Articles

Making Corporations Environmentally Sustainable: The Limits of Responsible Investing

*By Gail E. Henderson**

A. Introduction

Almost weekly, it seems, my inbox fills with dozens of academic articles on the topic of "socially responsible investing" or "SRI".[1] Non-profit organizations across Europe and North America promote SRI as the new investment industry standard.[2] Business schools now offer certificate programs in "sustainable investment".[3] In 2006, the UN launched the Principles for Responsible Investment (PRI) to provide a framework for investors interested

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[1] A sample of titles from the SRPN Socially Responsible Investment and Corporate Social Responsibility e-journals for the month of August 2012 include Ivan Tchotourian, *Investors, Investment Funds and New French Law: The Clouded Crystal Ball – Is There Really More Power to Promote CSR?* UNIVERSITY OF NANTES - FACULTY OF LAW AND POLITICAL SCIENCE 2012, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2115835. Joshua Humphreys et al, *Environmental, Social and Governance Investing by College and University Endowments in the United States: Social Responsibility, Sustainability, and Stakeholder Relations*, TELLUS INSTITUTE 2012, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2112158. Julie Cotter & Muftah Najah, *Institutional investor influence on global climate change disclosure practices* 37:2 AUSTRALIAN JOURNAL OF MANAGEMENT 169 (2012). Franz Fuerst *et. al.*, *A Green Winner's Curse? Investor Behavior in the Market for Eco-Certified Office Buildings*, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2114528 (last accessed: 1 December 2012). I am aware that this paper is contributing to the onslaught.

[2] These organizations include the Social Investment Organization and SHARE (Canada), US SIF, UK SIF, and Eurosif.

[3] The John Molson School of Business at Concordia University offers a Sustainable Investment Professional Certification. The Haas School of Business at the University of California, Berkeley, offers students the opportunity to act as principals of the student-led Haas Socially Responsible Investment Fund, with over $1.5 million in assets under management. For prospective business school students, the Aspen Institute publishes *The Sustainable MBA: The 2010-2011 Guide To Business Schools That Are Making a Difference.* See http://www.aspeninstitute.org/publications/mbaguide (last accessed: 1 December 2012).

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in practicing responsible investing.[4] The PRI now boast over 1,000 signatories, including asset owners and investment managers.[5]

These articles, organizations, certificates and principles are all part of the newest wave of the socially responsible investing movement. "New wave" responsible investors integrate environmental, social and governance (ESG) factors into their actions as shareholders, including whether to buy, hold or sell shares in a company,[6] and how to exercise voting rights. They also might quietly engage with corporate management on ESG issues. They do so not out of deeply-held ethical or moral convictions, but based on the belief that ESG factors may have a material effect on investment returns, particularly over the long-term,[7] and that "responsible" companies, which seek to mitigate their negative environmental or

[4] David Hess calls 2006 a "break-out year" for responsible investing. David Hess, *Public Pensions and the Promise of Shareholder Activism for the Next Frontier of Corporate Governance: Sustainable Economic Development*, 2 VA. L. & BUS. REV. 221, 223 (2007).

[5] Principles for Responsible Investment, *Signatories to the Principles for Responsible Investment*, available at: http://www.unpri.org/signatories/#psp (last accessed: 1 December 2012).

[6] Excluding companies from an investment portfolio solely on the basis of ESG factors, however, is not viewed as essential to practicing new wave responsible investing. See UNEP FI Asset Management Working Group, *Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment* at 27 (" The object of ESG incorporation into mainstream investment decision-making therefore is not to exclude socially or ethically unacceptable stocks or shares but to focus a brighter light on the impact of all material considerations on investment value"). For Canadian public-sector pension funds, divestment is considered a "last resort", or applied very selectively. See, e.g., bcIMC, Responsible Investing Report Annual Summary – April 2010 to March 2011 at 7, available at: http://www.bcimc.com/publications/pdf/ResponsibleInvesting/ResponsibleInvestingSummary2010-2011.pdf (last accessed: 1 December 2012).

[7] Responsible investing also encourages investors to take a long-term perspective on their investments: see, e.g., UN Principles of Responsible Investment, Principle 2, possible actions: "File shareholder resolutions consistent with long-term ESG considerations", *Principles for Responsible Investment*, available at: www.unpri.org/principles (last accessed: 1 December 2012). A more specific time period is seldom provided in discussions of responsible investment, but the Marathon Club, a group of institutional investors, senior executives and senior specialists whose purpose is to encourage institutional investors "to be more long-term in their thinking and actions", suggests an investment horizon of five to seven years. Marathon Club, *Guidance Note for Long-Term Investing* (2007), available at: http://www.usshq.co.uk/Documents/MarathonClub%20Guidance%20on%20Long%20Term%20Investing%202007.pdf (last accessed: 1 December 2012).

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social impacts or to produce positive ones, make better long-term investments.[8] This approach to investing if often summed up in the catchphrase "doing well by doing good".[9]

One predicted upshot of new wave responsible investing (RI)[10] is that, in seeking to maximize investment returns, institutional investors concerned with a company's environmental performance – the "E" in ESG – will act as a kind of additional regulator,[11] monitoring companies' environmental performance and pushing corporate management to work continually to reduce the company's environmental footprint.[12] In this way, new wave RI is a form of transnational private regulation. Proponents of new wave RI predict that companies will respond to this form of regulation, since the institutionalized goal of corporate management is to keep investors (shareholders) happy.[13] New wave RI therefore works within the paradigm of "shareholder primacy", the theory that the sole object of corporate governance[14] is to ensure that the corporation is maximizing long-term shareholder value.[15]

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[8] *See* Preamble to the PRI, online: www.unpri.org/principles/ (last accessed: 1 December 2012, "we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognize that applying these Principles may better align investors with broader objectives of society.").

[9] Michael Knoll, *Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment*, 57 BUS LAW 681, 683 (2002).

[10] Although "socially responsible investing" or "SRI" is still the popular terminology, I use "responsible investing" or "RI" to distinguish the "new wave", which emphasizes the relevance of ESG factors to maximizing investment returns, from its ethical predecessor, discussed in Part IV, below. See Mercer LLC, *Best Practices in Responsible Investment for Canadian Pension Funds* (November 2009), available at: www.socialinvestment.ca/.../PensionsReport_Nov2009_ENGL.pdf ((last accessed: 1 December 2012, using "responsible investment" "to refer to the developments among institutional investors").

[11] Steve Waygood, Rory Sullivan & Alan Morley, *Harnessing investors to support the implementation of health and safety public policy* in RESPONSIBLE INVESTMENT 326 (Rory Sullivan & Craig Mackenzie, eds., 2006); Hess, *supra* note 4 at 226 (public-sector pension funds "have the potential to serve a valuable role" in new regulatory approaches to controlling environmental harm caused by corporations).

[12] Rob Lake, *Henderson Global Investors: Engagement and activism* in RESPONSIBLE INVESTMENT 175 (Rory Sullivan & Craig Mackenzie, eds., 2006).

[13] Poonam Puri, *The Future of Stakeholder Interests in Corporate Governance*, 48 CAN. BUS. L.J. 427, 438 (2010) ("The underlying theory [of the PRI] is that in encouraging investors to become more active owners, senior corporate leadership will take a more active interest in extra-financial drivers of risk and reward.").

[14] Corporate governance can be defined narrowly as "the structure and functioning of boards of directors or the rights and prerogatives of shareholders in boardroom decision-making" or broadly as "the whole set of legal, cultural, and institutional arrangements that determine what...corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated." *See* MARGARET M. BLAIR, OWNERSHIP AND CONTROL 3 (1995).

[15] See *e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law* 89 GEO. L. J. 439 (2001).

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Although new wave, or business case, RI undoubtedly will have some positive effects on corporate environmental performance, there are important limits on what this particular form of private transnational regulation can achieve. To some extent, these are limits on the "business case" for integrating ESG factors into investment decision-making: a company's environmental impacts will not always come back to haunt it in the form of bottom-line costs that will have a material effect on shareholder value. There is, of course, a moral or ethical case for institutional investors to integrate ESG factors into their investment decision-making. But removing the need for a connection to long-term investment value does not transcend all of the limits on RI's potential ability to improve corporations' environmental performance. Investors are at an informational disadvantage to corporate boards, due both to their outsider status and to the sheer number of companies in which they are invested. Many environmental issues, and their possible solutions, will be specific to a particular portfolio company, making it more difficult for investors to influence corporate behavior on these issues across their portfolio. Substantial improvements in corporations' environmental performance will come about only by focusing on the source of the problem – corporations themselves – and imposing the legal obligation to take into account environmental factors on corporate boards of directors, rather than investment fund boards of trustees.[16] Responsible investing, business case or moral case, nevertheless has an important role to play in reinforcing this obligation, and rewarding companies that take steps to improve their environmental performance.

The editors of this symposium invited conference participants to submit short articles, more in the nature of essays or "thought-pieces". This article is very much a collection of my thoughts on the topic of responsible investing, the limits on its potential to improve corporations' environmental performance, and the arguments in favor of focusing on the duties of corporate boards of directors, rather than those of investment fund trustees. Given the ongoing interest in responsible investing, a more thorough examination of the issues raised in this thought-piece is most certainly deserved, but must be left for another day.

Part B provides a very brief background of the history and theory of responsible investing. Part C outlines the limits of new wave RI's ability to improve corporations' environmental performance. Part D explores the idea of a moral or legal obligation on investment fund trustees to take ESG factors into account for their own sake, and the inherent limits of this approach. Part E concludes with an argument in favor of focusing on corporate boards of directors, rather than investment fund boards of trustees, in attempting to reorient the economy towards environmental sustainability.

[16] Although some large institutional investors, such as the Canada Pension Plan Investment Board, refer to the members of their governing board as directors rather than trustees, I use trustees here in order to distinguish them from corporate boards of directors.

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B. Background

Socially responsible investing first emerged, or at least "first came to public attention", in the 1960s,[17] as part of the civil rights and Vietnam war protest movements.[18] Originally, this approach to investing involved foregoing certain investment opportunities because they clashed with investors' personal values. The most common exclusions were "sin stocks" – "companies involved in alcohol, gambling, pornography" and tobacco – and weapons manufacturers.[19] The subsequent shift from "values" investing to "value" investing[20] reflects in part the shift in the concentration of shareholdings from individual to institutional investors.[21] The investment choices of individual investors affect only their own personal wealth; the investment choices of institutional investors are made by trustees on behalf of thousands of beneficiaries, whose views on ethical issues ranging from weapons manufacturing to animal testing would be difficult to canvass, let alone turn into a coherent investment policy. New wave RI was motivated in part to appeal to these institutional investors, which now dominate the capital markets, by emphasizing ESG factors' connection to long-term investment returns over any ethical issues they might raise.

Proponents claim that new wave RI helps to communicate to portfolio companies "correct" corporate behavior[22] and, by focusing on the long term, encourages corporate managers to pay more attention to environmental issues, as well as providing them with the necessary space to do so.[23] The knowledge that investors are more concerned with long-term value than short-term stock market prices is presumed to give corporate managers "greater

[17] Knoll, *supra* note 9 at 684 (dating SRI back to nineteenth century screening of "sin" stocks).

[18] BENJAMIN RICHARDSON, SOCIALLY RESPONSIBLE INVESTMENT LAW: REGULATING THE UNSEEN POLLUTERS 74 (2008), noting that one of the first "ethical" shareholder proposals was filed against Dow protesting the manufacture of napalm).

[19] These continue to be popular exclusions for funds applying ethical screens. See Humphreys *et. al*., *supra* note 1 at 6, 14. Tobacco and weapons manufacturers are excluded from the Canadian Jantzi Social Index. *See* Jantzi Sustainalytics, available at: http://sustainalytics.com (last accessed: 1 December 2012).

[20] There is still a strong, but niche, market for SRI funds in the "values" investing vein. *See e.g*., Russell Sparkes, *A historical perspective*, *in* RESPONSIBLE INVESTMENT (Rory Sullivan & Craig Mackenzie, eds., 2006), 52.

[21] See, e.g., James Hawley & Andrew Williams, *The Universal Owner's Role in Sustainable Economic Development*, 9 CORPORATE ENVIRONMENTAL STRATEGY 284, 285 (2002); RICHARDSON, *supra* note 18 at 540 ("In the UK, the amount of all shares held by individuals fell from 54 percent in 1963 to below 13 percent in 2006.").

[22] RICHARDSON, *supra* note 18 at 302.

[23] Roger Urwin, *Pension Funds as Universal Owners: Opportunity Beckons and Leadership Calls*, 4:1 ROTMAN INT'L L. J. OF PENSION MGMT 26, 28 (2011).

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freedom to manage diverse stakeholder interests in a more balanced way."[24] Responsible investing also may "engender a stronger internal [firm] commitment to…process innovation" aimed at long-term objectives, such as increasing market share or reducing costs over the long-term, rather than focusing on "radical product innovation" aimed at shorter-term, narrow financial objectives.[25]

In addition to taking into account the environmental impacts of individual portfolio companies, James Hawley and Andrew Williams argue that large institutional investors ought to concern themselves with environmental problems, such as climate change, that have the potential to affect the economy as a whole.[26] One company's or sector's negative externalities may end up as another's internalized costs, and due to the sheer size of their highly-diversified investment portfolios, large institutional investors are very likely to own shares in both. For this reason, Hawley and Williams describe such investors as "universal owners". Given their wide exposure to environmental risks, universal owners ought to engage in "universal monitoring" by articulating a position on corporate behavior or environmental issues that affect the economy as a whole, and communicating that position to portfolio companies[27] through, for example, the fund's proxy voting policy.[28] Institutional investors may also communicate their position on environmental issues directly to the boards of portfolio companies through "engagement" activities. Most funds have a policy of not disclosing the names of companies with which they engage, but they might report on the issue prompting engagement, and the board's response.[29]

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[24] Shelley Marshall, Kirsten Anderson & Ian Ramsay, *Are superannuation funds and other institutional investors in Australia acting like 'universal investors'?*, 51:4 J. OF INDUSTRIAL REL. 441 (2009).

[25] RODERICK MARTIN, PETER CASSON & TAHIR NISAR, INVESTOR ENGAGEMENT: INVESTORS AND MANAGEMENT PRACTICE UNDER SHAREHOLDER VALUE 27 (2007).

[26] JAMES HAWLEY & ANDREW WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM (2000); Hawley & Williams, *supra* note 21.

[27] Hawley & Williams, *The Universal Owner's Role*, *id.*, 287-88. These positions might – and Hawley and Williams argue should – include support for environmental regulation that would reduce environmental risks to the economy.

[28] See, e.g., CPPIB's Proxy Voting Principles and Guidelines (February 9, 2012), available at: http://www.cppib.ca/files/F2012_-_Other_documents/Proxy_Voting_Guidelines_Feb2012.pdf (last accessed: 1 December 2012). In addition to indicating how CPPIB is likely to vote on a given proposal, the policy is also intended to "communicate our views on other important issues that boards will deal with in the normal course of business." *Id.* at 1.

[29] See, e.g., Public Sector Pension Investment Board, 2012 Annual Report at 44, available at: http://www.investpsp.ca/pdf/PSP-AR-2012-fin-statements-not-included.pdf (last accessed: 1 December 2012).

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New wave RI therefore can be seen as a form of transnational private regulatory governance.[30] Although institutional investors might be most comfortable engaging with companies in their home country,[31] many actively exercise their voting rights in all of the companies they own, which includes a substantial number of foreign companies.[32] New wave RI relies on market actors driven by market norms, specifically investment managers acting on behalf of institutional investors and seeking to maximize long-term investment returns. It also relies on civil society actors, such as NGOs, who, by drawing attention to corporate misbehavior, help to create the "risks" to long-term shareholder value with which new wave RI is concerned, usually in the form of reputational risks to the company's brand.[33]

The idea of institutional investors as regulators is not new: corporate law scholars have long touted the role of institutional investors as monitors of management, enforcing the laws and norms of proper corporate behavior.[34] Public-sector pension funds in particular have attracted attention as effective monitors of management, since they lack the conflicts of interest faced by other types of institutional investors.[35] Private-sector pension plans may refrain from criticizing the behavior of portfolio companies in order to avoid attracting such criticism themselves.[36] Banks and insurance companies likewise may refrain from

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[30] See also RICHARDSON, *supra* note 18 at 517 (responsible investing is part of the "third way" between command-and-control regulation and "unbridled deregulation".); Hess, *supra* note 4 at 232.

[31] Raj Thanotheram, *A critical perspective on activism: views from a pension fund professional* in RESPONSIBLE INVESTMENT (Rory Sullivan & Craig Mackenzie, eds., 2006), 302 (noting that pension funds may be most comfortable engaging with companies in their home jurisdiction); bc IMC, Corporate Governance Principles and Proxy Voting Guidelines (August 2010) at 2, available at: http://www.bcimc.com/publications/pdf/ResponsibleInvesting/CorporateGovernancePrinciplesProxyVotingGuidelines.pdf (last accessed: 1 December 2012, discussing engaging with foreign companies on corporate governance issues).

[32] Eurosif, *Pension Programme SRI Toolkit* (2004-05), 23, available at: http://www.eurosif.org/sri-resources/pension-fund-toolkit (last accessed: 1 December 2012, "institutional investors are increasingly investing beyond their domestic borders. Voting thus becomes de facto a cross-border issue.").

[33] Elisa Morgera, "From Stockholm to Johannesburg: From Corporate Responsibility to Corporate Accountability for the Global Protection of the Environment?" 13 RECIEL 214 at 221.

[34] ROBERT MONKS & NELL MINOW, CORPORATE GOVERNANCE, 2d ed (2001), 109. Of course, this promise has not always been fulfilled: Puri (note 13), 445 (The global financial crisis of 2008/2009 has been attributed, at least in part, to…a failure of institutional investors to "act as owners" in holding management and the board of directors accountable for their decisions.").

[35] Eurosif, *supra* note 32 at 31; HAWLEY & WILLIAMS, *FIDUCIARY CAPITALISM, supra note 26* at 64 and 131.

[36] Benjamin Richardson, *Financing Environmental Change: A New Role for Canadian Environmental Law* 49 McGill L. J. 145, 159 (2004) (noting that most private pension plans in the corporate sector ignore environmental issues); Martin, Casson & Nisar (note 23), 43; MONKS & MINOW, *supra* note 34 at 125; Robert Monks & Allen Sykes, *Companies run in shareholders' long-term interests also serve society's long-term interests* in RESPONSIBLE INVESTMENT 232 (Rory Sullivan & Craig Mackenzie, eds., 2006).

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challenging or voting against management of a company with which the bank or insurance company does business.[37] All institutional investors, however, are facing pressure from regulators and institutional investor organizations to fulfill their expected role as active monitors of corporate management.

For now, most new wave RI is voluntary, but national and regional governments are beginning to incorporate it into their domestic regulatory regimes, particularly with respect to pension funds. The Canadian province of Ontario last year announced that it would follow the UK and other EU countries in requiring pension funds to disclose the extent to which they consider ESG factors.[38] Other jurisdictions have gone a step further, mandating that pension funds consider ESG factors.[39] The United Kingdom has expressly incorporated the logic of new wave RI into its corporate statute under the guise of "enlightened shareholder value".[40] UK corporate directors are required "to promote the success of the company for the benefit of its members [shareholders] as a whole, and in doing so have regard (amongst other matters) to (a) the likely consequences of any decision in the long term" and "(d) the impact of the company's operations on the community and the environment."[41]

The appeal of new wave RI is that it appears to offer a path to environmental sustainability that does not require altering the existing corporate governance framework of the Anglo-American corporation; the focus remains squarely on maximizing shareholder value.[42] New wave RI does not impose on investment fund trustees conflicting duties; rather, "it provides a seemingly clear, single-value goal – maximize shareholder wealth – one that is consistent with a narrow interpretation of the institution's fiduciary duty to its

[37] MONKS & MINOW, *supra* note 34 at 111 and 113.

[38] *2011 Ontario Budget: Chapter III: Tax and Pension Systems for Ontario's Future*, available at: http://www.fin.gov.on.ca/en/budget/ontariobudgets/2011/ch3.html#c3_secB (last accessed: 1 December 2012); UNEP FI Asset Management Working Group, *Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment*, 15 (2009); Hess (note 4), 253.

[39] Richardson, *Financing Environmental Change*, *supra* note 36 (discussing Sweden and New Zealand).

[40] *Companies Act, 2006*, 2006, c. 46.

[41] *Id*., s. 172(1)(a) and (d). Subsections (b), (c), (e) and (f) instruct board members to consider the interests of employees, the need to foster business relationships with customers and suppliers, the company's reputation, and the need to act fairly between shareholders. The legislation has been criticized for providing little guidance to directors as to how to apply this provision in practice: Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's 'Enlightened Shareholder Value Approach'* (2007) 29 SYDNEY L. REV. 577 at 597.

[42] *See e.g.,* Hess, *supra* note 4 at 227 (the goal of RI is to ensure corporations focus on long-term value creation through sustainable economic development).

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beneficiaries."[43] Nor does it ask corporate management to balance or trade-off environmental responsibility against profitability, because over the long-term, new wave RI tells us, they go hand in hand. The problem with this story is that the continued emphasis on maximizing shareholder value places important limits on new wave RI's ability to improve corporate environmental performance, limits discussed in the next section.

C. Inherent Limits of "Business Case" Responsible Investing as Environmental Regulation

I. Materiality

New wave RI is premised on the belief that environmental factors may affect long-term shareholder value. The difficulty with applying this belief to investment decision-making is that it is not always evident how the company's environmental impacts will affect the bottom-line. Empirical studies attempting to link companies' overall environmental records to financial performance remain inconclusive.[44] In assessing a specific project or business decision, it may often be the case that environmental issues seem unlikely to have a "material" effect on shareholder value.[45] The effect must reach the level of materiality in order for an investment manager to be able to justify a decision on the basis of enhancing long-term investment returns. Part of the difficulty in determining the materiality of environmental factors is the general difficulty translating environmental risks into monetary terms.[46] The other difficulty is the time horizons involved. In many cases, any predicted effect of environmental risks on shareholder value will occur only in the distant future, meaning that an investment manager would need to discount for the uncertainty

[43] HAWLEY & WILLIAMS, FIDUCIARY CAPITALISM, *supra* note 26, at 97 (describing the finance model of capitalism). Hawley and Williams' "fiduciary capitalism" or "universal owner" theory does not challenge the objective to maximize shareholder value, just shifts the focus from individual firms to the portfolio as a whole: *id*., 99.

[44] See, e.g., Rory Sullivan, Craig Mackenzie & Steve Waygood, *Does a focus on social, ethical and environmental issues enhance investment performance?* in RESPONSIBLE INVESTMENT (Rory Sullivan & Craig Mackenzie, eds., 2006), 58. See also DAVID VOGEL, THE MARKET FOR VIRTUE: THE POTENTIAL AND LIMITS OF CORPORATE SOCIAL RESPONSIBILITY (2005), 29-33 for a summary review of the various studies.

[45] Under Canadian securities regulation, information is "material" if it would affect a "reasonable" investor's decision to buy, hold or sell a security. The OSC has noted that the "reasonable investor" test has shifted to include more environmental information. See Ontario Securities Commission, Corporate Sustainability Reporting Initiative: Report to the Minister of Finance at 14 (2009), available at: http://www.osc.gov.on.ca/documents/en/Securities-Category5/rule_20091218_51-717_mof-rpt.pdf.

[46] NICK HANLEY, JASON SHOGREN & BEN WHITE, ENVIRONMENTAL ECONOMICS: IN THEORY AND PRACTICE, 2d ed (2007), 322. The Enhanced Analytics Initiative defines ESG factors as sharing the characteristic of not readily quantifiable, which would seem to add to the difficulty investors face in actually practicing new wave RI. See Freshfields Bruckhaus Deringer, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*, 18 (2005), available at: http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf (last accessed: 1 December 2012).

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that this predicted effect will actually occur. The farther out the predicted effect, the less likely it is that the fund will still own the investment at the point in time shareholder value is negatively affected. In other words, the investor will have cashed out before the predicted risk to shareholder value materializes. Even pension funds investing for the purpose of covering liabilities decades into the future generally hold individual investments for a much shorter time period. The nature of the environmental risks that could affect shareholder value also varies over different time periods. Although environmental harm is likely to create direct risks to a company's operations over the very long-term, by exhausting a natural resource or environmental service on which the company depends, the risks that will appear most salient to investment managers, with the exception of catastrophes such as the Deepwater Horizon explosion, are more likely to be indirect, in the form of NGO campaigns or broader reputational risks. These indirect risks are less likely to have a material effect on shareholder value.[47] To the extent that responsible investing relies on third parties, such as NGOs, to create a material effect on the company's bottom line through publicity, institutional investors are likely to be most concerned with specific, narrow issues that are the current focus of NGO action, such as hydraulic fracturing of natural gas, the subject of at least four shareholder proposals in 2012, rather than interconnected, complex problems of environmental degradation that are less well-suited to extensive media coverage. Finally, limited liability means that an investor's downside risk is limited to the initial investment. Although the shareholdings of an institutional investor in any given portfolio company may be large in absolute terms, they will represent only a small percentage of that shareholder's overall portfolio, making any given risk to the value of one company even less significant when viewed in the context of the portfolio as a whole.

The universal owner theory, discussed above, suggests that large institutional investors should focus on the impacts of environmental issues not on individual portfolio companies, but on the economy as a whole. Again, however, universal owners face the general difficulty in calculating the costs of environmental harm to the economy.[48] The economic effects of some environmental threats, such as climate change, are well documented.[49] The economic effects of other environmental problems, such as biodiversity loss, may be less well known, or more difficult to translate into monetary terms. And there are innumerable, localized environmental impacts that will have no discernible effects on the

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[47] See, e.g., Vogel, *supra* note 44 at 158; RICHARDSON, *supra* note 18 at 513.

[48] HAWLEY & WILLIAMS, FIDUCIARY CAPITALISM, *supra* note 26 at 23 and 33.

[49] See, e.g., Nicholas Stern, *Stern Review on the economics of climate change*, available at: National Archives, http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/independent_reviews/stern_review_economics_climate_change/stern_review_report.cfm (last accessed: 1 December 2012).

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national or global economy. Furthermore, not all environmental costs will be internalized, even when taking an economy-wide view, in the absence of regulation.[50]

II. Information asymmetry

Assuming investment managers and analysts could solve the problem of assessing accurately the financial effects of environmental risks on shareholder value, they would require sufficient information from the company to conduct this assessment. Like government regulators,[51] however, investors lack direct access to information about a company's environmental impacts. Investors can – and do – ask for better environmental disclosure from portfolio companies,[52] and better disclosure on its own may have some positive effects on corporate environmental performance. Like government regulators, however, institutional investors lack the kind of specific, inside information to communicate to a portfolio company specific process innovations that would help to reduce the company's environmental impacts.[53] The distance between investors and foreign portfolio companies, and the sheer number of companies in which large funds are invested exacerbate this informational asymmetry.[54] CPPIB, for example, has "positions in over 3,100 companies worldwide,"[55] making it impossible, or at least prohibitively expensive for CPPIB to monitor carefully the environmental performance of each company in its investment portfolios.

[50] RICHARDSON, *supra* note 18 at 135 and 486.

[51] See Gail Henderson, *A Fiduciary Duty to Minimize the Corporation's Environmental Impacts*, INTL. & COMP. CORP. L. J. (forthcoming).

[52] Eight of the shareholder proposals filed against US publicly listed companies in 2012 asked the company to start producing an annual "sustainability" report. Many others asked the company to provide a report on the environmental risks of a specific activity, such as oil sands development, natural gas hydraulic fracturing, and mountaintop removal coal mining.

[53] The situation is different for private equity funds, which tend to take a controlling interest in a smaller number of companies. Given the volatility of public markets, pension funds are becoming bigger players in private equity.

[54] MONKS & MINOW, *supra* note 34 at 151 (discussing the limits on the ability of institutional investors "for optimal monitoring"); RICHARDSON, *supra* note 18 at 194.

[55] CPPIB, 2011 Report on Responsible Investing, 3 and 6, available at: www.cppib.ca/files/PDF/CPPIB_RI_Report.PDF (last accessed: 1 December 2012).

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III. Differences among "E", "S" and "G"

One area in which institutional investors have succeeded in changing corporate behavior is in the area of corporate governance – the "G" in ESG. There are a number of possible explanations for this success. First, there appears to be a consensus around a set of good governance practices, such as having a majority of independent board members, which allows institutional investors to present a consistent message on these issues. Institutional investors helped to form this consensus through participation in institutional investor organizations, such as the Canadian Coalition of Good Governance.[56] Second, these good governance best practices apply universally to corporations in all sectors of the economy.[57] Environmental and social issues, in contrast, will vary significantly from sector to sector and even among companies within sectors, depending on their geographic location or particular operations.[58] For this reason, it may be more difficult for investors to develop a set of environmental best practices or standards which apply across all sectors and clearly set out investors' expectations of good environmental governance.[59] To overcome this difficulty, institutional investors tend to focus on a small number of environmental issues at a time, in isolation from other environmental concerns. Currently, a number of institutional investors are focusing on climate change. Climate change is clearly a pressing environmental problem, but it is not the only one, and focusing too closely on greenhouse gas emissions may lead companies to solve this problem in manner that causes other serious environmental harm.

Institutional investors could do more to promote existing international environmental standards and guidelines, which would help to reinforce the emerging international norms of corporate behavior found within these documents.[60] The OECD Guidelines for Multinational Enterprises, for example, contain voluntary standards with respect to environmental management. There is also an International Standards Organization standard for environmental management systems – ISO 14000. Even these standards, however, must be drafted in broad enough terms to apply to the myriad impacts corporations have on the environment. The OECD Guidelines instruct multinational corporations to set performance objectives and targets, among other procedural steps to

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[56] Thanotheram, *supra* note 31 at 303**.**

[57] Although distinctions may be made between publicly listed and privately held corporations.

[58] Different methods of oil and natural gas extraction, for example, raise different environmental issues.

[59] RICHARDSON, *supra* note 18 at 147 (citing the absence of universal benchmarks to measure sustainability performance as inhibiting investment analysis of environmental issues).

[60] UNEP FI Asset Management Working Group, *supra* note 38 at 26. See also *id.*, 434 (discussing the role of sustainability ranking agencies or indices).

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improve environmental performance, but they do not include substantive objectives or targets. Similarly, ISO 14000 is not a substantive standard, but a process standard. Although better environmental disclosure would assist institutional investors in monitoring companies' environmental performance,[61] ultimately, it is up to corporate management to set substantive objectives or targets and to ensure those targets are met.

Although some of the social issues raised by corporate activity may be similarly individualized, many are nonetheless amenable to clear standards of behavior. David Vogel notes that "in contrast to labor standards, where a rough consensus has emerged about how firms in developing countries that supply Western companies should treat their employees, the standards for corporate environmental responsibility are much less clear."[62] The specific circumstances in which human rights issues will arise may vary among corporations, but the standard of corporate behavior – to respect human rights – does not.[63] The substantive content of those rights is also spelled out: the OECD Guidelines' Commentary on Human Rights lists the relevant international declarations and covenants.[64] Similarly, the issue of corruption may arise under different circumstances, but the rule of behavior remains the same: do not bribe public officials.[65] Although environmental harm and human rights violations or bribery can both occur as a consequence or side-effect of otherwise legal and socially-desirable economic activity, the UN Framework and OECD Guidelines on human rights and corruption is premised on the assumption that economic activity is possible *without* these two negative consequences. Since almost all-economic activity impacts the environment in some way, it is not possible to solve the problem of corporate environmental harm with blanket prohibitions alone. There are, of course, instances of environmental damage that arise from violations of the law or from illegal economic activity. This is not the case, however, for many environmental problems, such as the emission of greenhouse gases. For this reason, making corporate activity environmentally sustainable is less a matter of blanket

[61] A number of shareholder proposals filed against North American companies between 2009 and 2012, which received a significant level of institutional investor support, asked companies to set GHG emission targets and to report on their progress in meeting those targets.

[62] Vogel, *supra* note 44 at 110.

[63] See OECD Guidelines for Multinational Enterprises, Ch IV, 31 (2011), which has incorporated the United Nations Framework for Business and Human Rights 'Protect, Respect and Remedy'.

[64] *Id.*, Ch IV, Commentary, 32.

[65] See, e.g., *Corruption of Foreign Public Officials Act*, SC 1998, c. 34. See also OECD Guidelines, *id.*, Ch VII – Combatting Bribery, Bribe Solicitation and Extortion, 47 ("Enterprises should not, directly or indirectly, offer, promise, give, or demand a bribe or other undue advantage to obtain or retain business or other improper advantage."). The OECD has recommended that countries eliminate exceptions for "small facilitation payments", making the prohibition on bribery absolute: *Recommendations of the Council for Further Combating Bribery of Foreign Public Officials* (26 November 2009).

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prohibitions or universal standards of conduct and more a matter of managing the environmental impacts of economic activity on a case-by-case basis.

Another distinction between governance issues, on the one hand, and environmental and social issues, on the other, may be the ease with which investors can monitor companies' governance practices from the outside. A simple Google search will tell an investment manager whether a corporation has separated the Chair of the Board from the CEO position. It is slightly more difficult to determine whether there are a majority of independent directors on the board, but such information is usually found in a company's public disclosure; in Canada, publicly listed companies must disclose this information.[66] It is possible, of course, for an interested investment manager to determine whether a company has an environmental management system in place. It is more difficult, if not impossible, for an institutional investor to monitor implementation of that system in order to determine whether the corporation is proactively reducing its environmental impacts, unless the company is disclosing detailed annual information about its environmental performance, in accordance with a voluntary standard such as the Global Reporting Initiative. In some ways, this makes environmental performance much like financial performance: it is as difficult for investors to monitor whether corporate management is making best efforts to minimize environmental impacts as it is to monitor whether corporate management is making best efforts to maximize profits. This difficulty in monitoring is often cited as the reason for imposing on directors a fiduciary duty to act in the best interests of the corporation.

IV. Ultimately, returns trump

In the "Frequently Asked Questions" section of its website, the Ontario Teachers' Pension Plan responds to the question "What efforts are made to ensure investee companies respect human rights and the environment?" as follows:

> We have a responsibility to consider all investments that we believe will earn a reasonable return in order to pay teachers' pensions. We look at all risk factors (including environmental, social and governance issues) to assess the impact they could have on a company's long-term performance. If our assessment shows a company is an appropriate investment for the plan, we invest.[67]

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[66] *National Instrument 58-101 – Disclosure of Corporate Governance Practices*.

[67] Ontario Teachers' Pension Plan, *Listening to members*, available at: http://www.otpp.com/wps/wcm/connect/otpp_en/Home/Responsible+Investing/Qs+and+As/ (last accessed: 1 December 2012).

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The Public Sector Pension Investment Board takes a similar "pragmatic view", stating that it will adapt its approach to responsible investing "to the local financial and legal environment *and the commercial imperatives* within which a particular company operates."[68] These public-sector pension funds have good reasons for their positions: their primary legal and, arguably, moral obligation is to ensure that teachers and federal civil servants receive the pension promised to them in their employment contract. In an aging society, security of pension assets is also a social or public good, as is a healthy natural environment.

There is also nothing inconsistent in the position of these pension funds with new wave RI.[69] Eurosif, which promotes RI, states in its "Toolkit" for pension funds that responsible investing policies should grant trustees discretion not to apply SRI "where it would result in harm to plan beneficiaries."[70] This priority structure is also built into the UK's "enlightened shareholder value" approach to directors' duties: the UK *Companies Act* instructs directors to have regard to "the *desirability* of the company maintaining a reputation for high standards of business conduct".[71]

The problem for new wave RI as environmental regulation is that the message these statements send to portfolio companies is that social and environmental responsibility is nice, but when push comes to shove, the priority is to generate returns on investment. This message reinforces the status quo or "business as usual", because even if improved environmental performance would indeed enhance returns over the long term, there is no immediate or short-term incentive for the company to change its existing practices. The Canadian National Round Table on the Environment and the Economy notes that to the extent investors fail to reward the companies that take steps to mitigate their environmental and social impacts, "they effectively discourage companies from going any

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[68] Public Sector Pension Investment Board, *Responsible Investing Policy* 2 (12 November 2009), available at: http://www.investpsp.ca/pdf/responsible-investment-policy.pdf (last accessed: 1 December 2012). See also bcIMC, Responsible Investing factsheet, 1, available at: http://www.bcimc.com/publications/pdf/Factsheet_ResponsibleInvesting_20120331.pdf (last accessed: 1 December 2012, "[w]here possible without sacrificing returns, we include ESG factors in our investment decisions.").

[69] See, e.g., Julie Cotter & Muftah Najah, *Institutional investor influence on global climate change disclosure practices*, 37 AUS. J. OF MGMT. 169, 174 (2012) ("the shareholder engagement perspective concerns itself solely with the long-term interests of shareholders.").

[70] Eurosif, *supra* note 32, at 32.

[71] *Supra* note 36, s. 172 (1)(e). See Gudula Deipenbrock & Mads Andenas, *Directors' Duties to Promote the Success of the Company and 'Enlightened Shareholder Value'. Comparing English and German Company Law*, 7 INTERNATIONAL AND COMPARATIVE CORPORATE LAW JOURNAL 1, 28 (2010). The Supreme Court of Canada arguably took a similar approach to directors' duties in *BCE Inc v 1976 Debentureholders*, 2008 SCC 69. Although the Court states that directors "may be obliged" to consider the interests of non-shareholder stakeholders (para. 66), any consideration must tie back to the "best interests *of the corporation*" [emphasis added]. For this reason, it seems unlikely that *BCE* will lead to significant improvements in corporations' environmental performance.

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further."[72] It may be that under this approach, how well a company manages ESG risks is an insufficient reason on its own to cause institutional investors to invest in that company over another which does not. New wave RI's emphasis on maximizing investment returns also means that any economic costs of environmental harm would have to be set off against the economic gains from the corporate activity at issue. This means that new wave RI is unlikely to bring about substantial improvements in corporations' environmental performance. The irony is that this "returns trump" approach may cause new wave RI to undermine itself.[73] As long as institutional investors apply this approach to their stated belief that responsible companies make better long-term investments, and insist that environmental factors cross the materiality threshold before they are considered in making investment decisions, companies are unlikely to improve their environmental performance sufficiently to reduce the environmental risks to long-term shareholder value.

By allowing returns to trump, new wave RI also serves to reinforce the current emphasis on economic growth. I have argued elsewhere that achieving environmentally sustainable development requires a shift away from continual economic growth as an end in itself, rather than as a means to other social goods, which must be balanced against environmental quality.[74] By allowing returns to trump ESG factors, new wave RI reinforces the current deification of economic growth for its own sake. For this reason, new wave RI will not serve to slow growth to a level within ecological limits.[75]

It may be that new wave RI is motivated by the concern that to make investment decisions on the basis of achieving any aim other than the maximization of returns will "subvert" free markets.[76] But the whole point of new wave RI is that the market is failing to take environmental factors sufficiently into account. Correcting this failure may require more than new wave or "returns trump" RI. It may require investment fund trustees to explicitly base their investment decisions on environmental factors – to practice "moral case" RI,

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[72] National Round Table on the Environment and the Economy, *Capital Markets and Sustainability – Investing in a Sustainable Future* (2007), 8, available at: http://nrtee-trnee.ca/wp-content/uploads/2011/08/NRTEE-capital-markets.pdf (last accessed: 1 December 2012).

[73] RICHARDSON, *supra* note 18 at 102. Lawrence Mitchell makes a similar observation about shareholder wealth maximization as the object of the corporation: Mitchell (note 60), 5.

[74] Gail Henderson, *Rawls & Sustainable Development*, 7 MCGILL INT'L. J. OF SUS. DEV. L. & POL'Y. 1 (2011).

[75] RICHARDSON, *supra* note 18 at 16.

[76] See Larry Catà Backer, *Sovereign Wealth Funds as Regulatory Chameleons: The Norwegian Sovereign Wealth Funds and Public Governance Through Private Global Investment*, 41 GEORGETOWN J. OF INT'L. L. 101, 125 (2009) (noting that this argument is made against SWFs, on the ground that as government investment funds they will make investments for the purpose of achieving the political aims of their governments).

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thereby "distorting" the market in favor of the least environmentally harmful companies.[77] This alternative approach to responsible investing is discussed in the next section.

D. Can "Moral Case" Responsible Investing Do Better?

In his book, *Socially Responsible Investment Law*, Professor Benjamin Richardson argues in favor of "refram[ing] the core objective of financial institutions to an overarching responsibility for ethical investing for sustainability", such that the only permissible financial returns are those "achieved without unaccounted-for public costs to the environment and social welfare."[78] In seeking to avoid returns generated in an unsustainable manner, mandatory RI motivated by an environmental ethic should reallocate capital away from the most environmentally harmful investments.[79] This reframing may be necessary not only to fulfill the promise of responsible investing to reduce the environmental harm caused by corporations, but also to fulfill its promise of enhancing investment returns over the long-term. Notwithstanding the possible positive effect on investment returns over the long-term, at the time investment decisions are made, environmental factors would be taken into account for the purpose of achieving environmental sustainability, rather than maximizing returns.

Richardson's argument could be seen as a partial shift back to what we might call "first wave" responsible investing. Originally, socially responsible investing was about aligning the content of an individual's or an organization's investment portfolio with the moral values held by that individual or organization.[80] For example, university students argued it was contrary to the moral values a university should seek to uphold to invest in companies with assets in Apartheid South Africa. In contrast to new wave RI, it was understood that such an alignment might have a *negative* effect on investment returns.[81] The students' argument was a moral argument against benefitting financially from unethical business practices. Richardson's argument in favor of mandatory responsible investing is, similarly, a

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[77] See Vogel, *supra* note 44 at 166 (suggesting that responsible investing would have a greater impact on environmental protection if investors "were more willing to also invest in companies that earned less because they had chosen to act more responsibly.").

[78] RICHARDSON, *supra* note 18 at 514.

[79] *Id.*, 523. Richardson suggests that if responsible investors dominated the capital markets, they could raise the cost of capital enough to impose a type of Pigovian tax on environmentally unfriendly firms: *id.* at 152.

[80] See, e.g., *id.* 73-74; and 111-20 (regarding faith-based investing).

[81] Vogel, *supra* note 44 at 22 ("The students who demanded that their universities sell their holdings in firms with investments in South Africa or firms with defense contracts did not believe that this investment strategy would financially benefit their institutions.").

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moral argument against benefitting from investments in environmentally unsustainable projects or in companies with poor environmental practices.

The problem with even a partial shift back to "first wave" or "moral case" RI is the discomfort of investment fund boards of trustees with basing investment decisions on "ethical" rather than "financial" factors. This discomfort is part of the reason for new wave RI. In a 2006 survey of US public pension fund trustees, the most common response given as to why a fund had decided not to practice responsible investing was trustees' belief it was not appropriate to make investment decisions based on ethical issues.[82] Aside from the concern that basing investment decisions on ethical factors conflicts with their fiduciary duty to beneficiaries[83] and their mandate to maximize investment returns, this view likely reflects the idea that maximizing returns is an "objective" or apolitical criterion on which to base investment decisions, whereas ethical or moral factors constitute "subjective" or political criteria.[84] This next three sections address the possible objections to mandatory, moral case RI, arising from its potential conflict with the fund's investment mandate, and from concerns regarding the legitimacy of investment fund trustees basing investment decisions on non-financial factors and accountability to beneficiaries as to how investment decisions get made.

I. Diversification

Modern portfolio theory emphasizes the importance of diversifying investments to protect against risks to particular companies or sectors.[85] Pension funds are thought to have a fiduciary duty to diversify their investments in order to minimize the risks of a funding shortfall.[86] Excluding a category of investments on the basis of ethical concerns is therefore understood as increasing risk by constraining the fund's ability to diversify.[87] The difference between excluding investments based on the ethical issues that drove the "first wave" of RI and basing investment decisions on environmental factors is that the former did not

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[82] Hess, *supra* note 4 at 246.

[83] *Supra* note 43 and accompanying text.

[84] RICHARDSON, *supra* note 18 at 21.

[85] Freshfields Bruckhaus Deringer, *supra* note 46 at 7; Richardson, *Financing Environmental Change, supra* note 36 at 153.

[86] Richardson, *Financing Environmental Change*, *id.*; Freshfields Bruckhaus Deringer *id.* at 8, although the duty to diversify is not a duty to diversify "maximally": *id.* at 110.

[87] UNEP FI Asset Management Working Group, *supra* note 38 at 15; CPPIB, Policy on Responsible Investing at 1, s. 2.0. But see Eurosif, "Toolkit" at 18 ("pension funds using norms-based screening [i.e., based on international standards such as the UN Global Compact] report insignificant changes in risk levels.").

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have a significant effect on a fund's ability to diversify adequately their investment portfolio. There are not that many weapons manufacturers. In contrast, almost every company generates some quantity of greenhouse gas emissions. Canada's economy in particular is heavily weighted in natural resource extraction. The companies that might appear to have the smallest environmental footprint – high-tech or internet companies – are particularly susceptible to stock market bubbles, and their long-term profitability is often highly uncertain. Just ask Mark Zuckerberg. Pension funds concerned with meeting long-term pension plan liabilities may be wary of over-weighting these sectors in their portfolios.

This does not mean that it would be impossible to require investment funds to take environmental factors into account in making investment decisions. Funds could get around the diversification problem by applying a "best in class" approach to choosing portfolio companies.[88] This approach might be less likely to change the allocation of capital among industry sectors, but it would serve to reward the companies within a sector doing the best job of mitigating their environmental impacts, thus addressing the current failure to do so, identified by the National Round Table.[89] Alternatively, funds could continue to invest in environmentally-harmful companies, but the motivation behind engaging with boards and exercising shareholders' voting rights would be based not on assumptions around enhancing long-term value, but rather on the role of institutional investors in minimizing the negative social and environmental impacts of corporate behavior.

II. Legitimacy

An important objection to moral case RI is that investment trustees lack the legitimacy to base decisions on environmental, rather than financial, factors, and that general concerns about the environmental impacts of corporate activity are better left to policy-makers within government. In any case, empirical evidence would suggest that trustees themselves feel that they lack this legitimacy.[90] Environmental issues are not wholly removed from the current mandate of most large institutional investors, however. The

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[88] A "best in class" approach selects for an investment portfolio those companies which have the best environmental performance within their sector, thus ensuring that the portfolio is still diversified across industries. This is the approach taken by the Dow Jones Sustainability World Index. See DJSI, *Index Family Overview*, available at: http://www.sustainability-indexes.com/dow-jones-sustainability-indexes/index.jsp.

[89] *Supra* note 67.

[90] Hess, *supra* note 4 at 246; Freshfields Bruckhaus Deringer, *supra* note 46 at 27. See also Humphreys et al, *supra* note 1 at 12 (noting that officials at the endowment funds of University of Pennsylvania, Yale and Princeton "went to great lengths to convey that their refusal to make future investments [in HEI funds] was financial rather than 'social' or 'ethical'.").

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purpose of a pension plan, for example, whether public or private, is to help to ensure beneficiaries' comfort in their old age by providing them with a retirement income. This promised comfort might be undermined if the portfolio companies providing the retirement income are harming beneficiaries' future quality of life by polluting the air or water or by contributing to climate change. It is therefore legitimate for pension fund trustees to consider beneficiaries' best interests in a broader sense, beyond their best financial interests. The UK Universities Superannuation Fund has adopted this position, stating that it has a role to play in helping its members realize the "*real* value" of their retirement income by helping to ensure that its beneficiaries "retire in a world characterized by a healthy environment, vibrant economy and peaceful society."[91] Beneficiaries themselves may come to realize that profits earned on investments may be illusory if they are offset by the costs of the social and environmental impacts caused by portfolio companies, such as increased health care costs due to pollution-related illness.[92] Interpreting beneficiaries' best interests narrowly as their interest in the financial returns of the fund may be counterproductive to beneficiaries' well being in the long-term.

Large institutional investors do not invest exclusively – or even primarily – in the country in which their beneficiaries reside. Many instances of irresponsible corporate conduct will have no impact on beneficiaries' quality of life. On what basis, then, could a Canadian investment fund justify engaging with a mining company operating in South America regarding its environmental impacts – or, for that matter, with a US company on its non-discrimination policy – except on the basis of maximizing investment returns?[93] Such engagement would have to be based on a broader moral obligation to avoid profiting from environmental harm or human rights violations. With respect to environmental issues, engagement could be justified on the basis of the transboundary and global nature of many environmental problems,[94] or on the basis that certain environmental goods, such as the Amazon rainforest, constitute part of the common heritage of humankind. The legitimacy of basing investment decisions on such principles is enhanced by adhering to

[91] USS, *Responsible Investment: Background & Rationale*, available at: http://www.uss.co.uk/UssInvestments/Responsibleinvestment/BackgroundRationale/Pages/default.aspx (last accessed: 1 December 2012) [emphasis in original]. See also Thanotheram (note 27), 308-09; Hawley & Williams, *Fiduciary Capitalism*, *supra* note 26 at 28.

[92] Kimberly Gladman, *Why the PRI is Not Just PR: Perspectives on the Principles for Responsible Investment*, THE CORPORATE LIBRARY, 4 (2010); Hawley & Williams, *id.*, xvii (profits from investing in tobacco offset by the health care costs imposed on beneficiaries). See DAVID R BOYD, UNNATURAL LAW: RETHINKING CANADIAN ENVIRONMENTAL LAW AND POLICY (2003), 66 (although estimates vary widely, from 5,000 to 16,000 premature deaths are caused by air pollution each year, and environmental NGOs and both levels of government agree "that air pollution costs Canada billions of dollars annually in health care.").

[93] See, e.g., Catà Backer, supra note 76 at 189 (Norway's Government Pension Fund Global "deliberately seeks to project Norwegian policy preferences on a host of private actors otherwise beyond its reach.").

[94] EDITH BROWN WEISS, IN FAIRNESS TO FUTURE GENERATIONS: INTERNATIONAL LAW, COMMON PATRIMONY, AND INTERGENERATIONAL LAW (Tokyo: The United Nations University, 1992) at 27.

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international codes such as the UN Global Compact or the OECD Guidelines for Multinational Enterprises, which represent an international consensus on appropriate corporate conduct.

Collaboration among pension funds also has the potential to increase the legitimacy of applying moral judgment to investment decisions. Although institutional investor organizations tend to focus on traditional corporate governance issues, there are those, such as the Carbon Disclosure Project (CDP), specifically aimed at environmental issues. The current mandate of the CDP, to improve the quality of information available to investors, fits more easily into the new wave RI paradigm of enhancing long-term investment returns.[95] On broader issues of public policy, a lack of input from other stakeholders or from civil society may undermine the legitimacy of institutional investor organizations. On the other hand, such organizations may have more legitimacy with, and therefore more influence over, corporate actors than do NGOs.[96]

It also might be argued that investment funds, like the corporations they own, require their own social license to operate, the terms of which include consideration of ESG issues.[97] The Norwegian Global Fund's ethical policy, for example, is based on the idea that since citizens of Norway have no choice in being the ultimate beneficial shareholders of the Fund's portfolio companies, the investments made by the Fund must be acceptable to most citizens.[98] This same logic would apply to national pension funds, such as the Canada Pension Plan Investment Board. Many of the world's largest institutional investors are investing public funds, such as state revenues from natural resource royalties, or mandatory pension contributions, or they invest on behalf of public-sector union pension plans, any funding shortfall of which will be covered by government tax revenues. A recent commission report on pensions found that beneficiaries themselves want to know that their pension funds are "not only profitably and safely invested, but also that they are invested in companies that behave as good corporate citizens should", and that the fund is

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[95] Carbon Disclosure Project, *Catalyzing Business and Government Action*, available at: https://www.cdproject.net/en-US/Pages/About-Us.aspx (last accessed: 1 December 2012).

[96] Waygood, Sullivan & Morley, *supra* note 11 at 328.

[97] *Id.* at 83 (speaking with respect to the financial sector).

[98] Statement by Director General Martin Skancke, Asset Management Department, Norwegian Ministry of Finance, to the Subcommittee on Domestic and International Monetary Policy, Trade and Technology and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, US House of Representatives, Hearings on "Foreign Government Investment in the US Economy and Financial Sector" (5 March 2008), 4, available at: http://www.regjeringen.no/upload/FIN/Vedlegg/aff/Congress_testimony_martin_skancke.pdf (last accessed: 1 December 2012).

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using its leverage as a major shareholder to support environmental and social policies through, for example, proxy voting.[99]

III. Accountability

A concern related to the legitimacy of trustees basing investment decisions on non-financial factors is the problem of accountability to beneficiaries. Trustees may be concerned that beneficiaries or others will view particular decisions as an abuse of the trustees' discretion, or based on the trustees' own personal preferences, rather than on principles agreed on *ex ante*. This possible objection brings us back to the idea that financial criteria are "objective" and that decisions based on financial criteria alone are therefore more defensible than "subjective" ethical or moral criteria. Underlying this idea is the assumption that a heterogeneous group of beneficiaries can all agree with the former criteria, but will hold varied and possibly conflicting beliefs regarding the latter.

There are a number of potential responses to this concern. The Freshfields Report argues that there will be classes of investments that trustees are "entitled to avoid on the grounds that their ESG characteristics are likely to make them so repugnant to beneficiaries that they should not be invested in," regardless of the expected financial return.[100] While there may be such a category, it is likely to be extremely small; many more investment decisions will fall within an ethical grey zone which trustees will require some concrete guidelines to navigate through. Consulting beneficiaries is one possibility,[101] but it is likely impractical in most cases, particularly in the case of takeover bids or other transactions that require a level of secrecy. Even consulting beneficiaries on investment policies may raise issues of procedural fairness since the existing beneficiaries at the time a policy is put in place will have greater input than subsequent beneficiaries.

Beyond the small category of "repugnant" investments, there are ethical positions that are reasonable and defensible without requiring the prior agreement of beneficiaries. The political values reflected in the Canadian *Charter of Rights and Freedoms*, for example, represent a set of values all Canadians are expected to share, or at least to respect, and

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[99] *A Fine Balance, Report of the Expert Commission on Pensions* (31 October 2008), 173, available at: http://www.fin.gov.on.ca/en/consultations/pension/report/Pensions_Report_Eng_web.pdf (last accessed: 1 December 2012).

[100] Freshfields Bruckhaus Deringer, *supra* note 46 at 12. The Freshfields Report cites the example of child labor as such a "widely recognized norm".

[101] RICHARDSON ,*supra* note 18 at 218. CPPIB holds biennial public meetings, although the purpose appears more informational than consultative. See CPPIB, "Public Meetings", available at: http://www.cppib.ca/About_Us/public_meetings.html (last accessed: 1 December 2012).

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which Canadian society aspires to uphold. These values include the principles of equality and non-discrimination, values reflected in shareholder proposals filed against US companies requesting the inclusion of sexual orientation as a prohibited ground in the company's non-discrimination policy.[102] A Canadian institutional investor could defend a policy of voting in favor of these proposals on the basis of their consistency with *Charter* values.[103] The difficulty with respect to environmental issues is that although it might be possible to point to legislative documents representing a societal consensus on environmental values, unlike issues such as discrimination on the basis of gender or sexual orientation, it is more difficult to communicate to portfolio companies, in general terms, how they ought to conform to those values in practice.[104]

Funds can further alleviate concerns that trustees are simply acting on the basis of personal morality and not on a pre-determined set of disclosed principles or international standards through greater transparency.[105] As noted above, an increasing number of jurisdictions are requiring pension funds to disclose their ESG policies.[106] CPPIB and Canada's other largest public-sector pension funds voluntarily disclose their investment policies, including proxy voting guidelines, and voting records. Norway's Government Pension Fund Global discloses the reasoning behind any decision to exclude a company from the fund's portfolio.

Concerns regarding "moral case" RI, therefore, are not insurmountable. Unfortunately, responsible investing undertaken for ethical reasons suffers from some of the same inherent limits as new wave RI. Institutional investors remain at an informational disadvantage to corporate management. Environmental issues remain less susceptible than governance and some social issues to clear, universal standards of behavior that can be communicated easily to portfolio companies. The only limit of new wave RI that moral case responsible investing appears to alleviate is the limit imposed by the materiality requirement. It seems likely, therefore, that responsible investing, even when motivated

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[102] See, e.g., shareholder proposal filed against KBR, Inc. in 2011. The company amended its Code of Ethics after this proposal received a record 61.7% shareholder support. See KBR, Inc., Form DEF 14A, 4 April 2011 and 5 April 2012, available at: www.sec.gov/edgar.shtml (last accessed: 1 December 2012); Ted Allen, "Greater Support for Shareholder Proposals on E&S Issues", ISS Governance blog (20 June 2011), available at: http://blog.issgovernance.com/gov/2011/06/greater-support-for-shareholder-proposals-on-es-issues.html (last accessed: 1 December 2012).

[103] Even having this kind of policy does not save trustees from having to make potential contentious decisions. For example, are shareholder proposals requesting gender parity on boards consistent with *Charter* values or an unjustified interference in the appointment process?

[104] S*upra* note 53, and accompanying text.

[105] Richardson, *supra* note 18 at 25; Hess (note 4), 260 (regarding preventing the politicization of US public pension funds).

[106] *Supra* note 38, and accompanying text.

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explicitly by a moral obligation to avoid profiting from environmental harm, would fail to bring about substantial improvements in corporations' environmental performance.

E. Conclusion: The Principle of Subsidiarity and a Duty on Boards of Directors

If moral case RI will not improve corporate environmental performance sufficiently to achieve environmental sustainability, then what alternatives are available to policy-makers? I argue elsewhere in favor of altering the fiduciary duty of corporate boards of directors to include a duty to minimize the corporation's environmental impacts.[107] The purpose of imposing such a duty on corporate boards is to fill the gaps left by other forms of environmental regulation by requiring boards to ensure that the corporation is gathering information about its own environmental impacts and taking steps to prevent, or at least to mitigate, those impacts. I focus on corporate boards as the best way to harness the innovative capacity of the corporation to make operational changes that will prevent or reduce environmental impacts.

To help explain the argument for focusing on corporate boards rather than investment fund trustees, the principle of subsidiarity may prove useful. The principle of subsidiarity holds "that decisions affecting individuals should, as far as reasonably possible, be made by the level of government closest to the individuals affected."[108] The Supreme Court of Canada invoked the principle in a decision upholding a municipal ban on pesticides. In her reasons for judgment, Justice L'Heureux-Dubé described subsidiarity as "a proposition that law-making and implementation are often best achieved at a level of government that is not only effective, but also closest to the citizens affected and thus most responsive to their needs".[109]

Applied to the problem of controlling corporate environmental harm, the principle of subsidiarity implies that integrating environmental considerations into the fiduciary duty of decision-makers is better imposed at the level of the corporate board of directors, rather than investment fund trustees. Responsible investing relies on investors to put pressure on directors who in turn are expected to direct changes in the company's operations that will improve environmental outcomes. A fiduciary duty imposed directly on the board of directors shortens this chain of actions and reactions. Boards of directors are closer to the problem than institutional investors: they have better access to information regarding the corporation's environmental impacts and a better understanding of the company's

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[107] Gail Henderson, *supra* note 51.

[108] PETER HOGG, CONSTITUTIONAL LAW OF CANADA, 5th ed., Supplemented, vol. 1, 5-12 (2007).

[109] *114957 Canada v Hudson*, [2001] 2 SCR 241, para 3; Hogg at 5-14.

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operations and how these could be altered to mitigate environmental impacts. Boards are able to respond quickly to changes in a company's operations that may have environmental repercussions. It is true that boards rely on senior managers and other full-time employees to provide them with information and to implement any mitigation measures, but the board has the ultimate responsibility to ensure that proper procedures for managing environmental impacts are in place and functioning properly.[110] Institutional investors not only are a further step removed from a company's daily operations, but also, due to the imperative to diversify their portfolios,[111] are invested in too many companies to monitor all of them closely. Institutional investors may try to overcome these challenges by focusing on a small number of specific environmental issues. Focusing on specific environmental issues in isolation from the general problem of environmental degradation may result in companies taking measures that respond to the narrow concerns of investors, but in fact increases the company's overall environmental footprint. Imposing a duty on boards of directors, rather than investment fund managers, should lead all boards to take a holistic approach to mitigating the companies' environmental impacts, rather than focusing on isolated environmental issues of current interest to institutional investors. Since the duty focuses on a corporation's own environmental impacts, imposing a duty at the level of the corporate board of directors may not raise the same questions of legitimacy as imposing a similar duty on investment fund trustees.

In addition to greater distance from the problem, imposing the duty on investment fund trustees is unlikely to change the norms under which corporate directors operate. Both business case and moral case RI are premised on understanding the fiduciary duty of directors as a duty to act in the best interests of shareholders alone. Both are attempts to change corporate behavior by expanding the understanding of shareholders' "best interests" to include environmental sustainability, either by connecting it to long-term investment value or through a legal duty on shareholders to consider environmental impacts. Neither attempts to challenge this "shareholder primacy" paradigm of corporate governance, leaving the social norms internalized by directors unchanged. This means that directors are unlikely to pressure managers to go beyond what is necessary to keep investors happy. Boards operating under a duty to minimize the corporation's environmental impacts are more likely to take a broader view of their responsibility to the environment and to implement changes beyond those demanded by investors. Institutional investors practicing RI may then support these changes, either as being in their best long-term financial interests or out of a moral or legal obligation. But instigating these changes requires a change in the duties and norms operating on corporate directors, rather than on investment fund trustees.

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[110] *Canada Business Corporations Act*, RSC 1985, c. C-44, s. 102(1) ("Subject to any unanimous shareholder agreement, the directors shall manage, or supervise the management of, the business and affairs of a corporation.").

[111] *Supra* note 86, and accompanying text.

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This is not to suggest that institutional investors have no role to play in achieving environmental sustainability, or that they could not do more to improve corporate environmental performance. Nor am I suggesting that the tentative steps toward greater integration of environmental factors into investment decision-making taken to date are entirely unhelpful. Investors could do more, for example, to promote international standards, such as the OECD Guidelines, and other emerging international norms of corporate behavior with respect to the environment. And it seems likely that changes in corporate behavior pushed for by investors in the name of enhancing long-term returns will lead to some improvement in corporate environmental performance. Increasing institutional investor support for environmentally-related shareholder proposals, such as those asking companies to appoint a board member with environmental expertise, may force companies to respond, thereby increasing the awareness and understanding of environmental issues on corporate boards. Most fundamentally, any adjustment to the duties of boards of directors may be undermined if investors are focused solely on maximizing investment returns. But the practical limits on institutional investors' ability to monitor corporate management, coupled with the individualized nature of corporate environmental harm and possible responses to that harm, mean that responsible investing will not, on its own, improve corporations' environmental performance sufficiently to achieve environmental sustainability. Responsible investing is better viewed as an important complement to a legal duty imposed on boards of directors to minimize the corporation's environmental impacts. A duty imposed directly on boards of directors, which are closer to and better able to respond to corporations' environmental impacts, is more likely to bring about the reductions in environmental harm caused by corporations necessary to achieve environmental sustainability and ensure the ability of future generations to benefit from and to enjoy the natural environment.

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