

**SOCIALLY RESPONSIBLE INVESTING:  
IMPLEMENTATION OF  
CORPORATE SOCIAL RESPONSIBILITY  
IN THE EUROPEAN FINANCIAL MARKETS**

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***“Financial markets are a product of society and as such they must reflect society’s concerns.”<sup>1</sup>***

The London Principles,  
2002

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<sup>1</sup> Corporation of London, *Financing the Future. London Principles. The Role of UK Financial Services in Sustainable Development*, 2002, p. 1

## ACRONYMS

AUM	Assets Under Management
BDS	Boycott, Divestment and Sanctions
CSR	Corporate Social Responsibility
EIRIS	Ethical Investment Research and Investment Service
EFAMA	European Fund and Asset Management Association
ESG	Environmental, social and governance (with reference to impact/issues)
EUROSIF	European Sustainable Investment Forum
GRI	Global Reporting Initiative
Ibid.	“The same place” referring to the note immediately preceding
Idem.	“The same as” referring to a preceding note
PRI	Principles for Responsible Investment
SIF	Sustainable Investing Forum
SRI	Socially Responsible Investing
UKSIF	United Kingdom Sustainable Investment Forum

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## INTRODUCTION

The effects of globalization on financial markets and investing have been manifold. The oil disasters and nuclear disasters and climate change reports have become catalysts for the development of renewable energy investments. Opposition to and boycotting of businesses operating in human-rights violating regimes have fuelled ethical screening moves. Greater awareness of third world poverty and the need for sustainable solutions has been behind the emergence of the community investing and microfinance sector. The recent financial crisis which spread on a global scale has renewed the spotlight on business ethics.

Globalization brought increasing concern to businesses through a category of issues collectively referred to as ESG or Environmental, Social and Governance issues. It has revealed the large potential for effects of these issues on the performance of businesses and has served to affirm their materiality. Investing processes are an important part of businesses and as such have been affected by ESG issues as well.

Socially Responsible Investing, also known as SRI, refers to the practice of making investment decisions based not only on financial, but also on non-financial criteria such as ESG factors. The existence and rise of SRI has proven to be not just simply a new niche in the market, but has raised awareness of a previously ignored issues brought into the forefront by the forces of globalization. While SRI has not yet become the investment norm in Europe (or any other part of the world for that matter), its importance has steadily been rising.

The European Commission has expressed the view that the concept of Socially Responsible Investing is closely related to the concepts of Corporate Social Responsibility (CSR) and Sustainable Development<sup>2</sup>. While CSR has gained importance in all business sectors in the last few years, SRI has particularly gained importance in the financial sector. Because Corporate Social Responsibility (CSR) has led companies to integrate social and environmental concerns in

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<sup>2</sup> Steurer, Reinhard., Margula, Sharon., Martinuzzi, André., *Socially Responsible Investment in EU Member States: Overview of Government Initiatives and SRI Experts' Expectations Toward Governments. Final Report to the EU High-Level Group on CSR*, Vienna University of Economics and Business Administration, April 2008.

their business operations and to step up interaction with their stakeholders on a voluntary basis,<sup>3</sup> Socially Responsible Investing can be regarded as the application of CSR principles in investment decisions.

Through the use and compilation of existing secondary research, in this work I aim to:

- (1) Provide a broad overview of the European market for Socially Responsible Investing;
- (2) Demonstrate that Socially Responsible Investing in Europe is steady on a trajectory of developing from a market niche to a mainstream investing practice;
- (3) Show the links through which Socially Responsible Investing is connected to Corporate Social Responsibility specifically in the context of European financial markets.

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<sup>3</sup> European Commission, COM (2001) 366 final, *Green Paper. Promoting a European Framework for Corporate Social Responsibility*, 18 July 2007

## PART 1

### WHAT IS SOCIALLY RESPONSIBLE INVESTMENT?

#### 1.1. SOCIALLY RESPONSIBLE INVESTMENT: Definition and Scope of Analysis

##### 1.1.1. DEFINITION: What is Socially Responsible Investing?

Defining Socially Responsible Investment is fraught with challenges. One of the most common criticisms is that the central concept is ill-defined.<sup>4</sup> A related criticism is that the definition of SRI is so broad that “it verges, at times, on being meaningless”.<sup>5</sup> In fact, according to the entrepreneur and activist Paul Hawken, “*the language used to describe SRI funds, including the term “SRI” itself, is vague and indiscriminate*”.<sup>6</sup>

One of the challenges is the existence of multitude of terms to capture different flavours of responsibility: “social”, “ethical”, “responsible”, “sustainable”, “socially responsible”, “morally responsible” and others, that are often used in overlapping ways. In fact, there are a large number of terms frequently used interchangeably in place of SRI, to name but a few: *Ethical Investing*, *Values-based Investing*, *Mission-based Investing*, *Socially Aware Investing*, *Responsible Investing* and the list goes on. Further difficulty stems from the fact that the very concept of Socially Responsible Investment continues to evolve.<sup>7</sup> This ongoing concept evolution couple with a multitude of reference points makes it an elusive term that means different things to different people.

Which one to use? Eurosif, the leading pan-European association of National Sustainable Investment Forums, uniting the largest number of key SRI market participants across the continent, defines it as follows:

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<sup>4</sup> Crane, Andrew et al. (eds), *The Oxford Handbook of Corporate Social Responsibility*, Oxford University Press, 2008, pp. 260-261

<sup>5</sup> Blowfield, Michael., Murray, Alan., *Corporate Responsibility: A Critical Introduction*, Oxford University Press, 2008, p. 299

<sup>6</sup> Paul Hawken & The Natural Capital Institute, “Socially Responsible Investing” (Sausalito, Calif.: Natural Capital Institute, Oct. 2004), p. 22.

<sup>7</sup> Eurosif, *2010 European SRI Study*, p. 8

*“Sustainable and Responsible Investing (SRI) is a generic term covering any type of investment process that combines investors’ financial objectives with their concerns about Environmental, Social and Governance (ESG) issues”.*<sup>8</sup>

Acknowledging that there is no universally accepted definition and that “this richness of different views challenges the investor to perfectly define and categorize SRI [which] is not easily ‘boxed in”, Eurosif points out the two constant factors that unite all the various terms:<sup>9</sup>

- (1) A concern with long-term investment;
- (2) Environmental, Social and Governance (ESG) issues as important criteria in determining long-term investment performance.

Peter Kinder, President of KLD Research & Analytics, a leading company providing ESG research for SRI investors, emphasizes the use of “investing” rather than “investment” to underline that the act of investing rather and not the investment vehicle is crucial for the concept.<sup>10</sup> “Socially responsible investing”, he reminds, “describes a conscious decision to behave in a particular way toward a defined end”<sup>11</sup>.

While Eurosif declares all of the existing and developing expressions of sustainability investing valid, it uses the term Socially Responsible Investing or SRI as “the most readily acknowledged expression”.<sup>12</sup> Therefore, for the purposes of this document, I will refer to Socially Responsible Investing using the term of choice by Eurosif.

### **1.1.2. SCOPE OF ANALYSIS: SRI Market in Focus**

The Socially Responsible Market is broadly divided into two streams based on whether the investments take place in the public or private financial markets: Ethical Investing for the former

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<sup>8</sup> Eurosif, *2010 European SRI Study*, p. 8

<sup>9</sup> Idem.

<sup>10</sup> Kinder, Peter, *Socially Responsible Investment: An Evolving Concept in a Changing World*, KLD Research & Analytics, September 2005, p. 5

<sup>11</sup> Idem.

<sup>12</sup> Idem.

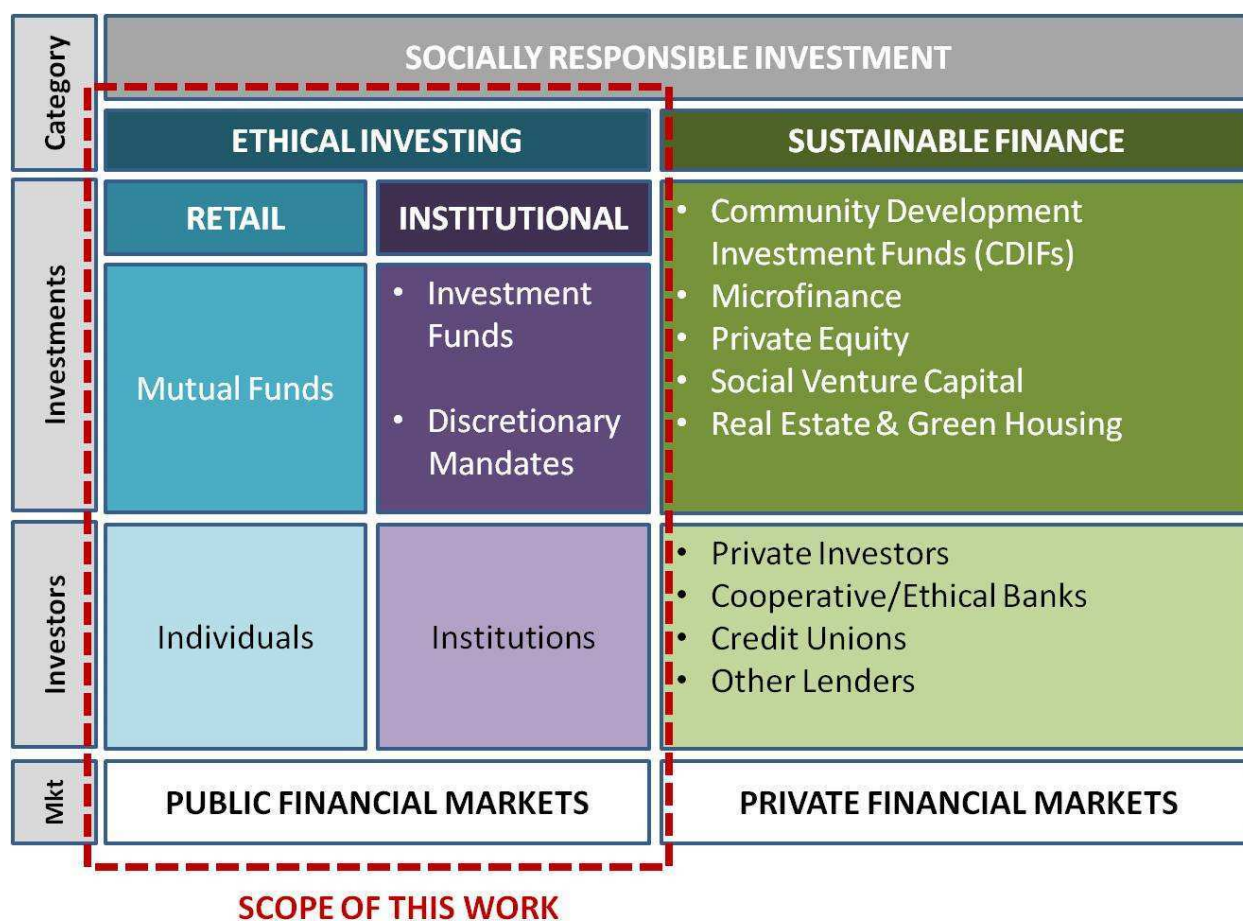


and Sustainable Finance for the latter. Ethical Investing is the most established and widely available form of Socially Responsible Investing. It denotes investments in publicly listed companies determined to be “more ethical” than their peers. Sustainable Finance is used to support the “social economy” through private investment. This kind of Socially Responsible Investment has traditionally been more scarce, less liquid and transparent, and more difficult to track. It is also less developed in Europe. To achieve a greater depth of analysis given volume constraints, in this work I will only focus on ethical investment, represented by the chart area singled out in red (see CHART 1).

### CHART 1: Socially Responsible Investment\* – Market View\*\*<sup>13</sup>

\*term “investment” preferred in reference to market

\*\*area does not represent size of each market segment



<sup>13</sup> Chart is not derived from a single source, but is compiled as a summary of widely held views on SRI sourced from all references listed in the Bibliography.

## 1.2. ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONCERNS AND INVESTING: Risks and Opportunities

Environmental, social and governance (hereafter, referred to as ESG) issues are also known as extra-financial or non-financial investment considerations. The triumvirate of environmental, social and governance issues is oftentimes referred to as Sustainability Factors or Triple Bottom Line.<sup>14</sup> Some of these issues are higher on the political and business agenda than ever. The recent global environmental, social and financial crises have also acted as a wake-up call for many investors. ESG issues are important for businesses because they are thought of in terms of presenting both risks and opportunities. Where ESG factors were once considered outside the realm of conventional investment decision making, they are now accepted as having a potentially material impact on financial performance and should therefore be embedded within the investment process.<sup>15</sup>

While the definition of SRI is still somewhat controversial, there is actual agreement on what ESG factors are. There are a vast number of ESG concerns relevant to corporations and specifically to investment decisions. They differ across companies, industries and geographies, but can be grouped in three broad categories. Examples of such concerns are captured in TABLE 1 below.

**TABLE 1: Examples of ESG Concerns Impacting Corporations<sup>16</sup>**

CATEGORY	EXAMPLE ISSUE
<b>ENVIRONMENTAL</b>	<ul style="list-style-type: none"> <li>• Climate change/Environmental pollution</li> <li>• Scarce resources</li> <li>• Waste Management</li> <li>• New regulation expanding the boundaries of environmental product liability</li> <li>• New markets for environmental services and environmentally-friendly products</li> </ul>

<sup>14</sup> The terms “Triple Bottom Line” was coined in 1994 by the British social entrepreneur John Pilkington.

<sup>15</sup> Mercer Responsible Investment Service (website)

<sup>16</sup> Future Proof? Embedding Environmental, Social and Governance Issues in Investment Markets. Who Wins Cares Initiative: Outcomes Report (2004 – 2008), p. 13.

<b>SOCIAL</b>	<ul style="list-style-type: none"> <li>• Workplace health and safety</li> <li>• Knowledge and human capital management</li> <li>• Labour and human rights issues within companies and their supply chains</li> <li>• Government and community relations</li> </ul>
<b>GOVERNANCE</b>	<ul style="list-style-type: none"> <li>• Board structure and accountability</li> <li>• Accounting and disclosure practices, transparency</li> <li>• Executive compensation</li> <li>• Management of corruption and bribery issues</li> </ul>

There are a number of challenges in capturing the effect of ESG factors on business in general and on investment in particular. The two main difficulties lie in measuring the ESG impact on businesses and in standardizing current ESG reporting across industries and geographies. According to Teresa Fogelberg, Deputy Chief Executive at the Global Reporting Initiative (GRI) (which will be discussed in Part 3: Regulation),<sup>17</sup> ESG impact is notoriously difficult in terms of describing by a set of precise and quantitative measures. The impact of environmental guidelines is the easiest to measure because they environmental parameters can be described with quantitative performance data. Social performance including human rights issues is traditionally more difficult. Governance is the most challenging aspect for investors to analyze because it is the least public and therefore the least transparent criterion of sustainability.

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<sup>17</sup> Five Questions About SRI – Weekly Expert Interview, 3 June 2011 (website)

## PART 2

### MARKET ANALYSIS

#### 2.1. EUROPEAN SRI MARKET: Growing in Size and Importance

Over the past decade, SRI has experienced explosive growth around the world reflecting the increasing awareness of investors to social, environmental, ethical and corporate governance issues<sup>18</sup>. Although the European SRI market is in the early stages of development with most developments dating back to the beginning of the 1990s (See Part 2: History of SRI), its share of the total asset management market in Europe is growing rapidly. This means that despite a fair share of criticism and skepticism both toward the concept and its implementation, it is attracting the growing interest of European investors resulting in its increasing importance as a market. This combination of an increasing market share and a high growth rate indicates the “mainstreaming” of SRI, that is - its transition from a niche investing practice to a more commonplace and eventually standard one in the European financial marketplace.

In sizing the market for Socially Responsible Investment, practitioners from the investment management industry and researchers and employ the concept of Assets Under Management (AUM). AUM is defined as “the market value of assets that an investment company manages on behalf of investors. Assets Under Management is looked at as a measure of success against the competition, [subject to] growth/decline due to both capital appreciation/losses and new money inflow/outflow”.<sup>19</sup>

According to Eurosif, total SRI AUM in Europe have reached 5 Trillion EUR, as of December 2009 (See CHART 1).<sup>20</sup> The increase in the European SRI market from 2.7 Trillion EUR in 2007 to 5 Trillion EUR at the end of 2009, represents, on a like-for-like basis,<sup>21</sup> a growth of about 87% over two years (2007 – 2009) or a Compound Annual Growth Rate (CAGR) of 37%.<sup>22</sup> This market growth rate is high by any standard and indicates that the European SRI market is expanding rapidly.

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<sup>18</sup> Aras, Guler., Crowther, David.(eds), *A Handbook of Corporate Governance and Social Responsibility*, Gower Publishing Limited (England) & Ashgate Publishing Company (USA). 2010. p. 23

<sup>19</sup> Investopedia – Assets Under Management (website)

<sup>20</sup> Eurosif, *2010 European SRI Study*, p. 11 (report)

<sup>21</sup> Including only the 13 EU countries, which were part of the Eurosif European SRI Survey in 2007

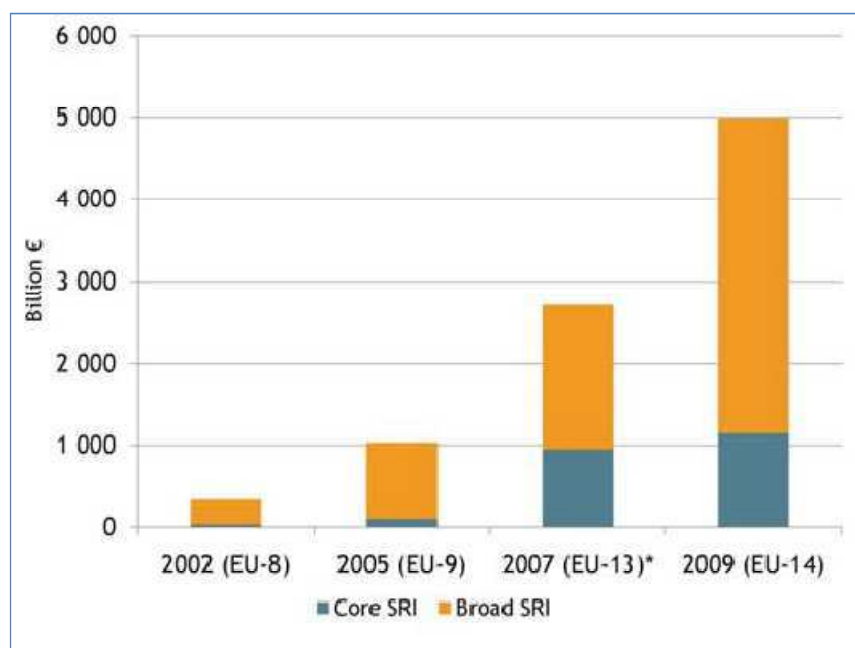
<sup>22</sup> Eurosif, *2010 European SRI Study*, p. 12 (report)

To obtain a more precise grasp of the European SRI market, one needs to segment it in smaller building blocks that are easier to identify and measure. In this analysis, I will refer to and use the two market segments that Eurosif distinguishes based on SRI investing strategy: Core and Broad SRI.<sup>23</sup>

- 1) Core SRI includes assets of investments where ethical exclusions (negative screens) and/or positive screens are applied;
- 2) Broad SRI includes assets of investments with simple exclusions (one or two negative screens only), integration and engagement strategies.

For definitions and details on SRI Strategies, see Part 4: SRI Methods and Means. Conceptually, Core SRI is equivalent to retail SRI, while Broad SRI – to institutional SRI.

**CHART 2: Core and Broad SRI in Europe (2002 – 2009)<sup>24</sup>**



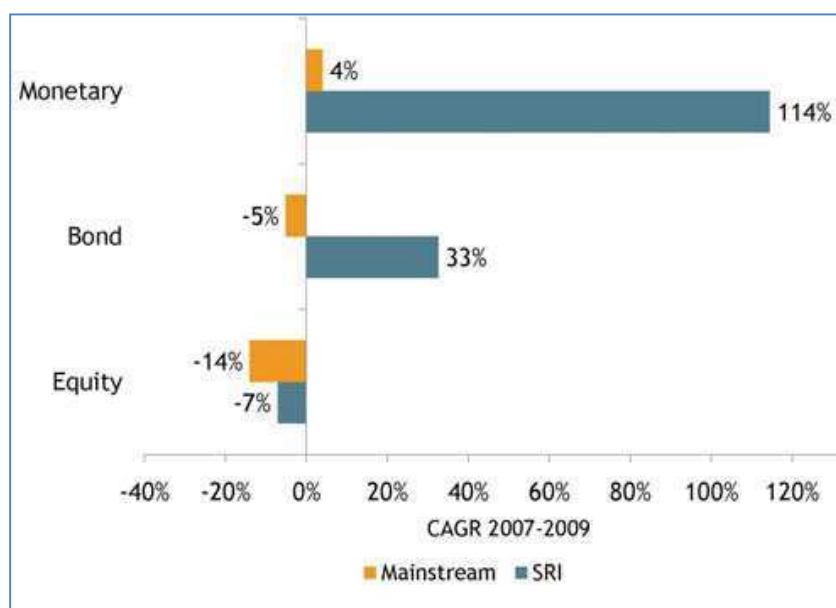
<sup>23</sup> Ibid, p. 8

<sup>24</sup> 2010 European SRI Study. Eurosif, p. 11 (report)

The market share of SRI as percentage of the overall European asset management market is also rising. Using estimates of the total European AUM industry for 2008 and 2009 by Eurosif and the European Fund and Asset Management Association (EFAMA), applied to the Core segment of the SRI market, one can calculate the market share of the total Core SRI assets at year-end 2009 to be as much as 10% of the asset management industry in Europe.<sup>25</sup>

Most recent data indicates that growth of the SRI market not only as a whole, but also by asset class (money market, fixed income and equities) has also exceeded that of mainstream funds.

**CHART 3: Growth of SRI and Mainstream Funds by Asset Class (2007 – 2009)<sup>26</sup>**



## 2.2. NATIONAL SRI MARKETS IN EUROPE: Parts of a Whole

Because of the nature of the asset management industry, defining national SRI markets vis-à-vis the entire European market transcends common geography. The European fund management

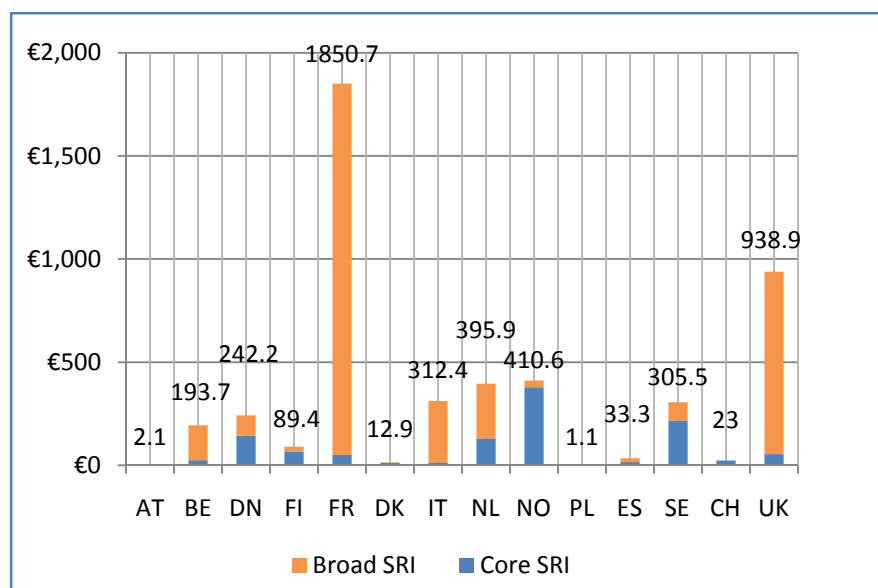
<sup>25</sup> Ibid.

<sup>26</sup> 2010 European SRI Study. Eurosif. p. 11 (report)

industry is increasingly cross-border resulting in funds domiciled in one country, managed in a second and sold in a third.<sup>27</sup> For this reason, and to remain consistent with the methodology of its previous studies, Eurosif defines national markets by the country where the SRI assets are being managed (i.e. where the SRI asset management team is located). For example, if an Italian asset manager with an SRI team based in Germany is managing assets for a French asset owner, this is counted in the German market.

In 2009, the top five largest national SRI markets are France (close to 2 Trillion EUR), United Kingdom (close to 1 Trillion EUR), Norway (411 Billion EUR), followed closely by the Netherlands (396 Billion EUR) and Italy (just over 300 Billion EUR), as shown in CHART 3.

**CHART 3: National SRI Markets by Assets Under Management in Billions (2009)<sup>28</sup>**



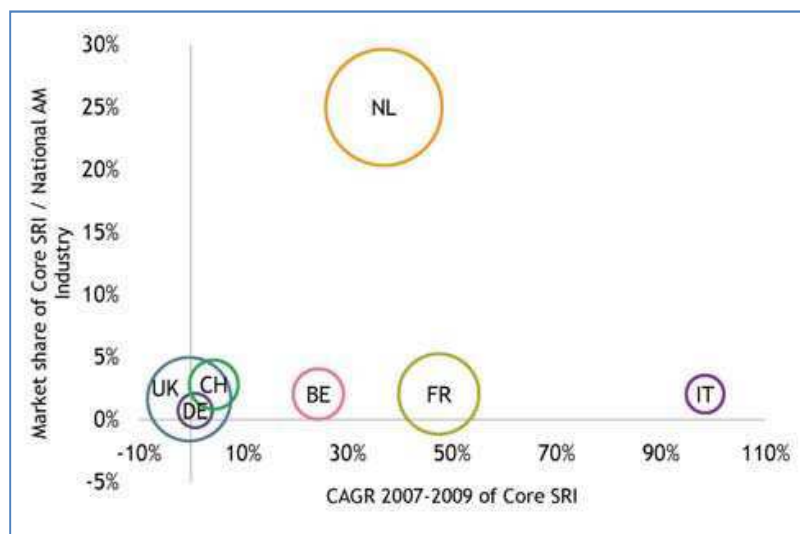
Further, the European market for SRI funds is not uniform as national differences such as the structure of national financial markets, and especially that of national asset management markets, including market size in terms of assets, market players, national regulations as well as the nature of investors come into play, combined with cultural differences. For example, for a single SRI

<sup>27</sup> Ibid, p. 9

<sup>28</sup> Data compiled from Eurosif, *2010 European SRI Study*.

strategy (Core SRI), Italy, France and the Netherlands show the fastest growing markets, while the United Kingdom, France and the Netherlands have the largest markets (CHART 4).

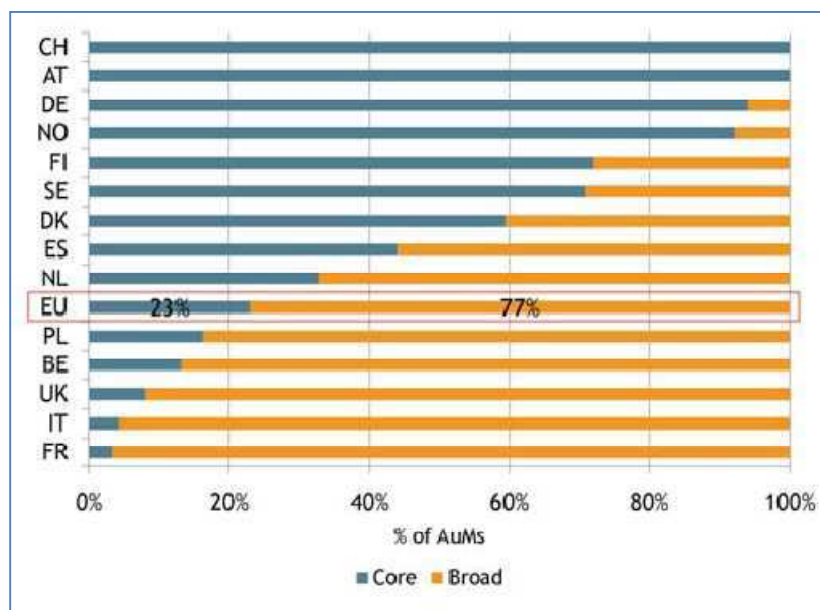
**CHART 4: Growth, Market Share and Size of Core SRI<sup>29</sup>**



National SRI market differences persist in regards to SRI strategies employed by fund managers as well. Chart 4 illustrates how the preferred SRI strategy varies by national market. At the opposite ends of the spectrum are Switzerland, entirely dominated by institutional SRI, and France, where retail SRI is leading.

<sup>29</sup> Eurosif, *2010 European SRI Study*. p. 12 (report)



**CHART 5: Share of Core and Broad SRI by Country in Europe<sup>30</sup>**

Even within Core and Broad SRI - the two large groups of SRI investment strategies used by Eurosif to segment the European market - there are differences by country. TABLE 2 illustrates that different European countries prefer different SRI investing strategies.

**TABLE 2: Uptake of SRI Strategies in European Countries<sup>31</sup>**

SRI Strategy	Description	Country Leaders
<b>CORE SRI: NEGATIVE SCREENING</b>		
Simple Exclusions	No more than two negative criteria	The Netherlands, Italy, Belgium and Sweden
Norms-based Exclusions	Identify and exclude from investment universe companies that violate certain principles (typically based on international	Norway, Sweden

<sup>30</sup> Idem.

<sup>31</sup> Eurosif, *2010 European SRI Study*. p. 12 (report)

	legal, ethical, social and environmental standards)	
Values-based Exclusions	More than two negative criteria or filters are applied	Nordic countries (Denmark, Finland, Norway and Sweden) as well as the Netherlands
<b>CORE SRI: POSITIVE SCREENING</b>		
Best-in-Class	Top-performing companies in a sector	France, Belgium, Finland
Thematic Funds	E.g. Clean Energy	Switzerland
<b>BROAD SRI: ENGAGEMENT</b>		
Engagement	Shareholder activism: direct private or public engagement of shareholders	United Kingdom, the Netherlands and Nordic countries
Integration	Inclusion of ESG factors into traditional financial analysis by asset managers	France, the Netherlands, Belgium

Each of these SRI investing strategies will be explained in detail the Part 5: SRI Means and Methods.

### 2.3. SRI MARKET PLAYERS: Putting the Pieces Together

The “ecosystem” of actors in the public SRI market space consists of a wide range of market participants.<sup>32</sup> Its complexity derives from the large number of players and their high degree of interconnectedness. SRI market players include:

- **ASSET OWNERS (INVESTORS):** At the forefront are the individual (retail) investors and institutional investors (pension, funds, insurance funds, organizations with large endowments such as churches, universities, charities, foundations and others), who increasingly consider environmental, social and governance (ESG) criteria in their investment decisions, while also seeking profitability.
- **ASSET MANAGERS (FUND MANAGERS):** Asset management firms create and manage SRI portfolios for these investors. They can pool the resources of many individual investors together and invest them in the market (in which case they are referred to as retail asset managers or investment trust (UK) / mutual fund (US) companies) or they can manage the assets of organizations with large amounts of assets (institutional asset managers). In creating SRI portfolios, they make ESG issues part of their investment strategy.
- **INVESTMENT CONSULTANTS:** advise trustees of corporate and public retirement plans, university endowments, foundations, healthcare systems. They research what ESG issues mean for their clients, and show how ESG issues are built into standard services such as investment strategy, asset allocation and manager selection
- **RESEARCH PROVIDERS:** Providers of investment research, data providers and rating agencies disseminate ESG-inclusive research assisting investors in selecting their SRI investments.

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<sup>32</sup> Oxford Business Knowledge, *OECD Roundtable on Corporate Responsibility: Recent Trends and Regulatory Implications in Socially Responsible Investment for Pension Funds*, 2007.

- **REGULATORS:** Market regulators including state governance (government) as well as non-state governance mechanisms (industry associations, lobbyist groups, NGOs, academia, think-tanks) promote or hinder SRI through formal and informal regulatory activities.

Next, I will briefly look at the roles and characteristics two of the above groups of SRI market players: investors and asset managers.

### 2.3.1. SRI INVESTORS: The Emergence of Institutional Investors

#### (1) Investor Objectives

An investor is an individual who invests capital with the objective of making a profit on the capital. All investors, both traditional and SRI, try to maximize returns and minimize the risk of their investments. The ambiguity arises when we aggregate many social investors and try to generalize about their behavior. Can we really speak meaningfully about the common experiences of a Catholic institution, an environmental foundation and a mutual fund focused on diversity issues?<sup>33</sup> Socially Responsible Investment covers a diverse range of investor activity and therefore it can be a response to a spectrum of motivations: mistrust of traditional investments post-global financial crisis, alignment of financial objectives with individual or organisation's values, customer demand, or desire to manage investment risks related to environmental, social and governance factors, to name but a few.<sup>34</sup>

The independent research provider KLD Research & Analytics distinguishes three groups of SRI investors based on their different motivational approaches toward SRI (TABLE 3)<sup>35</sup>:

- **Values-Based:** Seeking to align portfolio holdings with personal beliefs

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<sup>33</sup> Crane, Andrew et al., *The Oxford Handbook of Corporate Social Responsibility* (eds), Oxford University Press, 2008. p. 261

<sup>34</sup> EIRIS (website)

<sup>35</sup> Kinder, Peter, *Socially Responsible Investment: An Evolving Concept in a Changing World*, KLD Research & Analytics, September 2005, p. 17

- **Value-Seeking:** Seeking to identify ESG criteria that affect financial performance and therefore share price
- **Value-Enhancing:** Seeking to maintain or increase the financial value of their investments through engagement and shareholder techniques

**TABLE 3: Three Investor Approaches to SRI<sup>36</sup>**

APPROACH	ESG PURPOSE	SUCCESS CRITERIA	INVESTOR TYPE
VALUES-BASED	<ul style="list-style-type: none"> <li>• Consistency with own values</li> <li>• Social Change</li> </ul>	<ul style="list-style-type: none"> <li>• Return adjusted for risk tolerance</li> <li>• “Triple Bottom Line”</li> </ul>	<ul style="list-style-type: none"> <li>• Individual investors</li> <li>• Faith-based and social-cause institutions</li> </ul>
VALUE-SEEKING	<ul style="list-style-type: none"> <li>• Spot investment prospects</li> <li>• Corporate Change</li> </ul>	<ul style="list-style-type: none"> <li>• Market ROI (return on investment)</li> </ul>	<ul style="list-style-type: none"> <li>• Foundations &amp; Endowments</li> <li>• Fund managers</li> <li>• Pensions</li> </ul>
VALUE-ENHANCING	<ul style="list-style-type: none"> <li>• Identify underperforming companies</li> <li>• Corporate Change</li> </ul>	<ul style="list-style-type: none"> <li>• Market ROI (return on investment)</li> </ul>	<ul style="list-style-type: none"> <li>• Public pensions</li> </ul>

## (2) Investor Segments

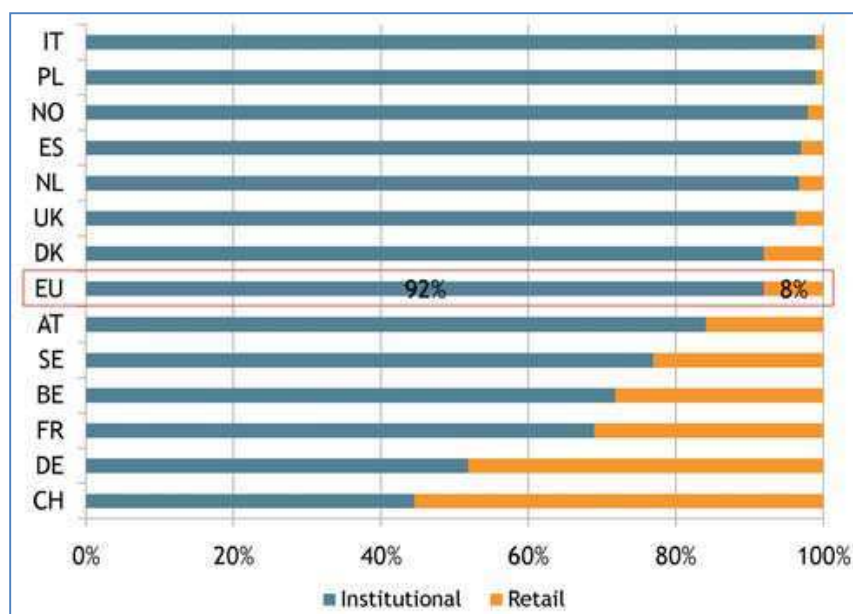
While the above framework is useful for understanding investor behavior, a different investor segmentation approach is needed for market sizing purposes. The two main investor segments for the purposes of market analysis are individual and institutional investors since they take different approaches to determining which companies are “socially responsible”.<sup>37</sup> The

<sup>36</sup> Kidner, p. 28 (paper)

<sup>37</sup> Blowfield, Michael., Murray, Alan., *Corporate Responsibility: A Critical Introduction*, Oxford University Press, 2008. p. 262

European SRI market remains driven by institutional investors representing 92% of the total EU SRI Market.<sup>38</sup>

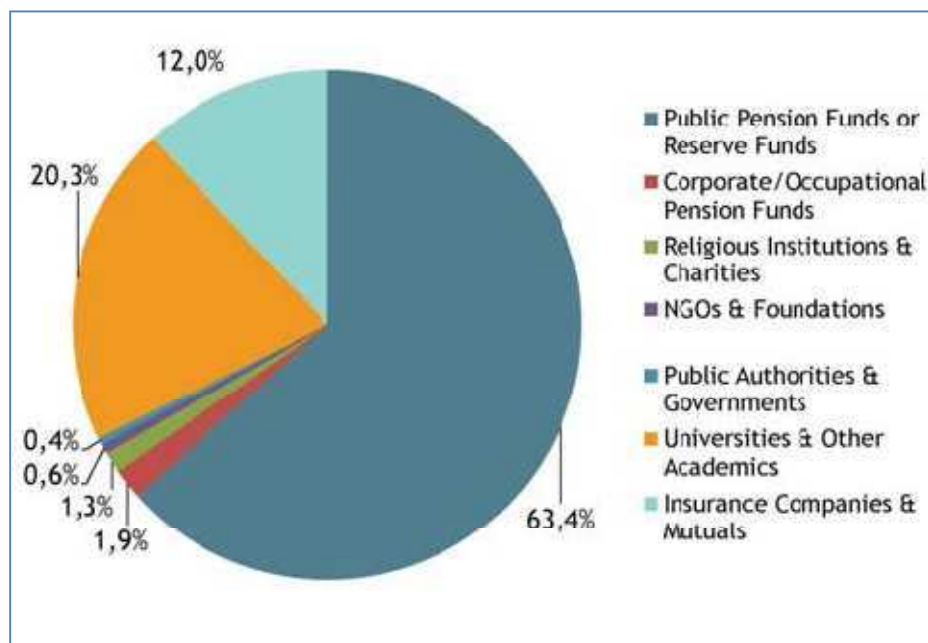
**CHART 6: Institutional vs. Retail SRI Investors by Country<sup>39</sup>**



There are several types of institutional investors that invest in European SRI funds. Public pension funds and reserve funds lead the way, followed by universities and insurance companies. Insurers are also increasingly looking at SRI products. Corporate and occupation pension funds still hold a modest position amongst SRI investors.

<sup>38</sup> Eurosif, 2010 *European SRI Study*, p. 15

<sup>39</sup> *Ibid*, p. 16

**CHART 7: Type of Institutional Investors (by Volume of SRI Assets)<sup>40</sup>**

The emergence of institutional investors as major SRI actors in Europe is an important trend that has served to affirm the mainstreaming of SRI and has brought new perspectives on the importance of SRI. This is a result of the fact that institutional investors have become among some of the strongest advocates for financial institutions to incorporate sustainable development principles in their investment decision making.

Retail investment reflects an individual's financial and non-financial choices, which means it is possible to tailor one's investments to one's views and principles. By contrast, institutional investors represent multiple stakeholders because they invest on behalf of others: employees, union members, and retirees among others. This creates fiduciary responsibilities for the institutional investors. It is defined as a relationship imposed by law where someone has voluntarily agreed to act in the capacity of a "caretaker" of another's rights, assets and/or well being. The fiduciary owes an obligation to carry out the responsibilities with the utmost degree

<sup>40</sup> Eurosif, *2010 European SRI Study*, p. 16

of good faith, honesty, integrity, loyalty and undivided service of the beneficiaries' interest.<sup>41</sup> As a result of this, institutional SRI investors have an obligation to reflect their fiduciary responsibilities toward the multiple stakeholders in their investments. Further, the volumes they invest may reach very large proportions and be decisive on markets. Because of this volume effect, investment decisions are not made by a sole financial officer, but rather by a group of empowered people (trustees) very often including union and investor representatives

The Asset Management Working Group's report, "A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment" (more commonly known as the "Freshfields report") issued in 2005 is considered a landmark for the institutional asset management industry in Europe. For the first time arguments for the necessity of integration of ESG issues into institutional investment are provided in this report. The debate that has taken place within the industry since then has eventually led to the conclusion that not only is ESG integration into mainstream investing compatible with fiduciary responsibilities, but it is should also be required as an element of fiduciary responsibility. In 2009, the same group published a sequel report that provides a legal roadmap for fiduciaries to operationalize their commitment to responsible investment.

A second reason why socially responsible investing strategies have been adopted by institutional investors in Europe is the fact that ESG concerns along with sound corporate governance are believed to enhance long-term company performance.<sup>42</sup> Institutional investors usually take a long-term, buy-and-hold approach to investing, and are therefore likely to be attracted to investment strategies that will impact their investments positively over the long run. "In a recent survey, 78% of European fund managers said that the compliance with SRI criteria enhances the long-term value of an investment."<sup>43</sup>

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<sup>41</sup> Asset Management Working Group of the United Nations Environment Programme – Finance Initiative, *Fiduciary Responsibility: Legal and Practical Aspects of Integrating Environmental, Social and Governance Issues into Institutional Investment. Follow-up to the AMWG's 2005 'Freshfields' Report*. July 2009.

<sup>42</sup> Christensen, Matt, "Socially Responsible Investing: Reaching New Heights. SRI in Europe and the UK", *GreenMoney Journal*, Summer 2011.

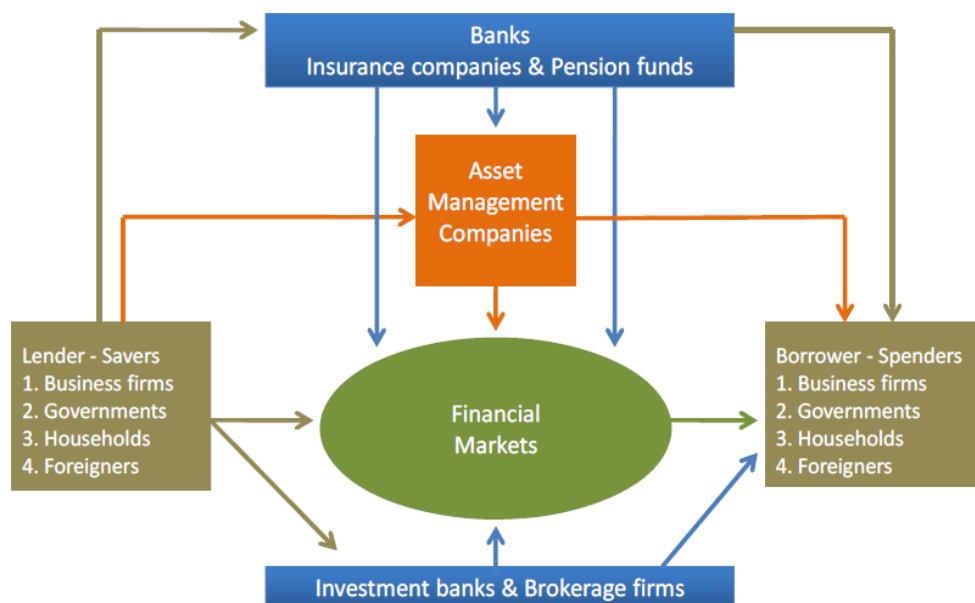
<sup>43</sup> Crane, Andrew., Matten, Dirk., *Business Ethics* (3<sup>rd</sup> ed.), Oxford University Press, 2010. p. 234



### 2.3.2. SRI ASSET MANAGERS: In Pursuit of Dual Objectives

Asset management companies are key players in the sphere of the public SRI market, which is the focus of my analysis. The basic function of asset management companies is that of a financial intermediary channelling funds from those that have saved (lender-savers) to those that have a shortage of funds (borrowers-savers).<sup>44</sup> Asset managers are the institutions directing the investment decisions for investors who have chosen to have their assets professionally managed. In playing their role, asset managers act as “the stewards of their clients’ interests. Their value proposition is to enable their clients to reach their investment objectives and to increase their financial prosperity. As such, they act in an “agency” capacity to manage assets at the request of the “principal”, i.e. the client, in accordance with an agreement. The property of the assets remains with the client (end-investor) i.e. they are not on the balance sheet of the asset managers. The asset managers are, however, in charge of the assets managed and accountable to the clients for those assets.

**CHART 8: Flow of Funds in Financial Markets<sup>45</sup>**



<sup>44</sup> Mishkin, Frederic., *The Economics of Money, Banking and Financial Markets*, 2008.

<sup>45</sup> European Fund and Asset Management Association, *Asset Management in Europe: Facts and Figures. Fourth Annual Review*. p. 5. Adapted from “The Economics of Money, Banking and Financial Markets”, by Frederic Mishkin (2008).

Delegating one's assets to professional managers (asset managers or fund managers) has three advantages: firstly, professional asset managers in theory are better informed and thus able to realize a superior investment performance; secondly, professionals can due to larger funds and lower transaction costs diversify their portfolios broadly; and thirdly, professionals provide economies of scale which should lower the cost of investment management.<sup>46</sup>

Asset managers have an incentive to strive for good performance of the funds they manage – better performance leads to a greater inflow of new capital. Investors may then react to disappointing results by transferring assets away not only between funds but also among asset managers, allocating funds only to the ones with the best performance. However in practice it is often necessary to satisfy customers at shorter intervals and performance may be measured on a short-term. Therefore, while on the one hand investors are under pressure to provide best performance, on the other, they are constrained by a tight time-frame of performance measurement that does not permit the implementation of a long-term strategy. This can create a conflict of interest between owners of funds (principals) – asset owners - and the managers of the funds (agents) – asset managers. This in turn leads to the problem of “agency costs”. The problem of agency costs is worsened for asset managers who employ SRI strategies because unlike traditional asset managers, SRI asset managers pursue dual objectives: both financial and extra-financial returns. It is believed that the multi-task nature of SRI fund managers may weaken their incentives to pursue economic efficiency, that is risk-adjusted returns, and thus increase agency costs.<sup>47</sup>

#### **2.4. SRI PRODUCTS: Expanding List**

The rapid growth of Socially Responsible Investment in Europe in terms of asset volume has led to an expanding range of SRI products. New SRI products are being developed continually. There has been manifold product differentiation across:<sup>48</sup>

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<sup>46</sup> Darman, pp.106-107

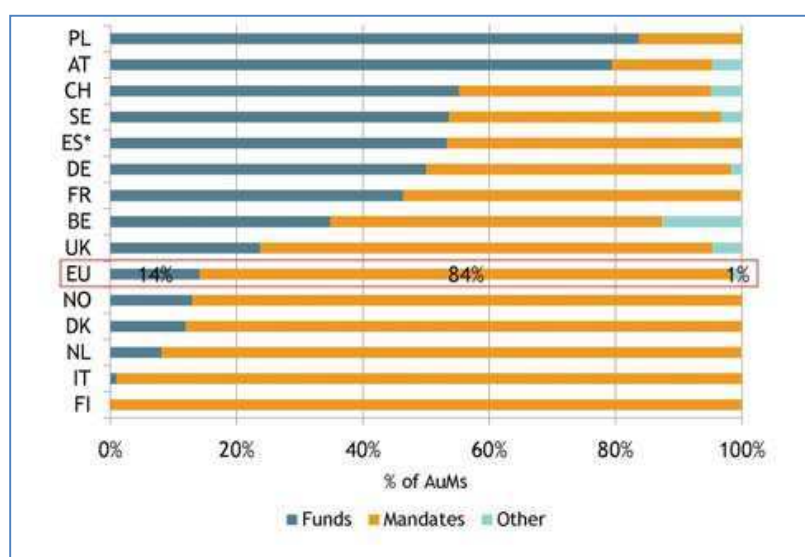
<sup>47</sup> Aras, Guler., Crowther, David. (eds), *A Handbook of Corporate Governance and Social Responsibility*, Gower Publishing Limited (England) & Ashgate Publishing Company (USA), 2010. p. 48

<sup>48</sup> Christensen, Matt, “Socially Responsible Investing: Reaching New Heights. SRI in Europe and the UK”, *GreenMoney Journal*, Summer 2011.

- Investment vehicles: mutual funds, segregated funds, funds of funds (FoFs), multi-management, exchange-traded funds (ETFs)
- Investment universe: industry, SRI screens applied
- Financial instruments : equity, debt, money market

The SRI vehicles most often used remain separate accounts (also referred to as discretionary mandates) (84%), followed by investment funds (14%) at the European level.<sup>49</sup> This reflects roughly the separation between institutional and retail SRI. Separate accounts are privately managed investment accounts, in which the investor owns the securities directly, while investment funds refer to mutual funds, in which the investor owns a share of a pool of money. The former are vehicles used by institutional investors, while the latter are used by retail investors.

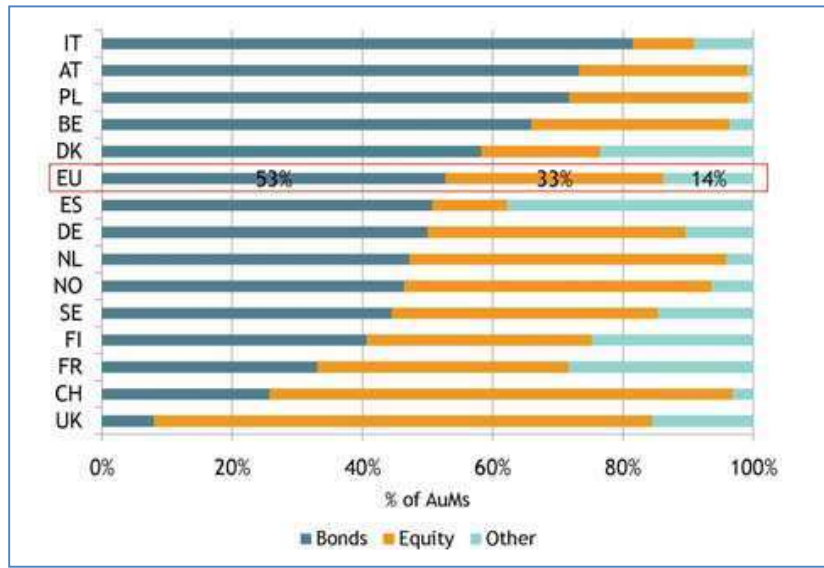
**CHART 9: SRI Investment Vehicles by Country<sup>50</sup>**



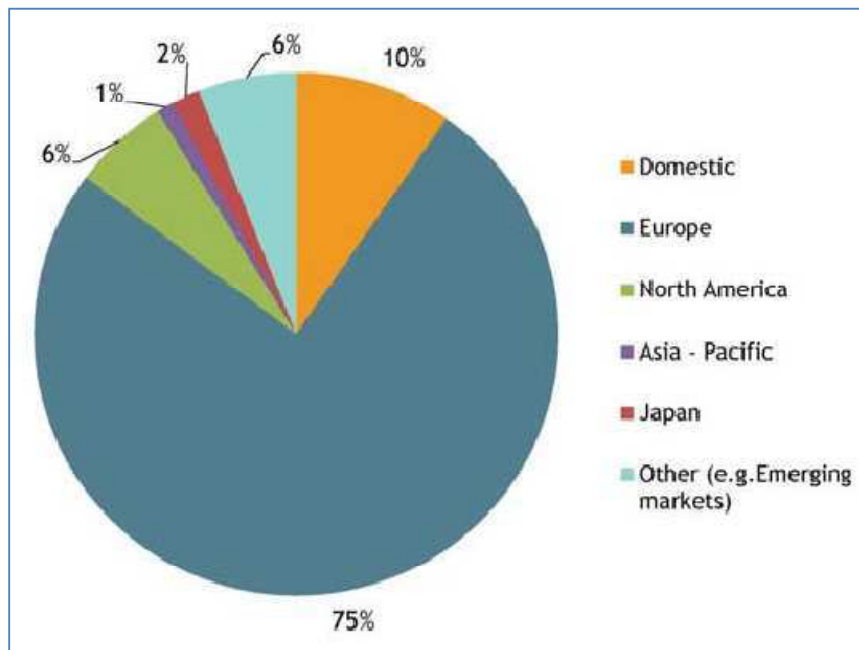
In terms of asset allocation, bonds are the preferred asset class, representing 53% of European SRI assets. Fixed-income investments are typically preferred by institutional investors with long-term liabilities, who are the dominant SRI investor group in Europe, as shown previously.

<sup>49</sup> Eurosif, *2010 European SRI Study*, p. 16

<sup>50</sup> Eurosif, *2010 European SRI Study*, p. 17

**CHART 10: SRI Asset Allocation by Country<sup>51</sup>**

Lastly, in terms of geographic allocation (applicable to equity assets/stocks only), a vast majority (85%) of SRI equities remain invested in Europe.

**CHART 11: Geographic Allocation of European SRI Equities<sup>52</sup>**

<sup>51</sup> Ibid. p. 17

<sup>52</sup> Eurosif, *2010 European SRI Study*, p. 18

## PART 3

### HISTORY OF SOCIALLY RESPONSIBLE INVESTMENT IN EUROPE

Socially Responsible Investment has a long history and many of its practices pre-date modern conceptions of social responsibility.<sup>53</sup> To best put Socially Responsible Investment in a historical frame, one can turn to Andrew Crane’s analysis of the historical position of SRI. He considers that SRI stands at the intersection of two powerful streams of western thought – on the one hand, religious and moral reasoning, on the other, economic and financial theory<sup>54</sup>. One tradition insists on the relevance of ethics to all realms of human activity, the other argues for a narrow focus on risk and return in capital allocation decisions. According to him “social investors have set themselves the daunting task of crafting portfolios that meet the requirements of both traditions [because they believe that] both world views matter.”<sup>55</sup>

Religious belief was the first rationale for SRI.<sup>56</sup> In fact, the principles of SRI are rooted in the early Judeo-Christian and Islamic traditions, which embrace peace and avoid business practices designed to harm human beings.<sup>57</sup>

#### **3.1. RELIGIOUS BEGINNINGS: The Bible, Quakers and Methodists**

The proper use of money has been an important topic in Christian discourse for thousands of years. Some of the most well known applications of socially responsible investing have their beginnings in religious motivation. For example, biblical prohibitions on the charging of interest mean that this form of investment restriction can be traced back at least 2,500 – 3,000 years.<sup>58</sup>

*“Exodus 22:25: If you lend money to my people, to the poor among you, you are not to act as a creditor to him; you shall not charge him interest”*

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<sup>53</sup> Crane, Andrew et al. (eds), *The Oxford Handbook of Corporate Social Responsibility*, Oxford University Press, 2008, p. 249 (monograph)

<sup>54</sup> Crane et al., p. 253 (monograph)

<sup>55</sup> Idem.

<sup>56</sup> Idem.

<sup>57</sup> Blowfield, Michael., Murray, Alan., *Corporate Responsibility: A Critical Introduction*, Oxford University Press, 2008, pp. 280-281 (monograph)

<sup>58</sup> Collie, Bob., Myers, Heather., *Responsible Investment: Five Tests of an SRI/ESG Policy*. Russell Investments. Aug 2008. (report)

Indeed, the Bible provides extensive guidance on the use of money, with over 250 scriptural verses that mention money:<sup>59</sup>

*"Luke 16:9-11(Phi): Now my advice to you is to use "money", tainted as it is, to make yourselves friends, so that when it comes to an end, they may welcome you into the houses of eternity. The man who is faithful in the little things will be faithful in the big things. So that if you are not fit to be trusted to deal with the wicked wealth of this world, who will trust you with true riches?"*<sup>60</sup>

Bible scholars have noted that in the New Testament, Jesus had more to say about money matters and the proper use of money than any other single subject.<sup>61</sup> Of Jesus' 39 parables, over half use money or work as a teaching tool.<sup>62</sup>

Therefore, it is not surprising that the first SRI investors were Christian investors who found abundant support for social investment – that is applying extra-financial criteria to investing - in the scriptures.<sup>63</sup> A religious movement - the Religious Society of Friends also known as Quakers – is credited with planting the seeds of modern SRI in Europe as early as the 17<sup>th</sup> century.<sup>64</sup> The Quaker movement began in England in the late 1640s, in a context of social upheaval.<sup>65</sup> It is categorized as one of the peace churches, alongside the Church of the Brethren, Mennonites and Amish, because of its emphasis on Christian pacifism. The Quakers' refusal to participate in war, including investing in the arms industry, is credited as one of the earliest forms of SRI. As the religious movement expanded, it faced opposition and persecution. Its members were among the first pilgrims to leave England in the 17<sup>th</sup> century in search of a new home. Quakers in flight sought shelter in the British colonies, including the USA, taking their religion, convictions and this earliest form of ethical investment outside England along the way.

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<sup>59</sup> Bible Quotes on Money (<http://www.acts17-11.com/money.html>)

<sup>60</sup> Ibid

<sup>61</sup> The Reverend Barbara Briggs, *More Than an Antidote to Anxiety*, 25 May 2008 Address

<sup>62</sup> Bible Scriptures About Money (website)

<sup>63</sup> Crane, Andrew et al. (eds), *The Oxford Handbook of Corporate Social Responsibility*, Oxford University Press, 2008, p. 253 (monograph)

<sup>64</sup> A Critical Introduction Blowfield, Michael., Murray, Alan., *Corporate Responsibility: A Critical Introduction*, Oxford University Press, 2008, pp. 280-281 (monograph)

<sup>65</sup> Wikipedia - Religious Society of Friends (website)

In addition to the Religious Society of Friends (Quakers), the emergence of SRI is closely related to another Christian movement – Methodism. One of the most articulate early adopters of SRI was John Wesley (1703–1791), a Church of England cleric and Christian theologian and one of the founders of Methodism. In his sermon “The Use of Money” (Sermon 50) delivered in the 1700s, Wesley emphasized that the use of money was the second most important subject of New Testament teaching, effectively outlining some basic tenets of social investing.

Wesley preaches that:

*“It is the bounden duty of all who are engaged in worldly business to observe that first and great rule of Christian wisdom with respect to money, “Gain all you can”<sup>66</sup>,*

but then cautions that:

*“to gain money we must not lose our souls”, “we ought not to gain money at the expense of life” or “to gain all we can without hurting our neighbor”<sup>67</sup>.* He concludes that:

*“therefore we may not sell anything which tends to impair health. Such is, eminently, all that liquid fire, commonly called drams or spirituous liquors”<sup>68</sup>.*

He continues his sermon to dispense a piece of advice that is still widely followed by socially responsible investors: *“Other businesses there are, which however innocent in themselves, cannot be followed with innocence now at least, not in England; such, for instance, as will not afford a competent maintenance without cheating or lying, or conformity to some custom which not consistent with a good conscience: These, likewise, are sacredly to be avoided.”<sup>69</sup>*

Wesley’s sermons may be read as the first blueprint for socially responsible investment.<sup>70</sup> It is because of this that Christian Methodist organizations have had significant influence on the development of modern SRI. For example, in the 1920s, the Methodist church in the United Kingdom began investing in the stock market, consciously avoiding companies involved in

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<sup>66</sup> Wesley, John., Sermon 50: The Use of Money, United Methodist Church – Global Ministries. (speech)

<sup>67</sup> Idem.

<sup>68</sup> Idem.

<sup>69</sup> Idem.

<sup>70</sup> Crane, Andrew et al., p. 270

alcohol and gambling. This created some of the first “screens” or frameworks under which European investors could evaluate business practices. Also, the Pax World Fund, recognized as the first SRI mutual fund in the United States, was founded in 1971 by United Methodist ministers.

### **3.2. FROM RELIGIOUS TO ECONOMIC RATIONALE: Das Adam Smith Problem**

Seeking the origins of Socially Responsible Investing one encounters its roots not only in religious - and from there - moral dimensions, but also in economic theory. In fact, “a more secular rationale for socially responsible investment appeals to economic self-interest [rather than to the Scriptures]”.<sup>71</sup> However, are economic and ethical reasoning compatible? Classical economics (for example, Adam Smith’s “invisible hand” and the social welfare theorems) states that there is no conflict between the two goals: In competitive and complete markets, when all firms maximize their own profits (value), resource allocation is optimal and social welfare is maximized.

Adam Smith (1723 – 1790), philosopher and the father of modern capitalism, famously showed in his work “The Wealth of Nations” that markets allocate resources efficiently. He believed that they work best when participants act primarily in their own self-interest. He argued that the free market - in which “every man, so long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with any other man” - is the best way to build wealth. However, at the same time, he sustained that the benefits of the free market should accrue not just to individuals but to society as a whole.

*“every individual necessarily labors to render the annual revenue of the society as great as he can. He, generally, indeed neither intends to promote the public interest, nor knows how much he is promoting it... he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the*

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<sup>71</sup> Crane, Andrew et al., p. 255



*worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.”<sup>72</sup>*

Smith then appears to explicitly deny the concept of Socially Responsible Investment:

*“I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.”<sup>73</sup>*

However, Adam Smith was a moral philosopher as well. In his “Theory of Moral Sentiments”, he placed great emphasis on the ethical responsibilities of individuals in society, acknowledging their importance:

*“Our natural egoism is partially restrained by our awareness of an external standard, the standard we would use to judge our actions if we were a spectator...”<sup>74</sup>*

Smith’s economic and moral views appear to be highly dissonant. Economist Joseph Schumpeter referred to this apparent contradiction as “Das Adam Smith Problem”. At the time, the problem originated because there was no widely agreed version on what links these two views, except for the common author, but increasingly “few today believe that Smith postulates two contradictory principles of human action.”<sup>75</sup>

### **3.3. MODERN DEVELOPMENTS: Years of Change**

#### **(1) 1960s – 1980s**

From the seventeenth century until the mid-twentieth century, the concept of socially-responsible investment remained a small, religiously-centered, movement.<sup>76</sup> The modern socially responsible investing movement evolved with the political climate of the 1960s. As movements against the

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<sup>72</sup> Crane et al., p. 255 (monograph)

<sup>73</sup> Crane et al., p. 255 (monograph)

<sup>74</sup> Idem.

<sup>75</sup> Wilson, Davis., Dixon, William., *Das Adam Smith Problem: A Critical Realist Perspective*, Leiden: Koninklijke Brill, 2006, p. 251 (monograph)

<sup>76</sup> Ciocchetti, Corey, *Socially Responsible Investment*, 2007. (paper)

Vietnam War emerged both in the U.S. and Europe alongside the civil rights, women's rights and environmental movements, investors took a renewed interest in socially responsible investing. Despite these developments, SRI remained very small in Europe until the late 1980s. In 1964, there were no ethical funds available for public investment anywhere in Europe.<sup>77</sup> The first ethical fund available to private investors *Ansvar Aktiefond Sverige* was launched in Sweden in 1965. In fact, only 18 ethical retail funds existed in Europe prior to 1989.<sup>78</sup>

The apartheid regime in South Africa significantly accelerated the promotion of ethical investment in Europe in the 1980s. In fact, it is considered that the turning point for SRI came during the campaign to eliminate the racial discrimination of Apartheid in South Africa.<sup>79</sup> The development of SRI in the 1980s was propelled by concerns among investors about supporting businesses with operations in South Africa, thereby supporting apartheid and the poor treatment of employees. A divestiture movement in South Africa by corporations emerged, calling for companies to offload their investments in South Africa.

In 1983, the Ethical Investment Research Service (EIRIS) was established as the UK's first independent research service for socially responsible investors.

## **(2) 1990s – 2000s**

Even though the origins of socially responsible investing are ancient, it has only come in full stride in the last 20 years.<sup>80</sup>

The decade of the 1990s saw a renewed interest in business ethics. The most relevant SRI topic from the dawn of the new millennium to the present is corporate governance. Originating with the recession of 2001 and peaking with the major corporate scandals that plagued the economy thereafter, corporate governance and business ethics have become major issues in the SRI

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<sup>77</sup> Kreander, Niklas, *An Analysis of European Ethical Funds*, University of Glasgow, Centre for Social and Environmental Accounting Research, 2001, pp. 6-7 (paper)

<sup>78</sup> Kreander, Niklas, *An Analysis of European Ethical Funds*, University of Glasgow, Centre for Social and Environmental Accounting Research, 2001, pp. 6-7 (paper)

<sup>79</sup> Social Funds – Introduction to SRI (website)

<sup>80</sup> Idem.

community as well as in the traditional investing world.<sup>81</sup> 2001 was a key year for the development of SRI in Europe. In 2001, the FTSE Group, a British provider of stock market indices and associated data services, launched the FTSE4Good family of social indices, sending a strong signal to investors that SRI is becoming mainstream. In the same year, the European Sustainable Investment Forum (Eurosif) was launched to address achieving sustainability through financial markets. It is a pan-European non-profit association supported by the European Commission.

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<sup>81</sup> Ciocchetti, Corey, *Socially Responsible Investment*, 2007. (paper)

## PART 4

### REGULATION OF THE EUROPEAN SRI MARKET

SRI regulation started out as rooted in the activist nature of Socially Responsible Investment, but with time has evolved to encompass not only advocacy-based voluntarism, but also legislative action at **several parallel levels: global, supranational and national**. Most of the European regulatory developments took place in the late 1990s and early 2000s. The series of financial scandals in recent years only increased demand for SRI and resulted in strengthened stakeholder consensus in pushing for further regulatory changes. In turn, the recent regulatory changes in Europe have served as a major growth driver of the European SRI market.

#### 4. 1. REGULATION DEFINED: Formal v. Informal

To understand better the rationale and impact of such initiatives, one needs to define regulation and its two forms: formal and informal. FORMAL REGULATION (also known as legal or official) is administrative legislation that constitutes or constrains rights and allocates responsibilities. It can be distinguished from primary legislation (by Parliament or elected legislative body) on the one hand and judicial decisions on the other hand.<sup>82</sup> Formal regulation usually takes the form of legal restrictions promulgated by direct government authority or by an industry regulatory body mandated by state legislators.<sup>83</sup> The objective of formal regulation is to introduce a coercive action to produce an outcome that might not otherwise occur, creating total benefits that exceed total costs for those affected by the regulation.<sup>84</sup>

In contrast to formal regulation, INFORMAL REGULATION is not legally binding by definition. Examples of informal regulation include self-regulation by an industry such as through a trade association or by another interest-based group of stakeholders, or social regulation such as norms.<sup>85</sup> Voluntary initiatives are an important form of informal regulation. The concept behind voluntary initiatives is outlined in the key document “The Importance of

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<sup>82</sup> Levi-Faur, David, *Regulation and Regulatory Governance*, Jerusalem Papers in Regulation and Governance, No.1, 20101 (paper)

<sup>83</sup> Wikipedia - Regulation (website)

<sup>84</sup> Legal Practitioner - Introduction to Corporate Regulation and Standardization (website)

<sup>85</sup> Wikipedia - Regulation (website)

Voluntarism” drafted for the UN Global Compact in 2009. By participating in a voluntary initiative, stakeholders, especially corporations, commit themselves to a set of shared standards and principles.<sup>86</sup> Stakeholders participate in such initiatives not because of obligation, but because of drivers and concerns – both internal and external.<sup>87</sup> Voluntary initiatives operate in the “co-operative space” where a critical mass of their members wish to work together to grow and develop responsible finance rather than the “competitive space” where they compete for their share of the resulting market.<sup>88</sup>

With their unique potential to become corporate drivers, voluntary initiatives are considered particularly important for the advancement of Corporate Social Responsibility. Their main objectives are instilling a culture of corporate leadership and innovation in pursuit of responsible behavior, moving corporate responsibility from concept to fact, and finally giving a voice to people’s concerns.<sup>89</sup> These goals are pursued by creating a strong emphasis on transparency, implementation and accountability.

Companies argue that codes of conduct and voluntary initiatives are better than regulation as they allow companies flexibility in how they meet the objectives of voluntary commitments. However, this mechanism works long as all companies are supporting the code and properly implementing its objectives. The reality is that most corporate codes of conduct have no enforcement mechanisms and little independent verification. Because of this, voluntary initiatives are not a substitute for effective regulation.<sup>90</sup> Predicated on the concept of voluntary self-regulation, they have been conceived by their propagators as **complements rather than substitutes** for regulatory regimes.<sup>91</sup> They can lead companies to strive to be better than the law requires and in this way move beyond lowest-common-denominator standards or rules.<sup>92</sup>

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<sup>86</sup> Latham & Watkins, LLP, *The Importance of Voluntarism*, 2009, p. 1 (paper)

<sup>87</sup> Idem.

<sup>88</sup> United Kingdom Sustainable and Investment Forum (website)

<sup>89</sup> Latham & Watkins, LLP, *The Importance of Voluntarism*, 2009, p. 4 (paper)

<sup>90</sup> Ibid, p. 1 (paper)

<sup>91</sup> UN Global Compact (website)

<sup>92</sup> Latham & Watkins, LLP, *The Importance of Voluntarism*, 2009, p. 2 (paper)



Framework based on principles for community action.<sup>95</sup> The Framework actions are based on integrating CSR in other EC policies, encouraging the adoption of CSR strategies by enterprises, lobbying for CSR transparency, integration of CSR in education, spreading information and facilitating the exchange of best-practices.

CSR emerged as a new paradigm in European policy in 2000 when it was included as an integral component of the Lisbon Agenda (action plan for the economy of the European Union between 2000 and 2010), in the Partnership for Growth and Jobs, considered critical for achieving the partnership goals: 3% average economic growth and the creation of 20 Million jobs by 2010. In 2000, the Lisbon Council made an appeal to companies' sense of social responsibility. In line with this, in 2001, the European Union began the development of its first CSR Strategy for Europe. In 2002, EC issued what many consider a key document – the Green Paper “Promoting a European Framework for Corporate Social Responsibility” - indicating the rising importance of CSR in EU policies.

In 2006, in keeping with the spirit and priority areas of its Annual Progress Report on Growth and Jobs, the Commission invites European enterprises to “move up a gear” and to strengthen their commitment to CSR.<sup>96</sup> In the same year, the Commission also published its most recent official Communication on CSR. In it EC affirms its objective of making Europe “a pole of excellence on CSR” and outlines ways in which the Commission intends to continue to promote CSR as a voluntary concept.<sup>97</sup> Concluding that the need for a partnership among all stakeholders EC is greater than ever, the EC announced backing for a European Alliance on CSR – a political umbrella for new or existing CSR initiatives by European enterprises. Acknowledging that CSR is more relevant than ever in the context of the global economic crisis, in March 2010 the European Commission made a renewed commitment to an EU strategy to promote Corporate Social Responsibility “as a key element in ensuring long term employee and consumer trust”.

Recent SRI-focused EU initiatives are mostly centered on the issues of transparency and disclosing ESG performance. There are presently no mandatory transparency laws at the EU level requiring investors to disclose the ESG aspects of their investments. European law from

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<sup>95</sup> European Commission, COM (2002) 347 final, 2 July 2002 (legal instruments)

<sup>96</sup> European Commission, COM (2006) 136 final, 22 March 2006 (legal instruments)

<sup>97</sup> Ibid.

2003 makes the following requirement on companies, which stops short of making ESG reporting mandatory for all corporations:

*“To the extent necessary for an understanding of the company's development, performance or position, the analysis [in the annual review] shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.”<sup>98</sup>*

Additionally, EU Member States can choose to exempt small and medium-sized enterprises from this requirement. However, the European Commission is currently in discussions around the need for further transparency on ESG issues from investors. Between September 2009 and February 2010 the European Commission hosted a series of multi-stakeholder workshops on the disclosure of environmental, social and governance (ESG) information.<sup>99</sup> In addition, The European Commission has launched an online public consultation to gather views on ways how to improve non-financial reporting by enterprises. In 2011, DG Enterprise and Industry published a call for proposals to build the capacity of mainstream investment actors to better use ESG information.

## **(2) EU Voluntary Initiatives**

The emergence of several voluntary initiatives has complemented formal regulatory actions in the mainstreaming of SRI considerations. Their uptake has pointed to a greater visibility and credibility for SRI products, thus ensuring the dissemination of sustainable offerings and their improved understanding from the public.<sup>100</sup> I will examine National Sustainable Investments Forums (SIFs) and Quality Labels as best-in-class voluntary SRI initiatives in Europe.

On a European level, the European Sustainable Investment Forum (Eurosif) has been a driving force for improved regulation around ESG issues and its disclosure by investors. In 2001, it was launched with the support of five national European Social Investment Forums (SIFs) (France, Germany, Italy, the Netherlands and the United Kingdom) and the European Commission. A

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<sup>98</sup> Directive 2003/51/EC of the EU Parliament and Council, 18 June 2003

<sup>99</sup> EC DG Enterprise & Industry – CSR Reporting & Disclosure (website)

<sup>100</sup> Eurosif, *2010 European SRI Study*, p. 16



Sustainable Investment Forum (SIF) is a non-profit interest-based association that works to promote SRI in a specific area of the world<sup>101</sup>.

Over the years, Eurosif has expanded to include another seven Sustainable Investment Forums. Today, Eurosif works as a pan-European partnership of 12 national Sustainable Investment Forums (SIFs) within the EU including Member Affiliates. Eurosif Member Affiliates include pension funds, asset managers, NGOs, trade unions, academic institutes and research providers, together representing assets totaling over 1 Trillion EUR<sup>102</sup>. Its mission is to develop sustainability through the European financial markets.

Eurosif submits position papers to the EU Commission on a regular basis. For example, Eurosif submitted a response to the public consultation on the Modernization of Directive 2004/109/EC Transparency Requirements for Listed Companies, in which it makes recommendations regarding the disclosure of Environmental, Social and Governance (ESG) data by listed companies, as well as on the disclosure of voting policies by institutional investors<sup>103</sup>. In 2004, Eurosif's push in the area of SRI transparency was supplemented by the launch of its SRI Transparency Code project with the support of the European Commission. The Code has a dual objective: to provide retail SRI funds with an opportunity to clarify their approach to SRI and to strengthen a proactive auto-regulation through setting up a common framework around good transparency practices<sup>104</sup>. It focuses specifically on retail SRI funds in order to increase accountability to consumers, ensure the dissemination of sustainable financial offerings and their improved understanding from the public<sup>105</sup>. Signatories to the code are highlighted through the use of a specially-developed Eurosif Transparency Logo. The logo functions as a quality label whose granting recognizes retail fund managers as fully transparent about their SRI screening criteria.

Quality Labels for SRI mutual funds have been introduced by individual countries as well. Quality label initiatives further enhance efforts to disseminate the most transparent information possible on SRI funds, to standardize ESG criteria and to provide individual investors with a

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<sup>101</sup> Eurosif – National Sustainable Investment Forums (website)

<sup>102</sup> European SRI Transparency Code, Version 2 (code)

<sup>103</sup> Ibid.

<sup>104</sup> Ibid.

<sup>105</sup> Ibid.

simple benchmark. This label does not cover the financial characteristics of the funds; it is neither a guarantee of financial performance nor an incentive to invest in the funds.<sup>106</sup> The Novethic SRI Label developed in France is the first example of this tool. Novethic is part of the French government-controlled financial institution Caisse des Dépôts et Consignations and a leading French research center on CSR and SRI. In 2009, it was the first entity in Europe to release an SRI certification system for mutual funds. The Novethic SRI Label is awarded to mutual funds in France, whose management systematically takes into account ESG criteria. Novethic gives its SRI label to a fund if it meets four key criteria.<sup>107</sup> First, the fund manager must examine environmental, social and governance factors in a systematic manner for at least 90% of the portfolio. Second, the fund manager must transparently and publicly present the SRI selection process. In addition, the management company must provide regular updates on the SRI characteristics of the stocks in its portfolio. Finally, in order to do this, the full list of portfolio holdings must be disclosed regularly. Novethic awarded its label to 92 funds in 2009 and 142 funds in 2010.<sup>108</sup>

### **4.3. CSR GLOBAL INITIATIVES: Complements to Regulation**

There have been a number of large-scale global initiatives launched to assist the private sector in the management of increasingly complex risks and opportunities in the environmental, social and governance (ESG) realms and seeking to embed markets with universal values and principles for all.<sup>109</sup> Despite the fact that not all of them are focused exclusively or directly on SRI, they have played a significant role for the establishment and rising importance of SRI globally.

In contrast to regulation, all of these initiatives are non-binding and voluntary. At the same time, however, they urge investors to take a more stringent view of SRI than the approach taken by national regulatory authorities, which rely largely on reporting and disclosure requirements, as was shown.<sup>110</sup>

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<sup>106</sup> Novethic (website)

<sup>107</sup> Eurosif, *2010 European SRI Study*, Novethic Case Study, p. 20 (report)

<sup>108</sup> Novethic (website)

<sup>109</sup> UN Global Compact – About Us (website)

<sup>110</sup> Oxford Business Knowledge, *OECD Roundtable on Corporate Responsibility: Recent Trends and Regulatory Implications in Socially Responsible Investment for Pension Funds*, 2007, p. 2 (paper)

To illustrate the link between Socially Responsible Investment and CSR global initiatives, I will examine five such initiatives: the United Nations Environment Program Finance Initiative, United Nations Global Compact, Global Reporting Initiative, Who Cares Wins Initiative and Principles for Responsible Investment.

#### **4.3.1. UNITED NATIONS ENVIRONMENT PROGRAM FINANCE INITIATIVE (UNEP-FI)**

The UNEP-FI is the earliest global initiative promoting linkages between financial performance and sustainability. It is a partnership between the United Nations Environment Program and the global financial sector to promote sustainable development via joint working groups and conferences. The initiative was established following the Rio Earth Summit in 1992 including the banking sector and subsequently incorporating the insurance and asset management sectors in 1995.<sup>111</sup> Over 200 signatories are required to uphold a commitment to sustainable development; however there is no process to report on members' progress or to verify their commitment to these principles.

#### **4.3.2. UNITED NATIONS GLOBAL COMPACT**

In 2000, the UN Global Compact was the first large-scale global initiative to encourage businesses worldwide to adopt sustainable and socially responsible policies, and to report on their implementation. It was first announced by the then UN Secretary-General Kofi Annan in an address to The World Economic Forum in 1999, and was officially launched the next year.

While the earliest initiatives for sustainable finance included environmental concerns only, the Global Compact expands its scope by focusing not only on financial institutions, but corporations in general, and by diversifying the range of ESG issues beyond the environment. It is a principle-based framework for businesses, stating ten principles in the four areas of human rights, labor, the environment and anti-corruption. The UN Global Compact pursues dual objectives: mainstream the ten principles in business activities around the world and catalyze actions in support of broader UN goals, including the Millennium Development Goals (MDGs).

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<sup>111</sup> UNEP-FI (website)

With over 8700 stakeholders including corporate stakeholders from over 130 countries, it is currently the largest voluntary corporate responsibility initiative in the world.<sup>112</sup>

In terms of implementation, the Global Compact incorporates a transparency and accountability policy known as the Communication on Progress (COP). The annual posting of a COP is an important demonstration of a participant's commitment to the UN Global Compact and its principles. Participating companies are required to follow this policy, as a commitment to transparency and disclosure is critical to the success of the initiative. Failure to communicate will result in a change in participant status and possible expulsion.

#### **4.3.3. GLOBAL REPORTING INITIATIVE**

The Global Reporting Initiative (GRI) Guidelines are one of the world's most prevalent standards that serve as a framework for reporting on extra-financial company performance such as ESG performance. They are neither a performance standard nor a management system, but a standardized reporting framework.

The GRI was formed by the United States based non-profits Ceres (formerly the Coalition for Environmentally Responsible Economies) and Tellus Institute, with the support of the UN Environment Program in 1997. The Guidelines were drafted in 1999 and launched in 2000.

GRI's core goal is the mainstreaming of disclosure on ESG performance.<sup>113</sup> GRI seeks to make sustainability reporting by all signatory organizations as routine as, and comparable to, financial reporting by harmonizing reporting standards. Reporting on ESG performance is an important way for an organization to manage its sustainability impact. According to management theories, organizations are much more likely to effectively manage an issue that they can measure.<sup>114</sup> Reporting leads to improved ESG outcomes because it allows organizations to measure, track, and improve their performance on specific issues. By taking a proactive role to collect, analyze, and report their ESG impact, companies can better manage it.

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<sup>112</sup> UN Global Compact – About Us (website)

<sup>113</sup> Global Reporting Initiative (website)

<sup>114</sup> Wikipedia – Global Reporting Initiative (website)

As well as helping organizations manage their impacts, GRI reporting promotes transparency and accountability. This is because the GRI performance information is disclosed in the public domain. In this way, stakeholders and the general public can track an organization's ESG performance on broad themes or particular issues. Performance can be monitored year-on-year, or can be compared to other similar organizations.

GRI Guidelines are regarded to be widely used.<sup>115</sup> As of January 2009, more than 1,500 organizations from 60 countries were using the GRI guidelines to produce their sustainability reports. GRI seeks to continually improve the Guidelines by updating them. A second version of the guidelines (G2 or "Second Generation") was released in 2000. The latest and most current iteration (G3) was released in 2006. Development of new, ever more robust G4 is underway.

In 2009, GRI took steps to move beyond mere voluntarism. It issued the Amsterdam Declaration on Transparency and Reporting calling on governments for the first time to require ESG disclosure from companies. According to GRI Board *"the root causes of the current economic crisis would have been moderated by a global transparency and accountability system based on the exercise of due diligence and the public reporting of environmental, social and governance (ESG) performance"*<sup>116</sup> A year later, at the 2010 Amsterdam Global Conference on Sustainability and Transparency, GRI announced two key propositions, which were met with broad support: firstly, by 2015, all large and medium-size companies in OECD countries and large emerging economies should be required to report on their Environmental, Social and Governance (ESG) performance and, if they do not do so, to explain why; and secondly, by 2020, there should be a generally accepted and applied international standard which would effectively integrate financial and ESG reporting by all organizations.<sup>117</sup>

#### **4.3.4. "WHO CARES WINS" INITIATIVE**

In 2004, on the heels of starting the UN Global Compact, Who Cares Wins was launched by Kofi Annan and the UN Global Compact. It eventually expanded to include an alliance of

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<sup>115</sup> Global Reporting Initiative (website)

<sup>116</sup> Global Reporting Initiative, *Year in Review 2008/2009* (report)

<sup>117</sup> Global Reporting Initiative, *Year in Review 2009/2010* (report)

various stakeholders including leading financial companies collectively representing over 6 Trillion USD in AUM (Assets Under Management),<sup>118</sup> the International Finance Corporation, the Swiss Government and the UN Global Compact itself.

Much like the Global Reporting Initiative, Who Cares Wins aimed to increase the industry's understanding of the risks and opportunities presented by environmental, social and governance (ESG) issues and to improve their integration in investment-decision-making through providing a structured platform for multi-stakeholder engagement. The principal setting for this engagement was a series of annual closed-door, invitation-only events for investment professionals. The initiative was brought to a close in 2008, leaving space for a next phase of ESG integration.

The Outcomes Report examines the results of the initiative in the period 2004-2008. Recognizing that the initiative aims to “enable change in a complex system”<sup>119</sup>, the report concludes that ESG issues have not been taken up by the different elements of the investment chain to equal extents and that “widespread implementation of these methodologies and tools has yet to occur throughout the financial industry, and will only be possible with the collaboration of all financial market actors.”<sup>120</sup> It develops a model of interaction between different actors on ESG integration and culminates in a set of ten recommendations for different investment market actors.

#### **4.3.5. PRINCIPLES FOR RESPONSIBLE INVESTMENT**

In 2006, the UN Global Compact and United Nations Environment Program's Finance Initiative (UNEP-FI) coordinated the creation of yet another principles-based multi-stakeholder CSR initiative - the Principles for Responsible Investment. While the Principles are not designed to be relevant to SRI products only, they point to a number of approaches practiced by socially responsible investors. The PRI initiative is similar to design to the UN Global Compact of 2000,

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<sup>118</sup> Who Cares Win, *Future Proof? Embedding Environmental, Social and Governance Issues in Investment Markets. Outcomes of the Who Cares Wins Initiative 2004-2008*, p. 6 (report)

<sup>119</sup> Ibid, p. 9

<sup>120</sup> Ibid, p. 3

but is closer to the field of SRI in that it focuses specifically on investment activities rather than broad business ones.

The principles were devised by the international investment community including 20 institutional investors from 12 countries as well as a 70-person multi-stakeholder group of experts from the investment industry, intergovernmental and governmental organizations, civil society and academia.<sup>121</sup> The Principles were conceived as a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices and so better align their objectives with those of society at large. They reflect the view that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios and therefore must be given appropriate consideration by investors.

Since the principles are voluntary and aspirational, there are no legal or regulatory sanctions associated with investor failure to comply. However, several mechanisms and tools have been created to assist and track principle implementation. Firstly, each of the six principles is accompanied by a suggested list of possible actions that helps investors bridge the realms of theory and practice. Additionally, the PRI Initiative was created after the launch of the Principles as a network of international investors working together to put the six Principles for Responsible Investment into practice. Lastly, even though signing the Principles for Responsible Investment is purely voluntary, signatories commit to completing the annual Reporting and Assessment Survey that helps evaluating progress in implementing the six Principles. Starting in 2013, the PRI Initiative also plans to introduce an annual mandatory public reporting inquiry for all signatories.

As of July 2011 over 900 investment institutions around the world have become signatories, representing approximately 25 Trillion USD in AUM (Assets Under Management)<sup>122</sup>. There are three main categories of signatories. The majority of signatories are investment managers (56%), defined as companies that serve an institutional and/or retail market and manage assets as a third-party provider. Other signatories include asset owners (25%), which are organizations that represent end-asset owners who hold long-term retirement savings, insurance and other assets such as pension funds, government reserve funds, foundations,

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<sup>121</sup> Principles for Responsible Investment (website)

<sup>122</sup> Principles for Responsible Investment (website)

endowments, insurance and reinsurance companies and depository organizations; and professional service partners (18%), which are organizations that offer products or services to asset owners and/or investment managers.

#### **4.4. NATIONAL LEVEL REGULATION: United Kingdom in the Lead**

Having discussed global and EU-level SRI-related regulation initiatives, I will now complete the European SRI Regulation overview with a short overview of national SRI regulations. By definition, national level SRI-regulation is created by national regulatory bodies. National legislators create these regulatory bodies or agencies to allow industry experts to focus their attention on specific issues such as Socially Responsible Investment. While in Europe there are an increasing number of countries introducing such legislation, the United Kingdom has to be distinguished as a first-mover in this field.

In 2002, at the World Summit on Sustainable Development in Johannesburg, Tony Blair announced the London Principles of Sustainable Finance Initiative. The initiative affirmed the UK as a leading standard-setter in Europe in terms of financial services organizations' role in sustainable development. The Principles embody the view that “sustainable development is both a moral imperative and an opportunity for the development of business”<sup>123</sup>. They address how the UK financial sector specifically could contribute to sustainable development by proposing conditions for a financial system, and the role of financial institutions within that system, that will enhance the financing of sustainable development.”<sup>124</sup> The set of seven London Principles are grouped in three broad categories: Economic Prosperity, Environmental Protection and Social Development and are signed by leading financial institutions.

The spirit behind the London Principles and the willingness to create a financial system committed to sustainable development have contributed to the United Kingdom's leading position in terms of SRI regulatory developments. The United Kingdom was the first country to regulate the disclosure of the ESG investment policies of pension funds and charities with

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<sup>123</sup> Corporation of London, *Financing the Future. London Principles. The Role of UK Financial Services in Sustainable Development*, 2002, pp. 2-3 (code)

<sup>124</sup> Corporation of London, *Financing the Future. London Principles. The Role of UK Financial Services in Sustainable Development*, 2002, p. 9 (code)



endowment funds. In July 2000, the groundbreaking Amendment to the 1995 Pensions Act requiring SRI disclosure in the UK Pension Statements of Investment Principles (SIPs) was issued, stating that:

*“trustees must state their policy in their Statement of Investment Principles [on]*

*(a) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments;*

*(b) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments”.*<sup>125</sup>

This informational policy requirement set the stage for the introduction of similar regulation in several countries in Continental Europe, eventually contributing considerably to the growth of the European SRI industry.

In the UK, several non-state governance mechanisms have also contributed to SRI regulatory efforts. “These self-regulation initiatives have either made up for the absence of local regulation, or have added to the arsenal of available rules on the local SRI markets.”<sup>126</sup> For example, organizations of institutional investors or multiple stakeholders have created SRI guidelines through their trade bodies. In October 2001, the Association of British insurers issued SRI disclosure guidelines, prompting a similar action by Dutch insurance companies in 2002. In addition, the first Sustainable Investment Forum in Europe, UKSIF, was launched in the UK in 1991, following the startup of the Social Investment Forum idea in the United States back in 1981. It functions as a membership network that promotes responsible investment. While it operates similarly to a trade association, it does not seek to defend and advance particular member interests, but rather draws on members’ expertise to fulfill its mission.<sup>127</sup> The addition of EIRIS, a leading independent provider of research into corporate ESG performance since 1983,

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<sup>125</sup> United Kingdom Pension Regulator – Trustee Guidance (website)

<sup>126</sup> Christensen, Matt, “Socially Responsible Investing: Reaching New Heights. SRI in Europe and the UK”, GreenMoney Journal, Summer 2011 (article)

<sup>127</sup> United Kingdom Social Investment Forum (website)

to the UK SRI landscape, while not a strictly governance body, has also enriched regulatory initiative by providing a better understanding of the issues at stake.

In Continental Europe, over the past decade, a growing number of national governments have passed a number of different SRI regulations. Currently, at least eight countries in Europe, in addition to the United Kingdom, have specific national SRI regulations in place: Belgium, France, Denmark, Germany, Italy, the Netherlands, Norway, Sweden and the United Kingdom.<sup>128</sup> The policy tools employed by them can be grouped into five categories:

### **SRI-Related NATIONAL POLICY TOOLS<sup>129</sup>**

1. **INFORMATIONAL POLICY INSTRUMENTS:** obligations on occupational pension funds to disclose their policies for ESG investment
2. **INTEGRATION POLICY INSTRUMENTS:** managers of funds with fiduciary duties (pension funds or employee savings plans) required to include ESG considerations into their investing activities
3. **CORPORATE NON-FINANCIAL REPORTING:** mandatory corporate non-financial reporting legislation introduced
4. **INCENTIVE POLICY INSTRUMENTS:** monetary, most often tax-based, incentives offered to encourage ESG-related investments
5. **CORPORATE GOVERNANCE REFORMS:** reforms to improve shareholder rights and voting to enable shareholder activism

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<sup>128</sup> Table data sourced from: Eurosif, 2010 *European SRI Study* (report) & Aras, Guler., Crowther, David. (eds), *A Handbook of Corporate Governance and Social Responsibility*, Gower Publishing Limited (England) & Ashgate Publishing Company (USA), 2010, pp. 399-400 (monograph)

<sup>129</sup> Policy categories sourced from: Richardson, Ben., *Regulation of Socially Responsible Investments in the Financial Services Sector: Global Trends and Lessons*, Osgoode Hall Law School, Toronto (presentation)

**TABLE: Summary of Major national SRI Regulatory Initiatives<sup>130</sup>**

Country	Year	Type	SRI-related Regulation
<b>INFORMATIONAL POLICY INSTRUMENTS</b>			
UK	2000	Mandatory	Amendment to 1995 Pensions Act came into force, requiring the trustees of occupational pension funds to disclose the extent to which ESG considerations are taken into account in investments
Belgium	1996	Mandatory	Certain Belgian companies and their affiliates must report social performance information over 3-year periods
	2001	Mandatory	“Vandebroucke Law” passed, requiring pension funds to report the degree to which their investments take into account ESG aspects.
Germany	2002	Mandatory	Certified private pension schemes and occupational pension schemes “must inform the members in writing, whether and in what form ethical, social or ecological aspects are taken into consideration when investing the paid-in contributions”.
Italy	2004	Mandatory	Pension funds are required to disclose non-financial factors (including ESG factors) influencing their investment decisions.

<sup>130</sup> Data sourced from: Aras, Guler., Crowther, David. (eds), *A Handbook of Corporate Governance and Social Responsibility*, Glower Publishing Limited (England) & Ashgate Publishing Company (USA), 2010, pp. 399-400 (monograph) & Araya, Monica., *Brief 2. Environmental and Social Reporting Developments Around the World*, Empresa Informa Forum, March 2005 (paper)

<b>INTEGRATION POLICY INSTRUMENTS</b>			
France	2001	Mandatory	Managers of the Employee Savings Plans are required to consider ESG factors when buying shares.
	2010	Mandatory	The Grenelle 2 legislation introduces new obligations for ALL asset managers to disclose on how ESG factors are being incorporated into their investment strategies.
UK	2001	Mandatory	Trustee Act came 2000 came into force, mandating that charity trustees must ensure that investments are suitable to a charity's stated aims, including applying ethical considerations to investments.
Sweden	2002	Mandatory	Swedish national pension funds are obliged to incorporate environmental and ethical aspects in their investment policies.
Norway	2004	Mandatory	Then Petroleum Fund of Norway, now known as Government Pension Fund – Global issues new mandatory regulation including ethical guidelines.
<b>CORPORATE NON-FINANCIAL REPORTING</b>			
Norway	1999	Mandatory	The Accounting Act requires all companies to include environmental information in their annual reports.

Sweden	1999	Mandatory	Companies that are required to have environmental permits have an obligation to disclose environmental information in their annual reports.
France	2001	Mandatory	The Legislation “New Economic Regulations” came into force, requiring publicly listed companies to publish social and environmental information in their annual reports.
Denmark	2001	Mandatory	The law on Annual Accounts required companies in certain environmentally-sensitive sectors to report on intellectual capital and environmental aspects in their management report if it is material to providing a true and fair view of the company’s financial position.
UK	2001	Voluntary	The Association of British Insurers (ABI) published disclosure guidelines, asking listed companies to report on material ESG risks relevant to their business activities.
	2002-2003	Mandatory	In 2002, the Cabinet Office in the UK published the Review of Charity Law, proposing that all charities with an annual income of over 1 Million GBP should report on the extent to which ESG issues are taken into account in their investment policy. The Home Office accepted this recommendation in 2003.

	2005	Mandatory	Under the proposed Guidelines for the Operating and Financial Review (OFR), the government modernized company law by, requiring directors to give shareholders relevant disclosures on ESG issues in annual reports where it is in the interests of the shareholders.
<b>INCENTIVE POLICY INSTRUMENTS</b>			
Germany	1991	Voluntary	The Renewable Energy Act gives a tax advantage to closed-end funds to invest in wind energy.
Netherlands	1995	Voluntary	The Dutch Tax Office introduces a “Green Investments Directive”, which applies a tax deduction for green investments, such as wind, solar energy and organic farming
UK	2002	Voluntary	Community Investing Tax Relief (CITR) Scheme set up under the Finance Act 2002, offering a tax incentive to investors in Community Development Finance Institutions
<b>CORPORATE GOVERNANCE REFORMS</b>			
France <sup>131</sup>	2001-2005	Mandatory	<ul style="list-style-type: none"> <li>• Exercise of voting rights made easier (2001).</li> <li>• Lower thresholds for minority shareholder rights (2002).</li> <li>• Annual ratification by shareholder meeting of non-routine transactions with significant</li> </ul>

<sup>131</sup> Enriques, Luca., Volpin, Paolo., “Corporate Governance Reforms in Continental Europe”, London Business School, pp. 117-140 in *Journal of Economic Perspectives*, Vol. 21, No. 1, Winter 2007, p. 29 (journal article)

			shareholders and of some forms of executive compensation (2001, 2003 and 2005).
Germany <sup>132</sup>	1998 - 2005	Mandatory	<ul style="list-style-type: none"> <li>• Multiple voting shares banned and banks' influence over shareholder meetings curbed (1998).</li> <li>• Exercise of voting rights made easier (2001).</li> <li>• Sale of corporate shareholdings tax-exempt (2002).</li> <li>• Communication among shareholders facilitated (2005).</li> </ul>
Italy <sup>133</sup>	1998 - 2005	Mandatory	<ul style="list-style-type: none"> <li>• Limits on validity of shareholder agreements (1998).</li> <li>• Qualified majority for major resolutions (1998)</li> <li>• Lower thresholds for minority shareholder rights (1998 and 2005).</li> <li>• Voting caps banned (2003).</li> <li>• Exercise of voting rights made easier (2003)</li> <li>• Shareholder approval of stockbased compensation (2005).</li> </ul>

<sup>132</sup> Enriques, Luca., Volpin, Paolo., "Corporate Governance Reforms in Continental Europe", London Business School, pp. 117-140 in *Journal of Economic Perspectives*, Vol. 21, No. 1, Winter 2007, p. 29 (journal article)

<sup>133</sup> Idem.

## PART 5

### SOCIALLY RESPONSIBLE INVESTING: MEANS AND METHODS

#### 5.1. OVERVIEW: The Evolution of SRI

Socially Responsible Investing strategies used in the public financial market can be divided into pre-investment ones (applied **before** or **at the point** of investing) and post-investment ones (applied **after** the point of investing). They are usually graduated in terms of “generations” to indicate an upward trajectory of evolution that comes with broader levels of application, increasing complexity of structure, and heightened potential for impact (see CHART 1).

##### (1) PRE-INVESTING STRATEGIES

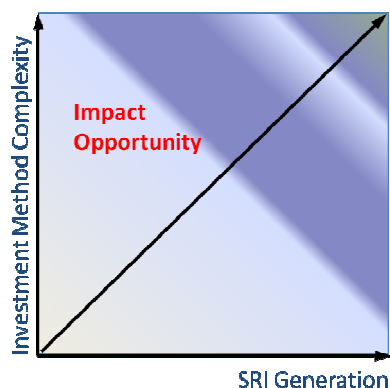
- **Negative Screening (first generation):** Identifying and then avoiding investments in companies that are engaged in objectionable activities.
- **Positive Screening (second generation):** Identifying and then purposefully investing in companies that are engaged in activities deemed to be positive/laudable.
- **Integrated/Sustainability Screening (third generation):** Combination of negative and positive screening

##### (2) POST-INVESTMENT STRATEGIES

- **Engagement/Shareholder Activism (fourth generation):** Holding investments in companies that are engaged in objectionable activities and utilizing shareholder rights to effect change in corporate policy.



## CHART 1: Impact Opportunity of SRI Strategies



### 5.2. PRE-INVESTMENT SRI STRATEGIES: SCREENING

Screening divides an investable universe between those companies suitable for the investor and those that are not based on a pre-determined set of criteria.<sup>134</sup> All investors apply screens to their investments. Ethical screening is “the evaluation of investment portfolios and funds based on environmental, social and ethical criteria”.<sup>135</sup>

Ethical or SRI screens have evolved over time to include a number of diverse criteria.<sup>136</sup> These screens can be broadly classified into two groups: negative and positive ones, whose objective is, respectively, to avoid “bad” companies and to invest in the “good” ones.<sup>137</sup>

<sup>134</sup> Kinder, Peter, *Socially Responsible Investment: An Evolving Concept in a Changing World*, KLD Research & Analytics, September 2005, pp. 25-26 (paper)

<sup>135</sup> Blowfield, Michael., Murray, Alan., *Corporate Responsibility: A Critical Introduction*, Oxford University Press, 2008, p. 283 (monograph)

<sup>136</sup> Aras, Guler., Crowther, David. (eds), *A Handbook of Corporate Governance and Social Responsibility*, Gower Publishing Limited (England) & Ashgate Publishing Company (USA), 2010, p. 50 (monograph)

<sup>137</sup> Kreander, Niklas, *An Analysis of European Ethical Funds*, University of Glasgow, Centre for Social and Environmental Accounting Research, 2001, p. 26 (paper)

### 5. 1. 1. NEGATIVE SCREENING: Excluding Low or Lacking Standards

“One way to define something is to say what it is not”.<sup>138</sup> The simplest possible one-step procedure in constructing a socially responsible investment portfolio is to exclude stocks of companies with a poor ESG track record. Negative screening is the oldest and most basic SRI strategy.<sup>139</sup> It can be defined as “the systematic method of excluding objectionable investments according to decision rules established beforehand”.<sup>140</sup>

Negative screening is based on a filter consisting of excluding specific stocks or industries on an initial asset pool. After performing the screen, portfolios are created via a standard financial and quantitative selection. Some SRI funds exclude companies from the investment universe when these firm revenues derived from sectors deemed un-ethical, others – when the these revenues exceed a specific threshold, whereas still others also apply negative screens to a company’s branches or suppliers.<sup>141</sup>

The most prevalent negative screen is centered on excluding the so-called “sin stocks” (stocks of companies involved in tobacco, alcohol and gambling) from an investment portfolio: Examples of the wide variety of negative screens applied are included in TABLE 1.

There are a number of advantages associated with negative screening as a SRI strategy. Firstly, it is an easily definable investment rule. Its inputs can be clearly specified allowing for a precise definition of the term “social responsibility” in investment. Moreover, the output is unambiguous – an investment is either prohibited or not.<sup>142</sup> This combination makes it a simple tool for risk management for a broad range of institutional investors, which in turns means that it can be structured to make efficient use of scarce research resources.<sup>143</sup>

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<sup>138</sup> Crane, Andrew et al. (eds), *The Oxford Handbook of Corporate Social Responsibility*, Oxford University Press, 2008, p. 261

<sup>139</sup> Aras, Guler., Crowther, David. (eds), *A Handbook of Corporate Governance and Social Responsibility*, Gower Publishing Limited (England) & Ashgate Publishing Company (USA), 2010, p. 402

<sup>140</sup> Crane et al., p. 250

<sup>141</sup> Aras & Crowther, p. 402

<sup>142</sup> Crane et al., p. 263

<sup>143</sup> Idem.

At the same, time, there are a number of disadvantages of negative screening. Many SRI practitioners discount it as "real" SRI and consider it just a basic entry point.<sup>144</sup> Its major shortcoming is considered to be its lack of a mechanism to recognize positive social characteristics.<sup>145</sup> Under stepwise screening even companies with a positive social track record can be removed because of involvement with a particular issue. For example, it is not uncommon for companies that are generous donors to charity or have a strong record of promoting diversity in their organization to be excluded regardless of how many positive characteristics are present. In his analysis of disadvantages of negative screening, Andrew Crane notes that in reality "many clients prefer a more nuanced view of corporate responsibility".

Another problem with stepwise screening is that the addition of restrictions can result in over-constraining the investment portfolio. According to Andrew Crane, "it is not hard to develop a reasonable-sounding list of restrictions that eliminates almost the entire investment universe from consideration".<sup>146</sup> Despite the shortcomings outlined above, negative screening remains the most commonly employed method of constructing social investment portfolios.

To mitigate some of the disadvantages of negative screening, a version of negative screening called Relative Weighting is oftentimes applied. Under relative weighting companies are not automatically excluded. Instead, an assessment is made of both strengths and weaknesses for each company and a ranking is assigned to each company. Rankings allow comparisons can be made across the universe of companies or within industries. This information is then incorporated into the investment manager's portfolio construction policies.<sup>147</sup>

Relative weighting transforms "the definition of CSR from a binary one (in the portfolio or out) to a scaled variable".<sup>148</sup> This offers an important advantage over simple negative screening in that it allows a "best of the worst approach". On the one hand, this gives investors an opportunity to diversify their portfolio and affords them greater flexibility. Some researchers

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<sup>144</sup> Christensen, Matt, "Socially Responsible Investing: Reaching New Heights. SRI in Europe and the UK", GreenMoney Journal, Summer 2011 (online publication article)

<sup>145</sup> Crane et al., p. 263

<sup>146</sup> Idem.

<sup>147</sup> Crane et al., p. 265

<sup>148</sup> Idem.

view this as “an important risk management tool in eras when industries excluded from screening performed strongly, such as ...the more recent example of the energy sector, whose underweighting in the mid-2000s due to environmental constraints led to underperformance in some cases”.<sup>149</sup>

On the other hand, relative weighting also has disadvantages as a SRI strategy. It is considered impractical for investors who do not wish to compromise their values and for whom if a whole industry is behaving badly, “it is not acceptable to own stock of a company behaving slightly less badly”. Andrew Crane concludes that “it is a paradox of socially responsible investment that clients are idealists, but practitioners must be relativists. Whether they use screening or relative weights, practitioners must rank companies on the social and environmental dimensions and then consult with the client on where to draw the line”.<sup>150</sup> Additionally, relative weighting is just that - it recognizes companies that perform relatively well across a broad spectrum of social or environmental criteria, but may not appropriately recognize those with exceptional records in focused dimensions. To address these issues, another core strategy – positive screening – is needed.

### **5.1.2. POSITIVE SCREENING: Focusing on Excellence**

While something can be defined by exclusion, it can also be defined by citing examples of excellence.<sup>151</sup> Following this principle, some socially responsible investors create portfolios focusing primarily on the positive aspects of corporate behavior. Instead of excluding bad companies, they hold only stocks that exemplify their social values.<sup>152</sup> This approach is referred to as positive screening. Positive screening can be defined as the selection of investments that perform best against criteria, in this case superior CSR standards.<sup>153</sup>

Examples of positive screens are included in TABLE 1.

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<sup>149</sup> Crane et al., p. 265

<sup>150</sup> Idem.

<sup>151</sup> Crane et al., p. 266

<sup>152</sup> Idem.

<sup>153</sup> Blowfield et al., p. 301

How can positive outliers with stellar social track records be identified in the sea of publicly traded companies? The authors of the Oxford Handbook of Corporate Social Responsibility suggest a group of characteristics of companies that have exemplary social records based on a study conducted in 2005 in which the membership of SIRAN, the professional association of social investment research analysts in the USA was polled.<sup>154</sup> According to this study, companies with exceptional social responsibility records were found to share five features:

1. Large market capitalization
2. Strong brand names
3. Consumer-facing orientation
4. Above market average historical growth rates, reinvestment rates and market expectations for future growth
5. Unionized employees are not in the majority

Just as with negative screening, relative weighting can be applied with positive screening as well. Similar to the “best of the worst” approach with negative screening, “best-in-class” rankings can be developed for positive screening. Firms are ranked within each industry or market sector based on CSR criteria and the best performers are selected for the investment portfolio.

### **5.1.3. INTEGRATED SCREENING: Combining Negative & Positive**

Having defined and illustrated negative and positive screening as pre-investment SRI strategies, it should be noted that usually investment companies apply a combination of the various types of screens.<sup>155</sup> In fact, negative and positive screens are often referred to as the first and second generation of SRI screens respectively<sup>156</sup>. The third generation of screens refers to an integrated approach of selecting companies based on the environmental, social and governance criteria

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<sup>154</sup> Crane et al., p. 266

<sup>155</sup> Aras & Crowther, p. 402

<sup>156</sup> Idem.

comprised by both negative and positive screens. This approach is called Sustainability or Triple Bottom Line.<sup>157</sup>

**TABLE 1: Socially Responsible Investment (SRI) Screens<sup>158</sup>**

Category	Type	Screens	Definitions
<b>“SIN”</b>	N	Tobacco	Avoiding manufacturers of tobacco products
	N	Alcohol	Avoiding producers of alcoholic beverages
	N	Gambling	Avoiding casinos and suppliers of gambling equipment
	N	Weapons	Avoiding firms producing weapons of firearms
	N	Pornography	Avoiding publishers of pornographic magazines or video tapes, or firms that provide adult-entertainment services
<b>ETHICAL</b>	N	Animal Test	Avoiding firms providing animal-testing services or involved in intensive farming of animals

<sup>157</sup> Aras & Crowther, p. 402

<sup>158</sup> Data sourced from Rachocka, Joanna, *Socially Responsible Investment in Europe*, Poznan University of Economics, Department of Consumption Economics, pp. 19-20 (paper); & Crane et al., pp. 403-404

	N	Abortion/Birth Control	Avoiding providers of abortion and manufacturers of abortion drugs or insurance companies that pay for elective abortions
	N	Genetic Engineering	Avoiding firms developing genetically-modified products
	P	Healthcare	Selecting firms whose products improve human health
	N	Non-Marital	Avoiding insurance companies providing coverage to non-married couples
	N	Islamic	Avoiding pork producers and commercial banks (used by fund managers according to Islamic principles)
<b>SOCIAL</b>	P	Business Practice	Selecting firms emphasizing product safety, quality and sustainability through investments in R&D

SOCIAL (cont'd)	P/N	Corporate Governance	<p>Selecting firms demonstrating best practices related to board independence, executive compensation, or other governance issues</p> <p>Avoiding firms with antitrust violations, consumer fraud and marketing scandals</p>
	P	Community	<p>Selecting firms with an active involvement in local communities</p>
	P/N	Diversity	<p>Selecting firms pursuing active policies in employing minorities, gays/lesbians, and/or disabled persons;</p> <p>Avoiding firms discriminating on gender race</p>
	P/N	Labor Relations	<p>Selecting firms providing good workplace conditions, empowering employee and/or strong union relationships;</p> <p>Avoiding firms with poor labor relations, exploiting their workforce or sweatshop</p>



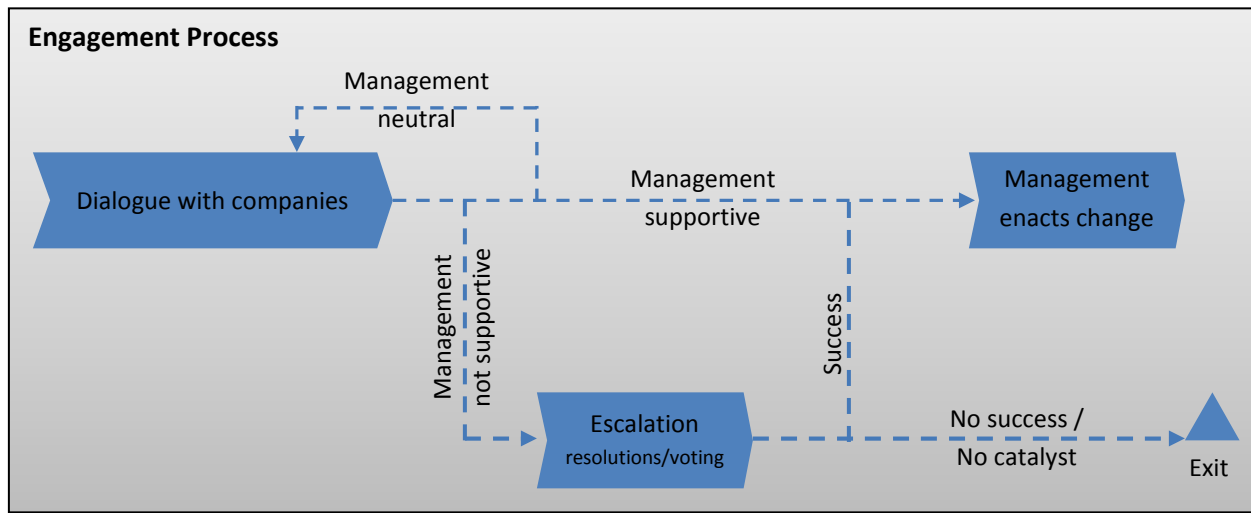
SOCIAL (cont'd)	P/N	Human Rights	<p>Selecting firms with policies to protect human rights</p> <p>Avoiding firms with bad records on human rights issues</p>
	P/N	Foreign Operations	<p>Selecting firms with human rights policies for foreign operations</p> <p>Avoiding firms employing child labor overseas or operating in countries with oppressive regimes</p>
<b>ENVIRONMENTAL</b>	P/N	Environment	<p>Selecting firms with high environmental standards (e.g., proactive involvement in recycling, waste reduction and environmental cleanup)</p> <p>Avoiding firms with low environmental standards</p>
	P	Renewable Energy	<p>Selecting firms producing power from renewable energy</p>
	P	Biotechnology	<p>Selecting firms that support sustainable agriculture, biodiversity, local farmers, and industrial applications of biotechnology</p>

	N	Nuclear	Avoiding companies operating nuclear power plants
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**5.2. POST-INVESTMENT SRI STRATEGIES: ENGAGEMENT**

With negative and positive screening considered first and second generation SRI strategies and their combination into an integrated or sustainable third generation strategy, engagement is known as the fourth generation of SRI strategies.<sup>159</sup> Next, I will explore the nature of the engagement process, look at its various stages and discuss the tools available at each stage (see CHART 1):

**CHART 1: Post-Investment SRI Strategies: The Process of Engagement<sup>160</sup>**



**5.2.1. EXIT, VOICE & LOYALTY: Investor Response Framework**

While one fundamental question (in which companies to invest or not to invest) is posed by SRI investors at the pre-investment stage, another arises at the post-investment stage: is the company

<sup>159</sup> Aras & Crowther, p. 234

<sup>160</sup> Hermes Funds (website)

invested in continuing to engage in socially responsible business practices?<sup>161</sup> And if it is not, then what course of action should the investor take?

In 1970, the German economist Albert Hirschman (1915 - ) proposed the Exit, Voice and Loyalty framework, which can be used to describe possible investor responses to decline in firms. Although his approach was not conceived to address SRI specifically, his framework is considered a valuable resource for understanding the options available to social investors.<sup>162</sup> His work strongly suggests that both screening and shareholder activism should be employed.

The basic idea of his framework is that members of an organization, whether a business, a nation or any other form of human grouping, have two possible responses when they perceive that the organization is demonstrating a decrease in quality or benefit to the member: they can **exit** (withdraw from the relationship); or, they can **voice** (attempt to repair or improve the relationship through communication of the complaint, grievance or proposal for change).<sup>163</sup> The relationship between Exit and Voice is mediated by the interplay of Loyalty to the organization.

Translating Hirschman's concept into an investment context means that shareholder concerned about an organization's behavior has three options: Exit, Voice and Loyalty. Exit is the classical economic response to dissatisfaction with organizational behavior and also the strategy behind negative screening discussed earlier.<sup>164</sup> A firm that provides an unattractive investment opportunity will lose shareholders, just as a company selling an inferior product will lose customers. According to Hirschman, the problem with Exit is that it abandons the opportunity to change things for the better because it does not provide a solution for investors aspiring to change corporate behavior.

Hence, Hirschman proposes an alternative to Exit, which he calls Voice. Investors confronted with questionable corporate behavior have the option of raising their objections before the management instead of just selling the stock and disassociating with the company. It is easy to draw a parallel between Voice and shareholder engagement, which will be discussed next. Exit

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<sup>161</sup> Blowfield & Murray, p. 288 (monograph)

<sup>162</sup> Crane et al., p. 257 (monograph)

<sup>163</sup> Hirschman, Albert O., *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States*. Cambridge, MA, USA: Harvard University Press. 1970. ISBN 0-674-27660-4 (paper)

<sup>164</sup> Crane et al., p. 257 (monograph)

and voice also interact in unique and sometimes unexpected ways; by providing greater opportunity for feedback and criticism, exit can be reduced; conversely, stifling of dissent leads to increased pressure for members of the organization to use the only other means available to express discontent, departure.<sup>165</sup>

Finally, In Hirschman's framework, the choice of Exit or Voice is supplemented by a third option called Loyalty. Loyalty is a rational assessment of the likelihood that the organization will do the right thing over time<sup>166</sup>. In a social investment context this means companies with problems that can be remedied can remain in investors' portfolios as long as company management is willing to address them.

### **5.2.2. ENGAGEMENT DEFINED: The Role of the Shareholder**

In the realm of Socially Responsible Investment shareholder engagement efforts are thought to correspond to the Voice component of Hirschman's 1970 framework. Engagement is the process by means of which shareholders/investors become involved with the business to influence its activities, behaviors and operations.<sup>167</sup>

Shareholders are the main actors who carry out engagement strategies. Shareholders are referred to as the "owners" of a corporation. Once they have invested capital in the corporation and own a proportional share of it, they are entitled to certain rights and obligations.<sup>168</sup> The fundamental right of shareholders is to have information about the ownership structure of the corporation. Additionally, shareholders have the right to register ownership, sell the stock, attend the Annual General Meeting, vote shareholder resolutions and elect board members, receive relevant information about the corporation on a timely and regular basis and share in the profits of the company.<sup>169</sup>

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<sup>165</sup> Wikipedia – Exit, Voice and Loyalty Framework (website)

<sup>166</sup> Crane et al., p. 257 (monograph)

<sup>167</sup> Blowfield & Murray, p. 288 (monograph)

<sup>168</sup> Darman, Guler Manisali., *Corporate Governance Worldwide: A Guide to Best Practices for Managers*, Paris: ICC, 2004 (monograph)

<sup>169</sup> Darman, p. 50 (monograph)

Shareholder advocacy proponents attempt to take advantage of share ownership and the potential of such ownership to obtain access to management and to other shareholders. They claim that one of the potential levers with which to make corporations accountable for their ethical behavior is to buy shares in that company.<sup>170</sup> The basic idea that shareholders of a company are entitled to have a say in corporate decisions by virtue of their ownership implies that they can use this avenue to monitor and advance the ESG track record of a corporation. It is because of this potential to “engage” company management, that shareholders are increasingly seen not just as the owners of a corporation but also as a force for a wider social accountability.<sup>171</sup>

The impetus for shareholder activism as a SRI strategy can vary. An investor might discover after the fact that a company in which he or she owns stock was acting in a manner contrary to ESG principles. Rather than simply sell his or her stock, the investor can then act to correct the problem. Even though engagement strategies are typically post-investment SRI strategies that use a posteriori information about the corporation, increasingly shareholder activists target a specific company with a questionable ESG track record, for example ties to a government known for its human rights violations. To pressure the company into severing its ties, the activists will acquire stock and begin a campaign.

### **5.2.3. SHAREHOLDER ACTIVISM: The Voice of the Shareholder**

If shareholders are to influence corporate decisions, what tools do they have at their disposal to do so? The three main engagement tactics include private discussions, shareholder resolutions and proxy voting, and public divestments.

Many investors including socially responsible ones seek to change corporate behavior directly through a tool called shareholder activism. Shareholder activism includes activities that are undertaken in the belief that investors and shareholders can work together with the management

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<sup>170</sup> Crane & Matten, p. 265 (monograph)

<sup>171</sup> Crane & Matten, p. 262 (monograph)

which runs the company on their behalf to change course and improve financial as well as social performance over time.<sup>172</sup>

Shareholder activism can be conducted both privately and publicly.

### **(1) PRIVATE METHODS: Discussions**

The socially responsible investing community currently rallies around the idea that shareholder discussions with management should be the first step taken in efforts to create desired social returns.<sup>173</sup> In fact, in relationship-oriented markets, corporate governance can also be exercised through powerful arm's-length relationships between the management, the board, and the shareholders.<sup>174</sup>

This private mechanism is based on direct dialogue with the company management through personal communication channels between shareholders and the management. Individual or groups of shareholders can arrange a meeting with high-level company management to voice their concerns. The issues discussed are not limited to company CSR practices but are typically closely connected with them. Often, if company management feels a change is warranted, these face-to-face encounters result in amended corporate policy and no further action is necessary<sup>175</sup>. Management is often more willing to engage in these informal discussions because a mutual understanding and compromise often limits the shareholder resolutions that occur under the public category of shareholder activism.<sup>176</sup>

### **(2) PUBLIC METHODS: Shareholder Resolutions & Voting**

Assuming direct dialogue with the management does not yield results, shareholders can turn to the public mechanism for shareholder advocacy. This is an umbrella term for a variety of “more

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<sup>172</sup> Blowfield & Murray, p. 289 (monograph)

<sup>173</sup> Ciocchetti, Corey, *Socially Responsible Investment*, 2007, pp. 26 – 27 (paper)

<sup>174</sup> Darman, p. 98 (monograph)

<sup>175</sup> Ciocchetti, Corey, *Socially Responsible Investment*, 2007, pp. 26 – 27 (paper)

<sup>176</sup> Idem.

structured and persuasive”<sup>177</sup> options – from raising questions during the annual general meetings to filing shareholder resolutions.

The shareholders’ right to speak at the annual general meeting is an opportunity for the shareholders to voice their opinions on company policies. Normally, this forum would be used by investors to take on the company on performance issues and other typical shareholder concerns.<sup>178</sup> However, this right also opens the possibility for shareholders to voice their concerns and challenge the company on allegedly unethical practices.

Another public mechanism for shareholder activism is proposing a shareholder resolution during the Annual General Meeting of a company or sometimes even calling an extraordinary shareholder meeting to do so. A shareholder resolution is a proposal by a shareholder or a group of shareholders recommending a change in company actions or policies regarding a particular issue.<sup>179</sup> Typically, shareholders submit resolutions that are opposed to company management, hence the insistence for a vote. Issues at stake focus on corporate governance issues such as composition of the board of directors, executive compensation, declarations made by company management, recent negative publicity as well as ESG track record. The proposal process and resolution content requirements are governed by the local investment authorities. If the proposal meets all the requirements, it is included in the proxy statement. A proxy statement is a communication from a corporation to its stockholders before the Annual General Meeting to inform stockholders about significant events taking place at the meeting and to give them enough information so they can vote.<sup>180</sup> Once in the proxy statement, the proposal must be formally presented at the company Annual General Meeting and then voted by shareholders present or voting by proxy, where a proxy is an authorized person or a written authorization to act on behalf of another.<sup>181</sup>

Shareholder resolutions receive a majority vote in a small, but increasing proportion of cases. If they pass, they are legally binding in the UK and most of continental Europe.<sup>182</sup> However, even

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<sup>177</sup> Ciocchetti, pp. 26 – 27 (paper)

<sup>178</sup> Crane & Matten, pp. 262 – 270 (monograph)

<sup>179</sup> Ciocchetti, pp. 26 – 27 (paper)

<sup>180</sup> Investopedia – Proxy Statement (website)

<sup>181</sup> Dictionary Definition – Proxy (website)

<sup>182</sup> Cziraki, Peter., Renneboog, Luc., Szilagyi, Peter., *Shareholder Activism through Proxy Proposals: The European Perspective*, Tilburg University, DP 2009-019, 2009.

if they don't pass, their importance cannot be underestimated. In fact, most shareholder resolutions concerning ESG issues do not garner a majority of shareholder votes.<sup>183</sup> At the same time, what may seem like a mere percentage of the total votes cast in favor of an ESG-related proposal at a company Annual General Meeting may represent millions of shareholders - a large voice against the company practice at issue.<sup>184</sup> Additionally, shareholder proposals can be accompanied by company investors issuing press statements or arranging briefings to make their reservations known publicly in an effort to engage public opinion as well.

Therefore, companies often take even the smallest resolution approval rates as an impetus to enter into discussions previously avoided or even to outright amend current company policy to accept the shareholder proposal in order to avoid negative publicity. As Andrew Crane and Dirk Matten note, embedded in larger campaigns, the filing of shareholder resolutions can be a very effective way of making corporations change their behavior, or at least informing a broader range of constituencies about critical ethical issues.<sup>185</sup> At the same time, as powerful tool as shareholder activism sounds in both its private and public forms, it is not deprived of disadvantages. Andrew Crane and Dirk Matten note that “on the downside, in buying shares of a corporation with a particularly bad social track record, a shareholder group can get involved with “the enemy”, which in the long run may result in integrity problems.<sup>186</sup> Furthermore, for activists, shareholder resolutions are usually costly and resource intensive.

### **(3) PUBLIC METHODS: Protest Divestment**

Another form of shareholder activism is protest divestment. Protest divestment usually happens after discussions and resolutions have failed. It is comprised of the intentional selling of stock or other assets on a large scale not only to relinquish affiliation with an organization, but also to raise public awareness and create financial pressure on a corporation or a government to force social change.<sup>187</sup>

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<sup>183</sup> Ciocchetti, pp. 26 – 27 (paper)

<sup>184</sup> Idem.

<sup>185</sup> Crane & Matten, p. 262

<sup>186</sup> Crane & Matten., p. 266

<sup>187</sup> Investopedia – Protest Divestment (website)



Can the simple act of selling stock affect social change?<sup>188</sup> If one is to consider Hirschman's Exit, Loyalty, Voice framework discussed previously walking away from an investment is equivalent to disassociation from a problem that stops short of in terms of effecting change. Internationally, the best known and most successful example of protest divestment is the anti-Apartheid divestment campaign in the 1980s in the United States. Anti-apartheid protests in the United States started in the 1960s, particularly on the campuses of American colleges and universities. Student-members of the college-based anti-apartheid movement started pressuring their universities to divest stocks of companies doing business in South Africa. Because of their sheer size, endowment funds of American higher education institutions wield a significant capital market power. By 1988, a total of 155 colleges had at least partially divested.

While the roots of the divestment movement took hold in America's college campuses, other large entities, including pension funds, also soon sold their stocks. From 1985 to 1990, over 200 U.S. companies cut all ties with South Africa, resulting in a loss of 1 Billion USD in direct American investment. After the divestment movement gained attention worldwide, U.S Congress passed a series of economic sanctions against South Africa. Divestment movements took off in other countries as well. South Africa was ravaged by capital flight as businesses, investors and money left the country. The rand, South Africa's currency, was significantly devalued and inflation reached double digits. The country's choices became reforming its politics or risking complete and total economic isolation. In 1994, apartheid in South Africa ended.

Since its success in ending South African apartheid, protest divestment has been suggested as a tool and used to effect social change in other countries, namely Sudan, Burma, Iran, Syria and Israel. Yet, although it sends a strong message to management, divestment is not necessarily the most effective method of promoting change within an organization in that other investors who are not concerned with corporate social responsibility issues will maintain investment in the company.<sup>189</sup>

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<sup>188</sup> Investopedia Article – Protest Divestment and The End of Apartheid (website)

<sup>189</sup> Social Funds (website)

#### **5.2.4. ENGAGEMENT IN ACTION: The European Landscape**

Having defined and discussed the theoretical postulates of shareholder engagement as a SRI strategy and its tactics, I will now examine its practical applications in the context of the European financial markets.

##### **(1) SHAREHOLDER ACTIVISM IN EUROPE**

The European SRI market for engagement practices represents 1.5 Trillion EUR.<sup>190</sup> Engagement is practiced both at the domestic and international levels. At the aggregated European level, engagement activities mostly concern governance issues, followed by environmental and then social issues.<sup>191</sup> However, both the extent and focus of shareholder activism differs among European countries, making up for a dynamic engagement market in Europe. The UK remains the leader in this area followed by the Netherlands and the Nordic countries.

With direct private discussions with the management as the activity of choice, public shareholder engagement with the management is used scarcely in Europe not just in the case of ESG issues, but also in general.<sup>192</sup> This is one of the areas where European investors most differ from their North American counterparts. However, the importance and relevance of active participation of European shareholders have increased following the recent global corporate scandals of the 2000s<sup>193</sup>. Not only has the number of cases of large public shareholder engagement with the management risen, but in fact this has evolved into its own investing style, as demonstrated by the case of the Hermes Focus Funds.

##### **(2) SHAREHOLDER ACTIVIST INVESTING: HERMES FOCUS FUNDS<sup>194</sup>**

Hermes, a UK boutique fund manager has long been at the forefront of the shareholder activist movement in Europe. It was established in 1983 and is owned by the BT Pension Scheme. As of

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<sup>190</sup> SRI Study, Eurosif. 2010. P. 15

<sup>191</sup> SRI Study, Eurosif. 2010. P. 15

<sup>192</sup> SRI Study, Eurosif. 2010. P. 15

<sup>193</sup> Blowfield & Murray, pp. 288-289 (monograph)

<sup>194</sup> Paul Coombes, *Agenda of a Shareholder Activist* in McKinsey Quarterly, May 2004. (online publication article)

March 2011, Hermes had 25.1 billion GBP of Assets Under Management for over 175 clients<sup>195</sup>. In the early 1990s, Hermes embarked on the task of improving the performance and governance of underperforming companies in its index tracking fund (known as Index Tracking Investments). It started actively using its voting rights to intervene on issues such as board composition, director independence and executive pay. As a long-term investor in the stocks of the index tracking fund, Hermes saw intervention as a means of improving its own performance.

In 1998 Hermes took its corporate governance program to the next level by pioneering the establishment of the first “shareholder-engagement funds” known as the Hermes Focus Funds. The family of Hermes Focus Funds (HFF) is an example of shareholder activist investing. Run by Hermes Focus Asset Management, these funds take an even more direct approach to improving what Hermes describes as the index fund’s “problem companies”. HFF seek to generate value by buying stakes in companies Hermes believes to be undervalued because of financial, strategic, corporate governance or ESG issues – usually becoming one of the largest owners – and then engaging extensively with the management working to resolve them.

In 2002, following the revelation of corporate governance breaches in the context of the global financial crisis, Hermes coined and published the Hermes Principles<sup>196</sup>, which set forth what Hermes thinks companies should do to increase shareholder value in the long-run. In addition to communication, financial and strategic prerogatives, the principles also include ESG issues. The principles have become the backbone of its activist efforts with the management of the various companies where Hermes Focus Funds are invested.

### **(3) PROTEST DIVESTMENT IN EUROPE**

Protest divestment is also taking ground in Europe. Institutional investors and pension funds in particular have been actively using this SRI avenue.

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<sup>195</sup> Hermes Funds – About Us (website)

<sup>196</sup> Hermes Funds – Principles (website)

Boycott, Divestment and Sanctions is a campaign first initiated in 2005 by 171 Palestinian non-governmental organizations in support of the Palestinian cause<sup>197</sup>. The campaign calls for boycott, divestment and sanctions against Israel until it complies with the principles of the Universal Declaration of Human Rights and international law in its treatment of Palestine and its people.

The movement has been received especially well in the Nordic countries. Norway in particular has a growing BDS movement. One aspect of this movement is exemplified by the divestment of the Norwegian Government Pension Fund Global (GPF). In 2009, the fund pulled all its holdings from the Israeli arms firm Elbit. The divestment was due to the firm's involvement in the construction of the West Bank separation fence. Elbit manufactures a monitoring system installed on the separation fence. Israel erected the fence following a wave of Palestinian terror attacks at the height of the second intifada; it says the barrier is a necessary measure to stop Palestinian suicide bombers and protect settlers. The Palestinians oppose the fence route, saying it is designed to grab land they want for a future state.

Norway's decision was based on the recommendation of Norway's Ministry of Finance Council on Ethics, whose role is to ensure that government investments abroad meet ethical guidelines. Referring to a 2004 International Court of Justice ruling, stating that the separation fence represented a breach of international law<sup>198</sup>, Norway's Ministry of Finance considered "the fund's investment in Elbit to constitute an unacceptable risk of complicity in serious violations of fundamental ethical norms."<sup>199</sup> The Norwegian Minister of Finance at the time Kristin Halvorsen concluded that "We do not wish to fund companies that so directly contribute to violations of international humanitarian law."<sup>200</sup> Only a year after, in 2010, the Norwegian Government Pension Fund Global announced further divestment from two other Israeli companies, Africa Israel Investments and Danya Cebus, due to their involvement in the construction of illegal settlements in the West Bank.

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<sup>197</sup> Boycott, Divestment and Sanctions (BDS) Movement (website)

<sup>198</sup> ICJ Press Release 2004/28, 9 July 2004

<sup>199</sup> Israel summons Norway envoy to protest divestment from arms firm (article). Haaretz, 4 Sep 2009 (www.haaretz.com), last consulted on 12 July 2011

<sup>200</sup> Israel summons Norway envoy to protest divestment from arms firm (article). Haaretz, 4 Sep 2009 (www.haaretz.com), last consulted on 12 July 2011

### 5.2.5. INSTITUTIONAL LEADERSHIP: Pillar of Engagement

The potential of shareholder engagement strategies described previously is large. But it should be noted that while the purchase of even a small amount of stock will create a shareholder relationship with the company, a more significant stake is needed to truly obtain access to and attention from company management.<sup>201</sup> Given the vast number of shares in dispersed ownership, the influence of a single shareholder is rather small; however, with institutional investors, which are holders of large share packages, the opportunity to move the corporate needle on ESG issues is significant. Therefore, even though both private and institutional investors may raise the issues, typically it is institutional managers that play the largest role in the process of shareholder activism.<sup>202</sup>

In publicly held companies, the dispersion of shares has created corporations that are seemingly ownerless<sup>203</sup>. At the same time, the concentration of corporate shares in the hands of institutional investors - large organizations such as government-controlled pension or insurance funds, employee savings or retirement plans, foundations, universities among others - has stimulated activism by formerly passive shareholders. Pension funds in particular, have become strong advocates for shareholder interests and good governance in corporations whose shares they own. To reflect this stance, some of them (such as CALPERS in the United States) have started to prefer the term “shareowner” to shareholder. Shareowner is preferable because it has the connotation that equity ownership carries with it active responsibilities and does not imply that one is a mere passive holder of shares.<sup>204</sup>

The role of institutional investors, particularly those acting on behalf of pension funds, is of greater importance in the United Kingdom and the United States than in the rest of the world, due to the structure of capital markets. While this has created opportunities for joint initiatives, this has also highlighted the question of whether engagement strategies for SRI can be successfully employed in Europe outside the UK. For example, in 2002 the National Association of Pension Funds of the UK, working with the Institutional Shareholders Committee of the U.S. drew up a Statement of Principles of Shareholder Activism. The principles represent the first

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<sup>201</sup> Ciocchetti, p. 10 (paper)

<sup>202</sup> Blowfield & Murray, p. 288 (monograph)

<sup>203</sup> Darman, p. 98 (monograph)

<sup>204</sup> Idem.

comprehensive statement of best practices governing the responsibilities of institutional shareholders and investment managers in relation to the companies in which they invest.

Additionally, one of the most significant developments in institutional investing has been the teaming up of the National Association of Pension Funds of the UK (NAPF) and the Institutional Shareholder Services (ISS), the foremost corporate governance group in the US. Their joint venture, Research Recommendations and Electronic Voting (RREV), provides a web-based service offering research on companies, recommendations on which way to vote and information about proxy voting.

## CONCLUSION: WHERE NEXT?

In today's interconnected global economy, the long-term value and success of business are inextricably linked to the integration of environmental, social and governance issues into corporate management and operations. Some of the long-established concerns of Socially Responsible Investing are higher on the political and business agenda than ever before. The strength of debates on ESG issues suggests that SRI is bound to become part of mainstream investing.

Socially Responsible Investing is considered a practical application of the idea that “financial markets are a product of society and as such they must reflect society’s concerns.”<sup>205</sup> “Over the past hundred years, investment has taken on a passive character and has become a mere financial transaction. SRI restores something of the former meaning of the term by affirming the investor’s commitment to a company”.<sup>206</sup>

SRI in Europe is gaining wider market acceptance and is firmly on a trajectory to become part of mainstream investing. In fact, Eurosif considers this moment to be transformative for the European SRI sector, with many drivers coming together towards the mainstreaming of the field.<sup>207</sup> It has migrated from the domain of values-based personal investing to become part of much larger institutional portfolios. Despite differences in the uptake of SRI across EU countries, the overall European market for SRI is growing rapidly and is increasing its importance as a sizable segment of the European asset management segment. More investment companies are now beginning to offer socially responsible investment options in addition to their traditional financial management strategies. More investors are becoming aware of the availability of SRI strategies. More SRI offerings are being created.

While the proliferation of SRI market elements on the European continent is considered a positive development, it should be noted that the drive for standardization both in terms of

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<sup>205</sup> Corporation of London, *Financing the Future. London Principles. The Role of UK Financial Services in Sustainable Development*, 2002.

<sup>206</sup> Kinder, Peter, *Socially Responsible Investment: An Evolving Concept in a Changing World*, KLD Research & Analytics, September 2005, p. 6

<sup>207</sup> Eurosif, *2011 European SRI Study*, p. 6

terminology and reporting of non-financial concerns in the sector is critical for its further establishment. Increased consideration of environmental, social and governance issues will ultimately lead to better investment decisions, create stronger and more resilient financial markets, and contribute to the sustainable development of societies. Socially Responsible Investing is part of our global efforts to finance the future.



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