcement. Interviewee SAI-4 indicated that this is the reason why there are a disproportionate number of asset managers in relation to asset owners in the South African PRI signatory list. However, as suggested by Interviewee SAI-5, the decision to become PRI signatories for most of the asset managers has been "more in principle than in practice". She posited that:

*“...it dragged the asset management industry into the space quite sort of almost reluctantly. There were lots of people who signed up to the PRI and they didn’t really know what they were doing. They just signed because they knew if they didn’t sign it, they couldn’t put their tenders into the GEPF.”*  
(Interviewee SAI-5)

Interviewees SAI-7 and SANI-1 emphasised that, even though the GEPF was the only pension fund that required their asset managers to become PRI signatories and to abide by the PRI Principles, the fact that the GEPF is the largest South African pension fund represents a powerful driver to asset managers. Interviewee SAI-7 suggested that it is easy to drive Responsible Investment when the demand comes from the asset owners. As the asset management industry is highly competitive, Interviewees SAI-7 argued that:

*“There will be very little kick-back from our industry because our industry is extremely competitive, the asset management industry. So if it moves away from one asset manager, there will definitely be another asset manager who will take on that mandate if it becomes a 5-year turnover clause or an ESG clause or anything like it.”* (Interviewee SAI-7)

Interviewees SAI-7 claimed that, if one pension fund decides to include ESG issues in their mandates and the current asset manager decides not to comply with the requirements, there will certainly be another asset manager interested in obtaining the mandate and complying with the new conditions, given the competitive nature of the asset management industry.

In Brazil, Interviewee M (not identified for confidentiality purposes) observed a trend in the evolution of the PRI signatories, similar to that which occurred in South Africa. Interviewee M explained that in 2006, there was a collective adherence to the PRI principles by approximately ten to twelve pension funds. After this collective endorsement, a large number of asset managers followed and became PRI signatories as well. She argued that this trend, in which asset managers follow their clients, occurs worldwide in terms of PRI membership. Interviewee M added that, as the majority of pension funds in Brazil manage their assets externally, once they become PRI signatories, their duty to comply with the PRI principles relies on putting pressure on their asset managers to incorporate ESG issues, leading these asset managers to be interested to learn about Responsible Investment.

Nonetheless, Interviewee M noticed that there is an incoherence between what pension funds request and how they evaluate their asset managers.

*“Pension funds ask their asset managers to become signatories, to have Responsible Investment practices, etc. But in the manager selection, they check the asset managers’ ranking of six months, one year, and the guy who did not perform as much as he should have in the last year is cut from the list.” (Interviewee M)*

She explained that some pension funds request their asset managers to become PRI signatories and to adopt Responsible Investment practices. However, when they select their asset managers, they evaluate asset managers according to short-term financial performance instead. Equally, Interviewee BRNI-5 observed that pension funds threaten to end or to not renew the contracts of their asset managers when asset managers are underperforming in relation to their peers.

The statements above suggest that PRI pension fund signatories are important drivers for asset managers to incorporate Responsible Investment practices. By encouraging them to become PRI signatories and to commit to the PRI principles, pension funds are indirectly incentivising asset managers to engage with companies. However, it has been highlighted that, in Brazil, this practice has not yet been incorporated into the process of selecting and evaluating asset managers.

### **5.1.3.3. Other considerations**

In South Africa, a number of interviewees acknowledged that part of the asset management industry has been proactive in terms of incorporating ESG issues. Five South African interviewees claimed that although there is limited actual pressure from pension funds on asset managers, there are a number of asset managers in South Africa that are adopting Responsible Investment proactively. Interviewee SANI-3 noticed that, even though asset managers are constrained by their mandates to incorporate ESG issues, some of them decided to take ownership and to approach their clients with the intention to include ESG issues into

their investment processes. As put by Interviewee SANI-10, “the tail has been wagging the dog rather than the dog wagging the tail in the South African context”. Interviewee SAI-8 claimed that this is especially important for asset managers who are PRI signatories and who have committed to the PRI Principles. In addition, Interviewee SAI-7 argued that there are a number of asset managers who have decided to incorporate ESG issues because they have endorsed CRISA and because they believe that there might be valuation attributes in including ESG issues. Interviewee SAI-8 commented that some asset managers, observing the requirements of Regulation 28 for pension funds, wish to be prepared for future demands of their clients.

In summary, the interviewees acknowledged that, although there is limited actual pressure from pension funds in South Africa, some players in the asset management industry have been proactive to adopt Responsible Investment practices and to engage with companies.

#### **5.1.3.4. Discussion**

The interview findings provide partial support to the proposition that investors’ clients do not encourage investors to engage with companies.

In terms of the relationship between pension funds and beneficiaries, the interview findings provide support to the proposition. The interview results demonstrate that a majority (50%) of the South African interviewees (representing 67% of the South African pension funds interviewed) and 25% of the Brazilian interviewees (representing 50% of the Brazilian pension funds interviewed) believe that pension fund beneficiaries do not encourage their pension funds to adopt Responsible Investment practices or to engage with investee companies on ESG issues. Thus, the interview findings corroborate the literature which suggests that beneficiaries are far removed from the investment decisions that occur on their behalf (Thamotheram and Wildsmith 2007). Further, even though they are often referred to, they are rarely seen in the world of pension fund management (Clark and Hebb 2004). Similarly, the interviewees argued that the beneficiaries in Brazil and South Africa are fairly removed from the pension fund investment process. In Brazil, there is no interest from beneficiaries in understanding how their money is being managed by the pension fund or how they are applying ESG considerations to their investments. Equally, in South Africa, pension

fund beneficiaries are not concerned about Responsible Investment largely because they do not have understanding of investment and ESG issues and because they do not feel a sense of ownership towards the funds to which they contribute. Moreover, the interviewees mentioned that beneficiaries are sceptical about the financial returns of Responsible Investment, concern which is not unfounded considering that the literature has not reached a verdict as to whether the incorporation of ESG issues improves financial performance. Academic studies reported positive (e.g. Abramson and Chung 2000; Orlitzky et al. 2003; Shank et al. 2005) neutral (e.g. Bauer et al. 2006; Bello 2005; Benson et al. 2006) and negative relationships (Chong et al. 2006; Hong and Kacperczyk 2009). Therefore, uncertainty over the financial impact of Responsible Investment is a justifiable concern.

As far as the relationship between pension funds and their asset managers is concerned, the interview findings do not provide support to the proposition: a majority of 75% of the South African interviewees (including 78% of all South African asset managers interviewed) and 35% of the Brazilian respondents (including 86% of all Brazilian asset managers interviewed) believe that pension funds offer some incentive for asset managers to adopt Responsible Investment practices and, to a lesser extent, to engage with companies. This occurs through pension funds outsourcing their engagement capabilities, questioning their service providers on their Responsible Investment practices and, as PRI signatories, encouraging asset managers to become signatories and to be involved in Responsible Investment practices. The interviewees argued that pension funds are encouraging asset managers to adopt Responsible Investment and engagement practices in South Africa driven by the lack of knowledge, financial resources and of staff in pension funds (this issue is further discussed under Propositions 4 and 5) and encouragement from Regulation 28, CRISA and the PRI. In Brazil, the interviewees reported that pension funds are encouraging asset managers to adopt Responsible Investment practices, driven by a lack of financial resources and of staff of pension funds, and encouragement from the PRI.

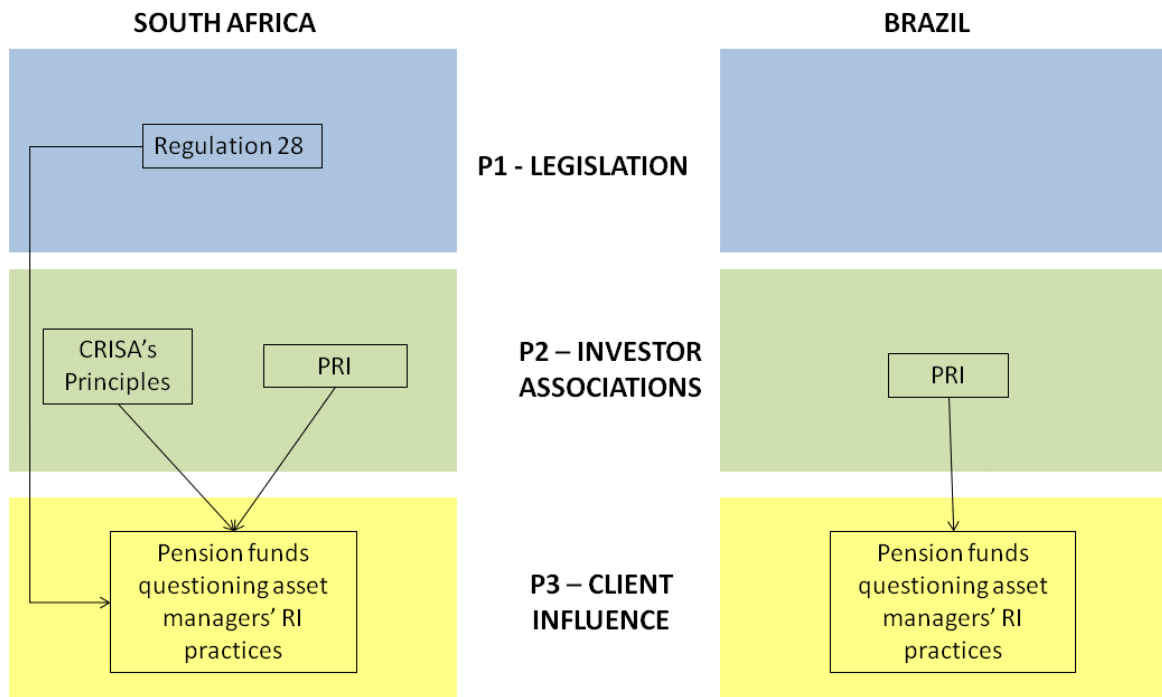
The research findings stand in contrast with the literature which found that pension fund trustees, in delegating investment responsibilities to fund managers, reinforce short-term incentives by evaluating fund managers on a quarterly basis, inhibiting long-term investing (Tilba and McNulty 2013; Waygood 2011; Richardson 2008) and, as it follows, long-term strategies as it is the case of shareholder engagement.

One of the main reasons for why the research findings contradict the literature is to do with the structure of the investment industry in South Africa, dominated by the Government Employees Pension Fund (GEPF). As discussed above, an overwhelming proportion of 42% of South African interviewees argued that the GEPF has been a significant driver to encourage asset managers to speak about Responsible Investment. As discussed earlier, this is because, in 2007, the GEPF included in the tender requirements for asset managers the need to be a PRI signatory. As a result, there was a flow of asset managers who joined the initiative. The power of the GEPF in the asset investment industry lies in its size: the pension fund is the largest pension fund in South Africa and in the whole of Africa. At the same time, the interviewees reported that the South African asset management industry is fairly competitive, further increasing the power of the pension funds. Even if pension funds make their tender requirements more demanding, they are likely to find asset managers in the market willing to comply with the stricter mandates.

Secondly, as discussed under Propositions 1 and 2, Brazil and South Africa have country-specific legal and voluntary guidelines in place that encourage pension funds to consider Responsible Investment issues. In South Africa, the interviewees reported that Regulation 28, CRISA and the PRI are incentivising pension funds to incorporate ESG issues in their investment processes. However, due to limited resources available to pension funds and a limited investment understanding of pension fund trustees, pension funds transfer these RI responsibilities to their asset managers. Nonetheless, as discussed earlier, this has been transferred through pension funds demonstrating interest about the RI practices of asset managers (in questionnaires, questions in requests for proposals and due diligence), but not through effective changes in the mandates (with the exception of GEPF and their tender requirements). Likewise, in Brazil, the PRI is encouraging pension fund signatories to adopt RI practices. However, due to the size of most Brazilian pension funds, they are, at this stage, transferring these responsibilities to asset managers by questioning their RI practices. As is the case in South Africa, such questioning has not yet been translated into effective pressure in the mandates.

The influence of mandatory and voluntary regulations on pension fund demand is illustrated in the figure below:

**Figure 5.2 - Mandatory and voluntary regulations influencing client demand in South Africa and Brazil**



Overall, the proposition is partially supported. While the findings corroborate the literature that beneficiaries do not encourage pension funds to adopt Responsible Investment practices and engage with companies, the findings contradict the literature as pension funds are encouraging their asset managers to adopt Responsible Investment.

#### 5.1.4. Proposition 4 – impact of investor size

**Proposition 4 – Larger investors are more likely to engage with companies than are smaller investors**

**Supported**

As shown in the literature review (Chapter 1) and confirmed by the statistical findings (Chapter 4), larger investors are more likely to engage with companies on ESG issues than smaller investors in Brazil and South Africa. Bearing in mind that the sample used in the

statistical data analysis does not represent the whole Brazilian and South African investment community, the interviewees from these two countries were asked whether they agree with the statement. The results show that there is an overwhelming support for Proposition 4, as seen in the table below:

**Table 5.8 – Interviewees’ perceptions on the relationship between size and engagement behaviour**

Interviewees claimed that:	South Africa		Brazil	
	n	%	n	%
<b>Larger investors engage more than smaller ones (i + ii + iii + iv)</b>	<b>16</b>	<b>67%</b>	<b>12</b>	<b>60%</b>
i. Larger investors engage more than smaller ones in general	11	46%	4	20%
ii. Larger pension funds engage more than smaller funds (only referred to pension funds)	1	4%	2	10%
iii. Larger asset managers engage more than smaller asset managers (only referred to asset managers)	0	0	1	5%
iv. The link applies to pension funds, but not to asset managers	4	17%	5	25%
<b>Larger investors do not engage more than smaller investors (v + vi)</b>	<b>2</b>	<b>8%</b>	<b>3</b>	<b>15%</b>
v. Larger investors do not engage more than smaller investors in general	0	0	1	5%
vi. Larger asset managers do not engage more than smaller asset managers (only referred to asset managers)	2	8%	2	10%
<b>Did not respond, did not have an opinion or were not asked the question (when they were not actively involved with the investment community)</b>	<b>6</b>	<b>25%</b>	<b>5</b>	<b>25%</b>
<b>TOTAL</b>	<b>24</b>	<b>100%</b>	<b>20</b>	<b>100%</b>



As shown in Table 5.8, 67% of the South African and 60% of the Brazilian interviewees believe that larger investors engage more with investee companies on ESG issues than smaller investors. Forty-six per cent of South African and 20% of Brazilian interviewees claimed that larger investors engage more than smaller investors. Twenty-one percent of South African and 35% of Brazilian interviewees (ii + iv) argued that larger pension funds engage more than smaller funds and 5% of Brazilian interviewees contended that larger asset managers engage more than smaller ones. The interview findings are consistent with the literature review and the statistical data analysis. Hence, the proposition is supported.

The interviews were also used to investigate the reasons for why larger investors engage more than smaller ones. The arguments are shown below.

#### 5.1.4.1. Reasons for why larger investors engage more than smaller ones

As demonstrated in Table 5.9, the reasons given by the interviewees why larger investors engage more than smaller ones are threefold: availability of resources, potential to influence investee companies through significant shareholdings and asset allocation.

**Table 5.9 – Interviewees’ reasons for positive relationship between size and engagement behaviour**

Interviewees claimed:	South Africa		Brazil	
	n	%	n	%
i. Availability of resources of larger investors	6	25%	8	40%
ii. Potential influence of significant investors on companies	4	17%	4	20%
iii. Proportional investment in equities	0	0	1	5%
iv. No reason or other reason given	8	34%	2	10%

These arguments will be explored below.

## i. Availability of resources

Six South African (25%) and eight Brazilian interviewees (40%) contended that larger investors engage more than smaller ones due to availability of financial resources and staff.

In South Africa, Interviewee SAI-2 posited that:

*“...those larger investors would tend to have more resources or more people concentrated in looking at the portfolios and therefore they would have more time to do that. Smaller guys have to contend with cost and everything else and capacity. And therefore would tend to be less involved and less engaged.”* (Interviewee SAI-2)

Interviewee SAI-2 argued that larger investors have more financial resources and employees to engage with companies. Similarly, Interviewee SANI-11 stated that larger investors have more capacity and money to research and to analyse ESG risks, which are necessary for the engagement process. On the other hand, Interviewee SAI-2 posited that smaller investors have less capacity for engagement activities. To illustrate Interviewee SAI-2’s account, Asset Manager X (not identified for confidentiality purposes) claimed that, as a small investor, they do not have the “manpower or the finance” to engage with companies. Hence, these investors believe that the availability of finance and staff gives larger investors the ability to engage.

On the pension fund side, four out of the five South African interviewees that suggested that larger pension funds engage more than smaller funds (ii + iv of Table 5.8) also claimed availability of resources as a reason to engage. As posited by Interviewee SAI-1:

*“On the pension fund side, I think the trend is that the larger pension funds are the ones that have got the most resources available to be active owners and to engage with investee companies.”*  
*“...generally size does matter and size does allow the pension funds to have people working in the pension funds looking into the issues.”* (Interviewee SAI-1)

Interviewee SAI-1 noticed that size is an important factor in determining whether investors hold engagement activities because large investors have the available staff to engage with

companies. Interviewee SAI-1 suggested that the ten largest pension funds in terms of assets under management in South Africa have the human capacity to engage with investee companies or they may outsource the ownership aspects to a third-party service provider who would engage on their behalf. In addition, Interviewee SANI-8 noted that financial resources among large investors are more abundant, claiming that, as bigger funds “have a much bigger governance budget, they have a much bigger ability to actually think about these things” which Interviewee SANI-10 attributes to “a consequence of probably slack resources”.

Similarly, in Brazil, eight interviewees (40%) also posited that larger investors engage more than smaller ones in Brazil due to availability of resources. Interviewee BRI-12 argued that larger investors have the human resources and the technical capacity to be dedicated to engagement activities, while the smaller ones do not have the necessary staff to devote time for engaging. Interviewee BRI-9 suggested that, in the case of larger investors, the costs related to engagement are more easily ‘diluted’ among all other costs bigger investors have.

On the asset management side, Interviewee BRNI-3 claimed that smaller investors engage less than larger ones because they do not have the financial resources to engage with companies. On the pension fund side, four out of the seven interviewees who argued that larger pension funds engage more than smaller funds (ii + iv of Table 5.8) also cited availability of resources. Interviewees BRI-10 and BRNI-4 mentioned that larger pension funds have more resources to devote to engagement. In addition, as posited by Interviewee BRI-2:

*“A pension fund that has six people does not have staff that can be dedicated to engaging actively (...). The larger the institution, I think the more structure to support an active engagement.”*  
(Interviewee BRI-2)

Interviewee BRI-2 argued that the larger the pension fund the more staff they have to support an active engagement approach, while Interviewee BRI-6 contended that larger investors have more ability to appoint staff to be dedicated to analysing the investee companies more thoroughly. In contrast, Interviewees BRI-2 and BRI-6 claimed that smaller pension funds do not have sufficient staff to actively engage with companies.

As shown above, 25% of the South African interviewees and 40% of the Brazilian interviewees cited availability of resources as a reason why larger investors engage more than smaller ones.

## **ii. Potential influence of larger investors on companies**

Another reason given by four South African interviewees (17%) and four Brazilian respondents (20%) why larger investors engage more than smaller ones is the potential influence that larger investors have on their investee companies ('clout').

In South Africa, four interviewees (17%) argued that larger investors engage more than smaller ones because, as they have the ability to have significant exposure in the investee companies and more potential to influence companies than the smaller investors, they are more motivated to engage with them.

Interviewee SANI-5 explained that the shareholder market in South Africa is very concentrated, which confers on larger investors a significant influence on companies. To illustrate, Interviewee SAI-10 noted that larger investors like the Government Employees Pension Fund (GEPF) own approximately 25% of the total local market capitalisation and have the power to force management to adopt sustainable practices. Interviewee X (not identified to preserve their anonymity) posited that, as one of the largest investors in the country, they have a very significant asset base and are usually significant shareholders in many listed companies – often owners of three to five per cent of large cap stocks and up to 50% of middle and small cap stocks. The interviewee specified that such level of shareholding is not observed among developed market investors who usually own one or two per cent of a company. As a result, investors like themselves acquire a different power relationship with the targeted investee companies in South Africa, gaining high level of access to management in companies. As argued by Interviewee X:

*“So the nature of our relationship with management teams and board of directors is often that of a significant owner or, at least, of an important owner which, I think, in the context of the way most people understand engagement, that changes the nature of the conversation given that we have a very,*

*I mean, by definition, there is a different sort of power relationship between ourselves and our targeted investee companies.” (Interviewee X)*

The interviewee added that the organisation meets the management teams of major companies twice a year and are also often consulted by companies. Another large investor (also not identified to preserve their anonymity) noted that they are engaged by the management of companies on a proactive basis on issues such as strategy, new proposed executive policies, governance and sustainability. As with the previous large investor, this investor is visited by the management of companies regularly.

In terms of pension funds, one of the five interviewees that claimed that larger pension funds engage more (ii + iv of Table 5.8) also cited share ownership as an influencing factor. Interviewee SANI-1 suggested that smaller pension funds have not been engaging because they feel that, as they do not have significant shareholdings, they do not have the potential to influence companies.

Similarly, in Brazil, four interviewees (20%) argued that larger investors engage more than smaller ones because they have more ‘clout’ to influence companies.

Interviewees BRI-5 and BRNI-1 noted that some pension funds, such as PREVI, Petros, Funcef and Infraprev, are so large that they have significant shareholdings in many companies. As a consequence, according to Interviewee SAI-6, these significant investors have more access to corporate information than other shareholders through appointing members onto Boards of Directors (‘Conselhos de Administração’) and Fiscal Councils (‘Conselhos Fiscais’) who then participate and influence the Boards’ internal discussions. As noted by Interviewee BRI-6:

*“When you have 10% of the company’s shareholdings, you are inside the company. You will have access to information that one does not normally have. Also, you will dedicate staff to analyse the company, find issues that the company is experiencing.” “Sometimes you are following the agenda of the Board of Directors, of the Fiscal Council, because you have a representative in the Fiscal Council, you are in the Board’s Committees” (Interviewee BRI-6).*

Interviewees BRI-6 and BRNI-1 explained why investors that appoint Board members are able to engage with companies. Interviewee BRI-6 noted that having representatives onto Board of Directors, Board Committees and Fiscal Council allows the investors to closely follow the corporate discussions being held in these meetings and to have access to information that is not normally publicly available. Interviewee BRNI-1 pointed out that large pension funds such as Previ and Petros train these Board representatives on sustainability themes so that they can then include these issues in the Board's internal discussions. One of the interviewees (not identified for confidentiality purposes) explained that the Board members that represent PREVI, Brazil's largest pension fund, are trained on sustainability issues by the pension fund through symposiums, presentations and online chats to discuss issues such as the Global Reporting Initiative (GRI), the Carbon Disclosure Project (CDP), the United Nations-backed Principles for Responsible Investment (PRI) and other sustainability topics. They then have the capacity to bring these issues to the companies' internal discussions. In addition, Interviewee BRNI-5 mentioned that PREVI recommends that their investee companies have permanent Fiscal Councils as a corporate governance mechanism to overlook the acts of the Executive Directors. Interviewee BRNI-5 cited the example of BR Foods in which PREVI, as a significant shareholder, requested the permanent establishment of the Fiscal Council. PREVI was then able to appoint its own representatives on the Fiscal Council.

However in South Africa, appointing Board members is not a common practice. As claimed by Interviewees SAI-4 and SAI-6, the King Code does not allow investors to appoint representatives in the Board as the Code expects that "there should be a balance of non-executive and independent non-executive directors". Moreover, Interviewee SAI-5 claimed that they do not take seats in investee companies' Boards because that would compromise their ability to trade their shares freely.

As shown above, 17% of the South African interviewees and 20% of the Brazilian interviewees cited the potential significant shareholders have to influence investee companies as a reason why larger investors engage more than smaller ones.

### **iii. Investment in equities**

Another reason given by one Brazilian interviewee as to why larger pension funds engage more than smaller pension funds in Brazil relates to asset class allocation of Brazilian pension funds. As argued by Interviewee BRNI-4:

*“Larger pension funds tend to be more aggressive and they tend to have a larger part of their investments in variable income”. “The smaller the pension fund the less complex investments will be and the less opportunity they will have to be active investors.” (Interviewee BRNI-4)*

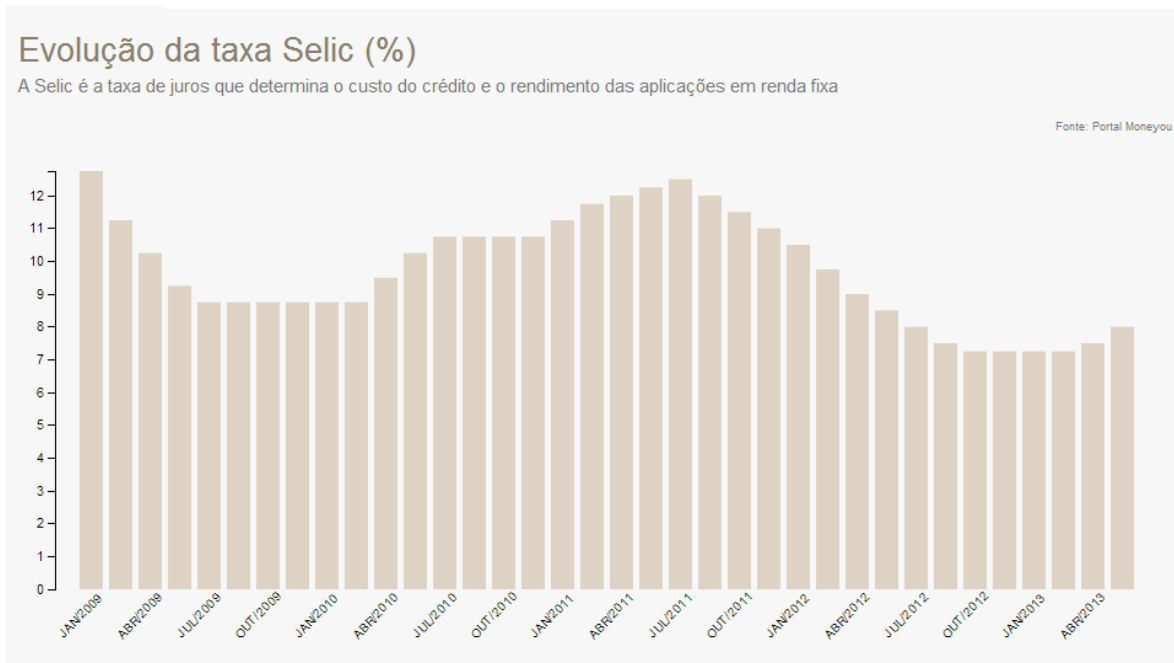
Interviewee BRNI-4 argued that larger Brazilian pension funds tend to be more aggressive in their investment style, allocating a larger part of their investments to variable income. Interviewee BRNI-1 cited as an example PREVI which invests 60% of their assets in variable income. In contrast, smaller pension funds adopt a more conservative approach investing in fixed income. Data from ABRAPP (2012), the Brazilian Association of Pension Funds, shows that the Brazilian pension fund industry invests approximately 62% of their assets in fixed income (15% of the total in government-debt bonds) and 29%<sup>27</sup> in variable income (e.g. listed equities and investment funds). As it follows, Interviewee BRNI-4 claimed that larger investors are more interested in engaging with investee companies because they have a larger proportion of their assets invested in corporations, while smaller pension funds invest predominantly in government bonds.

Nevertheless, Interviewee BRNI-1 highlighted that the pension fund industry is facing a transition period. Up until recently, it has been profitable for pension funds to invest in government-debt bonds because interest rates were high and these bonds had a long-term perspective, usually being paid by 2045-2050. However, as noted by Interviewees BRNI-1 and BRNI-4, the interest rates have been declining in Brazil. The graph below shows the decline of the basic interest rate, Selic, the local interest rate that determines the cost of credit and the returns of fixed income investments:

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<sup>27</sup> However, as noted by Interviewee BRNI-1, this percentage of variable income is ‘distorted’ by PREVI’s investments. The total investment of the pension fund industry in variable income excluding PREVI would fall to approximately 20%.

**Figure 5.3 - Basic interest rate (Selic)'s trends**



Source: Estadão (2013)

From July 2011 to June 2012 (time in which the interviews were held in Brazil), the Selic rate declined considerably from 12.5% to 8.5%. Interviewee BRNI-4 argued that the decrease in the annual interest rates and the consequent lower ability of pension funds to achieve their actuarial targets investing in government bonds is likely to drive pension funds to start diversifying their investments. Investor BRI-3 illustrated the trend, stating that they have been reevaluating their investment strategies and considering allocating more assets to other asset classes, such as to public and private equities, financial bonds (“letras financeiras”), certificates of deposits (CDBs) and other bonds.

In summary, Interviewee BRNI-4 posited that today larger investors engage more with investee companies as a consequence of their investment allocation, whereby they have more assets invested in corporations than smaller investors. Nevertheless, Interviewees BRNI-1 and BRNI-4 believe that the decrease in the interest rate will drive both large and small Brazilian investors to increase their investments in variable income, motivating them to develop closer relationships with the investee companies and, as a result, to increase their engagement activities.



#### 5.1.4.2. Reasons for why size and engagement behaviour are not related

Whilst the majority of interviewees in Brazil and South Africa believe that larger investors engage more than smaller ones, a minority of interviewees argued that there is no relationship between size and engagement behaviour, especially in relation to the asset management industry. The reasons given for this perception, as shown in Table 5.10, is the activist approach that some smaller investors adopt and perception of existence of conflicts of interest of larger asset managers that are part of financial conglomerates.

**Table 5.10 – Interviewees’ reasons for lack of relationship between size and engagement behaviour**

Interviewees claimed:	South Africa		Brazil	
	N	%	n	%
1. Activist approach of smaller investors	6	25%	4	20%
2. Conflicts of interest in financial groups	0	0	2	10%
3. No reason or other reason	0	0	4	20%

These arguments will be explored below.

##### i. Activist approach of smaller investors

Six South African interviewees (25%) and four Brazilian respondents (20%) argued that size and engagement behaviour are not related, and that this is due to the activist approach of smaller investors.

In South Africa, all six interviewees (iv + vi of Table 5.8) who claimed that size and engagement behaviour are not linked in the case of asset managers also stated that the determinant for engagement behaviour is more related to investment approach than to size. It was argued that the majority of asset managers who engage with companies in South Africa are also managers who developed their competitiveness and value around activist strategies. As claimed by Interviewee SAI-1:

*“When it comes to the asset managers, I think it depends more on the investment philosophy of the asset manager.” (Interviewee SAI-1)*

Interviewee SAI-11 claimed that smaller South African asset managers often engage more than larger asset managers because of their incentives to engage. Interviewee SAI-11 argued that larger asset managers are more incentivised to increase the total amount of assets under management so that they get higher fees as a percentage of the managed assets. In contrast, she suggested that smaller asset managers must distinguish themselves from their competitors and one of the ways to do so is by being proactive in their engagement with investee companies. Interviewee SAI-1 mentioned that there are small asset managers in South Africa who are respected for their approach to Responsible Investment, ESG issues and engagement, using such approach as part of their marketing and branding.

Two other interviewees (SANI-1 and SANI-9) also mentioned that it is usually the small niche boutique houses that are more activist. Three of the six interviewees (iv + vi of Table 5.8) cited the example of Element Asset Managers as one activist niche responsible investment house that, according to Interviewee SANI-1, has created their capacity to engage successfully with companies around their focus issues. Cadiz and Futuregrowth were also cited by another interviewee. One small niche investor (not identified for confidentiality purposes) cited themselves as an example of activist asset manager, alleging that, despite their small size, they have developed a fairly effective structure to engage with companies in which all main roles (e.g. Chief Operating Officer, Chief Investment Officer, sector analyst) are highly involved in the engagement process.

In Brazil, four of the eight interviewees who argued that there is no relationship between size and engagement behaviour (iv + v + vi of Table 5.8) also cited the investor’s approach as a determinant for engagement. Interviewee BRI-7 claimed that it is the investor’s engagement policy that determines shareholder engagement behaviour rather than size, even though larger investors have more ‘clout’ to influence companies. Referring to the asset management industry, three interviewees cited that an active approach is the main reason why some asset managers engage. As explained by Interviewee BRI-2, there are small asset managers in Brazil that have created specific products, such as governance or sustainability funds, and

that have directed their structure to managing these funds in a customised manner, including adopting an active engagement approach. As claimed by Interviewee BRI-2:

*“Small asset managers may have an active engagement because they are structured to manage this type of product.”* (Interviewee BRI-2)

Interviewees BRI-5 and BRI-10 also mentioned that there are smaller asset managers in Brazil who have a clear activist approach and who engage more than large financial conglomerates. Interviewee BRI-5 cited Polo, Rio Bravo and Tarpo as examples of activist investment managers. In addition, another interviewee (not identified for anonymity reasons) noticed that some smaller asset managers work in collaboration with other asset managers to increase their strength towards the investee companies. She cited an example of an engagement initiative in which they participated involving asset managers that represented 20% of Brazilian listed company X and that succeeded in electing a number of members on the company’s Board of Directors. As discussed earlier, through having a member on the Board, investors can then participate and influence the company’s internal discussions.

As shown above, 25% of the South African interviewees and 20% of the Brazilian interviewees stated that engagement behaviour is more related to the investor’s activist approach than size to take part in engagement activities.

## **ii. Conflicts of interest in financial groups**

Another explanation given by two Brazilian interviewees (10%) why size and engagement behaviour are not related in the asset management industry refer to conflicts of interest that arise inside financial groups. Examples of large financial groups in Brazil include Banco do Brasil, Bradesco, Itaú Unibanco, HSBC, Santander and Sul América. As noted by Interviewees BRI-5 and BRNI-3, the asset managers of these conglomerates have the resources and significant shareholdings to engage with companies. However, Interviewee BRI-5 claimed that they do not engage because engaging with investee companies might conflict with the interests of the corporate area. She argued:

*“For example, think about XXX, I think they would not be activists because it’s conflicting. If their asset division has a significant shareholding in a certain company, they could be activists, but, if they do, that would be conflicting with the corporate area. So I don’t think they are activists. The large asset managers, I think they are rarely activists, the large managers that are part of conglomerates because there is a clear conflict.”* (Interviewee BRI-5)

Interviewee BRNI-3 also argued that she does believe size is an important factor in determining engagement behaviour, but that it is usually the independent medium-sized asset managers that are more activist as the larger ones are linked to financial conglomerates and have conflicts of interests to engage. Interviewee BRNI-3 argued that the conglomerate’s asset management division may want to avoid putting pressure on certain investee companies who are current or potential clients of the banking area in order to maintain good corporate relations. She cited the example of Petrobras, the largest oil company in the country and one of the largest Brazilian listed companies. Referring to voting on shareholder resolutions, Interviewee BRNI-3 claimed that any financial group would avoid voting against Petrobras’ management recommendations to avoid losing (or to improve the chances of winning) Petrobras’ financial businesses.

Nonetheless, conflicts of interest are not perceived by all interviewees. Interviewee BRI-1 stated that she does not perceive this type of conflicts of interest. Three asset managers that are part of financial conglomerates (not identified for confidentiality purposes) mentioned that issues involving conflicts of interest do not occur in their organisations. One of them posited that they do not yet engage on social and environmental issues with the investee companies. However, they do not believe that there will be conflicts of interest when they do engage because the asset management area already engages with the investee companies on financial and corporate governance aspects and the business interests of the corporate area have never interfered with or prevented the asset manager from acting on the investee companies. Another asset manager who is part of a financial group claimed that conflicts of interest do not happen in their organisation and that there were even cases in which the asset management area requested the help of the banking division to engage investee companies.

In sum, 10% of the Brazilian interviewees believe that large asset managers engage less because larger managers are linked to financial groups who have conflicts of interest. However, this argument is not shared by some other interviewees.

Overall, the reasons given by the interviewees who claimed that size and engagement behaviour are not related refer to the activist approach of smaller investors and conflicts of interest of larger asset managers that are part of financial conglomerates.

#### 5.1.4.3. Discussion

The interview findings show that there is an overwhelming support for Proposition 4 as the majority of the interviewees in Brazil and in South Africa believe that larger investors engage more than smaller ones.

As shown above, 67% of the South African interviewees and 60% of the Brazilian interviewees claimed that size and engagement behaviour are related. The reasons given by the interviewees were threefold: availability of resources, potential to influence investee companies and asset allocation of pension funds.

Two of these reasons (availability of resources and potential influence) are consistent with the literature. In terms of investor size, the literature found that larger funds are more likely to have in-house staff (Myners 2001; Myners 2004; Tilba and McNulty 2013) and slack resources to devote to the task (Choi and Fisch 2008; Rubach and Seborá 2009; Solomon 2010). Similarly, the Brazilian and South African interviewees claimed that larger investors usually have teams to dedicate the time and financial resources needed to research and to engage with individual companies. Interviewees of both countries argued that this is even more significant in the pension fund industry, noting that only the larger funds would have the availability of financial resources and personnel to engage with companies.

Regarding shareholder ownership, the literature suggests that controlling investors are encouraged to engage because their shareholdings provide them with leverage to gain access to and influence over the management of investee companies (Martin et al. 2007; Carleton et al. 1998 cited in Sabherwal and Smith 2008; Tilba and McNulty 2013). As discussed in

Chapter 2 and by the interviewees, shareholder ownership is concentrated in both countries. As a result, larger investors tend to have significant ownerships in the companies they invest. The South African interviewees contended that larger investors are usually owners of a significant portion of the listed companies and, therefore have a different power relationship with corporate management. In addition, larger investors may be consulted by the investee companies on strategic matters. This interactive two-way engagement process is acknowledged by the literature. Solomon and Solomon (2003 cited in Solomon 2010), Stapledon (1996) and Mallin (2013) pointed out that, while investors are asking companies about their strategy and performance, companies are also initiating discussion and asking for advice from large investors which demonstrates the importance that they attach to significant shareholders.

In Brazil, the interviewees did not indicate that there are proactive engagement efforts coming from investee companies. However, significant investors acquire even more power as they may elect representatives onto Boards of Directors, Board Committees and Fiscal Councils who then participate and influence the companies' decisions. The use of representatives of the institutional investors inside the companies is defended by Stapledon (1996) and Davies (1993) who argue that non-executive directors cannot be truly independent unless they are connected to a powerful group, as it is the case of institutional investors, to counterbalance company management. Stapledon (1996) and Davies (1993) claim that there are some issues which prevent traditional independent non-executive directors from monitoring the company effectively. These issues include the fact that traditional directors commonly owe their positions to the chairman and that they are constrained by limited time available for directorship duties and by a limited detailed knowledge of the company's business. Furthermore, Stapledon (1996) argues that many non-executive directors are senior executives of other listed companies and, as fellow business leaders with the executive directors, they may socialise in the same social circles, creating a relationship which represents a barrier to vigorous monitoring. This engagement approach of appointing investor representatives on the Boards of listed companies is not shared in South Africa. As mentioned previously, a few South African interviewees argued that appointing Board members is not considered a good corporate governance practice according to the South African King Code which expects "a balance of power, with a majority of non-executive directors", most of whom must be independent (IoD 2009). Moreover, one of the

interviewees reported that they do not appoint investor representatives onto Boards in order to ensure that they remain free to trade their shares in the market.

As for the third reason mentioned by the Brazilian interviewees as to why larger investors engage more (investment asset allocation), the interviewees made reference to the reduction in the interest rates in Brazil which could drive pension funds to diversify their investments, invest more in variable income and, as a result, engage more with companies. At the time of the interviews (June-July 2012), the trend of the interest rates was descending. However, since April 2013, the Brazilian Central Bank has been increasing the level of the interest rates and Central Bank's economists expect that the new rate will reach 9 - 9.25% by the end of the year (Rodrigues 2013). Thus, it will be interesting to observe the changes in the interest rates in the country in the next few years and whether it will influence the changes in asset allocation of pension funds and engagement behaviour.

Whilst the overwhelming majority of interviewees agreed that larger investors engage more, a minority of investors claimed that there is no relationship between size and engagement behaviour, especially in the asset management industry. The reasons given by the interviewees are the presence of smaller activist investors in both countries and the existence of conflicts of interest in large financial groups in Brazil.

The argument related to the existence of conflicts of interest is consistent with the literature which suggests that asset managers that are part of a financial services group might avoid engaging with investee companies because doing so may compromise the relationship of these companies with the other businesses of the financial group (Myners 2001; Mallin et al. 2005). As pointed out by a number of Brazilian interviewees, asset managers of financial conglomerates avoid engaging with companies in order to avoid conflicts with the corporate area of the group. Nonetheless, this opinion is not shared by all: other interviewees disagreed that conflicts of interest take place in practice in the country. This particular topic has proved challenging to research. One explanation for the difference in opinions can be attributed to reputational issues since three interviewees who dismissed the existence of conflicts of interest are part of financial groups. It may be that these asset managers have decided not to acknowledge conflicts of interest to avoid reputational damage and even the possibility of being regulated in the future. Another explanation relates to inaccurate perceptions. The interviewees who claimed that conflicts of interest exist are not asset managers from financial groups. Hence, they do not have first-hand experience of the existence of conflicts. These

interviewees could have the perception that conflicts of interest exist because they are in principle feasible, even though they do not take place. As for South Africa, conflict of interest was not identified as a reason why larger investors do not engage as much, possibly because South Africa does not have as many multinational financial groups established in the country as in Brazil.

Since 21% of the South African and 35% of the Brazilian interviewees (iv + vi of Table 5.8) believe that the relationship between size and engagement behaviour is applicable for asset managers, the research findings are not consistent with the statistical data analysis. The statistical results demonstrate that the link between size and engagement behaviour applies for both pension funds and asset managers. Among pension funds, the median value of assets under management for engagers is nearly US\$ 10 billion, while the median value for non-engagers is US\$ 5.1 billion. Among asset managers, the median value of assets under management for engagers is nearly US\$ 5.1 billion, while the median value for non-engagers is US\$ 527 million.

The statistical results and the accounts of the interviewees probably diverge for two reasons. Firstly, although there are a number of small boutique asset managers that are widely recognised for their engagement practices in both Brazil and South Africa (and were mentioned by the interviewees for this reason), they represent a minority of small asset managers while the majority of small asset managers have a more passive approach in terms of engaging with companies. Secondly, the data used does not measure intensity of engagement. Investors with low levels and high levels of engagement are included in the same category as ‘engagers’ even though they present different intensities of engagement behaviour (e.g. some engage occasionally and some engage more frequently). If engagement intensity were taken into consideration, it is possible that smaller asset managers would present more intense practices of engagement.

Overall, Proposition 4 is supported.



### 5.1.5. Proposition 5 – impact of investor type

**Proposition 5 – Asset owners are more likely to engage with companies than are asset managers.**

**Not supported**

The literature review (Chapter 1) suggests that asset owners/pension funds are more likely to engage with companies on ESG issues than asset managers due to their long-term investment horizon (Aguilera et al. 2006; Clark and Hebb 2004; Richardson 2009; Martin et al. 2007; Black 1992). In contrast, the statistical data analysis indicates that asset managers engage more than pension funds in Brazil and South Africa. In order to investigate the conflict between literature and statistical data analysis and given that the sample used in the statistical analysis does not represent the whole Brazilian and South African investment community, the interviewees were asked whether they agree that asset managers engage more in these countries. The results are shown in the table below:

**Table 5.11 – Interviewees’ perceptions on the relationship between investor type and engagement behaviour**

Interviewees claimed that:	South Africa		Brazil	
	n	%	n	%
Asset managers engage more than asset owners/pension funds do	16	67%	12	60%
Pension funds engage more than asset managers do	0	0	2	10%
Did not respond, did not have an opinion or were not asked the question (when they were not actively involved with the investment community)	8	33%	6	30%
<b>TOTAL</b>	<b>24</b>	<b>100%</b>	<b>20</b>	<b>100%</b>

As shown in Table 5.11, a majority (67%) of the South African interviewees and 60% of the Brazilian interviewees believe that asset managers engage more with investee companies than

pension funds do. Hence, the interview findings are not consistent with the literature review. The proposition is not supported. However, the interview findings corroborate the statistical data analysis which also found that asset managers engage more than pension funds in these countries.

The interviews were also used to investigate the reasons for why the interviewees believe that asset managers engage more. The arguments are shown below.

### 5.1.5.1. Reasons for why asset managers engage more than pension funds

As shown in Table 5.12, the reasons given by the interviewees why asset managers engage more than pension funds are the following:

**Table 5.12 – Interviewees’ reasons for why asset managers engage more than pension funds/asset owners**

Interviewees claimed:	South Africa		Brazil	
	N	%	n	%
i. Limited resources available to pension funds	6	25%	5	25%
ii. Limited knowledge of pension funds	5	21%	0	0
iii. Lack of Responsible Investment strategy	4	17%	0	0
4. Competitiveness	1	4%	2	10%
5. Other reasons				
Lack of understanding of the business case	2	8%	0	0
Investment asset allocation of pension funds	0	0	1	5%
Remuneration incentives	0	0	1	5%
High turnover of public pension funds’ management	0	0	2	10%
Government’s influence on public pension funds	0	0	1	5%
iv. No reason or other reason	3	12%	3	15%

These arguments will be discussed below.

**i. Limited resources available to pension funds**

The limited resources available to pension funds was cited by six South African interviewees (25%) and five Brazilian respondents (25%) as a reason for why asset managers engage more than pension funds.

In South Africa, as explained by Interviewee SAI-1, the bulk of the investment management of South African pension funds, including engagement work, is carried out by investment consultants appointed by the pension fund and by the investment managers mandated to invest and manage the pension fund's investments on their behalf. Interviewees SAI-1 and SANI-1 argued that South African pension funds are outsourcing investment and engagement activities because they do not have the resources to do this by themselves. As claimed by Interviewees SAI-1 and SAI-2:

*“Most pension funds in South Africa, except for a few of the larger pension funds such as the GEPP, do not employ many staff – in most instances a Principal Officer is appointed for the fund but most of the responsibility is administrative in nature, like a Company Secretary of a listed company.”*  
(Interviewee SAI-1)

*“Other pension funds (except for the GEPP and Eskom), you just have a board of trustees who are non-executive, you have asset consultants who just help them appoint asset managers and that stands there. So asset managers tend to wield this amount of power because they have control over many of the assets of the different pension funds.”* (Interviewee SAI-2)

According to Interviewees SAI-1 and SAI-2, there are a reduced number of pension funds in South Africa that have in-house staff, while most pension funds would only have a board of trustees and employ asset consultants to assist them to appoint asset managers who would then manage investments on the pension fund's behalf. Interviewee SANI-9 indicated that

there are probably ten funds in the country that would have capacity to have permanent staff to engage with companies. Interviewee SANI-9 then asserted that for pension funds to be able to engage by themselves, they need to appoint a full-time ESG executive. Therefore, the majority of pension funds have capacity constraints to engage with investee companies on their own.

In Brazil, five interviewees (25%) also argued that asset managers engage more than pension funds because they have more resources available to engage. Interviewee BRI-5 noted that only the larger Brazilian pension funds manage their investments through internal staff, while the remaining pension funds outsource their management, including their activist work. As posited by Interviewee BRNI-4:

*“(pension funds) do not have internal capacity... (investment) management of the smaller pension funds is outsourced because they don’t have internal capacity to do research, to do analysis, to make investment decisions. Consequently, they don’t have capacity to engage, to monitor. It is all outsourced. They hire brokers to research companies, I mean, it’s all outsourced.”* (Interviewee BRNI-4)

Interviewee BRNI-4 agreed that smaller pension funds outsource their investment management because they do not possess the necessary staff to do research, to monitor and to engage with companies. Interviewee BRI-5 added that even the larger pension funds which do have internal staff sometimes do not have sufficient staff to engage with companies. Likewise, Interviewee BRI-12 contended that smaller and medium pension funds do not have the resources to hire analysts to dedicate time for engagement, outsourcing such work to their asset managers.

The statements above indicate that the interviewees believe that limited resources available to small and medium pension funds encourage them to outsource their engagement work to asset managers.

## **ii. Limited knowledge of pension funds**

In South Africa, another reason mentioned by five interviewees (21%) for why asset managers engage more than pension funds is the limited knowledge of pension funds.

As SANI-1 argued:

*“I think pension funds simply don’t have the capacity or the expertise to do the engagement and so it’s typically something that is outsourced to the asset manager because he has the technical understanding of the investment and he has arguably the resources to also do it if he is appointed to do it.”* (Interviewee SANI-1)

Interviewee SANI-1 claimed that South African pension funds are outsourcing engagement activities to asset managers because asset managers possess investment understanding while pension funds do not have the expertise. Similarly, Interviewee SANI-10 argued that most of the capital in the pension fund industry has been outsourced because asset owners tend not to be financial experts, so they delegate their authority to the asset managers who will provide them with expert information. SAI-6 also noted that the asset consulting industry has encouraged pension funds to outsource their investment capabilities to asset managers. As noted by Interviewee SAI-6:

*“You know, my sense is that the asset owner community has been quite slow to understand their role around Responsible Investment and their response and I think largely fuelled by the consulting industry has been to just hand on the responsibility to the asset managers.”* (Interviewee SAI-6)

In terms of pension fund trustee knowledge in particular, Interviewee SAI-9 argued that the level of investment knowledge of many pension fund trustees is low because they do not come from an asset management or financial services background. As Interviewee SANI-9 claimed:

*“...they are not strongly empowered, the trustees in South Africa are not typically very strong in a lot of skills and expertise in investment. They will take a lot of their guidance from the investment*

*consultants and actuaries and then they will take a lot of guidance from the asset managers and they will just expect them to take care of this for the fund.” (Interviewee SANI-9)*

Interviewee SANI-9 posited that trustees in South Africa are typically not knowledgeable in investment skills and, as a result, they take advice from asset consultants, actuaries and asset managers. According to SAI-7, in a board of trustees, you might have two or three individuals who fully understand investments and others who might not, especially on the employees’ side. Interviewee SANI-9 indicated that employee trustees are usually shop stewards that are voted by their work colleagues to sit on the board of the pension funds and that often have a low level of educational skills.

Another issue raised by the interviewees that contribute to the low level of knowledge of the trustees are the limitations placed on their availability to exert their roles as trustees. Interviewees SAI-8 and SAI-12 explained that trustees have full-time jobs and act as trustees as an add-on to their current jobs. As Interviewee SAI-12 indicated:

*“And the types of trustees that run these funds are people that do this just as an add on-to the actual day job, so they don’t have a lot of time to apply their minds to it.” “Because these are boards that meet probably four times a year and they will meet for between half a day and a whole day. And the amount of time that they have to allocate to different topics is absolutely shocking how small the opportunity it is to get to something like ESG. And if you do get to ESG, then what do you do? Because you are not experts and are you going to hire the experts? Every single one of these issues has huge debates around.” (Interviewee SAI-12)*

Interviewee SAI-12 claimed that pension fund trustees do not have enough time to reflect on their roles as trustees and to be dedicated to the task. Interviewee SAI-12 added that the boards of trustees probably meet four times a year for between half a day and a whole day, allocating a fairly limited amount of time to different topics and in particular, ESG issues. As added by Interviewee SANI-9, asset consultants and asset managers might have approximately two hours to cover a vast number of issues in the boards’ meetings, such as how the portfolio is performing, underperforming investments, regulatory duties, and so forth, leaving about ten minutes to speak about the ESG strategy. Interviewee SAI-1

remembered that besides the part-time commitment to act as trustees, the employer is not always willing to give the employee or employer-nominated trustee sufficient time off work to prepare for trustees' meetings or to attend training. She noted:

*"...and the other one is where you have employee nominated trustees that employer is not always willing to give the trustee the employee nominated or the employer nominated trustee sufficient time away from their day job to prepare for trustee meetings and to attend training etc."* (Interviewee SAI-1)

A further challenge for trustees to increase knowledge is the length of office. As claimed by Interviewee SAI-1, trustees are usually appointed for a three or four-year term as standard practice and it is normally in the second or third year that trustees start to become familiar with the requirements of being a responsible trustee on a pension fund board. She observed:

*"I think one of the challenges is probably more the length of service. So if trustees are part-time trustees and they are appointed for a three or a four-year term, to train trustees and to bring them up to speed on investment knowledge and to get their minds around the requirements of being a responsible trustee on a pension fund board does require a lot of training and, if they are only there for four years, it is normally in the second or third year that they are only starting to become more familiar with what the requirements of being a trustee are."* (Interviewee SAI-1)

However, as pointed out by Interviewees SAI-1 and SAI-9, in many instances, boards are replaced almost all at once after the trustee tenure and, as a result, there is no continuity of knowledge and experience on the board. Interviewee SAI-9 also argued that, due to short-term mandates, trustees do not have an incentive to engage in long-term commitments whose results they will not observe while they are in office. Furthermore, Interviewee SANI-12 claimed that many trustees are not encouraged to enhance their knowledge because many of them are not paid to perform their trustees' functions, acting in an honouring capacity instead.

The statements above suggest that the limited knowledge of South African pension fund trustees on investment and ESG issues discourages them to engage with companies, outsourcing their activities to asset managers instead.

### **iii. Lack of Responsible Investment strategy**

In South Africa, four interviewees (17%) argued that pension funds engage less than asset managers due to lack of a clear Responsible Investment strategy from pension funds. Interviewee SANI-5 claimed that pension funds do not have a Responsible Investment policy in place and do not know how to act on Responsible Investment. She contended:

*“I agree because I think asset owners, firstly, they still don’t know how to deal with Responsible Investment and how to relate with their investment managers because they don’t really have Responsible Investment policy in place yet, a very good one.”* (Interviewee SANI-5)

Likewise, Interviewee SAI-8 contended that most pension funds do not have a clear engagement strategy in place and, to date, this has not been outlined as a requirement. In contrast Interviewee SAI-6 argued that asset managers are being more substantive and clear in terms of what they are doing around ESG incorporation. Despite the lack of strategy in place by pension funds, Interviewee SAI-8 believes that this situation is likely to change in the near future due to “increased industry codes on shareholder activism and engagement”, referring to CRISA and the POA’s toolkit, discussed under Proposition 2.

The statements suggest that lack of a clear ESG strategy discourages pension funds to engage with companies.

### **iv. Competitive advantage**

Two Brazilian (10%) and one South African interviewee (4%) claimed that asset managers engage more than pension funds for competitive reasons. In Brazil, Interviewee BRI-7 argued



that asset managers are engaging with companies in order to compete with other asset managers in attracting pension funds. Similarly, Interviewee BRI-9 noted that asset managers are engaging with companies to gain a competing advantage with the pension funds. In South Africa, Interviewee SAI-1 noticed that South African asset managers often use their relationship with investee companies as their form of competitive advantage in the highly competitive South African asset management industry.

The statements suggest that competition encourages asset managers to engage with companies.

#### v. **Other reasons**

A number of other reasons were mentioned by the interviewees to justify why asset managers engage more than pension funds. As each argument was mentioned only once or twice, they are aggregated in this section.

In South Africa, two interviewees (8%) believe that pension funds engage less because they have not understood the business case of incorporating ESG issues. Interviewee SAI-4 claimed that there is still very limited awareness among asset owners that active Responsible Investment adds value and reduces risk. Interviewee SAI-4 observed that such lack of understanding of the business case is reflected in the small proportion of pension funds in relation to total number of PRI signatories (four asset owners out of 44 PRI signatories as of July 2013).

In contrast, Interviewee SAI-7 argued that:

*“I think some of us (asset managers) believe that there might be some valuation attributes hidden amongst us lot. We have seen the whole platinum mining thing now. We’ve seen issues at BP, we’ve seen issues in Japan, some of the factors there, and I think we just know that it is right thing to do. We are in a country also where water is scarce, power is dirty, you know, a lot of things that’s specific to this country. And the country is a signatory to all sorts of things. So ultimately corporate have to come with it. So I guess that’s known as the right thing to do, I think.”* (Interviewee SAI-7)

Interviewee SAI-7 claimed there is a belief among a number of South African asset managers that there are valuation attributions in incorporating ESG issues. She cited the platinum case in South Africa (Marikana case<sup>28</sup>) and the oil spill from BP as examples of how ESG issues affected corporate valuation. Interviewee SAI-7 also mentioned specific South African ESG risks, such as scarcity of water and polluting coal-based power (as highlighted in Chapter 2), which she believes also impacts valuation of South African companies.

Further, Interviewee BRNI-4 mentioned that pension funds engage less than asset managers in Brazil due to their investment asset allocation. As discussed under Proposition 4, she argued that, as the majority of Brazilian pension funds invest largely in fixed income, predominantly in government bonds, they are not as interested in engaging with companies. Interviewee BRNI-4 further claimed that only a minority of pension funds, the large pension funds which hold significant shares in companies, would be interested in engaging with companies by appointing representatives onto investee companies' Boards and influencing Boards' internal discussions.

Furthermore, a number of Brazilian interviewees cited reasons for why public pension funds in Brazil engage less than asset managers, as shown below.

First, Interviewee BRI-10 mentioned remuneration incentives. She argued that asset managers are encouraged to engage with companies on ESG issues because their remuneration depends on investment performance. Interviewee BRI-10 then noted that, in the case of the public pension funds, their managers and analysts have a fixed salary and job stability and are therefore not incentivised to improve investment performance through engaging with companies and risk compromising their relationship with the investee companies.

Second, Interviewee BRI-6 and BRNI-4 noted that public pension funds are less likely to adopt Responsible Investment practices because of the high turnover of pension fund directors. In Brazil, legislation states that a number of management roles in public companies, including public pension funds, are considered 'positions of trust' ('cargo de confiança') and, for this reason, candidates are appointed and nominated by the government in office. As Interviewee BRNI-4 observed:

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<sup>28</sup> The Marikana shootings happened on 16 August 2012 when police opened fire on miners from Lonmin's Marikana platinum mine who were on strike (BBC 2013).

*“...there is another important point, especially in the case of public pension funds is that they are public companies, so many of their directors are nominated. Their positions are considered positions of trust, a position nominated by the government in office. This generates high turnover among pension funds’ directors which may explain a few things. When the country’s president changes, the fund’s financial director changes, then you have to resume all the work of internal awareness, especially in the pension funds that have not yet institutionalised RI practices, do not have procedures, ethics code, investment policies, they don’t have that institutionalised in the fund (...) This compromises the development of RI practices in the pension funds...” (Interviewee BRNI-4)*

Interviewee BRNI-4 argued that there is high turnover in the management of public pension funds as their executive directors are likely to be replaced when a new country president is elected. Relating this to Responsible Investment, Interviewees BRI-6 and BRNI-4 argued that this turnover means that newly-appointed directors may discontinue the Responsible Investment program put in place by the previous directors, particularly when RI has not been institutionalised in the fund’s investment policy.

Third, Interviewee BRI-13 argued that public pension funds are less likely to engage with companies than asset managers because, in her opinion, public pension funds are influenced by the local government. Interviewee BRI-13 referred to the case of Petrobras in which, as discussed under Propositions 1 and 2, the government (Petrobras’ major shareholder) requested public pension funds which were also shareholders of the company to vote for an individual that the government recommended for Petrobras’ Board of Directors to become the representative of the minority shareholders. For Interviewee BRI-13, this demonstrates the power of the Brazilian government on public pension funds.

In summary, other reasons given by the interviewees as to why asset managers engage more are: lack of understanding of the business case by pension funds, pension fund investment asset allocation and, in the cases related to public pension funds, lack of remuneration incentive, high turnover of public pension fund management and government’s influence on public funds.

### 5.1.5.2. Other considerations

As discussed in Chapter 1, the literature demonstrates that there may be conflicts of interest related to corporate pension funds engaging with companies (Black 1992; Coffee 1991; Monks and Sykes 2006; Myners 2001) and asset managers linked to large financial groups (Myners 2001; Mallin et al. 2005) engaging with companies. To analyse these issues, I asked those who were more familiar with the pension fund industry about conflicts of interest related to corporate funds, and asked those familiar with the asset management industry about conflicts of interest related to financial groups. The findings are discussed below.

#### 5.1.5.2.1. Conflicts of interest in corporate pension funds

In terms of corporate pension funds, in South Africa, three interviewees (12%) claimed that there are conflicts of interest related to these funds. Interviewee SAI-1 stated that, in theory:

*“...a company shouldn’t be able to exert undue influence on the board of trustees of the private pension fund (because) pension funds in South Africa do have a fair amount of protection under the Pension Funds Act and some of the circulars from the Financial Services Board” (Interviewee SAI-10)*

However, Interviewee SAI-1 noted that, even though legislation protects pension fund trustees from undue corporate influence, in practice, there can be potential conflicts. Interviewee SANI-9 illustrated these conflicts with examples. In South Africa, Interviewee SANI-9 observed that a number of corporate pension funds from the same industry might join in one single pension fund to increase the fund’s pool and risk-sharing. In this case, there would be a conflict when engaging with companies from that industry as the potential targeted companies are also sponsors of the fund. Moreover, Interviewee SANI-9 noted that there could also be issues related to engaging with companies from other sectors due to the configuration of the South African corporations. Interviewee SANI-9 explained that, when the country was shut off from the world financially as a result of boycotts to the Apartheid

regime, corporations bought shares of other South African companies, leading to a complex system of crossholding. As a consequence, companies from one sector became shareholders of companies of other sectors. Interviewee SANI-9 argued that, even though there has been more diversification and the inflow of foreign investments helped to dilute those relationships, crossholding still exists. Hence, Interviewee SANI-9 posited that there could be cases in which a private pension fund might want to engage with a company from another sector, but the targeted company could be a significant shareholder of the corporation that sponsors the pension fund, leading to a conflict.

In Brazil, no interviewees mentioned the existence of conflicts of interest in corporate pension funds.

#### **5.1.5.2.2. Conflicts of interest in asset managers that are part of financial groups**

As for potential conflicts of interest among asset managers that are part of larger financial groups, the findings are mixed both in the Brazilian and South African contexts.

In South Africa, six interviewees agreed that there exists this type of conflict of interest. Interviewee SAI-4 noted that the international boycott of South Africa during Apartheid produced large financial service organisations in the country providing a range of services, including life assurance, pension fund business, corporate banking and asset management. To illustrate the conflict of interest in these groups, Interviewee SAI-4 mentioned that it might be difficult for the asset management department of a financial group to vote against the management of one particular company because the targeted company might be important to other businesses of the group. Similarly, Interviewee SAI-12 argued that asset managers would be reluctant to engage over difficult issues if the targeted company is a large client of the banking department because this could impact on the business of other units. Likewise, Interviewees SAI-1 and SANI-9 noted that, if the group's asset management decides to engage with a company on ESG issues, that company might discard the possibility of taking their business in the future to the group's banking pocket, as they would become unsympathetic to the group as a whole. They observed:

*“...well, actually, if you are going to take this hard line with us, we will, you know, take our business elsewhere.” (Interviewee SAI-1)*

*“I’m not giving a business to those guys, they give me a hard time.” (Interviewee SANI-9)*

Moreover, Interviewee SAI-4 explained that the existence of conflicts of interest of asset managers is the reason why some investors were reluctant to include a clause in the Code for Responsible Investment in South Africa (CRISA) to disclose proxy voting. According to Interviewee SAI-4, asset managers feared that, by disclosing their votes, they would upset companies’ management and lose business as a consequence. Nevertheless, the disclosure principle was included in the Code under Principle 5:

**“Principle 5:** Non-disclosure of voting records by an institutional investor and its service providers precludes the investee company the opportunity to engage with the institutional investor or its service providers regarding the vote exercised.” (IoD 2011)

Interviewee SAI-1 also highlighted that the potential for conflict of interest has been acknowledged in CRISA under Principle 4:

**“Principle 4:** An institutional investor should recognise the circumstances and relationships that hold a potential for conflicts of interest and should pro-actively manage these when they occur.” (IoD 2011)

In contrast to the statements of the interviewees above, four South African interviewees (not identified for confidentiality purposes) disagreed that this kind of conflict of interest is an issue in South Africa. Asset Manager X, part of a financial group, claimed that although conflicts of interest seem in principle feasible, this has never been an issue in the organisation and the asset management department is not even aware who the clients of other areas are.

Asset Manager X attributed this partially to how the group is organised, as the banking and asset management divisions are structurally independent in the group. She observed:

*“I’ve done some serious engagement at corporate levels (...) and sometimes it’s been uncomfortable, but it’s never stopped us doing what we felt it was the right thing to do. Obviously, conceptually, conflicts must be a very real issue, but we’ve managed almost by historical evolution, because the asset management division was always very, very separate....”* (Asset Manager X)

Asset Manager Y, also part of a financial conglomerate, asserted that she has never come across this sort of situation, although she does not exclude the possibility of it happening in the future. Interviewee Z argued that “Chinese walls”<sup>29</sup> within these entities impede the asset management divisions to be influenced by relationships of other divisions within the group.

In Brazil, as mentioned under Proposition 4, two interviewees also argued that there are conflicts of interest related to asset managers linked to financial conglomerates. Interviewee BRI-7 claimed that the engagement behaviour of asset managers might be affected when target companies are clients of the corporate area. Interviewee BRI-5 asserted that asset managers who are part of financial groups would probably not be activists because, even though the asset manager could engage with the investee companies in which they are significant shareholders, they do not because this might conflict with the interests of the corporate area.

In contrast, also as mentioned under Proposition 4, three interviewees (not identified for confidentiality purposes) argued that there are no conflicts in financial groups. Asset Manager A, part of a financial conglomerate, argued that:

*“That (the conflict of interest), independently of the relationship with ESG issues, could already happen in relation to engaging on financial performance.(...) I have been working at the asset division for XX years and we have never been through this sort of interference. Even in AGM’s voting, we, as activists in corporate governance issues, and even in relation to our access to companies to discuss corporate strategies, financial performance, and that has never been the case. Thus, we don’t*

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<sup>29</sup> The ethical barrier between different divisions of a financial (or other) institution to avoid conflict of interest.

*believe that there would be any type of conflict of interest, especially because the bank has also been adopting sustainability practices...” (Asset Manager A)*

Asset Manager A claimed that, although they have not been engaging with companies on social and environmental issues, they have already been engaging on financial and corporate governance matters and being part of a financial group has never led to any conflict of interest in relation to the corporate area. Similarly, Asset Manager B, also part of a financial conglomerate, posited that there are measures in place to ensure that conflicts do not take place in her organisation and that she has even witnessed cases in the group in which companies that were clients of the banking area were not selected for investment according to the asset manager’s ESG methodology. Asset Manager B added that the asset management area has once requested the help of the banking department to engage underperforming companies in relation to their ESG evaluation.

Furthermore, two Brazilian interviewees argued that being part of financial conglomerates actually encourages asset managers to incorporate sustainability issues. Asset Manager C, part of a financial group, observed that, since the group has created a sustainability department, the department has been in dialogue with the asset management division to promote sustainability, such as bringing specialists to speak about sustainability issues to the financial analysts. Likewise, Asset Manager B noticed that in Brazil, some asset managers started to discuss and act towards sustainability because they are linked to financial groups, driven by corporate values, risk management or reputational concerns.

Therefore, the interviewees in both countries demonstrate that they have different perceptions concerning conflicts of interests arising from asset managers who are part of financial conglomerates.

### **5.1.5.3. Discussion**

The interview findings are not consistent with the literature as a majority (67%) of the South African and 60% of the Brazilian respondents believe that asset managers engage more than pension funds. Nonetheless, the interview findings corroborate the results of the statistical



data analysis which found that 44% of the asset owners and 82% of the asset managers in the sample engage with companies, leading to a 38 percentage difference in engagement behaviour for the two types of investors.

Two of the reasons given by the interviewees why asset managers engage more than pension funds (limited knowledge of pension funds and competition among asset managers) are found in the literature. Firstly, the limited knowledge of pension funds has been identified in the academic literature (Myners 2001; Kakabadse et al. 2003; Kakabadse and Kakabadse 2005; Monks and Minow 2011) showing that trustees' limited knowledge is not an issue which is found in developing countries only. In the UK, Myners (2001) observed that trustees are undertrained and unprepared for their responsibilities. He found that 62% of trustees had no professional qualification in finance or investment, half received less than three days' training when they took office and 49% of trustees spent three hours or less preparing for pension investment meetings. Similarly, Kakabadse et al. (2003) surveyed UK pension fund trustees and found that 74% had background in areas other than financial investment and held no relevant qualification in financial investment. In the US, Monks and Minow (2011) states that, as trustees of public pension funds may be composed by diverse members such as employees, retirees, political appointees, elected officials or other experts, their expertise may rely in other areas than investment. In addition, they may not be paid enough to be able to devote a substantial amount of time to this task. Likewise, in South Africa, the interviewees claimed that pension fund trustees, especially on the employees' side, lack the understanding of investment and ESG issues and are not encouraged to develop their skills and expertise. The lack of knowledge of trustees seems to be an important barrier both in developed and developing countries.

Secondly, two Brazilian interviewees and one South African interviewee argued that asset managers engage with companies more than pension funds for competitive reasons in order to attract pension funds as clients. The interviewees claimed that asset managers use their engagement activities and relationship with investee companies to cultivate competitive advantage. Equally, Hendry et al. (2007) found that the UK asset managers have been engaging with companies for competitive considerations in order to pitch for, gain and retain pension funds' businesses. This shows that asset managers in emerging and developed countries also use their engagement capabilities to enhance their level of competitiveness.

Among the Brazilian interviewees, four interviewees mentioned that public pension funds are less likely to engage because of their low remuneration incentives and job stability, high director turnover and governmental influence. These findings seem to contrast with the literature review which suggests that public pension funds are more likely to engage than other types of investors because public funds are not dependent on commercial relationships with those in whom they invest (Monks and Minow 2011; Romano 1993; Black 1992; Coffee 1991). As a result, they are more likely to be activists in corporate governance issues (Romano 1993; Schmolke 2006 cited in Rubach and Seborá 2009) and are more likely to oppose management's proposals (Coffee 1991). Nonetheless, the literature also acknowledges that it is only a small number of public pension funds that have been actively involved in governance issues (Monks and Minow 2011). Examples include the California Public Employees' Retirement System (CalPERS), the New York City Employees' Retirement System (NYCERS) and the State of Wisconsin Investment Board (SWIB) who have a policy of voting all their shares (Mallin 2001). Likewise, in Brazil, as mentioned under Proposition 4, the interviewees reported that it is only a handful of public pension funds - the large ones - that are activists. However, the reason for their activism is less to do with a lack of business conflicts of interest and more to do with the fact that they have significant ownership holdings to appoint representatives onto Boards of investee companies and to influence Board meetings. It is possible that the influence of the causes raised by these four interviewees as discouraging public funds to adopt RI practices and engage with companies, in the case of large public funds, may be reduced/neutralised by their ability to engage in the Boards of the investee companies.

Another issue related to the type of investor raised by the South African and Brazilian interviewees is the potential conflicts of interest existing in corporate pension funds and in asset managers who are part of large financial groups.

As for conflicts related to corporate pension funds, these were acknowledged by three South African interviewees. They argued that, even though there are regulations in place to avoid such conflicts, in actuality corporate pension funds may avoid engaging with companies as these companies may be sponsors of the fund or shareholders of their own sponsors. This occurs because there are industry pension funds congregating funds of various companies from the same sector and because there is some level of crossholding in the country. These findings are consistent with the literature which indicates that corporate pension funds are discouraged from engaging with companies because there is an implicit understanding among

private pension funds that each pension fund will avoid being active in return for a reciprocal attitude from the others (Monks and Sykes 2006), while the exercise of one corporation's shareholder power over a fellow corporation's managers could lead to future retaliation (Ryan and Schneider 2003). As a result, the sponsoring private companies steer clear of conflicts with other companies by avoiding that pension funds engage (Black 1992; Coffee 1991).

No conflicts of interest of this nature were acknowledged in Brazil, possibly because corporate pension funds tend to be smaller in the country, while public pension funds represent the largest amount of assets under pension fund management. Data from ABRAPP (2012) shows that the largest ten public pension funds manage 56% of total assets under management by ABRAPP's pension fund members. Moreover, data from the 2011 PRI Assessment Survey shows that smaller pension funds are more likely to outsource their investment management than larger funds: the median value of pension funds managed externally is US\$ 3.9 billion, while the median value of assets of pension funds managed internally is US\$ 33.2 billion. As a result, most corporate pension funds are small and tend to outsource their investment management to asset managers. Therefore, they do not experience conflicts of interest because they do not have a direct relationship with the investee companies as this relationship is outsourced to the asset manager. Moreover, as discussed under Proposition 4, most pension funds in Brazil rely on meeting their actuarial goals through investing in governmental bonds. Hence, they have limited relationship with companies also because they have limited investment in corporations.

As for conflicts of interest related to asset managers that are part of larger investment groups, these were acknowledged by interviewees in Brazil and South Africa. Six South African and two Brazilian interviewees argued that these asset managers avoid engaging with companies who may be clients of the corporate area in order to avoid conflicts. The findings corroborate the literature which suggests that asset managers who are part of financial groups might avoid engaging with investee companies because doing so might compromise the relationship of these companies with the other businesses of the financial group (Black 1992; Myners 2001; Mallin et al. 2005). In contrast, four South African and three Brazilian interviewees claimed that there are no conflicts of interest because there are measures in place in these conglomerates to guarantee independence of departments. Furthermore, two Brazilian interviewees posited that being part of a conglomerate is even advantageous for the asset manager in terms of incorporating ESG issues because they may benefit from the

sustainability approach of the group as a whole. The existence of different viewpoints may be explained by the fact while the interviewees who argue that conflicts exist may have an inaccurate perception because they do not have first-hand experience of working in a financial group. In contrast, those who argued that there are no conflicts (mainly asset managers from financial groups) may have decided not to acknowledge conflicts of interest to avoid reputational damage and regulatory concerns in the future. This topic has been proved difficult to research.

As observed above, the literature suggests that pension funds are more likely to engage, while the statistical analysis and the interview findings indicate that asset managers engage more. The literature and the research findings probably diverge because, even though pension funds have long-term concerns and must provide pensions for their beneficiaries in the long-term (Richardson 2008; Coffee 1991), in Brazil and South Africa, most pension funds (often small and medium ones) manage their investment externally due to resource constraints and limited investment knowledge of pension fund trustees. Therefore, pension funds outsource their investments capabilities to the asset managers.

All in all, the proposition is not supported.

#### 5.1.6. Proposition 6 – impact of investment strategy

<b>Proposition 6 – Active investors are more likely to engage with companies than are passive investors.</b>
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**Strong support<sup>30</sup>**

As shown in the literature review (Chapter 1) and confirmed by the statistical findings (Chapter 4), active investors are more likely to engage with companies on ESG issues than

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<sup>30</sup> Over 79% of the interviewees in both countries agree with the proposition

passive investors. Bearing in mind that the sample used in the statistical data analysis does not represent the whole Brazilian and South African investment community, the interviewees from these two countries were asked whether they agree with the statement. The results demonstrate that there is an overwhelming support for Proposition 6, as shown below:

**Table 5.13 – Interviewees’ perceptions of the relationship between investment strategy and engagement behaviour**

Interviewees claimed that:	South Africa		Brazil	
	n	%	n	%
Active investors engage more with investee companies than passive investors	19	79%	17	85%
Did not respond, did not have an opinion or were not asked the question (when they were not actively involved with the investment community)	5	21%	3	15%
<b>TOTAL</b>	<b>24</b>	<b>100%</b>	<b>20</b>	<b>100%</b>

As shown in Table 5.13, a majority (79%) of the South African interviewees and 85% of the Brazilian interviewees believe that active investors engage more with investee companies than passive investors. None of the interviewees mentioned that passive investors engage more than the active ones. The interview findings are consistent both with the literature review and the statistical data analysis. Hence, the proposition is strongly supported.

The interviews were also used to investigate the reasons for why the interviewees believe that active investors engage more than the passive ones. The arguments are shown below.

#### **5.1.6.1. Reasons for why active investors engage more than passive investors**

As shown in Table 5.14, the arguments given by the interviewees as to why they believe that active investors engage more than passive investors are the following:

**Table 5.14 – Interviewees’ reasons for why active investors engage more than passive investors**

Interviewees claimed:	South Africa		Brazil	
	n	%	n	%
i. Investment goals of active and passive investors	11	46%	8	40%
ii. Power to divest from underperforming companies	2	8%	1	5%
iii. Remuneration incentives	2	8%	1	5%
iv. Characteristics of the local investment environment	2	8%	0	0
v. Investment horizon	0	0	3	15%
vi. Other reasons				
Payoff to engage	1	4%	0	0
Passive investors as minority investors	0	0	1	5%
Competitive advantage	1	4%	0	0
vii. No reason or other reason given	3	12%	4	20%

These arguments will be discussed below.

### **i. Investment goals of each type of investor**

Eleven South African interviewees (46%) and eight Brazilian interviewees (40%) claimed that active investors are more likely to engage with companies than passive investors because of their different investment goals. As indicated by the definition, active management aims to “beat the market” through the use of securities analysis and investment research, while passive management does not employ such instruments (Rudd 1986).

In South Africa, five interviewees posited that active investors are more likely to engage with individual companies on ESG issues because they are concerned with identifying and tackling the factors that may influence the financial performance of the investee companies. As posited by Interviewee SAI-8, active investors “really take an interest in what’s happening in that company, what is going to make that share price increase or what is going to make that share price fall”. Similarly, Interviewee SAI-10 noted that “active investors are looking for different signals in the business that will create or destroy value”. Interviewee SANI-1

mentioned that active investors are interested in “what the overall factors are that might influence the returns on that stock”.

To identify the factors that influence financial returns, Interviewee SAI-8 claimed that active investors engage in extensive research and analysis of the underlying companies. In addition, Interviewees SANI-9 and SANI-11 posited that, as active investors are interested in how a share performs, they are more likely to give ESG issues consideration if they realise that these issues affect performance. As noted by SANI-9:

*“If you are actively picking stocks, then you would probably take more of an interest in the underlying performance of those stocks and then you would probably give ESG considerations more consideration.”* (Interviewee SANI-9)

Likewise, Interviewee SAI-8 pointed out that, if investors are interested in the risks that could affect share price, it makes sense to analyse the ESG risks as well. Interviewee SAI-10 added that, in search for signals that can impact value, one source is engaging with companies. Through dialoguing with management, investors might obtain a better view of the factors that create value.

In contrast, six South African interviewees argued that passive investors are less likely to engage with companies because they are not interested in improving the performance of the individual companies. Four of them claimed that, as passive investors are not responsible for stock picking, neither are they concerned with the composition of the index nor are they worried about the performance of the individual companies. As stated by Interviewee SANI-3, “they (the passive investors) don’t see that they’ve made an active decision to hold a particular stock”. Similarly, as posited by Interviewee SAI-8:

*“They don’t actually care who is in that index, they are just buying the index. They don’t even see the names. It is sort of nameless.”* (Interviewee SAI-8)

Three interviewees claimed that the only concern of passive investors is to match the index's rate of return. As argued by Interviewees SAI-2 and SAI-10, they are not incentivised to analyse or to improve the performance of the individual companies. Interviewee SAI-10 observed that:

*"...they don't even go to the point of analysing the underlying companies. So what they say is: the market goes up, I go up, if the market goes down, I go down."* (Interviewee SAI-10)

Likewise, Interviewee SAI-9 noted that there is no incentive for passive investors to be involved in ESG performance, because it is not their objective to improve the performance of the individual companies.

Furthermore, four interviewees (21%) observed that, as passive investors do not wish to outperform the index which they follow, they reduce costs in their structure. In South Africa, SANI-5 observed that passive investors work on a low cost structure, attempting to save costs instead of having an active approach. Interviewee SAI-7 considers passive investors to be "parasitic" since they work on a cost-efficient model and avoid active ownership expenditures like voting on resolutions. Likewise, Interviewee SANI-3 argued that passive investors do not have the capacity to spend time on voting and other activist activities.

In Brazil, seven interviewees (35%) also claimed that active investors engage more than smaller ones due to their different investment goals. Interviewee X (not identified for confidentiality purposes) noted that active investors aim to obtain a relevant outperformance in relation to the market. She claimed:

*"We want to have a relevant outperformance in relation to the index, Ibovespa or another index. So we are going to have this cost (of engaging with companies), but we will have, if it all works out and if we do a good job, the benefit of a relevant outperformance in relation to the market."* (Interviewee X)

In the search for outperformance, Interviewee BRI-8 argued that active investors look for different alternatives to enhance performance, becoming more attentive to ESG issues.



Interviewee BRI-2 added that, in order to improve performance, active investors tend to have a closer relationship with the companies in which they invest. Interviewees BRI-9 and BRNI-2 also noticed that active investors engage more because they have more appetite for risk and are more in tune with the market trends.

In contrast, Interviewee BRI-2 claimed that passive investors are less concerned about engaging with companies because they are not worried about the financial performance of the individual companies in which they invest. As pointed out by Interviewees BRI-10 and BRI-12, there is no incentive for passive asset managers to engage with companies and to improve the investee companies' performance because it is not part of their mandates to outperform the index.

In addition, two respondents also argued that the cost structure of passive investors limits their engagement behaviour. As claimed by Interviewee BRNI-4, passive investors believe in the market efficiency. Therefore, they do not believe that it is worth engaging in additional costs to have a research team and to analyse the performance of companies since, as investors who believe in the market efficiency, having a deeper knowledge and engaging with the companies will not impact investment returns. Interviewee BRI-12 added that passive investors do not engage in costly endeavours, such as engaging with companies, because it is not in their mandates to outperform the index. She claimed:

*“The passive investor would have this cost (of engaging with companies), but it (engaging) is not part of his mandate. Thus, there is not a good cost-benefit relationship for them to engage.”* (Interviewee BRI-12)

Therefore, for Interviewee BRI-12, the cost-benefit analysis of passive investors engaging does not justify being an activist investor.

The statements above indicate that Brazilian and South African interviewees believe that active investors engage more than passive investors because of the different appetite of investors for financial performance. While active investors take an interest in evaluating and interfering with a company, including from an ESG perspective, to enhance performance,

passive investors are encouraged to keep costs low and to refrain from engaging with companies.

## ii. Power to divest from underperforming companies

Another reason given by two South African interviewees (8%) and one Brazilian Interviewee (5%) for why passive investors engage less than the active ones is that passive investors cannot divest from companies that are underperforming.

In South Africa, Interviewee SAI-2 contended that passive investors do not see a role for themselves in terms of influencing companies since they cannot divest from them. Interviewee SAI-9 added that, even if a passive investor found a company that has not complied with a number of performance criteria, the investor does not have the power to exclude the company from the investment list by the nature of the work performed with a passive approach. She stated:

*“...you find a company that you think has transgressed a number of your rules, what are you going to do? You leave it off your list, you can't. By very nature of the work that you do.” (Interviewee SAI-9)*

In Brazil, Interviewee BRI-11 also argued that the inability to divest limits passive investors' engagement. She argued that, even if passive investors found companies that they did not consider sustainable, they would not be allowed to divest due to their investment mandates. Interviewee BRI-11 then noticed that this fact represented a barrier to one of the investor's own engagement. When the investor requested that the company change their practices, the company refused to comply with the investor's requests, arguing that, as a passive investor, they would not be able to divest from the company.

Hence, the inability to divest is perceived as limiting engagement behaviour for passive investors in Brazil and in South Africa. These interviewees believe that not being able to threaten divestment constrains passive investors from engaging with companies.

### iii. Remuneration incentives

Two South African interviewees (8%) and one Brazilian interviewee (5%) claimed that active investors engage more than passive investors because of their remuneration structure.

In South Africa, Interviewee SAI-1 noted that active investors are being paid a premium to be activists. Interviewee SAI-11 explained that active managers are remunerated accordingly if they generate alpha or excess returns on the benchmark. For instance, if they generate an excess of the minimum rate of return (the ‘hurdle rate’) that was accorded in the mandate, they are better rewarded. Therefore, active investors will make use of different strategies, including engaging in dialogue with companies, in order to improve corporate performance and, as a result, improving investment performance and their own remuneration. On the other hand, Interviewee SAI-11 claimed that investment managers who employ a passive approach do not engage with companies because they are not remunerated to do so. According to Interviewee SAI-11:

*“...a passive investor is paid generally just to track the index or to track an underlining asset and not necessarily to generate alpha, above that”.* (Interviewee SAI-11)

As explained by Interviewee SAI-11, the mandates of passive managers consist in generating market returns, not financial performance above the index performance. Therefore, passive investors are not financially incentivised to adopt strategies that can improve performance such as analysing corporate governance issues and engaging with companies.

In Brazil, Interviewee BRI-10 also claimed that passive investors engage less than active investors due to a lack of remuneration incentives. She posited that, as passive investors are remunerated according to the tracking error (difference between the fund’s returns and the benchmark) and not the fund’s performance outperforming the market, they are less incentivised to attend the company’s Annual General Meeting and ‘disturb’ management by requesting changes in corporate performance.

Hence, remuneration incentives are perceived by the interviewees to encourage active investors to engage with companies in Brazil and in South Africa.

#### iv. Characteristics of the local investment environment

In South Africa, two interviewees (8%) explained that the reason for why active investors engage more than passive investors is the fact that there is a predominance of active investors in the country. Although there is no country data available to determine the percentage of active investors in relation to the total number of investors, the 2011 PRI data shows that 95% of the PRI signatories in South Africa adopt a predominantly active approach. As claimed by Interviewee SAI-5, there are not many passive investors in South Africa: while most South African asset managers are active investment managers, most pension funds are running some degree of active portfolios through their asset management allocations. Interviewee SAI-5 posited:

*“I think firstly there are not a lot of passive investors in South Africa. Most investors claim to have some – most asset managers in South Africa are active investment managers, so that’s the first thing. Outside of the Government Employees Pension Fund, there aren’t really big funds that run passive portfolios. Most of them are running some degree of active portfolios through the asset management allocations. So that’s why I think the stats will be the way they are.”* (Interviewee SAI-5)

Interviewee SANI-8 agreed that there is not a large passive industry in South Africa. As a result, the majority of engagers are active investors because active investors are also the majority of investors in South Africa.

Even though there is a predominance of active investors in the country, Interviewees SAI-5 and SANI-10 cited the case of the Government Employees Pension Fund (GEPF) as an exception of pension fund which, according to Interviewee SAI-5, is “the single biggest active passive investor”. Even though the GEPF does not adopt a predominantly passive approach, the amount of assets managed passively is substantial. According to the 2011 PRI data, 42% of GEPF’s US\$ 138 billion of assets under management is managed passively, representing nearly US\$ 58 billion. Interviewee SANI-10 indicated how activist the GEPF is by noting that “they are by far the most interested in engagement and probably involved in just about every major engagement with the companies that exist in South Africa”.

Interviewee SAI-1 explained why she believes that it makes sense for the GEPF to engage with companies when nearly half of the assets of pension fund are managed passively. As discussed under Proposition 1, the universe of South African listed companies is rather small as there are only between 150 and 200 companies listed in the JSE in which pension funds would invest. As a result of the limited number of possible investments in the JSE, it is more advantageous for pension funds to engage with the investee companies that are not performing well rather than divesting from them.

The statements show that active investors engage more than passive ones in South Africa because they are the majority of investors in the country, with the exception of the Government Employees Pension Fund as it is a large passive activist investor.

#### **v. Investment horizon**

In Brazil, three interviewees (15%) argued that active investors engage more than passive investors because of their different investment horizons.

Interviewee BRI-4 contended that active investors are more concerned with long-term investment than passive investors. Interviewee BRI-5 explained that active investors have a bottom-up investing approach, focusing more on the analysis of individual companies than on market cycles. As follows, active investors are concerned about adding value to the companies in the medium and long term in order to improve their own investments. Therefore, it makes sense for active investors to engage with companies to add value to their investments. Interviewee BRI-5 noted:

*“Investors doing bottom-up analysis are interested in adding value to the company in the investment period. In indexed funds, often the investment management is top-down, which means that you will be selling or buying stocks not because of the stock valuation, but because of (investment) flow, even changes in market expectations.” “I think the funds that tend to be more activists are those that have a bottom-up approach.” (Interviewee BRI-5)*

In contrast, Interviewee BRI-4 argued that passive investors are more concerned about short-term investments. Interviewee BRI-5 noted that passive investors are less interested in the valuation of individual stocks in the medium and long term than active investors. Similarly, Interviewee BRI-5 contended that, for passive investors, improving the performance of individual companies through engagement is not seen as a reasonable strategy.

These statements suggest that active investors, as long-term investors, are more interested to engage with companies and improve their market value in the medium and long term than passive investors.

#### vi. Other reasons

A number of other reasons were cited by three other interviewees as to why they believe that active investors engage more than passive investors. As each reason was cited only once, they are aggregated in this section.

Firstly, Interviewee SANI-9 argued that passive investors engage less because it is not financially advantageous for them to engage. She claimed that indexed investors have such broad holdings that the ‘payoff’ from engaging with one company to improve performance on ESG issues represents a limited impact on the total portfolio performance. Interviewee SANI-9 claimed:

*“Because you buy an index, a company only makes up a small portion of that...you know, if you passively buy an index, maybe there are 50 or 60 or 70 companies in the index. So one company’s ESG performance is 1/70 of your concern in that portfolio.”* (Interviewee SANI-9)

Interviewee SANI-9 expanded on this point by noting that a bad ESG performance of one company will have a 1/70 financial impact on the overall financial performance of an index composed by other 69 companies. Interviewee SAI-8 commented on the low impact that highly diversified investors generate when they engage with individual companies:

*“You are holding a diversified portfolio shares and one of your shares is misbehaving. How much of an impact does that actually have on your portfolio? Probably negligible. So how much time and energy are you going to devote as management to that one share when it is so easy to diversify away from its impact?” (Interviewee SAI-8)*

Interviewee SAI-8 also observed that the impact that companies with bad performance have on the overall portfolio is too low to justify the use of staff and effort to improve the performance of the company.

Another reason identified by Interviewee BRI-1 why active investors engage more than passive investors is the fact that passive investors do not have ‘clout’. Interviewee BRI-1 cited that passive investors, as highly diversified shareholders, are usually minority investors in the companies they invest. Thus, they do not have representatives sitting on the Boards of companies and they have low voting power. According to Interviewee BRI-1, their lack of influence discourages them to engage with companies. This argument has also been examined under Proposition 4.

Third, Interviewee SAI-6 noted that active investors engage more than passive investors because engaging with companies gives investors a competitive edge. She contended that what active investors sell to their clients as part of their value-added is the fact that they will pick stocks actively and conduct face-to-face diligence with the management of the companies. According to Interviewee SAI-6:

*“Whereas the active managers, part of the value add that they sell to their clients is that they are actively stock picking and part of that process means that they do a lot more thorough face-to-face due diligence with the management of companies, you know.” (Interviewee SAI-6)*

Interviewee SAI-6 cited the example of one South African active asset manager and how the organisation is proud to state as part of their selling point to clients that they have a relationship and engage with the management of investee companies. As cited under Proposition 5, Interviewee SAI-1 noticed that South African asset managers often use their

relationship with investee companies to cultivate competitive advantage in the highly competitive South African asset management industry.

In sum, the low payoff to passive investors engaging with companies, lack of potential influence on companies of passive investors and competitive advantage of active investors were identified are other reasons for why active investors engage more than smaller investors.

#### 5.1.6.2. Importance for passive investors to engage with companies

It is noteworthy that, in South Africa, five interviewees (21%) mentioned, that, even though active investors engage more than passive investors and despite the lack of importance that passive investors attribute to engagement strategies, they believe that passive investors should engage. According to Interviewee SAI-4, when passive investors engage with companies, the actual value of the company is translated into its share price. By improving its management practices, the company achieves its potential and the share price reflects the actual value of the business. If a company is overvalued (when the company's share price is higher than the underlying value of the company), the risk is that the company's shares will have a larger part of the index, leading to value loss at a later stage when the share price drops to reflect the actual value of the business. According to Interviewee SAI-4:

*“To me, I believe it is even more important for passive type of investments like that for the investor to actually engage because otherwise you are just trapped in terms of what of the exposure this index has and the price of the company is much higher than the underlying valuation, of course, it becomes larger and larger and larger part of this index, and, if you are not engaging, that risk actually grows that you could destroy value at the latest stage.” (Interviewee SAI-4)*

The fact that these interviewees mentioned the importance of passive investors engaging with companies is a reflection of the discussions held during the development of the Code for Responsible Investing in South Africa (CRISA), as discussed under Proposition 2. According to Interviewee Y (not identified for confidentiality purposes):



*“...it was a big decision when we set up CRISA: “should passive investors engage, shouldn’t they”, but the Committee made the decision that, even though you are a passive investor, you are still an investor and that again it is something that I think some of the passive funds might not have taken up yet.” (Interviewee Y)*

Interviewees SAI-4 and Interviewee Y recalled that, in a number of conversations during the creation of CRISA, passive investors suggested that it was not appropriate for them to engage. However, the CRISA Committee made the decision that passive investors should engage with companies on ESG issues. As a result, a special sentence was included under Principle 2 of CRISA to emphasise their responsibility: “even if passive investment strategies are followed, active voting policies incorporating sustainability considerations including ESG should still be followed”.

#### **5.1.6.3. Discussion**

There is an overwhelming support for Proposition 6 as the majority of the interviewees in Brazil and in South Africa believe that active investors engage more than passive ones. As shown above, 79% of the South African interviewees and 85% of the Brazilian interviewees claimed that active investors engage more than passive investors, while none of the interviewees believe that passive investors engage more than the active ones.

The findings are consistent with both the literature review and the statistical data analysis which found that 74% of the active investors engage with companies, while only 37% of passive investors do, leading to a 37 percentage difference in engagement behaviour for the two types of investors.

The reasons given by the interviewees as to why active investors engage more were numerous: investment goals of active and passive investors; power to divest from underperforming companies; remuneration incentives; characteristics of the local investment environment; investment horizon; low payoff of passive investors to engage with companies; lack of potential influence on companies of passive investors; and competitive advantage of active investors.

Two of these arguments (investment goals and low payoff) are considered in the literature. Firstly, the low cost structure of passive investors is mentioned in the literature. As passive investors have abandoned attempts to outperform the market, they aim to reduce costs to maximise returns (Choi and Fisch 2008) and to remain competitive (Coffee 1991). As a result, passive investors and their service providers avoid engaging in costly activities, such as corporate governance issues (Black 1990) and monitoring companies (Martin et al 2007) to keep operating costs low. Similarly, the interviewees in Brazil and in South Africa noticed that, as passive investors are not interested in outperforming the market, they employ a low cost structure which includes avoiding engagement costs.

Secondly, the argument related to low payoff for engagement is also found in the literature. Passive investors usually hold such diversified portfolios that it is beyond their realistic capacity to monitor and intervene on investee companies (Coffee 1991; Martin et al. 2007). In addition, considering that no single stock is likely to amount to more than a small percentage of the portfolio, expected payoff from involvement with issues at any single corporation in the portfolio is low (Lowenstein 1991 cited in Coffee 1991). Similarly, one South African interviewee noted that indexed investors have such broad holdings that the payoff from engaging with one company to improve performance on ESG issues represents a limited impact on the total portfolio performance.

In sum, Proposition 6 is strongly supported.

## **5.2. Strategies of shareholder engagement**

Even though the identification of shareholder engagement strategies was not part of the original scope of this research, the interviews provided evidence that the strategies used by investors to engage with companies on ESG issues vary between countries. The interview findings show that the most common strategies of shareholder engagement adopted in Brazil are collaborative engagement and appointing representatives onto Boards of Directors, while, in South Africa, the most common strategy cited largely takes the form of individual meetings with investee companies. These will be discussed below.

### 5.2.1. Collaborative engagement

Collaborative engagement was cited by ten Brazilian (50%) and two South African interviewees (8%) as one of the common engagement strategies adopted by institutional investors. As described in Chapter 1, collaborative engagement involves a coalition of investors engaging with companies on environmental, social and corporate governance (ESG) issues.

In Brazil, three collaborative engagement initiatives were cited in the interviews: the engagement held at the PRI Engagement Group, the initiative held at AMEC and the initiative mentioned by Interviewee X (not identified for confidentiality reasons).

First, four Brazilian interviewees mentioned the engagement conducted within the Engagement Working Group of the PRI Brazil Network in which Brazilian and foreign signatories formed a coalition to encourage the largest Brazilian listed companies to adopt the Global Reporting Initiative (GRI) framework for sustainability reporting. As mentioned by Interviewee BRI-11:

*“We are involved in the Engagement Group to try to encourage companies to use the GRI report which for us is very important in order to have some sort of (reporting) standardisation.” “So we believe that the GRI is a very important initiative for us analysts and we are encouraging companies in Brazil to adopt the GRI framework to report corporate information to facilitate our work.”*  
(Interviewee BRI-11)

This engagement initiative involved sending letters to the 100 largest listed Brazilian companies (IBrX100) and having behind-the-doors dialogue with 17 listed companies to encourage adoption of the GRI framework or to congratulate those companies that had already adopted it (PRI et al. 2012).

Second, three Brazilian interviewees cited the engagement coordinated by AMEC, the association for minority investors, which brings together investors to elect a representative of

minority investors for the Board of Directors at Petrobras. As mentioned by Interviewee Y (not identified for anonymity purposes):

*“We were also involved in the election for Petrobras’ Board in which AMEC served as a hub for shareholders to elect a representative for Petrobras’ Board.”* (Interviewee Y)

Interviewees BRI-12 and BRNI-3 reported that the initiative was not successful because the public pension funds who were also shareholders of Petrobras were treated as minority shareholders for the purpose of nominating and electing directors. As discussed earlier in this chapter, these public funds voted according to the recommendations of the Brazilian government who are the company’s majority shareholder, and managed to appoint the controversial candidate proposed by the government to occupy one of the board seats legally designated for representatives of minority shareholders. Despite the failure of the minority investors to elect a candidate, AMEC provided the space for them to collaborate and act on the company.

In the third collaborative initiative, Interviewee X (not identified for confidentiality reasons) reported that they have participated in a coalition of asset managers representing 20% of the market capitalisation of a Brazilian listed company, succeeding in electing a number of members to the company’s Board of Directors.

These three initiatives have been mentioned earlier under Propositions 1 and 2. As discussed previously, the institutional environment in Brazil seems to be conducive to collaborative engagement, driven by a combination of lack of regulatory constraints and legal incentives for investor collaboration, concentration of ownership and support of investor associations. First, the Brazilian legislation does not approach ‘acting in concert’ issues and, as a result, there are no legal constraints for collaboration. Second, the Brazilian Companies Law offer instruments encouraging minority investors to form coalitions and to elect representatives in the investee companies’ Boards and Fiscal Councils, mechanisms used by the investors involved in the engagement at AMEC and in the initiative in which Interviewee X participated. Third, the concentration of ownership in the country means that, for minority investors to exert some control on the investee companies, they need to collaborate with each other to become more relevant in the discussions with companies. Fourth, Brazilian investor

associations have been providing a space for investors to collaborate and to engage with companies, as is the cases with AMEC and the PRI Brazil Network. Furthermore, the PRI model of engaging on ESG issues collaboratively has been imported by the PRI Brazil Network as a framework that has been used by the PRI globally to assist and coordinate their signatories to engage with companies worldwide. Hence, the legislation coupled with a concentrated ownership environment and the influence of investor associations contributed to the increase of collaborative engagement in Brazil.

A smaller number of South African interviewees (two interviewees, or 8%) also cited collaboration as an engagement strategy adopted by South African investors. Interviewee SAI-1 observed that a number of South African investors have been engaging collaboratively on thematic ESG issues, such as requesting companies to report against the Integrated Reporting Framework and to adopt the Global Reporting Initiative (GRI) guidelines:

*“On thematic ESG issues, I think we are seeing more investors collaboratively engaging, but that would be something like climate change or disclosure against the Carbon Disclosure Project for Water, you know, improved corporate governance reporting or reporting against Integrated Reporting Framework using the GRI guidelines. If something is generic or thematic, I think it is fairly likely that we will have a fairly number of investors collaborating on that.”* (Interviewee SAI-1)

However, Interviewees SAI-1 and SAI-4 posited that investors are wary of engaging with individual companies in order to avoid being deemed to be acting in concert. As mentioned under Proposition 1, this is because of the Companies Act’s ‘acting in concert’ regulations that state that, if investors are deemed to be acting in concert, they might have to make an offer to minority shareholders. Therefore, investors avoid engaging in collaboration or they prefer to engage collaboratively with groups of companies on specific issues rather than with individual companies. Furthermore, as also mentioned under Proposition 1, in South Africa, a number of interviewees noticed that the asset management industry is fairly competitive and, as a consequence of its competitive culture, many asset managers are reluctant to collaborate with others and use ‘acting in concert’ concerns as an excuse not to collaborate. Thus, the limiting legislation and the competitive culture lead investors to collaborate on a limited basis mainly on thematic issues with groups of companies rather than with individual companies.

## 5.2.2. Appointment of Board representatives

Another common strategy cited by six Brazilian interviewees (30%) is the appointment of investor representatives onto Boards of Directors and Board Committees of investee companies. According to Interviewee SAI-2, this strategy is largely adopted by large Brazilian pension funds. As explained by Interviewee BRNI-5, investors that have significant holdings in investee companies can more easily nominate representatives onto companies' Boards of Directors and Fiscal Councils, and they can then engage with companies through dialoguing with management and offering recommendations. Two interviewees also noted that some large pension funds, such as PREVI, have been promoting awareness on ESG issues to these investor representatives so that they raise these issues in the Boards' meetings. According to Interviewee BRNI-1:

*“The large pension funds certainly have this practice with the people who are nominated Board members. Previ, Petros, Funcef, Infraprev, these large pension funds that have direct investment (on companies)...” “...they have this practice with the Board members to make them aware of the topic (sustainability) and it is then included in the (Board’s) agenda of the investee companies.”*  
(Interviewee BRNI-1)

In addition, as mentioned above under collaborative engagement, the experience of Interviewee X shows that investors who do not have significant shareholdings individually may form a coalition to try to elect their representatives in the Boards of Directors to have their voices heard in the companies, as was the case for the interviewee who joined forces with other investors to elect a number of members in the Board of Directors of a Brazilian listed company.

As discussed under Proposition 4, the use of representatives of institutional investors inside the companies is defended by Stapledon (1996) and Davies (1993) who argue that non-executive directors cannot be truly independent unless they are connected to a powerful group such as institutional investors which allows them to counterbalance company management. Stapledon (1996) and Davies (1993) claim that there are some issues which

impede the ability of traditional independent non-executive directors to monitor the company effectively, such as the fact that traditional directors commonly owe their positions to the chairman. Moreover, as many non-executive directors are senior executive of other listed companies, they may lack the time and the specific knowledge of the company to provide effective monitoring. Stapledon (1996) also argued that the position of the non-executive director as a monitor is further compromised when the chairman and the CEO positions are occupied by the same person and when there is executive dominance in the board. In sum, Stapledon (1996) and Davies (1993) contend that independence of director can only be achieved by making non-executives dependent on another powerful group.

As also mentioned under Proposition 4, the approach of appointing investor representatives on the Boards is not shared in South Africa. Two South African interviewees argued that appointing Board members is not considered a good corporate governance practice according to the South African King Code which expects “a balance of power, with a majority of non-executive directors”, most of whom must be independent (IoD 2009). As pointed out by Interviewee SAI-6:

*“...you are not allowed to do that (appointing members on the Boards of Directors of investee companies). You are not allowed to do that in terms of the King Commission, but obviously in private equity we do.” (Interviewee SAI-6)*

Moreover, Interviewee SAI-5 reported that they are not interested in appointing investor representatives on the Boards of investee companies because this affects their ability to trade shares freely. Hence, in listed companies, South African investors tend not to appoint non-executive directors.

### **5.2.3. Individual meetings on ESG issues**

Five South African (21%) and two Brazilian interviewees (10%) argued that another common shareholder engagement strategy is individual meetings with companies to discuss ESG issues.

In South Africa, five interviewees (21%) cited individual meetings with investee companies on ESG issues as one common engagement strategy adopted by South African investors. One large investor (not identified for confidentiality purposes) mentioned that they analyse the largest South African listed companies according to ESG criteria and then highlight the worst performing companies for engagement or further dialogue. As an example, she mentioned that, a few days before the interview, she had a meeting with the management team of one of South Africa's largest retailers to discuss ESG issues. Another large South African investor (also not identified for confidentiality purposes) posited that they engage approximately 110 companies twice a year, leading to 200 to 300 engagement meeting per year at a face-to-face level. She further argued that they have a high level of access to management given their large size. The investor also mentioned that, at the time of the interviews, they were engaging with a number of large companies from the extractive industry.

Further, as mentioned under Proposition 4, two large investors (not identified for confidentiality purposes) claimed that, given the size of their portfolio, they are also frequently consulted by the companies' management on diverse corporate issues, such as strategic issues and proposed executive policies. One of them posited:

*"The management comes to our offices regularly and we do hold meetings for stakes in businesses and, given the size of our investment portfolio, you know, XXX is a big known company in South Africa, so management engages us."* (Interviewee Y)

As mentioned earlier, this interactive two-way engagement process is acknowledged by the literature. Solomon and Solomon (2003 cited in Solomon 2010), Stapledon (1996) and Mallin (2013) pointed out that, while investors are asking companies about their strategy and performance, companies are also initiating discussion and asking for advice from large investors which demonstrates the importance that they attach to significant investors.

Furthermore, two South African interviewees argued that South African investors often engage with companies on ESG issues without realising that they are speaking about Responsible Investment. As claimed by Interviewee SAI-1:



*“I also need to say that I think a lot of engagements happen with companies often addressing ESG issues even though they may not be called ESG issues. So traditionally South Africa has been a very strong corporate governance culture and investment analysts will often take company to task where there are lapses in corporate governance and they will raise corporate governance issues in companies’ meetings, whether it is just a results’ presentation or an investor roadshow, so it is happening, but it doesn’t always happen under the banner of Responsible Investment or ESG engagement.” (Interviewee SAI-1)*

Interviewee SAI-1 posited that it is common for South African investors to discuss corporate governance issues with investee companies, even though investors might not realise that they are discussing ESG issues. According to Interviewee SAI-1, this is explained by the strong corporate governance culture in South Africa. Equally, Interviewee SANI-1 claimed that social and governance issues such as transformation and black economic empowerment have become part of the license to operate in the country and, hence, “shareholders definitely engage with companies on those issues without realising that it is ESG engagement”. Interviewee SAI-1 added that investors have been engaging with companies more on governance issues than on social and environmental issues.

The research findings are consistent with the literature, which indicates that due to South Africa’s Apartheid history, the South African government has gone much further than governments in many other countries to legislate social issues in corporate management, developing a number of regulations designed to reduce social inequalities in the country, such as the Employment Equity Act and Broad-Based Black Economic Empowerment (Hamann 2008 cited in King et al. 2010; West 2006). Moreover, pressure from foreign investors for improved governance practices in order to bring their money back in the country, coupled with pressure on companies to embrace international standards of corporate governance to compete in the new business environment, have led to the development of higher local governance standards, as illustrated by the King Reports (Rossouw et al 2002 cited in Andreasson 2011; Kakabadse and Korac-Kakabadse 2002 cited in Vaughn and Ryan 2006). Therefore, social and governance issues are considered mainstream business issues discussed with investee companies and not necessarily labelled as ESG issues.

In Brazil, only two interviewees mentioned that they have meetings with companies on ESG issues. Interviewee BRI-11 noted that they engage individually with companies on corporate

governance issues, but not yet on social and environmental issues. Another Brazilian interviewee (not identified for confidentiality purposes) observed that they engage with companies on ESG issues in order to obtain additional corporate information and to discuss corporate weaknesses that the investor has identified in their gap analysis research. The interviewee mentioned that they engaged with 39 companies on ESG issues in 2010. This investor is possibly an exception to the rule in Brazil in having individual engagement with companies on social and environmental issues. As part of a multinational group, they adopted the headquarters' methodology used to analyse the ESG performance of investee companies. This finding corroborates the literature which indicates that MNCs transfer best practices across international boundaries, for example, by applying stringent global corporate environmental standards (e.g. Christmann 2004; Dowell et al. 2000).

#### 5.2.4. Other engagement strategies

Another shareholder engagement strategy cited by three South African interviewees (13%) refers to engaging with companies on shareholder resolution issues prior to voting against management recommendations.

Interviewee SAI-2 argued that, when they decide to vote against management recommendations, they engage with the investee company on the voting issue through letters. On financial matters, they are likely to write to the chief financial officer; on governance issues, they would write to the chairman and, on more serious matters, they would write to the CEO. They would also engage with the chairman of the Remuneration Committee on remuneration-related issues. Interviewee SAI-2 contended that the investor approach to the company is often cordial, unless the company disrespects or disregards the demands of the shareholders. Similarly, Interviewee SAI-11 claimed that they would conduct research on the topic to be voted and, in case their decision is to vote against management, they would contact the chairman or, less often, the investor relations department or the CEO, to discuss the intended voting. Interviewee SAI-11 contended:

*“...when we vote on AGMs and mergers and acquisitions, things like, we will always call up the chairman of the business or the investor relations or the CEO, but preferably the chairman of the*

*business, and talk to them about our intended voting. So we would do the research on the voting, decide how we want to vote preliminary, saying that to them before we set off to our administrators through the whole proxy voting process. Just so they know how we voted and what we are concerned about. So then we can change our mind if they convince us otherwise if there's an issue that we are not aware of or we can use that as a platform to engage with them and to change their strategy going forward.” (Interviewee SAI-11)*

Interviewee SAI-11 argued that contacting the company gives the business the opportunity to defend the management's position. In case the company does not write back to or does not convince the investor about the management's position, they vote against management recommendations. Interviewee SAI-6 also claimed that they engage with companies around issues related to how they plan to vote proxies, including issues such as executive remuneration, independence of Board members, structure of the Board and policies for appointment of auditors. However, Interviewee SAI-6 argued that their approach has been mainly ad hoc instead of having a more consistent view of the different ESG issues and how they impact the creation of long-term shareholder value to drive their engagement.

The literature shows that this engagement approach of dialoguing prior to voting has also been used by investors in developed countries. According to Martin et al. (2007), the majority of British fund managers advises the Board of Directors in advance of either deliberately abstaining or voting against a resolution. Mallin (2012) noted that the UK institutional fund manager Hermes usually engages with companies via dialogue before voting against management or before abstaining from voting to attempt to have the directors change or clarify the resolution. If the dialogue fails, Hermes contacts the companies to explain their voting decision and encourage improvements.

The limited number of South African investors claiming that they engage prior to voting in South Africa may be explained by the fact that South African institutional investors tend to be apathetic in respect to voting, often not voting or participating in shareholder meetings, not disclosing voting policies (Institute of Directors 2005) or rarely presenting shareholder proposals at the Annual General Meetings (AGMs) (CFA Institute 2009).

In Brazil, this type of engagement has not been mentioned by any of the interviewees. This may be explained by the fact that there is a high level of shareholder concentration of ownership in Brazil (CFA Institute 2009), limiting the power of most individual investors to

vote and to have their voices heard by the companies. Moreover, until recently, the legislation did not permit investors to vote remotely. According to Interviewee BRI-5, the previous requirement to vote in person in the AGMs represented a barrier for investors to vote as it required expenditure of financial resources and time to attend AGMs. However, in 2011, Law 12431 amended the Companies Law to permit investors to vote electronically, facilitating voting by smaller investors. It is yet to be seen whether the change in legislation will encourage more investors to vote and to engage with companies on voting matters in the near future.

In sum, while the most common strategies of shareholder engagement cited by the interviewees in Brazil are collaborative engagement and participating in the Boards of Directors and Board Committees of investee companies, in South Africa, they mainly take the forms of individual meetings with investee companies. The reasons highlighted by the interviewees for why these were selected as common engagement practices refer to a combination of regulatory requirements, support from investor associations, concentration of ownership and competitive culture in the asset management industry.

**Summary of the chapter:** This chapter presented the results of the interviews held with institutional investors and other investment players in Brazil and South Africa on the institutional and organisational determinants of shareholder engagement. As shown in the table below, three propositions were supported (two of them strongly supported), one proposition was partially supported and two propositions were not supported.

**Table 5.15 - Analysed propositions**

<b>N</b>	<b>Factor</b>	<b>Proposition</b>	<b>Support</b>
<b>Institutional factors</b>			
1	Legislation	Legislation does not encourage investors to engage with companies in emerging markets.	No support
2	Influence of investor associations	Investor associations encourage investors to engage with companies.	Strong support

<b>N</b>	<b>Factor</b>	<b>Proposition</b>	<b>Support</b>
3	Client influence	Investor clients do not encourage investors to engage with companies.	Partial support
<b>Organisational factors</b>			
4	Investor size	Larger investors are more likely to engage with companies than are smaller investors.	Support
5	Investor type	Asset owners are more likely to engage with companies than are asset managers	No support
6	Investment strategy	Active investors are more likely to engage with companies than are passive investors	Strong support

The first proposition related to legislation is not supported as legislation was found to be an important factor encouraging shareholder engagement directly and indirectly in these countries. Directly, the Pension Funds Act in South Africa and the Companies Law and Law 3792/2009 in Brazil were found to incentivise South African investors to use voice over exit and to encourage Brazilian minority investors to use the legal mechanisms to which they have access to elect representatives on Boards of investee companies and further their corporate influence. Indirectly, these regulations were found to promote an enabling environment for engagement by promoting awareness of Responsible Investment and by making pension funds less wary of violating their fiduciary duties.

The second proposition, relating to the influence on investors associations, is strongly supported. Investors associations were found to encourage engagement directly and indirectly. Directly, the Brazilian associations PRI and AMEC provide a platform for investors to engage collaboratively. Indirectly, the associations PRI and ABRAPP promote Responsible Investment by promoting awareness of Responsible Investment. In South Africa, the PRI, the POA and ASISA also encourage engagement indirectly by providing (or assisting in the development of) RI voluntary frameworks and by promoting RI awareness. This study also demonstrates the willingness of the private sector in emerging markets to preempt and influence legislative initiatives related to shareholder engagement on ESG issues.

The third proposition, related to client pressure, is partially supported. First, supporting the literature, this study found that beneficiaries of pension funds do not exert pressure on

pension funds to adopt Responsible Investment practices and to engage with companies. However, in relation to pension fund pressure on asset managers, contrary to the expectations from the literature, pension funds were found to influence asset managers to adopt Responsible Investment practices and to engage. This study also found that the influence of the legal and self-regulatory guidelines (mentioned above) encourages pension funds to question asset managers about their RI practices and, to a lesser extent, to outsource engagement activities. This is because, since most pension funds in Brazil and South Africa are small and lack financial resources, staff and investment knowledge, they are shifting the RI responsibilities imposed on them by mandatory and voluntary regulations to external service providers.

The fourth proposition on the influence of investor size is supported. The statistical and interview findings show that larger investors engage more with investee companies than smaller investors do because smaller investors have insufficient resources available to them and the potential for smaller investors to influence companies is limited.

The fifth proposition on the influence of investor type is not supported. Contrary to the expectations from the literature, the statistical and interview findings show that asset managers are more likely to engage with investee companies than pension funds because pension funds have insufficient resources available to them and pension fund trustees lack investment understanding.

The sixth proposition is strongly supported. Supporting the literature, active investors are more likely to engage than passive investors as they are motivated by their goal to outperform the market as well as the remuneration incentives available to active managers. Furthermore, passive investors are unable to divest from companies.

This chapter also investigated the interviewees' perceptions of the most common shareholder engagement strategies in Brazil and South Africa. The research findings demonstrate that the engagement strategies most commonly employed by South African investors are individual meetings with companies to address ESG issues, while Brazilian investors mainly use collaborative engagement and appointment of investor representatives onto Boards of Directors in order to ensure the inclusion of ESG issues in the Board's discussions. The adoption of different engagement strategies in Brazil and South Africa is explained by a mix of regulatory requirements, support from investor associations, ownership concentration and competitive culture in the asset management industry.

## 6. CONCLUSION

This chapter highlights the main findings and contributions of this research, points out limitations, makes suggestions for future research studies and offers recommendations for professional practice.

### 6.1. Main findings and contributions

This study makes a number of theoretical contributions to the academic literature.

Firstly, this research contributes to the literature on shareholder engagement, particularly in the emerging markets. Even though adoption of shareholder engagement by institutional investors is increasing worldwide (PRI 2012), the amount of literature on the topic is limited (recent exceptions include studies from Clark and Hebb 2004; McLaren 2002; Gifford 2012; Guay et al. 2004; Rehbein et al. 2013). Moreover, as Gifford argues (2008: 256), “there needs to be exploration of the shareholder engagement context across different jurisdictions and cultural differences”. Existing academic studies tend to concentrate on studying engagement practices in the UK and the US (e.g. Gifford 2012; Clark and Hebb 2004; McLaren 2002) while less effort has been put into analysing engagement outside these two Anglo-Saxon contexts. To date, I have found just two academic studies (Choi and Cho 2003; Gond and Piani 2013) on shareholder engagement in the emerging markets, while there is no existing research into the factors that influence engagement in these countries. Therefore, there is a substantial gap in the literature with regard to this particular area of study.

This PhD study found that shareholder engagement strategies on environmental, social and corporate governance (ESG) issues vary across the emerging markets. In South Africa, domestic investors most commonly engage with companies through individual meetings to discuss ESG issues. This approach is similar to the strategies adopted by investors in the UK (cf. Martin et al. 2007; Sullivan and Mackenzie 2006). However, unlike the UK, social issues are more firmly embedded in the South African legislative framework, as illustrated by regulations related to Black Economic Empowerment and Employment Equality. This encourages South African investors to approach companies on social issues even though they

do not explicitly acknowledge them as ESG issues. In Brazil, collaborative engagement is one of the most common engagement strategies. This is because the high concentration of ownership, legal mechanisms protecting minority rights and collaborative platforms in investor associations encourage local investors to collaborate. The second most commonly adopted engagement strategy in Brazil is to secure appointment of investor representatives onto the Boards of Directors in order to ensure the inclusion of ESG issues in the Board's discussions. This strategy of appointing representatives is mainly used by large investors who own significant holdings. While this form of engagement is widely used in Brazil, particularly by large investors, it is not a common engagement strategy in South Africa as King III's governance guidelines establish that the majority of Board members must be independent non-executive directors.

As for this study's second contribution, the institutional perspective has proved to be a useful lens through which to analyse shareholder engagement in these countries. There are some studies on corporate governance (e.g. Chizema and Buck 2006; Lee and Yoo 2008; Aguilera et al, 2006; Weimer and Pape 1999), corporate social responsibility (e.g. Campbell 2007; Doh and Guay 2006; Matten and Moon 2008), Responsible Investment (e.g. Bengtsson 2008) and shareholder activism (e.g. Adegbite et al. 2012) which use the institutional framework. However, to my knowledge, no prior academic research has used Institutional Theory to examine the factors influencing shareholder engagement.

This study found that the institutional environment influences the level of shareholder engagement by domestic investors in these countries. Firstly, legislation was found to encourage shareholder engagement directly and indirectly. In South Africa, shareholder engagement is directly encouraged by the legal limitation on international exposure that pension funds may have, as defined by the Pension Funds Act, coupled with the limited number of South African listed companies, thereby incentivising investors to use voice over exit. In Brazil, the legal protection offered to minority investors by the Companies Law encourages these investors to use the available legal mechanisms to elect representatives onto the investee companies' Boards and further their corporate influence. Legislation also encourages shareholder engagement indirectly by incentivising Responsible Investment and creating an enabling environment for engagement in both countries. The Pension Funds Act in South Africa and the Companies Law and Law 3792/2009 in Brazil were found to promote awareness of Responsible Investment and, by enshrining ESG issues in law, to make pension funds less wary of violating their fiduciary duties. The research findings are contrary to



expectations from the literature which suggests that regulation does not influence engagement in emerging markets. The contradiction between the literature and empirical results suggests that the sophistication of the legislation on ESG issues in Brazil and South Africa is more typical of developed countries. Unlike many emerging markets/developing countries that are characterised by a lack of regulation (Ozen and Kusku 2009; Yang and Rivers 2009), Brazil and South Africa have regulations in place which encourage corporate responsible behaviour, demonstrating that at least some emerging markets are developing legislation related to ESG issues directed at companies and investors.

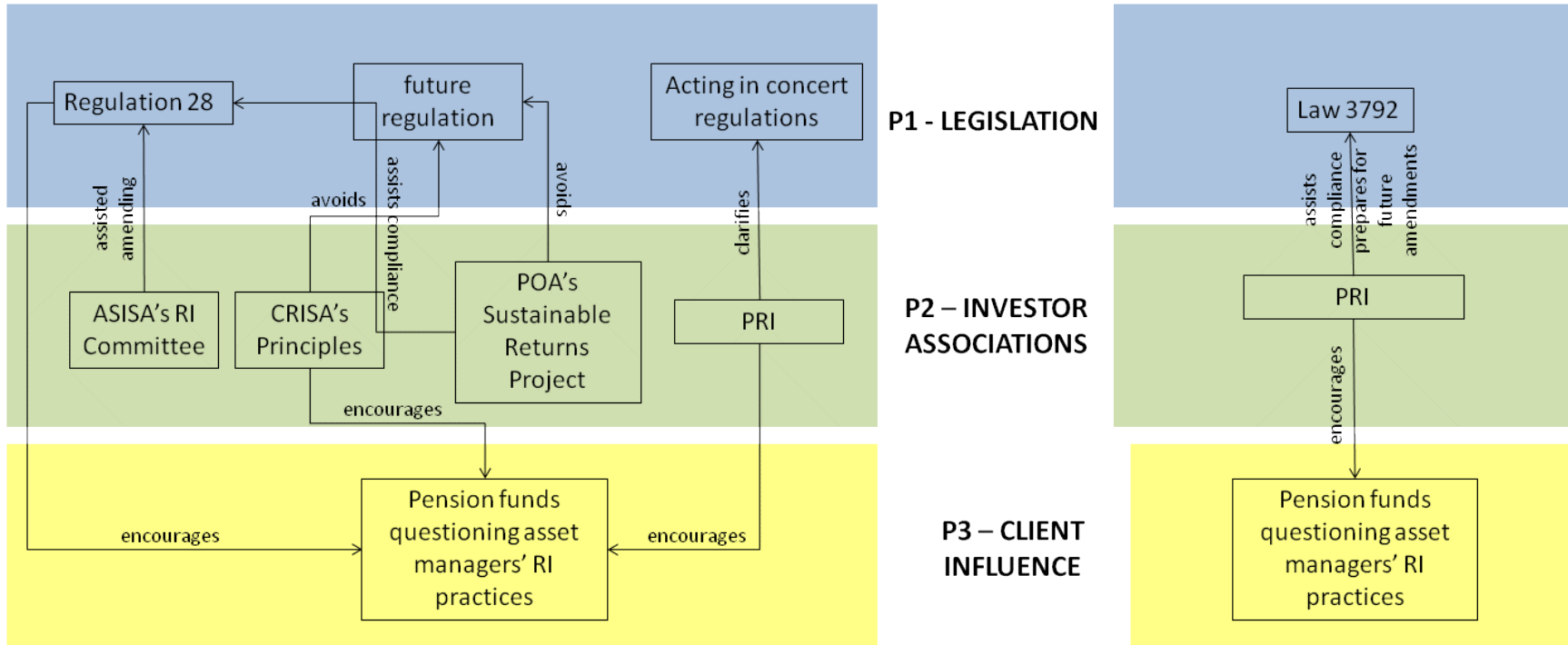
Next, the influence of investor associations was found to encourage Responsible Investment and engagement, both directly and indirectly. Direct influences include the PRI and AMEC platforms which allow investors to engage collaboratively in Brazil. With regard to indirect means of encouragement, in Brazil, the PRI and ABRAPP promote awareness of Responsible Investment, while the PRI assists investors to develop RI policies and practices so that they comply with Law 3792/2009. In South Africa, the PRI, the POA and ASISA also promote RI awareness and provide (or assist in the development of) voluntary RI frameworks to enable investors to adopt RI practices. Moreover, the PRI helps investors to avoid situations in which they may be deemed to be acting in concert by engaging with the Takeover Regulation Panel in order to clarify ‘acting in concert’ regulations. The research findings strongly support the literature by demonstrating the role of investor associations in encouraging shareholder engagement. Moreover, the findings show that there is a close relationship between legislation and the work of investor associations in both Brazil and South Africa as this research identified a number of instances of active behaviour by private sector associations with regard to government legislation (as shown in Figure 6.1). These instances demonstrate the willingness of the private sector in emerging markets to pre-empt and influence legislative initiatives related to shareholder engagement on ESG issues.

Subsequently, in terms of client pressure, this study found that pension fund beneficiaries do not put pressure on pension funds to adopt Responsible Investment practices as they are largely removed from the investment decisions made by the funds. However, in relation to pension fund pressure on asset managers, contrary to the expectations based on the literature, the influence of legal and self-regulatory guidelines (mentioned above) is encouraging pension funds to question asset managers about their RI practices and, to a lesser extent, to outsource engagement activities. Since most pension funds in Brazil and South Africa are small and lack financial resources, staff and investment knowledge, they are shifting the RI

responsibilities imposed on them by these mandatory and voluntary regulations to service providers. Hence, while beneficiaries do not encourage pension funds to adopt RI, pension funds are putting some pressure on asset managers to adopt RI practices and to engage with companies.

The interplay of institutional influences on shareholder engagement can be seen in Figure 6.1.

**Figure 6.1 - Interplay of institutional determinants**



As for the third contribution, this study helps to fill a gap in the literature on the organisational factors that influence shareholder engagement. Academic studies have assessed the influence of organisational characteristics on corporate governance (e.g. Kiel and Nicholson 2003; Ragothaman and Gollakota 2009; Gompers et al. 2003; Schmid and Zimmermann 2008; Balasubramiam et al. 2010), CSR (e.g. Chapple and Moon 2005; Amato and Amato 2007; Adams et al. 1998; Cowen et al. 1987; Hackston and Milne 1996) and shareholder activism (e.g. Choi and Fisch 2008; Rubach and Seborá 2009; Romano 1993; Black 1990). However, to my knowledge, a limited number of studies have been conducted on the influence of investor-level characteristics on Responsible Investment (e.g. Sievanen et al. 2011) and on shareholder engagement (e.g. Tilba and McNulty 2013; Rubach and Seborá 2009), while no studies have ever been carried out on the organisational determinants of shareholder engagement in the emerging markets.

This PhD study found that investor size and investment strategy are strong determinants of shareholder engagement in Brazil and South Africa, corroborating the literature. Larger investors are more likely to engage with investee companies than smaller investors due to the limited resources available to smaller investors and their restricted potential to influence companies. Furthermore, active investors were found to engage more than passive investors, motivated mainly by the active investors' goal to outperform the market, the inability of passive investors to divest from companies and remuneration incentives for active managers. Moreover, this research found that investor type is another determinant of engagement in these countries. However, contrary to expectations from the literature, asset managers are more likely to engage with investee companies than pension funds due to the limited resources available to pension funds and the lack of investment understanding among pension fund trustees.

Overall, this research study clearly addresses a gap in the current literature and it provides rich empirical insights from two emerging markets.

## **6.2. Reflection on methodology**

The methodology selected contributed to this research in several ways. Firstly, the selection of the methods employed was crucial to the study of this particular subject. One reason for

the limited amount of literature on shareholder engagement is the fact that obtaining data that measures engagement behaviour is rather difficult as dialogues between investors and companies take place ‘behind-the-scenes’ and without public knowledge (Amalric 2004; Gillan and Starks 2003). To overcome the fact that data on shareholder engagement is often not public, I decided to conduct semi-structured interviews with Brazilian and South African investors, on an anonymous basis, to hear their first-hand experience and perceptions of shareholder engagement in their respective countries. This contributed to the collection of fairly rich data with which to assess engagement in these countries, which would not have been possible through other methods such as analysis of public documents or conducting surveys. Moreover, having access to the PRI database helped me to gain a better understanding of the organisational factors influencing engagement in these countries. Therefore, the selection of the methods for this study was fundamental to overcoming the difficulty of obtaining data on engagement taking place ‘behind-the-scenes’.

Secondly, the use of mixed methods was fundamental to triangulating data and explaining the research results found in the statistical analysis. Considering that the statistical sample does not represent the whole universe of pension funds and asset managers in the two countries, the interviews were used to corroborate the results of the statistical analysis, helping to overcome the limitations of the sample, and to explain the reasons behind the results, leading to richer empirical findings.

Thirdly, the research findings demonstrate the importance of the selection of Brazil and South Africa for this study. These two countries were selected because they have the largest numbers of PRI signatories and largest numbers of engagement initiatives of all the emerging markets. As of 26 July 2013, there were 68 signatories in Brazil and 44 in South Africa (PRI 2013a). Moreover, in 2010, PRI signatories in these countries reported the largest number of engagements in the emerging markets: 241 extensive engagements in South Africa and 83 initiatives in Brazil (PRI 2010). The significant differences between the institutional environments in the two countries helped to highlight the influence of institutional factors on the level of engagement and on the selection of engagement strategies by local investors. It also demonstrated that, contrary to what the literature suggests, the impact of institutional factors is fairly strong in these two countries, indicating that Brazil and South Africa have institutional characteristics that have more in common with developed countries than emerging markets. Furthermore, this research highlighted a number of current and potential changes to the institutional environment in these countries, such as the increase in the level of

Brazilian interest rates, the potential amendment to Law 3792/2009 in Brazil and the impact of CRISA and Regulation 28 in South Africa, stressing that more research needs to be conducted in these countries in the future to enable us to fully understand the influence of these factors.

The methodology selected also implied some limitations for this study. The first one involves the generalisation of findings. Considering that the statistical data sample draws on the PRI database and that the interviewee sample is largely comprised of PRI signatories, both samples are focused on investors that, regardless of their level of adoption, value Responsible Investment practices. As a result, this study cannot claim to be representative of all institutional investors in Brazil and South Africa. Instead of using the PRI database, I could have conducted my own survey, including a larger number of investors in the sample. Moreover, the interview sample could have included institutional investors that do not adopt, or have not made a commitment to adopting, Responsible Investment practices, leading to a richer understanding of the influential factors on shareholder engagement, particularly the barriers to adopting engagement practices. However, considering issues of access and time constraints, the decision was made to use the PRI database and to focus on the “RI adopters”. Therefore, the understanding of shareholder engagement generated by this research is particular to the sample organisations.

Secondly, the research findings cannot be generalised to all emerging markets. This study has researched the particular contexts in which Brazilian and South African investors operate and the findings draw on these environments. As noted earlier, the literature and the interview findings demonstrate that Brazil and South Africa feature many characteristics that have more in common with developed countries than other emerging markets, such as the level of sophistication of the legislation and the active work of investor associations. Therefore, caution should be adopted when generalising to other emerging markets as they may not have the same level of institutional formalisation.

Next, as discussed in Chapter 2 (Methodology and Methods), a decision was made to use the variable related to existence of engagement (whether the investor engages or not with investee companies) rather than level of engagement (number of companies with which each investor engaged) due to some issues found in the data construction of the latter. Although the measure related to level of engagement apparently reflects the concept in question, a deeper analysis demonstrates that the variable lacks measurement validity. One of the

problems with this indicator is related to how signatories count collaborative engagements. According to the PRI survey guidelines, investors should count the number of companies with which they engaged instead of counting the number of initiatives in which they were involved. For instance, when an investor participates in a collaborative engagement that targets ten companies, s/he should count ten engagements for this initiative. However, a preliminary analysis of the data found that some of the investors surveyed counted each collaborative engagement with different companies as one engagement instead of counting the total number of companies engaged with. This issue led to significant distortions in the measurement validity of the variable. Whilst using an alternative variable limits the analysis of the extent to which organisational factors influence the intensity and level of shareholder engagement, after careful analysis, the decision was taken to do so as it would lead to more valid results.

### **6.3. Future studies**

Due to the limited amount of literature on shareholder engagement, there are many potential avenues for future research.

While this study partially addressed a gap in the literature on shareholder engagement, academic studies would benefit from further research on engagement in non-Anglo-Saxon contexts, such as Continental European countries, Asian countries and emerging markets. In the case of emerging markets, it is advisable that studies be conducted in a few years' time considering that the practice of shareholder engagement is not yet consolidated. Moreover, researchers could employ a similar framework to the one used in this research to analyse the determinants of engagement in other countries.

Secondly, following Gifford's (2008) suggestion, future studies could investigate company responses to shareholder engagement, examining the types of investor demands, the issues engaged on, the characteristics of the most sought after engaged companies, and so forth. The literature shows that there is a limited amount of research on engagement from the companies' side (exceptions include Hockerts and Moir 2004; Rehbein et al. 2013). Therefore, future research on this topic is required in both developed and developing countries. Again, in the case of emerging markets, it is advisable that studies be conducted in

a few years' time as the practice of shareholder engagement is not consolidated and the impact may not yet be perceptible to companies.

Subsequently, as mentioned in the section on limitations, it would be interesting to further this research and consider interviewing investors who do not have Responsible Investment practices or do not engage with companies so that a wider analysis of the factors influencing engagement, and particularly the barriers to it, could be conducted.

Next, this research has focused on the behaviour of investors engaging with listed companies. This research could be expanded in the future to encompass engagement related to other asset classes, particularly private equity. Some of the interviewees in this study reported that their interactions with listed companies differ from those with private equity firms in terms of the engagement strategies adopted, the level of investor leverage and the results obtained. For example, while having a representative on the Board of Directors is not a common engagement strategy in South Africa among listed companies due to listing governance requirements, the interviewees reported that it is a more common practice in private equity firms. In Brazil, the interviewees claimed that investors engaging to improve levels of corporate governance in private companies may actually reduce the company's level of competitiveness. Hence, more research on engagement involving other types of asset classes is needed, in both developed and developing countries.

In addition, future research would benefit from studying the role of consultants in driving (or discouraging) Responsible Investment in South Africa. As noted in the literature (e.g. Tilba and McNulty 2013) and by the South African interviewees, asset consultants are considered the "gatekeepers" of the industry, driving the behaviour of pension funds who use the services of consultants to make investment decisions and to choose investment managers. Focusing on the consultancy industry will help us to understand how they influence the pension fund industry and their potential role in encouraging RI in South Africa.

Furthermore, the literature would benefit from a study of the profile of trustees in both developed and emerging markets. This research found that there are a limited number of studies focused on this topic, while a more in-depth analysis of the profile of trustees has only been conducted in the UK (Myners 2001; Kakabadse et al. 2003). More research on trustees will help us to analyse the incentives they send to the investment market and to identify their needs (e.g. for training).



Finally, the academic literature would benefit from follow-up studies on shareholder engagement in Brazil and South Africa. This is because, at the time of the interviews, a number of changes to the institutional contexts were taking place, and, according to the interviewees, the full effects of these changes had not yet been felt. In South Africa, it is still uncertain what the effects of Regulation 28 and CRISA might be and whether the Sustainable Returns Project will deliver a helpful framework for pension funds to implement. In Brazil, there is uncertainty as to whether changes in the interest rates will be maintained and whether they will drive pension funds to diversify their investments and invest more in corporate asset classes. A possible amendment to Law 3792/2009 is also unconfirmed thus far. Follow-up work would provide the literature with longitudinal studies comparing institutional influences over time.

#### **6.4. Recommendations for professional practice**

The findings of this research also led to a number of practical implications which will help to develop Responsible Investment and shareholder engagement further in Brazil and South Africa, as well as in other countries.

Firstly, the general level of investment knowledge that pension fund beneficiaries possess in Brazil and South Africa was found to be rather low. Hence, there is an opportunity for pension funds, companies and trade unions to improve the level of understanding employees and retirees have of pension fund investment and Responsible Investment. Enhancing the investment understanding of beneficiaries is even more crucial considering that there is a trend, particularly among corporate pension funds, to shift from a defined benefit scheme to defined contribution, transferring the risk of investments from the fund sponsors to the beneficiaries. Pension funds and other investment players should increase the level of investment awareness among beneficiaries so that they have greater understanding and ownership of their pensions.

Secondly, the average level of investment understanding among South African pension fund trustees was also found to be low, which reflects the fact that most trustees do not have a background in investment matters, the lack of training provided by the employer, limited time for trustees to exercise their duties, short length of trustee mandates and lack of trustee

remuneration. Considering that trustees have a fundamental role in managing the money of millions of pension fund beneficiaries, pension fund sponsors and/or investor associations must offer more training to enable trustees to develop their skills and knowledge. It remains to be seen whether the Sustainable Returns Project will contribute to improving the level of investment and RI understanding among trustees in South Africa. Moreover, pension fund sponsors should provide more free time for trustees to exercise their duties, longer trustee mandates to encourage longer term strategies and the development of more capable trustees, as well as adequate remuneration to encourage trustees to perform their duties properly.

Moreover, pension funds should consider expanding the investment horizon used to evaluate asset managers so as to encourage them to adopt longer-term strategies, as in the case of shareholder engagement strategies. This could be done by including long-term investment goals in asset managers' mandates. This would contribute to aligning targets set for asset managers by pension funds with the interests of pension fund beneficiaries.

Next, this research showed that legislation is encouraging investors to adopt Responsible Investment and shareholder engagement practices. Governments from other countries should also consider developing ESG-related regulations for pension funds to reduce trustee fear of violating their fiduciary duties and to encourage investors to adopt more responsible investment practices.

Finally, this study also demonstrated that investor associations are particularly important in promoting responsible practices. Investor associations from other emerging markets could draw on the experience of the Brazilian and South African associations to help investors comply with Responsible Investment-related regulations and to engage, by offering collaborative engagement platforms.

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## APPENDIX 1 – Interview Guides

### Interview guide to investors

**Goal of this PhD research:** to investigate the factors that encourage or limit shareholder engagement in Brazil and South Africa

**Definition of shareholder engagement:** In this study, shareholder engagement is defined as direct negotiations between investors and portfolio companies regarding the company's strategic and operational matters. For the purposes of this research, only shareholder engagement with environmental, social and corporate governance (ESG) concerns will be considered. Filing resolutions and voting at Annual General Meetings will not be considered engagement.

#### Questions:

1. Please state your position and main responsibilities.
2. Please describe the state of Responsible Investment and shareholder engagement in South Africa: are institutional investors incorporating ESG issues into their investment decisions and engaging with investee companies on these issues?
3. Is your organisation engaging with companies at the moment on ESG issues?
4. In your opinion, what encourages/curbs shareholder engagement in South Africa?  
Consider:
  - a. Legislation
  - b. Investor associations
  - c. Pension fund beneficiaries (for pension funds) or pension funds (for asset managers)
5. According to the 2011 PRI assessment survey results:
  - a. Asset managers are more likely to engage with companies than are pension funds.
  - b. Active investors are more likely to engage with companies than are passive investors (who follow financial indexes).

- c. Larger investors are more likely to engage with companies than are smaller investors.

Do you agree with the results? Why do you think that is?

6. Do asset managers who are part of larger financial groups have conflicts of interest to engage with companies that are also clients of the corporate department?
7. Are there differences between public and private pension funds in terms of engagement practices?

### **Interview guide to non-investors**

**Goal of this PhD research:** to investigate the factors that encourage or limit shareholder engagement in Brazil and South Africa

**Definition of shareholder engagement:** In this study, shareholder engagement is defined as direct negotiations between investors and portfolio companies regarding the company's strategic and operational matters. For the purposes of this research, only shareholder engagement with environmental, social and corporate governance (ESG) concerns will be considered. Filing resolutions and voting at Annual General Meetings will not be considered engagement.

#### **Questions:**

1. Please state your position and main responsibilities.
2. Please describe the state of Responsible Investment and shareholder engagement in South Africa: are institutional investors incorporating ESG issues into their investment decisions and engaging with investee companies on these issues?
3. In your opinion, what encourages/curbs shareholder engagement in South Africa?  
Consider:
  - a. Legislation
  - b. Investor associations

- c. Pension fund beneficiaries (for pension funds) or pension funds (for asset managers)
4. According to the 2011 PRI assessment survey results:
- a. Asset managers are more likely to engage with companies than are pension funds.
  - b. Active investors are more likely to engage with companies than are passive investors (who follow financial indexes).
  - c. Larger investors are more likely to engage with companies than are smaller investors.

Do you agree with the results? Why do you think that is?

- 5. Do asset managers who are part of larger financial groups have conflicts of interest to engage with companies that are also clients of the corporate department?
- 6. Are there differences between public and private pension funds in terms of engagement practices?

## APPENDIX II – Description of Doctoral Project

**Doctoral project: Shareholder engagement in Brazil and South Africa**

**Doctoral candidate: Camila Yamahaki** ([c.yamahaki@mdx.ac.uk](mailto:c.yamahaki@mdx.ac.uk))

**University: Middlesex University (London, UK)**

**Supervisors: Prof. J. George Frynas and Dr. Jeff Evans**

**Objective:** This study aims to investigate the factors that influence shareholder engagement in the emerging markets. Shareholder engagement consists of direct negotiations between investors and portfolio companies regarding the company's strategic and operational matters. For the purposes of this research, only shareholder engagement with environmental, social and corporate governance (ESG) concerns will be considered.

**Rationale:** This particular research topic was selected because I found a gap in the literature on shareholder engagement in the emerging markets. Despite the limited literature on the topic, the level of shareholder engagement in the emerging markets is growing, requiring a better understanding of this area.

The identification of the factors that influence shareholder engagement will also help international investors understand the constraints of engaging in different environments, leading to the design of more effective engagement strategies.

**Sample:** Brazil and South Africa were selected because they are the leading countries in Responsible Investment and shareholder engagement among the emerging markets. These two countries have the largest number of PRI signatories and the largest number of reported engagements within the emerging markets.

Brazilian and South African investors (pension funds and asset managers), representatives of industry associations and other players within the Responsible Investment field will be

interviewed. Preference will be given to face-to-face interviews and in the participants' own language.

**Confidentiality and anonymity:** The data collected will be solely used for academic purposes. Anonymity and confidentiality will be maintained by not disclosing the names of the participants at any point and by not publishing single accounts in case there is possibility of identifying the participant. The interviews will be recorded for later transcription only if permitted by the participant.

**Study availability:** Final results will be available to all participating investors and investor associations.