Socially Responsible Investment Law

Regulating the Unseen Polluters

Benjamin J. Richardson

Oxford University Press

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Regulating the Unseen Polluters

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PREFACE

"Money should never be separated from mission. It is an instrument, not an end. Detached from values, it may indeed be the root of all evil. Linked effectively to social purpose, it can be the root of opportunity."

Rosabeth M. Kanter, "Money is the Root …" *Harvard Business Review,* May/June (1991): 9.

"The superior man seeks what is right; the inferior one, what is profitable …"

Confucius (551–479 BC)

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ABBREVIATIONS

ACSI	Australian Council of Superannuation Investors
ASIC	Australian Securities and Investments Commission
ASN	Algemene Spaarbank voor Nederland
ASrIA	Association for Sustainable and Responsible Investment in Asia
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CalPERS	California Public Employees' Retirement System
CCX	Chicago Climate Exchange
CDM	Clean Development Mechanism
CDP	Carbon Disclosure Project
CERCLA	Comprehensive Environmental Response, Compensation, and Liability Act
CERES	Coalition for Environmentally Responsible Economies
CIS	Collective investment scheme
CO_2	Carbon dioxide
CPP	Canada Pension Plan
CRA	Community Reinvestment Act

CRAs	Credit rating agencies
CSR	Corporate social responsibility
DJSIs	Dow Jones Sustainability Indexes
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	Export credit agency
EI	Economic instrument
EIRIS	Ethical Investment Research Service
EMAS	Eco-Management and Audit Scheme
EMS	Environmental management systems
ESG	Environmental, social, and governance
EPs	Equator Principles
EPA	Environmental Protection Agency
ERISA	Employee Retirement Income Security Act
ETI	Economically targeted investment
EU	European Union
Eurosif	European Social Investment Forum
FTSE	Financial Times Stock Exchange
GAAP	Generally Accepted Accounting Principles
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GHG	Greenhouse gas
GRI	Global Reporting Initiative
HNMI	High net-worth individual
HSBC	Hong Kong Shanghai Banking Corporation
IASB	International Accounting Standards Board

ICCR	Interfaith Center on Corporate Responsibility
ICJ	International Court of Justice
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IIGCC	Institutional Investors Group on Climate Change
ILO	International Labor Organization
INCR	Investor Network on Climate Risk
IOSCO	International Organization of Securities Commissions
ISO	International Organization for Standardization
IUCN	International Union for Conservation of Nature
JI	Joint Implementation
JPMC	JPMorgan Chase
KAIROS	Canadian Ecumenical Justice Initiatives
KLD	Kinder, Lydenberg, and Domini
LSIF	Labour-sponsored investment funds
MBI	Mission-based investment
MDB	Multilateral development bank
MPT	Modern portfolio theory
NAFTA	North American Free Trade Agreement
NAPF	National Association of Pension Funds
NCP	National contact point
NGO	Nongovernmental organization
NRTEE	National Round Table on the Environment and the Economy
NZSF	New Zealand Superannuation Fund
OECD	Organization for Economic Cooperation and Development
PAS	Public accountability statement

PDS	Product disclosure statement
RBC	Royal Bank of Canada
RIAA	Responsible Investment Association Australasia
S&P's	Standard and Poor's
SAM	Sustainable Asset Management
SEC	Securities and Exchange Commission
SHARE	Shareholder Association for Research and Education
SI	Sustainability indicator
SIF	Social Investment Forum
SIO	Social Investment Organization
SRI	Socially responsible investment
STT	Securities transaction tax
TCCR	Taskforce on the Churches and Corporate Responsibility
TIAA-CREF	Teachers Insurance and Annuity Association, College Retirement Equities Fund
TNC	Transnational corporation
TRI	Toxics Release Inventory
UK	United Kingdom
UKSIF	United Kingdom Social Investment Forum
UN	United Nations
US	United States
USS	Universities Superannuation Scheme
UNEPFI	United Nations Environment Program Finance Initiative
UNFCCC	United Nations Framework Convention on Climate Change
UNGC	United Nations Global Compact
UNPRI	United Nations Principles for Responsible Investment

VCF	Venture capital finance
WBCSD	World Business Council for Sustainable Development
WWF	World Wide Fund for Nature
WTO	World Trade Organization

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CHAPTER 1

The Potential and Limits of SRI

I. "Unseen Polluters": A Lacuna in Environmental Law

A. THE FINANCIAL SECTOR'S SIGNIFICANCE

Imagine. A bank declines finance to a profitable mining company, as its new venture is fraught with unacceptable environmental risks. A pension fund increases its investment positions in agricultural businesses that specifically adhere to leading international labor standards. And a mutual fund boycotts a lucrative pharmaceutical company infringing Indigenous medicinal knowledge. While we know that these decisions are not currently ordinary, everyday occurrences in the financial world, how much closer would we be to a socially just and ecologically sustainable economy if they were?

Encouragingly an ebullient movement known as "socially responsible investment" (SRI) is rising in international financial markets. Having evolved from its obscure beginnings of church-based, single-issue activism, it now represents a broad constellation of interests campaigning for socially, ethically, and environmentally responsible financing.[1] Unlike philanthropy, SRI seeks its desired changes through investments. Among SRI adherents are pension plans interested in sustainable, long-term investment, mutual funds selling

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1 R. Sparkes, "A Historical Perspective on the Growth of Socially Responsible Investment," in *Responsible Investment*, eds R. Sullivan and C. Mackenzie (Greenleaf Publishing, 2006), 39.

SRI portfolios to households, and banks requiring that their borrowers' projects minimize environmental degradation.[2]

While no authoritative definition of SRI exists, and investors often market the concept promiscuously, SRI has become increasingly recognized as primarily a means to further sustainable development.[3] The relationship between SRI and sustainable development is the underlying theme of this book. Sustainable development, the most widespread concept in modern environmental law and policy, seeks to ensure that economic growth does not diminish the capacity of the natural environment to meet the needs of future life.[4] Sustainability, as the ultimate goal, is a fundamentally necessary element of healthy natural and human systems.[5] It concerns the integrity of natural systems (global climate, evolutionary viability of ecosystems, and other vital life-supporting services) and societal and economic issues that may impinge upon environmental management (e.g., health, human rights, poverty). As explained by the International Court of Justice (ICJ) in the case concerning the *Gabčikovo-Nagymaros Project (Hungary/Slovakia)*,[6] implementation of the concept of sustainable development requires integration of ecological considerations into all aspects of economic decision-making, including presumably financial markets. SRI is a potential way to meld environmental, social, and economic considerations in investment decisions, raising them to a higher sustainability standard.

However, although maturing quickly, the SRI sector is still relatively insubstantial, likely below 10 percent of the capital markets of major economies.[7] Further, much finance masquerading as SRI hardly contributes to

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2 See M. Jeucken, *Sustainable Finance and Banking: The Financial Sector and the Future of the Planet* (Earthscan, 2001); S. Labatt and R.R. White, *Environmental Finance: A Guide to Environmental Risk Assessment and Financial Products* (John Wiley and Sons, 2002).

3 For an early perspective, see S. Meeker-Lowry, *Economics as if the Earth Really Mattered: A Catalyst Guide to Socially Conscious Investing* (New Society Publishers, 1988).

4 A. Djoghlaf, "The Concept of Sustainable Development," *Environmental Policy and Law* 36(5) (2006): 211: K. Bosselmann, *The Principle of Sustainability: Law and Governance* (Ashgate Publishing, 2008).

5 For introductions, see P. Harrison, *The Third Revolution: Population, Environment and a Sustainable World* (Penguin, 1992); G.C. Daily, *Nature's Services: Societal Dependence on Natural Ecosystems* (Island Press, 1997).

6 (1997) I.C.J. Rep. 92.

7 Social Investment Forum (SIF), *2005 Report on Socially Responsible Investing Trends in the United States: A 10-Year* Review (SIF, 2006); European Social Investment Forum (Eurosif), *Socially Responsible Investment among European Institutional Investors* (Eurosif, 2003); Corporate Monitor, *Sustainable Responsible Investment in Australia—2005* (Ethical Investment Association, 2005).

sustainable development, further diminishing its influence. But if its quality were improved and it were entrenched as the dominant consideration in financing decisions, SRI could transform capital markets into a means for sustainable development. To achieve such a change, legal reform of financial markets is required to mitigate numerous market and institutional barriers to SRI.

Financial institutions have systemically been remote to the environmental and social consequences underlying their decisions to provide corporate capital. Traditionally, financiers have not been held accountable for the downstream impacts of the transactions they fund. Similarly, on the upstream side, individuals who invest in mutual funds, make deposits in banks, or take part in pension plans typically have little knowledge about the kinds of projects or companies they support, and even less about any ensuing environmental harm. Investment is thus pervasive—"unwittingly or otherwise, we participate in, benefit from, and fund institutions many of which act immorally."[8] Causal relationships between finance and environmental impacts are separated widely across time and space, frequently obscuring holistic responsibility for the degradation. Hence, we may legitimately construe financial institutions as unseen polluters, who wittingly or unwittingly contribute to environmental and social problems they sponsor and profit from.

The general structure of financial markets does not motivate investors to act for the public good.[9] Certainly, sometimes financiers can exert positive influence, by stimulating business dialogue about social and environmental issues, pricing environmental risks that hurt the bottom line, and facilitating the transfer of knowledge and technology for sustainable development. Yet, given that the exclusive profit motive is traditionally seen as intrinsic to the concept of investment,[10] ultimately banks, mutual funds, and other financial institutions are commercial entities mandated to earn private profit rather than sustaining environmentally sound development for the public good. Governance of financial markets has exacerbated this situation. Past attempts at reforms to spur SRI have been generally too isolated, non-systemic, and superficial to engender significant and lasting change. A substantial chasm

8 A. Kolers, "Ethical Investing: The Permissibility of Participation," *The Journal of Political Philosophy* 9(4) (2001): 435, 442.

9 M.A. White, "Environmental Finance: Value and Risk in an Age of Ecology," *Business Strategy and the Environment* 5 (1996): 198.

10 D.R. Fischel, "The Corporate Governance Movement," *Vanderbilt Law Review* 35 (1982): 1259, 1280.

remains between much of the aspirations of SRI and the professional objectives of financiers.[11]

The time has come for regulation to address this lacuna and target the financial sector. The domain of environmental law is not intuitively associated with banks, pension funds, and other financiers, the economy's unseen polluters. Authorities typically connect ecological and social problems only to those companies that visibly exploit, consume, and pollute nature,[12] despite the fact that these activities are often only made possible by the capital support of the financial sector. A committee appointed by the Norwegian Government to propose ethical guidelines for the Government Petroleum Fund advised:

> Even though the issue of complicity raises difficult questions, the Committee considers, in principle, that owning shares or bonds in a company that can be expected to commit gross unethical actions may be regarded as complicity in these actions. The reason for this is that such investments are directly intended to achieve returns from the company, that a permanent connection is thus established between the Petroleum Fund and the company, and that the question of whether or not to invest in a company is a matter of free choice.[13]

Environmental issues are not the only subject of connection between financial institutions and their culpability for social problems. Take for example the litigation ensued by Holocaust survivors against Swiss and German banks for their collusion with the Nazis' expropriation of Jewish property.[14] Yet another example is Black South Africans' lawsuit brought under the United

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11 Friends of the Earth (FoE), *Ethical Investment in a Neo-Liberal Economy* (FoE, 2005); World Wide Fund for Nature (WWF) and BankTrack, *Shaping the Future of Sustainable Finance: Moving from Paper Promises to Performance* (WWF, 2006).

12 Few environmental lawyers and policy-makers until recently, have realized that corporate social responsibility hinges considerably on reforming the finance sector as well: e.g., Mineral Policy Institute (MPI), *The Buck's Gotta Stop Somewhere: Social and Environmental Accountability in the Financing of Mining* (MPI, 1998).

13 Graver Committee, *The Report from the Graver Committee* (Norwegian Ministry of Finance, 2003), s. 2.2.

14 P. van der Auweraert, "Holocaust Reparation Claims Fifty Years After: The Swiss Banks Litigation," *Nordic Journal of International Law* 71(4) (2002): 557.

States (US) *Alien Tort Claims Act* against international financiers for supporting the former apartheid regime.[15]

To attain sustainability in a finite biosphere, we must address the role of capital markets premised on infinite economic growth. The financial sector operates at a strategic level, because it is foundational to "wholesale" decisions regarding future development. The increased globalization of markets in recent decades has contributed to the financial-sector behemoth, and public accountability mechanisms have not kept pace with this exponential growth. Other factors in this growth are government policies of international deregulation and more liberalized markets.[16] Private financial institutions—a diverse group of banks, pension plans, mutual funds, credit unions, and others—hold far more development capital than governments.[17]

The biggest environmental impact of financiers is not their own direct ecological footprint, but indirect effects of allocating capital to the corporate sector.[18] Financiers' capital is transformed, through scale, time, and location into an instrument of development. As corporations are rarely always financially self-sufficient, they turn to capital markets to assist growth and new investments.[19] Financiers can also gain further influence through ownership

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15 J.G. Frynas, "Social and Environmental Litigation against Transnational Firms in Africa," *Journal of Modern African Studies* 42 (2004): 363.

16 Other factors include technology advances, underlying income growth, and demographic changes resulting in more savings for retirement: P.L. Davies, "Institutional Investors in the United Kingdom," in *Contemporary Issues in Corporate Governance*, eds D.D. Prentice and P.R.J. Holland (Clarendon Press, 1993), 69, 72–73; H. Blommestein and N. Funke, "Introduction to Institutional Investors and Institutional Investing," in *Institutional Investors in the New Financial Landscape*, eds H. Blommestein and N. Funke (OECD, 1998), 15–16.

17 Organization for Economic Cooperation and Development (OECD), *Financial Assets of Institutional Investors as a Percentage of GDP* (OECD, 2005); R.G. Hubbard, *Money, the Financial System, and the Economy* (Pearson and Addison-Wesley, 2005).

18 J. Rada and A. Trisoglio, "Capital Markets and Sustainable Development," *Columbia Journal of World Business* 27(3/4) (1992): 42; W.L. Thomas, "The Green Nexus: Financiers and Sustainable Development," *Georgetown International Environmental Law Review* 13 (2001): 899.

19 A. Hackethal and R.H. Schmidt, *Financing Patterns: Measurement Concepts and Empirical Results*, Working Paper (University of Frankfurt, 2003); J. Corbett and T. Jenkinson, "How is Investment Financed: A Study of Germany, Japan, the United Kingdom and the United States," *The Manchester School Supplement* (1997): 69.

stakes in companies.[20] Pressure from financial markets to maintain strong profitability obliges public companies to report financial results several times during the year. The economic growth this spurs and its social and environmental sequelae are thus intertwined with the caprices of the financial sector.

The investment community continues to downplay inclusion of environmental and social criteria for consideration in corporate financing decisions. In the public sector, the World Bank and multilateral development banks (MDBs) were the first financiers to introduce environmental impact assessment and public consultation procedures in project financing, and that only after a long campaign fought by nongovernmental organizations (NGOs) and other critics during the 1980s.[21] As for private sector financiers, despite their growing rhetoric about responsible financing, they have variously sought to thwart reforms aimed to make them accountable beyond the bottom line. In 1996, the US banking industry successfully lobbied Congress to amend the Superfund legislation to obtain a safe harbor from lender liability suits for cleanup costs of contaminated lands.[22] Also, the mutual fund industry in North America fiercely resisted regulations to make it disclose how it votes as a shareholder.[23] In the United Kingdom (UK) and Australia, the pension fund sectors initially opposed or doubted proposed legislation to make them disclose publicly their policies on ethical investment.[24] These vignettes generally reveal what really motivates many financial institutions—an unencumbered market to be able to achieve the highest returns for its investors.

It is therefore noteworthy that some SRI networks such as Canada's Social Investment Organization (SIO) and the UK Social Investment Forum (UKSIF) have lobbied authorities for regulatory reform as a means to leverage

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20 S.L. Gillan and L.T. Starks, *Relationship Investing and Shareholder Activism by Institutional Investors*, Working Paper (University of Texas, 1995).

21 Z.J.B. Plater, "Multilateral Development Banks, Environmental Diseconomies, and International Reform Pressures: The Example of Third World Dam-Building Projects," *Boston College Third World Law Journal* 9(2) (1989): 169; R. Muldoon, "The International Law of Ecodevelopment: Emerging Norms for Development Assistance Agencies," *Texas International Law Journal* 22(1) (1987): 1.

22 *Asset Conservation, Lender Liability and Deposit Insurance Protection Act*, 1996, Pub. L. No. 104-208, 110 Stat. 3009.

23 S. Davis, J. Lukomnik, and D. Pitt-Watson, *The New Capitalists. How Citizen Investors are Reshaping the Corporate Agenda* (Harvard Business School Press, 2006), 73.

24 D. Smith, "Pension Funds to Adopt Ethical Investment Policy," *The Times*, June 25, 2000, 2; Association of Superannuation Funds of Australia (ASFA), *Development of ASFA Policy on 'Ethical Investment'* (ASFA, October 2000).

change in capital markets. The UKSIF was one of the loudest voices for reforms to instill greater transparency among pension funds in their SRI policies.[25] Likewise, in the US, in 2007 many SRI groups petitioned the Securities Exchange Commission to abandon its plans perceived as curbing shareholders' rights to file advisory resolutions.[26]

SRI thus faces immense hurdles to influence significant systemic changes within financial markets. Appropriate laws and public policies will be crucial for improving the quality, extent, and impact of SRI.

B. SRI LAW AND GOVERNANCE

Law plays a critical although often poorly acknowledged role in shaping SRI. The legal system can facilitate, discipline, and coordinate financial markets in ways that both hinder and help SRI. Indeed, without legal ordering, markets of any sort, even the so-called "deregulated" ones, would hardly exist.[27] Much of the SRI literature has unfortunately only glossed over the legal system, characterizing the law as just an occasional umpire.[28] This stance may partly reflect faith in SRI's capacity to provide alternative standards to the fragmented and ineffectual controls of official regulation.

While SRI interfaces with formal legal governance systems, it is itself conceivable as "governance." It can be considered a form of self-regulation. SRI includes norms, institutions, and procedures that seek to achieve social and environmental changes through financial market governance. This web of governance is dynamic and heterogeneous; it encompasses guidance by voluntary codes of investment conduct, ordering via market indexes, and publicized pressure from SRI activists. These governance forces intersect with official laws, addressing for instance corporate environmental reporting standards, tax incentives for green investment, and the evolving fiduciary obligations of investment institutions. In the context of globalization, with fragmenting state authority and increasing corporate power, governance is

25 See, e.g., UKSIF, *Responsible Business: Sustainable Pension* (UKSIF, October 2007).

26 Social Investment Forum (SIF), "Record 22,500 Investors Speak Out Against Potential SEC Curbs on Shareholder Resolutions, Role in Board Nominations," Press release, October 10, 2007.

27 M. Moran and M. Wright, "Conclusion: The Interdependence of Markets and State," in *The Market and the State: Studies in Interdependence*, eds M. Moran and M. Wright (Macmillan, 1991), 239.

28 E.g., R. Sparkes, *Socially Responsible Investment: A Global Revolution* (John Wiley and Sons, 2002); J.J. Bouma, M. Jeucken, and L. Klinkers, eds, *Sustainable Banking: The Greening of Finance* (Greenleaf Publishing, 2001).

increasingly perceived as grown beyond the activities of governments (if ever it was thus confined).[29] The norms and processes that coordinate and discipline markets emanate from a diversity of actors beyond the state, such as NGOs and business groups, materializing as various unofficial and "private" norms. These norms can be just as influential as state legislation in overseeing market behavior.[30]

As a means of governance, SRI performs two distinct functions. In one, SRI acts as *surrogate* regulation: enlisting banks, mutual funds, and other financiers to disseminate environmental and social standards to the wider economy. SRI harnesses financial intermediaries as the instruments to convey norms and to discipline financed companies, other organizations, and individuals. One illustration of this is corporate governance reforms enabling institutional shareholders to exert more pressure on corporate management. Alternatively, voluntary codes could expect their signatories to assess the environmental risks of projects prior to granting finance or by making financing conditional on operational changes to remediate any identified deficiencies. Financial institutions acting as surrogate regulators in this fashion has existed before in other contexts, such as banks being required to report suspicious transactions as an adjunct to money laundering controls.[31]

In its second role, SRI governance seeks to directly control or influence financiers. This may involve imposing the liability of corporate sector environmental harms on its lenders, imposing fiduciary duties on pension funds to promote sustainable development, or requiring financial institutions to disclose their policies regarding criteria for investment and whether they include firms' environmental performance. While the primary function of this type of governance is to make the financial sector accountable in its own right, it is hoped that such techniques will ultimately influence the environmental and social behavior of the companies they finance.

The distinction between both governance-type functions is critical. The danger lurks in that SRI could become a self-congratulatory spectacle, in which financiers laud themselves for changing the behavior of others—those

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29 By way of introduction, see M. MacNeil, N. Sargent, and P. Swan, eds, *Law, Regulation and Governance* (Oxford University Press, 2003).

30 See M. Rein, "The Social Structure of Institutions: Neither Public Nor Private," in *Privatization and the Welfare State*, eds S.B. Kamerman and A.J. Kahn (Princeton University Press, 1989), 49; U. Mörth, ed., *Soft Law in Governance and Regulation: An Interdisciplinary Analysis* (Edward Elgar Publishing, 2005).

31 E.g., the US's *Bank Secrecy Act*, 1970, Pub. L. No. 91-508, 84 Stat. 1118.

they explicitly fund—without acknowledging their own culpability, which the second form of governance addresses. Sustainability demands that we recognize financial institutions' amorphous and often obscured influence, as institutions that fund and profit from projects and enterprises that sometimes injure the environment and communities.

Presently, SRI governance is patchy and underdeveloped, failing to provide an adequate platform to transform the financial sector towards sustainability. Dominant governing norms tend to frame SRI as an investment evaluation of business risk inextricably linked to financial opportunity. From this constrained perspective, SRI is viable only through better economic incentives, information, and technical analyses enabling "efficient" incorporation of social and environmental variables into investment considerations. There is little room in this paradigm for evaluation of unadulterated ethical principles divorced from financial goals: whether the financial system actually contributes to sustainability, what ethical principles should guide any transformation required, and on what basis those principles should be determined. Arguably, SRI must include an *ethical* approach to achieve sustainability through new forms of corporate finance. While financial markets are economic systems, propelled by pragmatic business considerations, they, like other sectors of society, must operate within fundamental societal norms. Articulated through new legal procedures and standards, ethical investment based on safeguarding the environment can help to keep financial markets within those normative boundaries.

C. THE ETIOLOGY OF UNSUSTAINABLE DEVELOPMENT

Corporate environmental harm, with its many facets, can be traced to several cardinal problems.[32] To fully understand SRI's potential as well as its limits, we must decipher the etiology of unsustainable development in relation to the financial sector and the companies it funds.

First, it is no surprise that harms occur when businesses seek to maximize profits through exploiting market failures. A market failure generally means inadequate factoring of the full costs or benefits in prices and economic decisions. Such failures often arise in relation to the environment, either because the applicable property rights are ill-defined (e.g., biodiversity) or because

32 For background, see I. Bernier, *Consumer Protection, Environmental Law, and Corporate Power* (University of Toronto Press, 1985); S. Beder, *Global Spin: The Corporate Assault on Environmentalism* (Chelsea Green Publishing, 1998).

the environmental characteristics are so-called public goods (e.g., atmosphere). Ecological economics literature highlights many related systemic market failures, including the under-valuation of ecosystems,[33] the taking of excessive risks,[34] and myopic decision-making.[35] Without targeted government regulation or stiff social sanctions to correct these market defects, they may be taken advantage of by businesses operating in a competitive market place.

Moreover, because financiers have traditionally been perceived as removed from, and by implication, not responsible for environmental harms connected to the development activities of companies they fund, they may face even fewer social or regulatory restraints to behave ethically. However, if such harms affect investors' bottom line, they have incentives to consider the wider ramifications of their investments. Regulation of corporate polluters that dramatically impacts on profitability can motivate those firms' financiers wishing to protect shareholder value or to avoid bad debt write-offs and losses.

Second among the cardinal problems, the nature of the corporation inhibits accountability. The corporation is a "legal fiction," constituted as a distinct legal personality with economic objectives primarily for the benefit of its shareholders. The modern corporation is not conceived, as it once was, as an entity constituted by special charter for some public purpose to which limited liability was attached as a privilege.[36] Today, the corporate form has mushroomed into large conglomerates run by professional managers, as intermediary bodies for deploying capital for the purposes of generating private profit. The original altruistic public good at its formation is symbolic at best. Similarly, many financial organizations are structured as corporations (e.g., banks and investment companies), and other organizations such as pension trusts have similar economic purposes via their fiduciary obligations. Historically, managers and financiers of corporations have been profit-centered and shareholder-focused, rather than holistically operating within the broader environment, taking account of their decisions, and being stakeholder focused. Unsurprisingly, the result has often been environmental pillage.

Agency problems exacerbate the issue. Internal governance in widely held public corporations engenders agency problems where the interests of

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33 R. Costanza, et al., "The Value of the World's Ecosystem Services and National Capital," *Nature* 389 (1997): 253.

34 J. von Amsberg, "Excessive Environmental Risks: An Intergenerational Market Failure," *European Economic Review* 39 (1995): 1447.

35 See M. Common, *Environmental and Resource Economics* (Longman, 1996).

36 See especially A.W. Fraser, *Reinventing Aristocracy: The Constitutional Reformation of Corporate Governance* (Ashgate Publishing, 1998).

corporate management and shareholders diverge.[37] The Enron, Parmalat, and Worldcom scandals demonstrate the shocking costs that may ensue when unscrupulous managers put personal financial interests ahead of those of the company and its shareholders.[38] Agency problems also inhere in financial organizations, particularly in the relationships between asset managers, fund custodians, and beneficiaries. Further, they can result in corporate management being lax on environmental standards to advance immediate financial interests. For example, systemically litigation against a company for pollution may not occur for years. This would appear only as a contingent liability in the notes of the financial statements. The delayed accounting can presumably appear to better the actual bottom line in the short term and thus enhance the company's reputation and as a corollary, executive remuneration. The temptation to delay accounting of true environmental costs and the possibility of over-accounting for what could be a very limited cost liability creates a tension that few managers resolve well. This tension is aggravated by short-term market demands for quarterly performance results, all of which affect share value. It is a vicious circle.

Harm can also ensue from management's incompetence or an inability to project short-term decisions into long-term implications. The concept of "bounded rationality" is advanced in the scholarly literature to describe this situation.[39] Essentially, companies, like other organizations and individuals, are not wholly knowledgeable or perfectly rational. They make mistakes. When firms are led with incompetence, it can result in errors producing wider social impacts, such as expensive pollution "accidents."[40] Thus, even where companies or their financiers have incentives not to exploit market failures and where the interests of corporate managers and shareholders, or fund managers, trustees and investors, are aligned, boundedly rational managers can fail to understand and thereby resolve complex environmental problems. In the financial sector, investment managers also

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37 See K. Eisenhardt, "Agency Theory: An Assessment and Review," *Academy of Management Review* 12(1) (1989): 57.

38 See M.M. Jennings, "A Primer on Enron: Lessons from a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures," *California Western Law Review* 39 (2003): 163.

39 See H. Simon, *Reason in Human Affairs* (Stanford University Press, 1983); J. Elster, *Sour Grapes: Studies in the Subversion of Rationality* (Cambridge University Press, 1983).

40 C. Mackenzie, "The Scope for Investor Action on Corporate Social and Environmental Impacts," in *Responsible Investment*, eds R. Sullivan and C. MacKenzie (Greenleaf Publishing, 2005), 20.

face acute difficulties in understanding how to incorporate social and environmental factors into their financial analysis.[41] Bounded rationality may result in corporate irresponsibility to the extent that insufficient resources and effort are applied to ameliorate such issues. Systemically, understanding how their decisions undermine sustainable development has often not been rewarded.

Can SRI make a difference? According to Gro Harlem Brundtland, former head of the World Commission on Environment and Development, "[s]ustainable development cannot be achieved without socially responsible investment."[42] The Brundtland Commission put the concept of sustainable development into the consciousness of the masses. If we had perfect environmental regulation and policies, presumably there would be little need for SRI. In a sense, SRI responds to the failures of front-line regulation. Although many governments have greatly improved environmental laws and regulation in recent decades, none has engineered a truly ecologically sustainable economy.[43] Different pathways to sustainability must be evaluated and considered, such as via the financial sector. But interactions of various ideological, financial, and institutional factors can inhibit SRI, as the following section explains.[44]

II. SRI: Evolutionary or Revolutionary?

A. THE BUSINESS AND ETHICAL MOTIVATIONS OF SRI

1. Business-case SRI

SRI reflects a potpourri of investment philosophies and methods, not all of which may be ambitious enough to address sources of corporate environmental harm. There are two primary forms, of which one is merely evolutionary, and the other is perhaps revolutionary. They are the business case and the ethical

41 National Round Table on the Environment and the Economy (NRTEE), *Capital Markets and Sustainability: Investing in a Sustainable Future. State of the Debate Report* (NRTEE, 2007), 31.

42 SIO, "Sustainable Development Depends on SRI: Dr. Gro Harlem Brundtland," at http://www.socialinvestment.ca/News&Archives/news-0607-Brundtland.htm.

43 See B.J. Richardson and S. Wood, eds, *Environmental Law for Sustainability: A Reader* (Hart Publishing, 2006).

44 World Economic Forum (WEF), *Mainstreaming Responsible Investment* (WEF, 2005), 23–27.

case for SRI. The business case caters to value-seeking investors. The ethical case serves values-based investors. Both reflect a similar division in the motivations for corporate social responsibility (CSR) found at the corporate level.[45]

The dominance of the business case partly reflects how investment companies, pension trusts, banks, and most other financial institutions view their legal fiduciary obligations solely for their financial performance. Even SRI retail investors, investing for themselves without fiduciary obligations to others, commonly prioritize short-term financial goals. Without coincidence, ethically-motivated SRI is more likely to prosper in institutions more closely tethered to civil society, such as churches, charitable foundations, credit unions, and cooperative banks, where the governing legal principles and prevailing culture more readily accommodate non-financial considerations.

Pragmatic business case investors tend to treat social, environmental, and corporate governance issues as factors that can affect the financial condition of companies, rather than as valuable ends in their own right. Specifically, the business case considers environmental and social issues primarily to the extent that they are perceivable as financially "material."[46] Materiality is assessed by significant financial risks or investment opportunities in relation to other financial measures. For example, an environmental hazard priced at $1 million may be immaterial to a multi-billion dollar corporation. It is a relative measure. These risks and opportunities range from the tangible (e.g., litigation and regulatory sanctions) to the intangible (e.g., reputational risks and damage to brand names). While business case SRI may be construed as "ethical," in the sense that ultimately all human decisions including investment choices reflect some set of social values, this form of SRI implies a narrow "homo economicus" conceptualization of individuals:[47] the human agent is a rational utility maximizer with a restricted and predictable range of predominantly economic interests. This concept of financial materiality informs a range of financial governance mechanisms, including fiduciary responsibilities, financial accounting, and corporate reporting systems.

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45 D. Vogel, *The Market for Virtue. The Potential and Limits of Corporate Social Responsibility* (Brookings Institution Press, 2005).

46 United Nations Environment Program Finance Initiative (UNEPFI), *The Materiality of Social, Environmental and Corporate Governance Issues in Equity Pricing* (UNEPFI, 2004).

47 O. Perez, "Facing the Global Hydra: Ecological Transformation at the Global Financial Frontier: The Ambitious Case of the Global Reporting Initiative," in *Constitutionalism, Multilevel Trade Governance and Social Regulation*, eds C. Joerges and E.U. Petersmann (Hart Publishing, 2006), 459.

Most business case SRI involves light-touch screens that filter out only the most pernicious companies where it is financially advantageous, polite engagement with corporate management, and technical assessments revealing financial risks and profitable opportunities inhering in corporate social and environmental behavior. In the post-Enron world of corporate scandals, investors seek better ways to identify risk, and to this end, SRI is increasingly relied on as a key strategy. There is however no bright-line distinction between "ordinary" investment and business case SRI. Conventional investment practices certainly consider financially acute environmental, social, and governance (ESG) issues. The main difference with business case SRI is that such matters should be taken into account routinely, and such investors should actively seek out ESG information and thereby enhance financial analysis. Such investors may see SRI as a way to achieve "alpha"—a measure of the incremental return added by a fund manager through active management.[48] Business case SRI thus takes some cues from the philosophy of ecological modernization, which sees a synergy between environmentally efficient and frugal businesses and enhanced profitability.[49]

There is abundant evidence of the financial drivers for SRI. To illustrate, the Institutional Investors Group on Climate Change (IIGCC) proclaims its goal to:

- Promote better understanding of the implications of climate change amongst our members and other institutional investors.
- Encourage companies and markets in which IIGCC members invest to address any material risks and opportunities to their businesses associated with climate change and a shift to a lower carbon economy.[50]

The United Nations Environment Program Finance Initiative's (UNEPFI) recent report, *Show Me the Money*, acknowledges ethical and sustainable development goals for SRI. Given its blatant title, it is not surprising however that the report touts:

> The first—and arguably for investors the most important—reason to integrate ESG [Environmental, Social and Governance] issues is, simply,

48 E.g., Innovest, *New Alpha Source for Asset Managers: Environmentally-Enhanced Investment Portfolios* (Innovest, 2003).

49 See E.U. von Weizsacker, A.B. Lovins, and L.H. Lovins, *Factor Four: Doubling Wealth, Halving Resource Use* (Earthscan, 1998); R.J. Romm, *Cool Companies: How the Best Businesses Boost Profits and Productivity by Cutting Greenhouse-Gas Emissions* (Island Press, 1999).

50 Http://www.iigcc.org.

> to make more money. There is a hypothesis, which we support, that a more thoroughgoing and systematic approach to integrating ESG issues in portfolios will, over time and in general, result in better financial performance.[51]

In another UNEPFI report, financial analysts are cautioned to "[c]ommunicate on issue-specific, proven, quantifiable, material links to business value; … [and to] avoid moral arguments."[52]

Catering to retail investors, the mutual fund sector also habitually appeals to the bottom line.[53] Thus, the Pax World Funds (once strongly affiliated to faith-based investment principles and use of ethical screens) proclaims:

> Today, socially responsible investing is less about what you don't invest in and more about what you do invest in …. We want Pax World's social screens to help us identify financially strong, socially responsible companies. We believe that companies meeting higher standards of corporate social responsibility are better long-term investments, and we want our shareholders to benefit from investing in these forward thinking companies.[54]

Financiers are not alone in advancing business case arguments for SRI. Unusually, a 2007 report by the eminent International Union for Conservation of Nature (IUCN)[55] also argues for a business case to protect biodiversity.[56]

Economy-wide adoption of these approaches to SRI could reduce some of the most egregious social and environmental problems traceable to the financial sector. Unlike zero tolerance ethical screens, business case SRI sometimes takes a more nuanced view of corporate behavior and opens up possibilities for investors to engage with recalcitrant firms to seek change. SRI-driven financiers are motivated by evidence of a correlation between improved

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51 UNEPFI, Asset Management Working Group, *Show Me the Money: Linking Environmental, Social and Governance Issues to Company Value* (UNEPFI, 2006), 4.

52 UNEPFI, *Generation Lost: Young Financial Analysts and Environmental, Social and Governance Issues. Executive Summary* (UNEPFI, 2004), 5.

53 R. Lowry, *Good Money: A Guide to Profitable Social Investing in the 90s* (W.W. Norton, 1991); B.N. Rosen, D.M. Sandler, and D. Shani, "Social Issues and Socially Responsible Investment Behavior: A Preliminary Empirical Investigation," *Journal of Consumer Affairs* 25(2) (1991): 221.

54 "Pax World Modernizes Social Investing Criteria," News Release, October 26, 2006, from http://www.paxworld.com.

55 Formerly known as the World Conservation Union.

56 I. Mulder, *Biodiversity, the Next Challenge for Financial Institutions?* (IUCN, 2007).

corporate sustainability performance and shareholder value.[57] Under widespread effects of such SRI, offending companies would presumably be penalized through higher capital costs.[58] Investors would be motivated to target unscrupulous corporate managers who place their own interests above the long-term interests of shareholders. Thus, this type of SRI could also address agency problems. Responsible investors may use shareholder advocacy strategies in order to change inappropriate corporate policies and practices.[59] Shareholders can encourage their firm to voluntarily comply with industry codes of conduct, even without any existing environmental regulation benchmarks.[60]

Another novel argument about why some financiers may practice SRI derives from the sheer breadth of their investments and loans. In *The Rise of Fiduciary Capitalism,* James Hawley and Andrew Williams herald the institutional investor (or "universal owner") as a new force for corporate responsibility.[61] The growth of large and diverse institutional investment holdings has, they believe, spawned the conditions for a new kind of responsible investment. Hawley and Williams contend that universal owners with broad stock portfolios have an interest in the health and long-term sustainability of the entire economy. By contrast, an investor in just one company or one economic sector will not be as broadly focused and will presumably care only about the financial performance of that narrow interest and not necessarily about the costs it may impose on others.

It is doubtful however whether universal owners such as large pension plans can coordinate their investments to keep economic growth within ecological limits. In the context of market capitalism, it is difficult to imagine

57 S.J. Feldman, P.A. Soyka, and P.G. Ameer, "Does Improving a Firm's Environmental Management System and Environmental Performance Result in a Higher Stock Price?" *Journal of Investing* 6(4) (1997): 87.

58 E. Sjöström, *Investment Stewardship: Actors and Methods for Socially and Environmentally Responsible Investments* (Project report for the Nordic Partnership in collaboration with the Stockholm School of Economics, January 2004).

59 See D.D. Guercio and J. Hawkins, "The Motivation and Impact of Pension Fund Activism," *Journal of Financial Economics* 52 (1989): 293; M.P. Smith, "Shareholder Activism by Institutional Investors: Evidence from CalPERS," *Journal of Finance* 51 (1996): 227.

60 J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Clarendon Press, 1995), 50–55.

61 J.P. Hawley and A.T. Williams, *The Rise of Fiduciary Capitalism* (University of Pennsylvania Press, 2000).

institutional investors steering toward a "steady-state economy."[62] The market contains no mechanism to scale the economy within the environmental carrying capacity of the planet. In the absence of state-imposed restraints, such as a cap on the economy's carbon emissions, universal investors face great hurdles in working collectively to resist economic growth imperatives. There is also an underlying assumption that investors today would be motivated to forego financial return on their future pensions in order to ensure sustainable growth for the benefit of posterity.

Institutional investors have little direct control over their investments, but act through intermediaries. This further weakens the universal investor hypothesis.[63] The investment portfolio of large institutional investors is commonly distributed over several asset management companies, so that each portfolio may consequently be narrower than the original "universal" portfolio.[64] Asset or fund managers' reward system and short-term investment mandates encourages narrow and myopic investment decision-making.[65] They are often assessed quarterly, and those who repeatedly fail to meet performance targets risk dismissal. Consequently, tracking the long-term environmental performance of companies is outside of their mandate and may not be the most financially viable investment selection criterion.

Business case SRI may lessen bounded rationality by enhancing knowledge and analysis of the financial significance of social and environmental conditions.[66] Where capital markets undervalue uncertain and intangible long-term environmental costs, improved investment analysis that measures the costs of unsustainable development can help correct this type of systemic failure. In practice, so far, the financial sector tends to lack the institutional competence and expertise to integrate environmental information into investment decision-making. Development of sustainability market indexes, SRI consultancy services, and other corporate rating mechanisms have helped to make sustainability performance considerations more mainstream. Still,

62 H.E. Daly, *Toward a Steady-State Economy* (W.H. Freeman, 1973).

63 P.L. Davies, "Institutional Investors in the United Kingdom," in *Contemporary Issues in Corporate Governance*, eds D.D. Prentice and P.R.J. Holland (Oxford University Press, 1993), 69, 72.

64 Mackenzie, note 40, 22.

65 K.D. Krawiec, "Accounting for Greed: Unravelling the Rogue Trader Mystery," *Oregon Law Review* 79 (2001): 301.

66 Many specialist consultancy organizations have emerged in North America and Europe to provide SRI advice and research to investors, such as Enhanced Analytics, http://www.enhanced-analytics.com, and KLD Research and Analytics, http://www.kld.com.

problems remain.[67] The rating systems focus too heavily on formal management systems rather than on the inherent environmental risks of a company's business. Furthermore, environmental and financial analyses tend to apply at the company level rather than economy-wide. This hampers the breadth of perspective necessary for "universal investing."

In this framework, ethical issues may be considered if they affect the bottom line, but normally they will not directly motivate financial institutions. Social or environmental concerns may be too nebulous for workable financial quantification. For example a recent report on the North American financial sector commented that, "[t]o the mainstream financial community, particulate matter emissions are not yet a big factor, as investment professionals believe that these do not have a significant impact on a company's finances."[68] And too much attention to "non-economic" criteria may competitively disadvantage a financier. A survey of European banks in 2002 noted: "the application of unrealistically high environmental criteria, in isolation of its competitors, the market and the regulators, would leave [the bank] out of the game."[69] Thus, investors can be utterly silent when corporate behavior raises broader, politically-imbued questions of social and environmental injustice.[70]

Although ethical issues may not be readily financially quantifiable, sometimes "reputational risks" may be of sufficient consequence to financiers to make them pay attention. Given that somewhere between 50 to 70 percent of major public companies' value is intangible, including brand name and goodwill, risk to a company's reputation can induce more ethical behavior.[71]

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67 J. Walker and E. Farnworth, *Rating Organisations—What is Their Impact on Corporate Sustainable Strategy?* (URS Corporate Sustainable Solutions, 2001); Å. Skillius and U. Wennberg, *Continuity, Credibility and Comparability: Key Challenges for Corporate Environmental Performance Measurement and Communication*, Report to the European Environment Agency (Lund University, 1998).

68 S. McGeachie, M. Kiernan, and E. Kirzner, *Finance and the Environment in North America: The State of Play of the Integration of Environmental Issues into Financial Research* (Environment Canada, 2005), 57.

69 ISIS Asset Management, *A Benchmarking Study: Environmental Credit-Risk Factors in the Pan-European Banking Sector* (ISIS Asset Management, 2002), 11.

70 B. Brown, "Deafening Silence from Ethical Funds on Hardie," *The Weekend Australian,* November 27–28, 2004 (discussing the liability claims filed by thousands of workers against James Hardie, the Australian asbestos miner).

71 Remarks, N. Purcell, Group General Manager, Westpac (UNEPFI Global Roundtable, Melbourne, Australia, October 24–25, 2007); D.C. Courts, M.G. Leiter, and M.A. Loch, "Brand Leverage," *The McKinsey Quarterly* 2 (1999): 100.

Unethical conduct can negatively affect a financier's reputation, which is particularly significant in the high-profile banking sector.[72] Even if such conduct does not directly affect share value, it may have secondary consequences such as affecting a firm's ability to attract and retain a higher-quality workforce. Shell's reputation was hurt in this way by its involvement in badly managed oil projects in Nigeria[73] A pioneering report by the World Resources Institute argues that the poor and marginalized can benefit from the business case approach only in cases where financiers find that their projects need community consent and legitimacy,[74] such as where, without such consent, conflicts may arise to harm a financier's reputation and thereby affect the bottom line. Large mining and energy projects conducted with large capital commitments in the short-term with long-term payback periods are particularly vulnerable to such risks. Nonetheless, reputational risk to financiers is not an echo for all underlying societal concerns, as sometimes the most disadvantaged groups and victims of environmental hardship lack the means to publicize their plight and challenge the corporate sector.

Thus, while business case SRI can be beneficial in various contexts, it faces structural limitations.[75] It creates an additional layer of prudential checks on lending and investment, without revolutionizing the economic status quo. ESG factors may remain incidental rather than core considerations in investment policy-making. Christoph Butz and Jean Laville explain:

> Financial professionals and mainstream investors are now willing to take sustainability issues into account if (but only if) they can be reasonably assumed to influence the bottom line. On the other hand, by adopting the concept of financial materiality, the sustainable investment community is tacitly abandoning any aspiration to convey the global challenges of sustainability to the companies they invest in.[76]

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72 Personal communication, Kim Brand, Senior Manager, Corporate Social Responsibility, Scotiabank (Toronto, September 26, 2007).

73 R. Beele, H. Fabig, and D. Wheeler, "Shell, Nigeria and the Ogoni. A Study in Unsustainable Development: II. Corporate Social Responsibility and Stakeholder Management versus a Rights-Based Approach to Sustainable Development," *Sustainable Development* 9(3) (2001): 121.

74 S. Herz, A. Vina, and J. Sohn, *Development without Conflict: The Business Case for Community Consent* (World Resources Institute, 2007).

75 J. McMurtry, *The Cancer Stage of Capitalism* (Pluto Press, 1998); H. Daly, *Beyond Growth: The Economics of Sustainable Development* (Beacon Press, 1996).

76 C. Butz and J. Laville, *Socially Responsible Investment: Avoiding the Financial Materiality Trap*, Ethos Discussion Paper No. 2 (Ethos Foundation, June 2007).

Constrained by the focus on financial materiality, business case SRI fails to see that "the ecological crisis constitutes a potentially insurmountable obstacle to modernity's dream of infinite material growth."[77] The natural environment is belatedly and partially recognized as an ingredient in the successful growth of financial capital. But the market that governs the financial sector has not accepted responsibility to build and protect natural capital.

The sheer gravity of our impact on the planet, as outlined by the UN's Millennium Ecosystem Assessment report and countless other research of its kind, demands a much more ambitious agenda for SRI and its governance.[78] As Paul Hawken once said of the challenge, "striving to attain the highest return is a direct cause of social injustice and environmental degradation.. . . How the SRI industry came to believe that it could use the same standard to reverse those ills may have more to do with marketing than philosophy."[79] The principal limitation of the business case to drive this transformation to sustainability is that sometimes there is no business case. What then?

2. Ethical Investment

The main alternative style of SRI is principally a matter of ethical necessity and a means of social and political change.[80] In some sectors, the ethical case for SRI is also known as mission or values-based investing. Consequential motives in ethical investment treat SRI as a means to change the criteria of capital allocation and motivate firms to improve their environmental and social behavior. It is associated with teleological ethics. This contrasts with the traditional deontological (or self-referential) type of ethical investment, involving investors who do not want to profit from unethical activities rather than placing a priority on leveraging change through investment. Critics of both forms of ethical investment describe them as negative and defensive in style, narrow in scope, and insufficiently linked to financial performance.[81] While these observations are certainly problematic, their influence is a key reason why ethical investment is waning. References to "ethical" in the SRI discourse are becoming scarcer, such as in 2007 when Australia's Ethical

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77 M.E. Zimmerman, *Contesting Earth's Future: Radical Ecology and Postmodernity* (University of California Press, 1994), 11.

78 Millennium Ecosystem Assessment Board (MEAB), *Living Beyond Our Means: Natural Assets and Human Well-Being. Statement from the Board* (MEAB, 2005).

79 P. Hawken, *Socially Responsible Investing* (Natural Capital Institute, 2004), 5.

80 A.T. Marlin, "Social Investing: Potent Force for Political Change," *Business and Society Review* (1986): 96.

81 E.g., presentation by J. Keefe, CEO, Pax World Funds (2007 Canadian Responsible Investment Conference, Montreal, May, 27–29, 2007).

Investment Association renamed itself as the Responsible Investment Association of Australasia.[82]

Ethical investment has the potential to more fully align the financial system with the requirements of sustainable development. In the ethical approach, investors (and corporations) have a moral obligation to act in ethically responsible ways, which should not be constrained by profit motives. It sees investors as having concerns beyond enhancing their private economic welfare. These concerns include North-South inequalities, climate change, labor rights, and Indigenous peoples' land claims. Also among the concerns are the traditional objections to tobacco, armaments, and pornography.

The ethical case however does not ignore the bottom line nor discard the business case justifications for SRI, as financial considerations often remain of vital concern. Ethical investors are not donating to charity but investing in enterprises which seek to create wealth while protecting and enhancing the social values of investors. Yet, ethical investment diverges from business case justifications by insisting on the consideration of ethical issues for their own sake, and not only for financial benefit. It presumes that an individual or organization remains moral when faced with any decision, including financial management: there is no dichotomy. While the market may value ethical conduct when embodied in regulation or social pressures expressed through the lens of reputational risk, ethics has not traditionally been integral to investment decisions. Just as we expect individuals to respect various ethical standards as members of society, regardless of any individual benefit, so too corporations and financiers should behave with regard to broader social values beyond their immediate financial self-interest.[83]

These considerations are not attractive to most financial institutions. Such institutions that invest on behalf of thousands or millions of investors have often dismissed calls that they should choose investments on ethical grounds, contending that as their fund members likely hold such diverse ethical views on social and environmental issues, it would be impossible to achieve a consensus of values to guide financial decision-making. Alternatively, the maximization of financial returns is considered a clear and easily measurable benchmark to which fund managers should be held accountable. This stance relegates ethics to a matter of subjective, personal taste, compared to the supposed hard objectivity of financial returns. Certainly, there will always be some room for individuals to choose lawful investments according to their

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82 Http://www.eia.org.au/html/s01_home/home.asp.

83 W. Cragg, "Business Ethics and Stakeholder Theory," *Business Ethics* 12(2) (2002): 113.

own moral scruples, such as eschewing financial ties to companies that engage in activities they find personally offensive, whether it be manufacturing alcohol or operating a casino. But where financial institutions manage the assets of many people and have the capacity to exert huge economic influence and potential social and environmental harm, the ethical investment movement demands adherence to specific social standards.[84]

Protection of critical ecological values should not be a discretionary option for financial institutions, but rather an essential ethical standard necessary to avert looming environmental threats such as climate change. Many scientists, policy-makers, and others see progress toward sustainable development as dependent upon challenging the anthropocentric and instrumental values of industrialized, capitalist society.[85] An ethical view helps us to understand and improve human behavior towards nature. Theorists have debated various alternative ethical frameworks, which commonly aim to broaden the moral community beyond human beings to encompass all living creatures and their ecosystems.[86] Such a "biocentric ethic" recognizes the ecological reality that humankind is interwoven into the "web of life."[87] In this vein, current imperatives suggest that we reject the view of "ethical" investment as catering only to chartered organizations (e.g., charitable investors) or individual investors managing their own portfolio. Everyone, especially large institutional investors, should act ethically in relation to the environment.

Religious institutions were the first to invest ethically.[88] They addressed social and environmental concerns not for their financial advantages, but for the moral desire and commission to improve the world we live in. The churches used their financial muscle to campaign against apartheid in South Africa, contributing to the regime's eventual demise. Today, some religious-based

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84 N. Gunningham, R.A. Kagan, and D. Thornton, "Social License and Environmental Protection: Why Businesses Go Beyond Compliance," *Law and Social Inquiry* 29 (2004): 307.

85 See generally A. Light and H. Rolston III, eds, *Environmental Ethics: An Anthology* (Blackwell, 2003); C. Soskolne, ed., *Sustaining Life on Earth* (Lexington Books, 2007).

86 For an overview, see P.W. Taylor, *Respect for Nature: A Theory of Environmental Ethics* (Princeton University Press, 1986).

87 F. Capra, *The Web of Life. A New Scientific Understanding of Living Systems* (Anchor Books, 1996).

88 N. Kreander, K. McPhail, and D. Molyneaux, "God's Fund Managers: A Critical Study of Stock Market Investment Practices of the Church of England and UK Methodists," *Accounting, Auditing and Accountability Journal* 17(3) (2004): 408.

investors again lead a radical and ambitious agenda. Contrast the IIGCC statement on climate change above with the following goals of the Interfaith Center on Corporate Responsibility's (ICCR) Global Working Group:

- Encourage companies to report on their global warming emissions "footprints," as well as disclose global warming related risks and opportunities to shareholders; and
- In recognition of future limits on global warming pollutants, encourage companies to behave proactively by reducing greenhouse gas emissions to sustainable levels.[89]

The ICCR, which coordinates SRI among religious investors, goes further than the IIGCC by stressing the priority of reducing carbon emissions. Its aim is to prevent or mitigate global warming for its own sake, rather than as a concern merely tied to shareholder value.

Apart from religious investors, ethically shaped investments are also found in the credit union sector, such as Canada's pioneering VanCity credit union; in the banking sector, such as the Cooperative Bank and Umweltbank;[90] in public-sector pension funds, such as the UK's Universities Superannuation Scheme (USS);[91] and in some mutual funds that offer robust ethically screened portfolios, such as Domini Social Investments.[92] Community investing schemes to promote affordable housing, job creation, and other benefits for disadvantaged communities also constitute a form of ethical investment, as sometimes these investors accept below-market rates of return in order to achieve social policy goals.[93] All of these institutions have sought to make social well-being and environmental protection integral parts of their missions, alongside financial goals. Business case perspectives still feature in their policies, but they are softened by a stronger recognition of ethical and sustainable development goals as intrinsically valuable.

This ethical approach is expressed even more strongly in some of the SRI governance standards advocated by civil society groups. The Collevecchio Declaration of Financial Institutions, drafted by a coalition of NGOs in 2003, proclaims:

> Financial institutions must expand their missions from ones that prioritize profit maximization to a vision of social and environmental sustainability. A commitment to sustainability would require FIs to

89 See http://www.iccr.org/issues/globalwarm/goalsobjectives.php.

90 See http://www.co-operativebank.co.uk and www.umweltbank.de.

91 See http://www.vancity.com and www.usshq.co.uk.

92 Domini Social Investments (DSI), *Global Investment Standards* (DSI, 2006).

93 See J. Nixon, et al., *The Double Bottom Line Handbook: A Practitioner's Guide to Regional Double Bottom Line Investment Initiatives and Funds* (Ford Foundation, 2007).

> fully integrate the consideration of ecological limits, social equity and economic justice into corporate strategies and core business areas (including credit, investing, underwriting, advising), to put sustainability objectives on an equal footing to shareholder maximization and client satisfaction, and to actively strive to finance transactions that promote sustainability.[94]

While such statements can help inform the ethics behind SRI, ethics should not be merely about principles derived from international instruments. Including a deliberative process within the financial sector can allow ethical practices to reflect institutionally specific situations and to adapt to investors' changing understanding of the world. A process of ethical deliberation is an educative process. Values that shape ethical investment must incorporate a democratic process providing a forum for ethical deliberation. Without dialogue and openness to new ideas, ethical investing may degenerate into an expression of narrow, intolerant values not any more conducive to sustainability.[95]

Undemocratic governance of corporations and financial institutions limits such ethical deliberation. Contrary to the predictions of Peter Drucker in *Unseen Revolution: How Pension Fund Socialism Came to America*,[96] pension funds and other financial institutions are not kernels of democratic decision-making. Fund managers, to whom financiers commonly delegate investment mandates, wield far more power than pension plan members.[97] Even specialist ethical mutual funds are often managed much like a regular mutual fund, with few mechanisms to consult investors about investment policy. Barriers to shareholder democracy in ordinary corporations do not need elaboration.[98]

B. STRENGTHENING SRI

What sort of policy changes could make ethical SRI for sustainability more widespread and thereby more influential? Of the various reforms canvassed in this book, some of the particularly critical approaches are foreshadowed here.

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94 Http://www.foe.org/camps/intl/declaration.html.

95 Consider, for instance, the investment policies of fundamentalist Christian mutual funds: e.g., Timothy Plan funds, at http://www.timothyplan.com.

96 P. Drucker, *Unseen Revolution: How Pension Fund Socialism Came to America* (Harper and Row, 1976).

97 R.A.G. Monks and N. Minow, *Power and Accountability* (HarperCollins, 1991), 201–2; A. Harmes, *Unseen Power: How Mutual Funds Threaten the Political and Economic Wealth of Nations* (Stoddard, 2001).

98 Parkinson, note 60, 168–69.

First, the state should set an example with regard to public finance; second, it should generally assert more influence over financial markets; and third, it should address strategic environmental issues such as climate change where the countervailing economic pressures may mute any ethically motivated investment. National pension funds provide a significant pool of capital whose financial power could be harnessed to challenge or influence an increasingly polluted and violent world, without sacrificing the financial needs of retirees. Already, national pension funds of Norway, Sweden, France, and New Zealand are legislatively mandated to invest ethically and responsibly. States must also cooperate to strengthen international law for SRI to thereby set more meaningful and legitimate controls on global financial markets. Existing transnational standards for SRI, such as the UN Principles for Responsible Investment (UNPRI), while helpful, appear unlikely to engender significant changes in the behavior of financiers over the near term.

Second, financial organizations must operate more transparently and democratically, not only to reduce agency problems, but also to promote more informed, ethical decisions. SRI needs legitimacy, particularly in determining what is "ethical" or "responsible" in local or specific contexts. If SRI is simply a fungible concept at the discretion of fund managers or unelected trustees, its legitimacy will be undermined, and it risks degenerating into another example of corporate "greenwash." Responsible financing must be based on democratically-determined norms that can be widely respected in society. Presently in the financial sector only credit unions are democratically structured (in theory), and the most critical debates about SRI are coming from NGO groups such as BankTrack. Legal reforms must aim to create conditions for participatory ethical deliberation underpinning SRI decisions, such as member nominated representatives and greater transparency in fund management.

Third, the fiduciary duties of financial institutions should extend consideration to the wider public impacts of private investment. However, there are formidable difficulties to recasting fiduciary duties to make them sufficiently clear and enforceable. A mere obligation to "promote sustainable development" would be too vague. Reforms like this are not unprecedented: the UK recently reformulated corporate directors' duties to include regard to community and environmental interests.[99] Legal commentators posit that in some jurisdictions existing statements of fiduciary duties incorporate a range

99 *Companies Act*, 2006, s. 172(1); see discussion in C.A. Williams and J.M. Conley, "Triumph or Tragedy: The Curious Path of Corporate Disclosure Reform in the UK," *William and Mary Environmental Law and Policy Review* 31(2) (2007): 317, 354–55.

of social and environmental stakeholder interests.[100] Advances in social accounting and sustainability indicators could help provide necessary metrics for a credible fiduciary standard of ethical investment, whereby the social and ecological costs and benefits of investment are quantified (in the case of social accounting) or performance standards are set to keep investors on a sustainable development course, based on indicators of sustainability. For residual social and environmental values too difficult to measure by either means, environmental policy standards such as the precautionary principle could help to ensure that investment choices respect ecological integrity.

These are not the only policy and governance reforms needed to embolden SRI but they are among the most vital. Collateral measures include better economic incentives (e.g., tax concessions for green investment), more robust corporate sustainability reporting standards, and even in some situations environmental liability for negligent financing decisions. These are reforms that would also strengthen the prospects for business case SRI, but more importantly could help financiers to find ways to meet ethical standards for sustainability.

Underlying these proposals is the belief that financial investments are not pure private property interests that the state should protect above other policy considerations, as some assume. Rather, regulation of investment decisions to counter harmful side-effects and promote community benefits is legitimate public policy. While individual investors' interests in their long-term economic welfare should be respected, private property rights should also be recognized as part of a web of reciprocal relations. In this vein, investors' rights are social constructs wherein individual rights to invest capital embody social interests as expressed through regulation.[101] In a sense, laws already reflect a societal consensus of a sort in restricting certain investments. For instance, corporations must abide by a multitude of social and environmental regulation, which constrain the investments of individuals who opt to invest in securities of such firms. SRI regulation takes this one step further to target investment decisions directly.

With these considerations in mind, the principal governance themes canvassed in this book are outlined below. They do not exhaust the potential

100 C.A. Williams and J.M. Conley, "Corporate Social Responsibility in the International Context: Is There an Emerging Fiduciary Duty to Consider Human Rights?" *University of Cincinnati Law Review* 74(Fall) (2005): 75.

101 R.H. Pildes, "Why Rights are Not Trumps: Social Meanings, Expressive Harms, and Constitutionalism," *Journal of Legal Studies* 27(2) (1998): 725.

legal analysis of SRI, but capture the most pressing governance concerns not sufficiently examined in the extant scholarship.

III. SRI Governance Themes

A. LEVERAGING CHANGE THROUGH MARKET-BASED REGULATION

The way financial institutions are governed has made the business case approach to SRI dominant. Pious calls for more ethical practices, on their own, won't motivate reform. To leverage change, we must link ethical values to other governance reforms. A key avenue of reform is fiduciary responsibilities. The fiduciary duties of institutional investors implicitly emphasize maximization of financial returns.[102] Relatedly, their internal governance does not empower democratic participation and reflection about investment goals. By these ways, investors are cast into a passive role, and traditional investment philosophies inappropriate for the challenges of sustainability go uncontested. Governance of corporations is similar; SRI-focused shareholders do not have an easy avenue to advocate change.[103] Further, the problem of bounded rationality among fiduciaries is exacerbated by corporate reporting norms that marginalize information about corporate environmental and social performance unless deemed financially material.[104]

Governments however have not entirely ignored SRI-related regulation. Their measures are classified into several groups. First, there are normative frameworks that provide substantive values as well as foundational principles and guidance on appropriate or desirable standards of performance. They occur in the legislative mandates of some national pension funds; but they are otherwise quite rare. Second, states have furnished process standards to enable assessment, verification, and communication of performance. Most SRI regulations are of this type: including corporate sustainability reporting standards,

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102 R. Ellison, "The Golden Fleece? Ethical Investment and Fiduciary Law," *Trust Law International* 5(4) (1994): 157; P. Ali and K. Yano, *Eco-Finance: The Legal Design and Regulation of Market-Based Environmental Instruments* (Kluwer Law, 2004), 128–40.

103 J.M. Roe, "Political and Legal Restraints on Ownership and Control of Public Companies," *Journal of Financial Economics* 27 (1990): 7; Parkinson, note 60, 24.

104 KPMG, *International Survey of Corporate Responsibility Reporting* (KPMG Global Sustainability Services, 2005).

requirements to disclose proxy voting and SRI policies, and other transparency measures. Third, economic incentive mechanisms are used to correct market failures to tip the balance in favor of a business case for responsible investment. These range from taxation concessions for green investment to lender liability for pollution.

Recurring questions of policy instrument design arise from these and other instruments. Apart from questions of function and effectiveness of such policy mechanisms, there is a deeper, foundational issue of overall regulatory design. Should the state consign itself to light-touch instruments, such as incentive and informational policy instruments? Or, should it be more interventionist, such as by mandating SRI and negotiating international laws to govern financial markets? And what combination of policy instruments, both hard and soft, can best promote SRI?

Some regulatory theorists favor "reflexive" regulation, noting the apparent failures of bureaucratic, "command and control" style regulation.[105] Certainly, some command controls have suffered serious implementation failures.[106] Regulation sometimes may function best when it uses methods congruent with the codes and norms of the market; informational, incentive, and other procedural policy tools that facilitate rather than dictate behavioral changes are of this genre. Reflexive law also dovetails with arguments for flexible, collaborative mechanisms of governance, in which policy functions are shared with or devolved to private interests.[107] Many policy mechanisms applied to or proposed for financial markets resonates this style of reflexive regulation. Corporate environmental reporting has reflexive properties: facilitating investors' scrutiny of the environmental activities of firms. Similarly, economic instruments such as pollution taxes seek to factor the price of environmental neglect in the language of the market.[108] These forms of regulation support business-case SRI, as they respect the prevailing norms of financial markets, and seek to engineer change within those parameters. However, because of evidence regarding the limited impact of the current

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105 G. Teubner, "Substantive and Reflexive Elements in Modern Law," *Law and Society Review* 17 (1983): 239; E.W. Orts, "Reflexive Environmental Law," *Northwestern University Law Review* 89(4) (1995): 1227.

106 C. Abbot, "Environmental Command Regulation," in *Environmental Law for Sustainability*, note 43, 61.

107 J.Q. Wilson, *The Politics of Regulation* (Basic Books, 1980); I. Ayres and J. Braithwaite, *Responsive Regulation* (Oxford University Press, 1992); P. Grabosky, "Using Non-Governmental Resources to Foster Regulatory Compliance," *Governance* 8(4) (1995); 527.

108 Orts, note 105.

menu of reforms, it is becoming doubtful whether the current tool-box of reflexive policy instruments alone will make a difference.

B. STRENGTHENING THE HAND OF THE STATE

An alternative path of more invasive, mandatory obligations to invest ethically and responsibly raises the dilemma of coherently defining SRI for governance purposes.[109] What should investors be mandated to do? The goal of safeguarding ecological integrity to ensure sustainability must be articulated in more specific and concrete ways. The SRI movement presently lacks an articulated consensus on key terminology and concepts.[110] "Socially responsible investment" tends to be a self-awarded title; individual institutions set their own criteria. A study by the Natural Capital Institute found "the screening methodologies and exceptions employed by most SRI funds allow practically any publicly-held corporation to be considered as an SRI portfolio company."[111] Without some societal control over what qualifies as SRI for sustainability purposes, the sector risks degenerating into promiscuous marketing slogans that mask true corporate behavior.[112] Leaving this aspect of SRI governance to the market marginalizes some environmental and social perspectives from SRI discourses.[113] The dominance of business case SRI partly reflects how many participants believe only the financial materiality standard can unify SRI practices. One way to overcome this disheartening situation short of rigid bureaucratic prescriptions would be to redefine the fiduciary duties of investment decision-makers. Fiduciaries could be obliged to promote actions

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109 See generally G. Frost, et al., "Bringing Ethical Investment to Account," *Australian Accounting Review* 14(3) (2004): 3; M.S. Schwartz, "The 'Ethics' of Ethical Investing," *Journal of Business Ethics* 43(3) (2003): 195.

110 See C. Cooper and B. Schlegelmilch, "Key Issues in Ethical Investment," *Business Ethics: A European Review* 2 (1993): 213; R. Sparkes, "Ethical Investment: Whose Ethics, Which Investment?" *Business Ethics: A European Review* 10 (2001): 194.

111 Hawken, note 79.

112 D.H. Schepers and S.P. Sethi, "Do Socially Responsible Funds Actually Deliver What they Promise? Bridging the Gap Between the Promise and Performance of Socially Responsible Funds," *Business and Society Review* 108(1) (2003): 11.

113 On the construction of environmental discourses, see M.A. Hajer, *The Politics of Environmental Discourse* (Clarendon Press, 1995); D. Salskov-Iversen, H.K. Hansen, and S. Bislev, "Governmentality, Globalization and Local Practice: Transformations of a Hegemonic Discourse," *Alternatives: Social Transformation and Humane Governance* 25 (2000): 183.

consistent with sustainable development, harnessing advances in social accounting and sustainability indicators to provide a reasonably objective basis for determining the social and ecological impacts of investment choices.

Another consideration is whether governments should become more involved in capital allocation, rather then merely telling others how to invest. Fashionable theories of financial market deregulation deride the economic inefficiencies that allegedly ensue from state intervention in the market.[114] Conversely, some scholarship highlights constructive roles of the state,[115] including partial socialization of the process of capital investment.[116] Harnessing the capital of state pension funds is a step in this direction. Already, legal reforms to national pension schemes in France, New Zealand, Norway, and Sweden mandate SRI, although with only limited statutory guidance on what this standard requires.[117] Another possibility for the state is to co-finance development with commercial entities, such as through export credit agencies,[118] creating leverage to impose sustainability conditions.

At the very least, governments must ensure more intergovernmental regulation of financial markets. Technological advances and capital market deregulation have expanded the mobility of capital able now to search globally for the most lucrative returns.[119] Globalization of banking, insurance,

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114 See E.S. Shaw, *Financial Deepening in Economic Development* (Oxford University Press, 1975); G. Yago, "Financial Repression and the Capital Crunch Recession: Political and Regulatory Barriers to Growth Economics," in *Economic Policy, Financial Markets, and Economic Growth*, eds B.S. Zycher and C. Lewis (Westview Press 1993), 81.

115 E.g., J.K. Staniskis and Z. Stasiskiene, "Promotion of Cleaner Production Investments: International Experience," *Journal of Cleaner Production* 11(6) (2003): 619.

116 T. Ghilarducci, *Labour's Capital: The Economics and Politics of Private Pensions* (MIT Press, 1992); R. Unger, *Democracy Realised: The Progressive Alternative* (Verso Books, 1998); R. Blackburn, "The New Collectivism: Pension Reform, Grey Capitalism and Complex Socialism," *New Left Review* 233 (1999): 3.

117 See discussion and references in chapter 5.

118 In practice, though, export credit agencies have not tended to assist sustainable development: S. Stern, "International Project Finance: The Ilisu Dam Project in 2004 and the Development of Common Guidelines and Standards for Export Credit Agencies," *Journal of Structured and Project Finance* 10(1) (2004): 46.

119 A. Walter, *World Power and World Money* (Harvester Wheatsheaf, 1993), 202–4.

and investment services has hampered many individual states' ability to regulate cross-border financial activities.[120] Domestic regulatory shifts that threaten economic interests can prompt financial resources to migrate to jurisdictions offering a more benign regulatory milieu. As a corollary, if regulatory changes are within a significant capital market, it can dramatically affect international markets with economic ties. Therefore, international collaboration is necessary to protect proponents of SRI from competitive disadvantages in the global market. Hard international law weakly governs transnational financial activities, and is non-existent in relation to the social and environmental impacts of finance.[121] Most international governance has come from the non-state sector through voluntary codes of conduct.

C. GOVERNANCE BEYOND THE STATE

Examining the governance challenges of SRI must take a broad view of what "regulation" entails. Beyond the state, voluntary codes of conduct and other governance tools provided by the market and civil society increasingly shape the behavior of financiers.[122] In recent decades, market actors have substantially encroached on the traditional domain of state governance, often pursuant to government policies delegating decision-making to the private sector. Legal scholars emphasize that regulation functions ever more in a pluralistic setting, in which market governance involves an ensemble of multi-layered and often fragmented institutional networks.[123] Jody Freeman sees governance as a process of "negotiated relationships"

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120 J. Braithwaite and P. Drahos, *Global Business Regulation* (Cambridge University Press, 2000), 7–8; and further S. Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (Cambridge University Press, 1996).

121 European Commission (EC), *Institutional Arrangements for the Regulation and Supervision of the Financial Sector* (EC Internal Market Directorate General, 2000); W. Dobson and P. Jacquet, *Financial Services Liberalization in the WTO* (Institute for International Economics, 1998).

122 E.g., B.J. Richardson, "The Equator Principles: The Voluntary Approach to Environmentally Sustainable Finance," *European Environmental Law Review* 14(11) (2005): 280.

123 See M. Rein, "The Social Structure of Institutions: Neither Public Nor Private," in *Privatization and the Welfare State*, eds S.B. Kamerman and A.J. Kahn (Princeton University Press, 1989); G. Stoker, "Governance as Theory," *International Social Sciences Journal* 155 (1998): 17.

between public and private actors,[124] while Leigh Hancher and Michael Moran theorize it as "shared regulatory spaces" inhabited by strategic governmental and private sector organizations.[125] Likewise, at a transnational level, Anne-Marie Slaughter describes "new governance networks" that have mobilized numerous categories of non-state entities, especially in the propagation of "soft law" standards.[126]

In this context, the last decade has witnessed a plethora of disparate standards, codes, and other non-state mechanisms designed to encourage responsible financing.[127] What have been the role, quality, and impact of these mechanisms?

As with state regulation, we find a mix of normative and process standards, as well as other governance techniques. Normative guidelines include the UNPRI and the work of the UNEPFI.[128] There are also many process standards. Corporate reporting and environmental assessment rules shape the quality and quantity of information available to social investors.[129] The Equator Principles (EPs)[130] and the Global Reporting Initiative (GRI)[131] are seminal examples. Additionally, management systems provide policy and procedural frameworks for organizations to continually manage their environmental and social activities. An example is the International Organization for Standardization (ISO) 14001 standard, to which some financiers have obtained certification.[132] Another technique of the non-state SRI sector is rating mechanisms, for evaluating and ranking corporate social and environmental performance for investment purposes. These include sustainability market

124 J. Freeman, "The Private Role in Public Governance," *New York University Law Review* 75 (2000): 543.

125 L. Hancher and M. Moran, "Organizing Regulatory Space," in *Capitalism, Culture and Economic Regulation*, eds L. Hancher and M. Moran (Clarendon Press, 1989), 271.

126 A.M. Slaughter, "Global Government Networks, Global Information Agencies and Disaggregated Democracy," *Michigan Journal of International Law* 24 (2003): 1041, 1057.

127 See D. Leipziger, *The Corporate Responsibility Code Book* (Greenleaf Publishing, 2003).

128 See http://www.unpri.org/principles.

129 KPMG, note 104, 51. See also J. Bebbington, et al., "Accountants' Attitudes and Environmentally-Sensitive Accounting," *Accounting and Business Research* 24(4) (1994): 109.

130 Http://www.equator-principles.com.

131 Http://www.globalreporting.org.

132 Http://www.iso.org.

indexes, notably the Dow Jones Sustainability Indexes.[133] From a legal standpoint, all of these mechanisms represent a form of private rule-making, which has flourished largely without state imprimatur.[134]

What has been the impact of this governance—both state and non-state—on the policies and practices of financiers, and ultimately, on the behavior of those they finance? A nagging criticism is that SRI governance, especially the voluntary kind, amounts to "greenwash"—a public facade of environmental regulation with an internal business-as-usual.[135] So far, policy changes span the adoption of responsible investment strategies, environmental risk assessment procedures, and sustainability reporting protocols. In turn, modifications in lending practices and inclusion of more SRI-conditioned finance in banks' and mutual funds' investment portfolios through SRI asset-selection screens are more prevalent. There is considerable research on whether SRI-driven finance influences capital costs of firms, or changes their policies through shareholder advocacy. While conventional finance theory doubts such effects,[136] some empirical evidence suggests SRI has some clout.[137] But, overall, the SRI market currently appears to be too small to induce profound market changes.

D. FINANCIERS' INSTITUTIONAL DIFFERENCES

Another seminal governance issue is how differences in the institutional characteristics of financiers influence their capacity or willingness to invest responsibly. Financial organizations are not homogeneous, and retain institutionally unique characteristics due to their specific legal form and market function.

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133 See http://www.sustainability-indexes.com.

134 O. Perez, *The New Universe of Green Finance: From Self-Regulation to Multi-Polar Governance*, Working Paper No. 07-3 (Bar-Ilan University, Faculty of Law, 2007).

135 Ibid., 71. See further S. Wood, "Green Revolution or Greenwash? Voluntary Environmental Standards, Public Law and Private Authority in Canada," in *New Perspectives on the Public-Private Divide,* ed. Law Commission of Canada (University of British Columbia Press, 2002).

136 Outlined in M.S. Knoll, "Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment," *Business Lawyer* 57 (2002): 681.

137 P. Lanoie, B. Laplante, and M. Roy, "Can Capital Markets Create Incentives for Pollution Control?" *Ecological Economics* 26 (1998): 31; R. Heinkel, A. Kraus, and J. Zechner, "The Effect of Green Investment on Corporate Behavior," *Journal of Financial and Quantitative Analysis* 36(4) (2001): 431.

Two distinctive features of investment regulation that may produce divergent responses to SRI are the scope of fiduciary duties and internal governance. For example, the fiduciary duties of pension funds, life insurance companies, and mutual funds are not identical and may accommodate SRI considerations in different ways.[138] The internal governance of financial institutions also varies, with credit unions enabling more member involvement in decision-making than banks or mutual funds.[139] These and other institutional differences, in turn, may produce divergent responses to SRI. Some financiers' institutional characteristics plausibly create a preference for sustainable, long-term financing, particularly with better law reform. Knowing which institutions are best or worst placed to promote sustainable corporate financing can help policy-makers better target SRI reforms.

Consider occupational pension funds, for instance.[140] They have long-term financial liabilities that should extend their investment horizons. They do not directly compete for business (unlike retail mutual funds); they cater to ordinary workers; and are usually untainted by collateral business ties to their portfolio companies (unlike banks and insurance companies offering additional services to clients). Conversely, SRI may conflict with the fiduciary duties of pension plan trustees to achieve certain mandated thresholds of financial returns.[141] Further, pension funds often invest through intermediaries such as asset management companies, which tend to be compensated on much narrower and shorter-term investment perspectives. However, these latter constraints are not unique to pension funds.

Civil society investors, such as charities and churches, are sometimes better placed to invest ethically.[142] Their expectations of high financial returns are muted in order to defend their principles of faith. Financial cooperatives,

138 See especially Freshfields Bruckhaus Deringer, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (UNEPFI, 2005).

139 I. Carmichael, *Pension Power: Unions, Pension Funds, and Social Investment in Canada* (University of Toronto Press, 2005).

140 Ibid; J. Gifford, "Measuring the Social, Environmental and Ethical Performance of Pension Funds," *Journal of Australian Political Economy* 53 (2004): 139.

141 B.J. Richardson, "Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?" *Banking and Finance Law Review* 22(1) (2006): 145.

142 Michael Jantzi Research Associates, *Investing in Change Mission-Based Investing for Foundations, Endowments and NGOs* (Canadian Council for International Cooperation, 2003); G.T. Gardner, *Inspiring Progress. Religions' Contributions to Sustainable Development* (W.W. Norton and Worldwatch Institute, 2006).

such as cooperative banks and credit unions, with ties to a particular community, also tend to be more committed to SRI than corporate-structured lenders. This suggests that if the SRI sector generally is to a have a strong ethical basis, it must deepen its ties to society. Purely market-based institutions seem less open to ethically-motivated SRI. Regulation of the financial sector may therefore need to find ways to strengthen these social ties, perhaps through more open and democratic governance within financial institutions including more "outside" stakeholder representation.

A final word of caution is that the centripetal forces of economic globalization dilute some of these institutional differences. Financial markets and services are becoming more integrated, evident by the emergence of financial conglomerates (supermarkets offering a panoply of financial services) and the integration of financial operations into global networks.[143] In this context, pension plans and mutual funds may increasingly share the same investment goals and practices. Yet, civil society based investors continue to retain their distinctive character and much stronger orientation to ethical investment.

E. SRI'S SUBJECT-MATTER

A further governance theme of this book deals with the subject matter of SRI. To what extent and why does its subject matter, such as human rights, climate change, animal liberation, and an infinite host of other causes, elicit different responses from financiers and generate different governance solutions?

The SRI market embraces a plethora of issues, some of which garner significant interest while others do not.[144] SRI screened portfolios commonly exclude or limit businesses connected to tobacco, gambling, animal testing, armaments, and (in recent years) companies with climate change impacts. On the other hand, the SRI sector has been less interested in other issues, such as Indigenous land rights or fair trade, which may raise uncomfortable questions about control of economic resources. We should therefore be cautious about the range of issues we can expect the SRI sector to champion. More thought given to understanding what kind of governance mechanisms might

143 H.M. Kim, *Globalization of International Financial Markets: Causes and Consequences* (Ashgate Publishing, 1999).

144 C. Cowton, "The Development of Ethical Investment Products," in *Ethical Conflicts in Finance*, eds A. Prindl and B. Prodhan (Blackwell, 1994); Avanzi SRI Research, *Green, Social and Ethical Funds in Europe 2004* (SIRI Group, November 2004).

improve SRI's engagement with those under-serviced causes is important for sustainability.

One chapter of this book focuses on the response of SRI to two issues—climate change and Indigenous peoples—to provide a deeper, nuanced understanding of the goals, methods, and effectiveness of SRI and its governance. Whereas climate change has generated considerable interest from the financial sector, principally because of business case considerations, Indigenous peoples, who pose more explicit social justice issues, have garnered less attention in jurisdictions with Aboriginal denizens despite being a much more immediate, contemporary issue especially in the resource sector.

Managing global warming requires cooperation between governments and financiers, particularly for new investment in renewable energy and more energy efficient technologies.[145] States can make such financing more likely by creating or restructuring markets. The Kyoto Protocol[146] introduced economic mechanisms (e.g., emissions trading and the Clean Development Mechanism) for this purpose.[147] Policies to reduce fossil fuels and promote renewable energies create new market opportunities and roles for financiers, ranging from brokerage services in carbon allowance trading to climate change risk assessments for financing transactions. Institutional investors are responding to some extent to the threat of global warming.[148] In 2000, they established the Carbon Disclosure Project to encourage companies to report their carbon emissions and risk management policies.[149] In 2003 an Investor Network on Climate Risk was formed to improve understanding of the financial risks and investment opportunities at stake.[150]

Indigenous peoples, by contrast, have received limited attention even in countries with Indigenous populations and ongoing conflicts over land and

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145 M. Grubb and R. Vigotti, *Renewable Energy Strategies for Europe: Vol. II: Electricity Systems and Primary Electricity Sources* (Royal Institute of Economic Affairs, 1997); J. Zarnikau, "Consumer Demand for 'Green Power' and Energy Efficiency," *Energy Policy* 31(15) (2003): 1661.

146 ILM 37 (1998): 22.

147 K. Halsnaes, "Market Potential for Kyoto Mechanisms. Estimation of Global Market Potential for Co-Operative Greenhouse Gas Emission Reduction Policies," *Energy Policy* 30 (2002): 13; J. Janssen, "Implementing the Kyoto Mechanisms: Potential Contributions by Banks and Insurance Companies," *Geneva Papers on Risk and Insurance* 25(4) (2000): 602.

148 A. Dlugolecki, *Climate Change and the Financial Services Industry* (UNEPFI Climate Change Working Group, 2002).

149 Http://www.cdproject.net.

150 Http://www.incr.com.

cultural rights. Indigenous land claims can seriously hinder mining, forestry, and other natural resource projects.[151] These are much more immediate threats than climate change, which is still just a forecast problem of uncertain although likely grave magnitude. Nevertheless, some ethical mutual funds do acknowledge the rights of Indigenous peoples.[152] The plight of such peoples is also increasingly highlighted at major international SRI conferences, such as at the 2007 UNEPFI Roundtable in Australia and the "SRI in the Rockies" conference in the US. The first SRI code to refer to Indigenous peoples is the 2003 Equator Principles for project financing,[153] although the World Bank has had policies on mitigating the impacts of development financing on Indigenous peoples since the 1980s.[154]

Why then are private financiers seemingly less aware of or less interested in Indigenous peoples in jurisdictions where they should be a more salient concern? Is it because Indigenous rights give rise to uncomfortable questions about access to land, control of environmental resources, and other social justice considerations that are incongruous with the prerogatives of private capital? Conversely, does the escalating interest in global warming have something to do with how climate risks can more readily factor into business case SRI? And, with both issues, to what extent is the response of the financial sector shaped by prevailing regulation?

IV. Plan of the Book

A. SCOPE

This book explores the possibilities and the limits of SRI for sustainability, and considers the adequacy of possible reforms to its governance. It takes a broad view of the SRI sector, considering not only investment institutions such as pension plans and mutual funds, but also banks and lending relationships. The banking sector has increasingly been scrutinized for its policies and impacts on sustainable development. Focusing on the goal of sustainable development, the book understandably concentrates on SRI's *environmental*

151 B.J. Richardson and D. Craig, "Indigenous Peoples, Law and the Environment," in *Environmental Law for Sustainability*, note 43, 195.

152 U. Trog, *SRI—Socially Responsible Investments* (Eco Design Foundation, 2001), 5–6.

153 Http://www.equator-principles.com.

154 G.A. Sarfaty, "The World Bank and the Internalization of Indigenous Rights Norms," *Yale Law Journal* 114(7) (2005): 1791.

aspects rather than its broader social agenda that encompasses a cocktail of issues including child labor, pornography, gambling, and other activities. Although, given that sustainability has significant social justice dimensions, particularly for Indigenous peoples, the social side of SRI is certainly not ignored.

This book concentrates on possible solutions achievable through financial markets and corporate financing in the exploration of SRI and its governance. It largely ignores other facets of financing for sustainability, such as charitable patronage to communities, foreign aid and debt relief, or World Bank development finance. Those issues entail some different legal and policy questions, and they enjoy a relative abundance of literature.[155] For the same reasons, the book does not examine the insurance industry and environmental risk management.[156]

This work is also necessarily selective in its jurisdictional coverage. It focuses on the major economies where the SRI market and concomitant legal reforms have principally arisen. These predominantly include developed nations: the UK, Germany, the Netherlands, and Scandinavian countries, among various Western European examples; as well as the US, Canada, Australia, and New Zealand. Prospects for reforming corporate finance appear most promising in these jurisdictions as they control most international capital resources, and may become examples for other jurisdictions on SRI governance. In 2007, a staggering 52 percent of global assets of investment companies were sourced in the US, and 35 percent in Europe, leaving only about 13 percent in the rest of the world.[157] The US and Western Europe similarly dominate other financial sectors, such as pension funds.[158]

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155 E.g., K. Miles, "Innovative Financing: Filling the Gaps in the Road to Sustainable Environmental Funding," *Review of European Community and International Environmental Law* 14(3) (2005): 202; J.P. Resor, "Debt-for-Nature Swaps: A Decade of Experience and New Directions for the Future," *Unasylva* 48(1) (1997): 1; World Bank, *Mainstreaming the Environment: The World Bank Group and the Environment* (World Bank, 1995); S.A. Silard, "The Global Environment Facility: A New Development in International Law and Organization," *George Washington Journal of International Law and Economics* 28(3) (1995): 607.

156 See further my other work: B.J. Richardson, "Mandating Environmental Liability Insurance," *Duke Environmental Law and Policy Forum* 12(2) (2002): 293.

157 Investment Company Institute (ICI), *Worldwide Mutual Fund Assets and Flows Second Quarter 2007* (ICI, November, 2007).

158 Watson Wyatt, *2007 Global Pensions Asset Study* (Watson Wyatt, 2007), 6.

Corporate finance and SRI in emerging markets is however a growing topic which the book examines to a lesser extent. Their capital markets are less mature, and foreign aid and other forms of public development financing often play a pivotal role in promoting sustainable development there. Although one international study in 2003 described SRI as "a developed-country phenomenon having yet to make significant inroads into emerging markets,"[159] the latest indications show the SRI market in the latter regions is taking off.[160] Governance changes should also ensue. For instance, in July 2007 the People's Bank of China instructed banks to call in existing loans, and to restrict new credit, to projects deemed environmentally undesirable by the government.[161]

This book inclines towards an optimistic view that SRI can help control unseen polluters, but only with significant changes to its aims, methods, and regulation. While some commentators have trumpeted an SRI "revolution,"[162] they hardly acknowledge the enabling role of legal institutions. "Law" and "governance" are not confined to official regulation of course; disparate non-state mechanisms of governance and their interaction, from voluntary codes of conduct to market index providers, are considered highly pertinent to SRI. Financial markets take their cue from a variety of institutions, and their governance is a result of a fragmented mix of state, market, and civil society institutions.

Underlying the book's arguments is a rejection of the fetishist notions that capital markets have a natural institutional form, organized around the logic of a financial system divorced from social and environmental responsibilities. In place of that hubris, a more civilized governance of capital markets for socially just and ecological sustainable development, centered on new forms of governance and policy enhancing the SRI sector, is recommended. As a priority, we should redefine the overarching fiduciary duties of

159 M. de Sousa-Shields, ed., *Towards Sustainable and Responsible Investment in Emerging Markets: A Review and Inventory of the Social Investment Industry's Activities and Potential in Emerging Markets* (International Finance Corporation, 2003), 10.

160 See sessions on "Principles for Responsible Investment in Emerging Markets Asia-Pacific," and "Hidden Treasure: The Sustainable Upside to Emerging Markets" (UNEPFI Global Roundtable, Melbourne, Australia, October 24–25, 2007).

161 "China Banks Told to Cut Lending to Heavy Polluters," *Reuters*, July 8, 2007.

162 E.g., R. Sparkes, *Socially Responsible Investment: A Global Revolution* (John Wiley and Sons, 2002); J. Ambachtsheer, *Socially Responsible Investing—Moving into the Mainstream* (June 23, 2005), at http://www.merceric.com.

financial institutions. Further, we must improve the decision-making processes of financial organizations to ground SRI goals and practices in a more democratic and defensible discourse. Other challenges include enhancing the strategic role of national pension funds in sustainable finance; building new forms of international cooperation for transnational financial markets; and providing a better mix of economic incentives and informational resources for SRI.

B. RESEARCH METHODS

This study of SRI governance derives from an interdisciplinary theoretical framework and extensive empirical research of SRI "in practice." Researching the legal and institutional form of capital markets alone does not reveal enough about the realities of SRI, as a product of culture, economics, and politics.[163] The book draws on an eclectic framework of inquiry, taking inspiration from reflexive law and other regulatory theories, legal pluralism, finance theory, applied ethics, and ecological economics.

While it is certainly not a formal work of *comparative* law scholarship, it incorporates comparative perspectives in the inter-jurisdictional aspects of the subject matter. SRI practices and legal mechanisms of various countries are canvassed, and variations investigated. Globalization of financial markets has encouraged considerable convergence in SRI methods and governance, such as through the UNPRI.

An ambitious research program was undertaken with funding from Canada's Social Sciences and Humanities Research Council. It utilized a composite of interviews as well as archival, library, and electronic research. There is a vast volume of policy papers, regulations, and corporate documentation, some available electronically, and others accessible only by archival research. The SRI literature exploded during the course of the research, making it difficult to keep abreast of the plethora of reports and studies produced by SRI think-tanks, individual scholars, and financial institutions. A team of students from Osgoode Hall Law School assisted ably during this phase.

Subsequent research phases required extensive empirical research on actual practices of SRI institutions and their governance. This investigation included approximately sixty interviews of representatives from all the major constituencies (e.g., public authorities, financiers, public interest NGOs,

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163 See J.T. Klein, *Interdisciplinarity: History, Theory and Practice* (Wayne State University Press, 1990).

and consultants).[164] The interviews were semi-structured face-to-face or telephone discussions, with questions formulated to elicit a range of experiences and perceptions relevant to SRI and its governance. To maintain the confidentiality of individuals consulted, sometimes only their institutional affiliation is identified or the generic organizational type is noted. It must be noted that arguments in this book do not necessarily reflect the views of the interviewees. Additional sources of empirical information were harvested to verify findings, including: surveys and case studies conducted by SRI associations, consultancy reports, graduate theses, and other data sources.

Despite the diverse and extensive research tools deployed, certain methodological problems inhere in this kind of study. Given the difficulty of isolating the impact of specific variables, sometimes only contingent and tentative conclusions about the role of SRI governance can be drawn. This problem inheres in most law in context research, and should not detract from the importance of this research to illuminate the strengths and weaknesses of SRI governance.

C. STRUCTURE

This book has eight chapters. The next chapter introduces finance capitalism and the SRI movement's attempts to bring some social and environmental accountability to it. It canvasses the various types of financial institutions, and explains the history, philosophies, and methods of SRI. Chapter 3 assesses the impact of SRI—its market size, financial performance, and influence on

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164 Organizations consulted or interviewed include: Association for Responsible and Sustainable Investment in Asia, Association of Superannuation Funds of Australia, Responsible Investment Association (Australasia), Canadian Institute of Chartered Accountants, Ethical Funds Company (Canada), Export Development Canada, Jantzi Research (Canada), KAIROS—Canadian Ecumenical Justice Initiatives, Mercer Investment Consulting (Canada), Interpraxis (Canada), Royal Bank of Canada, Scotiabank (Canada), Social Investment Organization (Canada), United Church of Canada, Domini Social Investments (US), KLD Research and Analytics (US), Social Investment Forum (US), Dutch Sustainability Research (Netherlands), Council for Socially Responsible Investment (New Zealand), New Zealand Superannuation Fund, Rodger Spiller and Associates (New Zealand), Ekobanken (Sweden), Ethical Investment Research Service (UK), Fair Pensions (UK), Henderson Global Investors (UK), UK Social Investment Forum, Universities Superannuation Scheme (UK), and United Nations Environment Program Finance Initiative.

financiers and the corporations they service. Evaluation of the effectiveness of SRI helps to understand which forms of regulation can best facilitate it. Chapter 4 examines how the legal system has traditionally hindered SRI. It focuses on the governing fiduciary duties and decision-making procedures within financiers, as well as the international framework for financial markets regulation.

Chapters 5 and 6 delve into recent governance reforms intended to boost SRI, dealing with official regulation (chapter 5) and non-state contributions (chapter 6). In reality, there is no clear-cut division between state and non-state governance, as there are many intertwined initiatives in SRI. A proliferation of codes, standards, and other mechanisms now structure the SRI market. Among them are the UNEPFI, EPs, UNPRI, and many more. Within state law, transparency regulation has prevailed, reflected for instance by requirements for pension funds to disclose whether they invest ethically, and obligations on mutual funds to reveal how they vote as shareholders in their portfolio companies.

Of the remaining chapters, the seventh explores SRI in practice in more detail, unveiling how differences in the character of environmental and social issues influence financiers' responses. It contrasts the responses of the SRI sector to climate change and Indigenous peoples, providing case studies that illuminate the interplay between business and ethical motivations for responsible financing. The eighth and final chapter, "The Path to Ethical Investment for Sustainability," ponders the steps to take if SRI is to offer something more useful to the quest for safeguarding the environment. It emphasizes reform of the fiduciary duties of institutional investors as a means to promote ethical investment.

CHAPTER 2

Corporate Financiers and the SRI Movement

I. The Era of Finance Capitalism

A. THE MARKET CONTEXT OF SRI

SRI's potential to advance sustainable development is shaped by the system of finance capitalism. SRI seeks solutions to our social and environmental dilemmas within the framework of capitalism, rather than outside that system. Therefore, it is useful to begin with an overview of the operation of financial markets, its principal institutions, and the way corporations raise capital.[1] To understand SRI properly requires some knowledge of the financial system that it works within. The second half of this chapter considers the SRI movement itself, including its actors, instruments, and goals.

According to textbooks, an economy's financial system serves to mobilize and allocate capital, to organize the settlement of payments, and to manage risks associated with financing and exchange. In particular, the financial system enables the crucial distribution of capital from savers to borrowers, and thereby in theory facilitates the efficient allocation of resources among different economic sectors and across time.[2] This resource transfer occurs through the services of financial intermediaries, such as banks, and through

1 This chapter, like the book generally, does not consider in detail how financial institutions fund the household and consumer markets, such as real estate and personal loans.

2 E.g., from F.J. Fabozzi, et al., *Foundations of Financial Markets and Institutions* (Prentice Hall, 2001); M. Levinson, *Guide to Financial Markets* (Bloomberg