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Enlisting Institutional Investors in Environmental Regulation: Some Comparative and Theoretical Perspectives

Benjamin J. Richardson*

I. Introduction

This Article investigates the role of private financial organizations in environmental policy and argues that the effectiveness of environmental regulation may be enhanced when it can encourage institutional investors to take account of the environmental effects of their decisions. Through a combination of incentive, informational, and regulatory mechanisms, governments can mobilize institutional investors to support environmental policy by providing a means of transmitting and amplifying primary regulatory controls through the market. Environmental policymakers and academic commentators are becoming interested in institutional investors, and other financial organizations, such as banks, due to growing concerns that traditional command techniques of environmental law are reaching the limits of their design capabilities. Nonetheless, institutional investors face some structural limitations on their ability to address environmental matters. They are, thus, likely to complement and enhance, rather than supplant, conventional environmental controls.

Interest in enlisting financial organizations as instruments of environmental governance should be seen in the context of debates regarding policy-instrument choices to promote sustainable development. Over the past decade, "sustainable development" has emerged in many countries as the primary goal of environmental law.¹ The principles of sustainability, as defined in

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¹ The literature is now voluminous: see, e.g., J.G. Frazier, Sustainable Development: Modern Elixir or Sack Dress?, 24(2) ENVTL. CONSERVATION 182 (1997); Andrew D. Basiago, Methods of Defining Sustainability, 3 SUSTAINABLE DEV. 109 (1995).
international laws and policies and among scientific and academic institutions, define economic prosperity as dependent on environmental integrity. The sustainable development ideal seeks to mediate or integrate the otherwise incongruous imperatives of, on the one hand, the unrestrained economic exploitation of resources and, on the other hand, the reality that all life hinges on the conservation of healthy ecosystems. A seminal feature of sustainability is the principle of integrating environmental and economic issues in decision-making. This integration requires the embedding of ecological concerns in both government and market-decision processes.

Policy reformers and scholars are devoting more attention to the possibility of new regulatory partnerships between the state and the private sector and greater use of economic instruments for motivating and financing sustainable development. Rather than merely reacting to the market, the state could be engineering changes that guide and reorient businesses more positively toward the environment. The challenge posed by environmental degradation requires new approaches to regulation that, whilst using the incentive effects of economic instruments such as eco-taxes and tradeable emission allowances, also specifically targets the behavior of market organizations from which environmental problems often germinate. Effective environmental regulation may reside in embedding environmental responsibilities in those macro-market organizations that play a pivotal role in influencing the environmental activities of individual enterprises and industry sectors. Reforming the financial sector so that it enhances the prospects for sustainable development raises fundamental questions regarding the organization of environmental governance.

This Article investigates the relevance of institutional investors to sustainable development and considers how government regulation could be adjusted to best facilitate the environmental role of this sector. The focus of this Article is on institutional

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3 Dernbach, supra note 2.

4 See, e.g., Peter N. Grabosky, Green Markets: Environmental Regulation by the Private Sector, 16 LAW & POL’Y 419 (1994).
investors, such as pension funds and life insurance companies, which dominate equity markets in many Western countries. This article begins with an exploration of the theoretical foundations for sharing environmental governance with financial organizations, including the relevance of environmental policy to the financial services sector and how regulation can be construed in relation to this sector. The Article's next two parts canvass the role of institutional investors in environmental governance as a key example of the financial services sector's potential. This section also analyzes the workings of capital markets and suggests reforms to enhance long-term investment and promote corporate environmental impacts as an efficient and effective means by which unsustainable development is deterred.

The final part explores additional legal and policy reforms necessary to provide a proper setting for enlisting financial organizations in environmental policy. It focuses on the role that improved environmental disclosure requirements have for businesses, corporate environmental management systems, and economic instruments. This Article explores these themes from a comparative and theoretical perspective, canvassing developments in Europe and North America in particular. Though not based on new empirical case studies, it surveys and collates existing research and practices. Finally, the Article advances some theoretical propositions and recommends some reforms in relation to ethical investment trends.

II. Sharing Environmental Governance

A. Concepts of Governance

Scholars and policymakers are increasingly interested in how institutions of public governance can be redesigned to draw on the skills and resources of third parties and to internalize compliance cultures within regulatees. Theories of "governmentality," "self-
organization,”7 and “reflexive regulation”8 reflect this burgeoning interest in state-market partnerships. Views of governance framed in terms of liberalist public versus private mechanisms, central planning versus privatization, and so on, are seen as increasingly inaccurate and unhelpful. Complementing this shift has been a change in understanding the nature of authority and the role of social norms and private institutions in performing regulatory-type functions.9 The definition and scope of regulation has long been a contested issue among scholars and policymakers,10 but they increasingly accept a wider concept of regulation encompassing a broad range of actions and institutions.

Regulatory theorists emphasize that regulators operate increasingly in a pluralistic setting where effective governance involves flexible, collaborative mechanisms in which state functions are shared with, or devolved to, private interests.11 Osborne and Gaebler favor governments using their leverage to facilitate rather than command so that governments “steer” the private sector toward public-policy objectives.12 Rose and Miller characterize this as “governing at a distance.”13 Whilst we cannot ignore the role of government, governance differs from the role of organizations and their rules. Instead of direct government control, governance may involve a combination of rules, incentives and discursive processes by which the state seeks to steer and coordinate the non-government sector.14 According to Freeman,
governance is increasingly shared through a process of “negotiated relationships” between the government and private stakeholders. Freeman rejects the public/private dichotomy inherent in many theoretical views of the state and argues that in reality governance tends to be “dynamic, non-hierarchical, and decentralized, envisioning give and take among public and private actors.” Salamon argues that the defining feature of the emerging approaches to “third-party government” is the “massive proliferation... in the tools of public action,” such as tax, insurance, loans, contracts, and regulation. He suggests,

[s]uch an approach is necessary because problems have become too complex for government to handle on its own, because disagreements exist about the proper ends of public action, and because government increasingly lacks the authority to enforce its will on other crucial actors without giving them a meaningful seat at the table.

There is a wide range of processes by which governance may be modulated through private institutions. Sometimes third parties may be directly conscripted, as when the government requires banks to report suspicious transactions and imposes obligations on businesses to undertake revenue collection for the state. Alternatively, governments may compel companies to use private institutions, as when firms are required to have their environmental performance assessed and certified by private auditors and to carry environmental liability insurance. Such delegation and assignment of regulatory roles to auditors, accountants, and other professions can be useful when they can

16 Id. at 571.
18 Id. at 1623.
19 The following discussion draws upon Peter N. Grabosky, Using Non-Governmental Resources to Foster Regulatory Compliance, 8 GOVERNANCE 527, 530–36 (1995).
20 Id. at 530.
21 Id. at 530–31.
develop appropriate regulatory standards and undertake effective supervision on behalf of the state. Obligations to assemble and disclose environmental performance information can also facilitate governance by informing markets and other institutions about the nature and effects of corporate operations. Apart from information techniques, incentives can support regulatory partnerships with the private sector—for instance, taxation benefits and regulatory relief to enterprises that agree to adopt approved environmental management systems and participate in alternative compliance programs.\(^\text{22}\)

A shift towards shared governance, however, is not without various challenges and potential hazards for the state. Risks range from policy incoherence, if the state is unable strategically to direct decision-making, to complete policy failures, if private institutions capture and distort regulatory programs. Rhodes cautions that absent effective systems of democratic supervision, if decisions are largely removed from the traditional governmental apparatus, new governance networks may reduce accountability.\(^\text{23}\) Implementation failures can arise because of conflicts of interest among participating private institutions as well as market failures due to factors such as imperfect information and insufficient competitive pressures.\(^\text{24}\) Governance failures may also result from private interests capturing the policy process. According to Hancher and Moran, in corporatist forms of interest intermediation characteristic of shared regulatory spaces, regulatory norms tend to result from brokerage and negotiation processes.\(^\text{25}\) Hancher and Moran predict that organizations likely to dominate regulatory spaces are large, hierarchically-organized entities.\(^\text{26}\)

Careful design of monitoring and oversight mechanisms is needed to ensure the state is able to track and verify implementation of policy goals and ensure governance systems are

\(^{22}\) Id. at 534–35

\(^{23}\) R.A.W. Rhodes, Understanding Governance: Policy Networks, Governance, Reflexivity and Accountability 54 (1997); see also Grabosky, supra note 19, at 538.

\(^{24}\) Grabosky, supra note 19, at 538–41.


\(^{26}\) Id. at 286–87.
democratically nourished. Grabosky sees the challenge as one of "meta-monitoring," by which government agencies focus on "strategic surveillance" and "monitor[] the overall regulatory system" but engage in "authoritative intervention" where third-party resources are lacking.\(^{27}\) Even without proactive intervention, regulatory partnerships with the private sector may disguise strong state control over the policy process. Bennett argues that if power is understood as the capacity to convince others to adjust their behavior in accordance with the principal's wishes, then enlistment of others by the state can be understood as an aspect of the exercise of power.\(^{28}\) Moreover, power may accrue from the very process of enlistment.

Today, considerable evidence of shared regulatory spaces involving the private provision of regulation exists. The trend is toward increasing reliance on private systems of governance through the contracting out of public-sector service provisions.\(^{29}\) Private organizations, thus, may furnish social services such as health care and undertake local government responsibilities including waste collection and street repair.\(^{30}\) Private organizations are also increasingly involved in monitoring and enforcing compliance with public regulatory standards.\(^{31}\) The contractual relationship between financial institutions and their customers has long been subject to regulation in the name of consumer protection and fraud control.\(^{32}\) Harnessing private entities in compliance control is justified by the often greater technical expertise held by private bodies and the prospect that some additional control will result, albeit perhaps, outside of direct political scrutiny. Participation of market institutions in the design of regulatory processes helps ensure that regulation is tailored to the institutional contexts in which it is intended to apply. This

\(^{27}\) Grabosky, supranote 19, at 543–44.


\(^{32}\) See Ross Cranston, Principles of Banking Law 153 (1997).
participation also gives non-governmental interests a stake in the success of regulation. However, the private role in all these processes has rarely displaced the regulator’s formal role as authoritative decision-maker.33

B. Sharing Responsibility for Environmental Policy

Arguments for more pluralistic, shared regulatory regimes are particularly pertinent to environmental policy.34 At a meta-policy level, the achievement of an ecologically sustainable future involves both rejecting the boundaries between economic and environmental policymaking and fusing new regulatory partnerships in which the linkages between economic decision-making and ecological health can be drawn. The principle of integration of environmental and developmental policy is one of the pillars of sustainable development; yet, in many countries, prevailing systems of government tend to fragment and disconnect relevant issues and actors.35 A new model of a more open and flexible governance involving different institutions must be designed to accommodate the complex conditions of late capitalism, where economic activity transcends the domain of traditional, administratively-defined responsibilities, and corporate entities wield resources and influence that defy the web of command regulation. The ideal of a wholly discrete system of environmental law is anachronistic given pressures to diffuse and embed ecological considerations throughout aspects of social and economic governance that influence environmental conditions.36 For the state, an environmental law diaspora requires a “whole of government” approach encompassing, for instance, the greening of government budgets, ecological tax reforms, adoption of sustainability indicators, and the introduction of environmental

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33 Freeman, supra note 15, at 637.
costs in national accounts. The development of "green ministers" networks, environmental reporting by all government departments, and special cabinet environmental committees are mechanisms by which some governments are attempting to ensure cross-sectoral integration of environmental policy. The greening of public purchasing policies and improvements in actual public sector operations that use environmental resources are also necessary.

For the market, effective diffusion of environmental policy is likely to require a combination of mechanisms that revolve around using economic instruments and financial organizations. Whilst sanctions should retain a role primarily as regulatory threats or front-line controls in relation to environmental activities too dangerous or contentious for market implementation, incentive and information-based processes are likely to be more popular instruments for facilitating state-market partnerships. Discourses and procedures that guide, rather than force, behavior are important elements in the successful enrollment of market institutions in governance. Emerging discussions regarding "corporate environmentalism" and "ethical investment" are increasingly important in changing the underlying culture of market institutions and encouraging actors to reflect on, and be more self-aware about, their ability to contribute positively to environmental policy. These discourses share an orientation toward mobilizing market institutions as a means of public policy

37 Among current reforms, see ORG. FOR ECON. COOPERATION & DEV., ENVIRONMENTAL TAXES AND GREEN TAX REFORM (1997); ORG. FOR ECON. COOPERATION & DEV., TOWARDS SUSTAINABLE DEVELOPMENT: INDICATORS TO MEASURE PROGRESS (2000).


and provide an emerging normative framework for shared environmental governance.

When regulation addresses the organizational and procedural structures of economic entities that shape their decision-making culture, it may assist discursive practices. Teubner and other proponents of "reflexive" forms of law have advocated the extension of mechanisms that serve to stimulate desired behavior within regulated institutions, producing an enhanced sensitivity to public policy objectives and a readiness to reflect and adjust organizational policies and procedures accordingly. This approach to governance involves making private organizational fields internally and externally more visible for management and policy purposes. Because of the existence of significant functional differentiation in our social systems, it has been argued that mechanisms to promote corporate social responsibility need to operate at the level of the specific subsystems because uniform normative structures would not succeed.

Luhmann has argued that subsystems in functionally differentiated complex societies could be integrated only by creating decentralized and reflective structures, rather than central regulation by means of substantive norms. Similarly, in rejecting regulatory compulsion for promoting corporate social responsibility, Teubner argues the role of law should be to stimulate indirectly the controlling internal organizational structures of companies: “[t]he role of law then is not the external control of the firm’s conduct, but external mobilization of internal self-control resources.” Teubner believes that corporations are more likely to be sensitive to the external effects of their operations through procedural standards and organizational


43 Gunther Teubner, Corporate Fiduciary Duties and Their Beneficiaries, in CORPORATE GOVERNANCE AND DIRECTORS' LIABILITIES: LEGAL, ECONOMIC AND SOCIOLOGICAL ANALYSES ON CORPORATE SOCIAL RESPONSIBILITY 149, 162 (Klaus J. Hopt & Gunther Teubner eds., 1985).

44 LUHMANN, supra note 7.

45 Teubner, supra note 43, at 160.
devices, rather than imposition of substantive standards of fiduciary responsibilities.\textsuperscript{46} Requirements to disclose, inform, and consult with outside social and environmental interests may help stimulate the social responsibility of economic enterprises.\textsuperscript{47} These are decentralized integrative mechanisms that, by encouraging consideration of the impacts of the regulatee’s activities, serve to link the economic activities of corporations with their non-economic environment.\textsuperscript{48}

Enhanced understanding of the connections between environmental and financial risk is likely to be one of the most salient consequences of regulatory moves to stimulate greater environmental awareness within the financial services sector. But in order to encourage deeper reflection within market institutions, it is important that environmental and ethical concerns be translated and presented in a style relevant to prevailing financial institutional analysis. Requirements for improved corporate disclosure of environmental risk are emerging as a key means for facilitating this awareness.\textsuperscript{49} Reporting, auditing, and environmental management system methodologies can render the behavior of corporations more transparent and open to reflection, learning, and modification of operations.\textsuperscript{50} Repetto and Austin suggest

> [u]nless environmental issues are dealt with inside the corporation in ways similar to those used to manage other business risks and opportunities, environmental control in such industries will remain an internal regulatory function superimposed on the company’s core business concerns rather than part of the process of maximizing shareholder value.\textsuperscript{51}

In addition to discursive and informational mechanisms, economic instruments are likely to become an important feature of

\textsuperscript{46} See id.
\textsuperscript{47} See id. at 166–72.
\textsuperscript{48} See id. at 160–64.
\textsuperscript{50} See Teubner, \textit{supra} note 43, at 166.
\textsuperscript{51} \textit{Robert Repetto & Duncan Austin, Pure Profit: The Financial Implications of Environmental Performance} 1 (2000).
future environmental governance systems.\textsuperscript{52} The problem to be addressed, according to the European Commission's most recent environmental action program, is that "[c]ompanies that fail to meet legislative environmental requirements are penalised. Yet, those that go beyond are usually not rewarded neither by government nor, often, in the marketplace."\textsuperscript{53} Indeed, the effective enrollment of financial organizations in such systems is likely to depend substantially upon the concomitant existence of economic instruments for conveying the appropriate pricing signals to corporate managers.\textsuperscript{54}

Today, in most countries, the market rather than the state is the dominant forum for the distribution of development resources. Although it is politically and economically unfeasible for governments to become directly involved in wholesale decisions of the market regarding allocation of investment resources, the market must nevertheless be reoriented by the state along sustainable lines. Substantial literature in economic theory suggests that serious market failures occur when the market fails to incorporate resource depletion and pollution impacts in its decisions.\textsuperscript{55} In particular, sustainable development will not be achievable unless markets place greater emphasis on long-term investments and appropriately value the environmental costs and benefits of corporate decisions. Such changes could lead to firms which facilitate sustainable development being viewed as more valuable by markets. This perception of increased value could give these firms preferential access to finance, insurance, and investment resources from relevant financial institutions.

Economic incentive mechanisms have so far dominated

\textsuperscript{52} Regarding the importance and uptake of economic instrument approaches, see generally \textit{Environmental Justice and Market Mechanisms: Key Challenges for Environmental Law and Policy} (Klaus Bösselmann & Benjamin J. Richardson eds. 1999); \textit{Jennifer Rietbergen-McCraken & Hussein Abaza, Economic Instruments for Environmental Management: A Worldwide Compendium of Case Studies} (2000).

\textsuperscript{53} On the Sixth Environment Action Programme of the European Community, COM(01) 31 final at 17.

\textsuperscript{54} See \textit{id.}

debates regarding the reinvigoration of environmental governance through market institutions. The broadening of the mix of policy instruments to reorient markets along sustainable lines has focused particularly on taxes and tradeable permits. Economic instruments can make the costs and benefits of environmental activities more transparent, thereby facilitating resource conservation and technological innovation. But, such instruments only indirectly affect the germination of environmental problems sourced in financial markets. Obviously, by financially penalizing or rewarding companies for their environmental behavior, pollution charges and other instruments can help convey appropriate signals to financial markets engaged in valuing, insuring, and investing in enterprises. The problem, however, is that the message conveyed by economic instruments can become obfuscated and lost in the wider noise of the marketplace where institutions are responding to many different, and often louder, signals. Economic managers are reacting, inter alia, to consumer preferences, employee demands, and corporate competition threats. What is crucially missing in existing regulatory strategies is the actual targeting of financial organizations. These regulatory strategies can be important for broadcasting the effects of environmental concerns through other sectors of the economy.

A stronger program of environmental policy diffusion must also address the role of market organizations, such as banks and institutional investors, which fundamentally allow and facilitate development activity. Although a burgeoning literature addresses changes in the environmental attitudes of business and financial

57 For arguments about the advantages of economic instruments, see Gyula Bándi, Financial Instruments in Environmental Protection, in EUROPEAN ENVIRONMENTAL LAW: A COMPARATIVE PERSPECTIVE 240 (Gerd Winter ed., 1996).
58 See id. at 204.
60 See id.
61 See GUNNINGHAM & GRABOSKY, supra note 34, at 106–23; Grabosky, supra note 4, at 426–37.
markets and postulates theories as to the most appropriate characteristics of enterprise environmental management, a paucity of studies explore in detail how financial organizations could function as instruments of control for corporate environmental management. At a policy level, Europe’s Fifth Action Programme on the Environment (1993-2000) was one of the first policy initiatives to recognize the importance of the financial sector when it asserted “financial institutions which assume the risk of companies and plants can exercise considerable influence – in some cases control – over investment and management decisions which could be brought to play for the benefit of the environment.” Entitled Towards Sustainability, the Programme projected the concept of “shared responsibility” to symbolize a multi-party approach to environmental management, entailing “the use of an extended, and integrated range of instruments.” Despite this belief, little research into the environmental role of financial organizations has been undertaken.

It would appear that the financial services sector has generic relevance to the achievement of sustainable development in a variety of guises: as investors, supplying the resources for environmental initiatives; as valuers, pricing risks and estimating returns for companies; and as stakeholders, such as shareholders and lenders, exercising influence over corporate management. To illustrate, financial organizations may demand environmental appraisals of borrowers’ projects to price the environmental risks of development. Financial organizations and markets have always been, and in many ways increasingly will be, subject to detailed regulation and close monitoring to ensure transparency, accountability, and to prevent unfair dealings in pursuit of certain public policy objectives. The challenge is to graft onto the

62 Id.
64 Id. at 27.
65 Id. at 24–25.
67 See generally George J. Benston, Consumer Protection as Justification for
financial services regulatory systems an additional stratum of environmental controls to steer agents toward sustainable development. Rather than government attempting to regulate the minutiae of company environmental practices, government bodies could confine themselves to regulating at the wholesale level, setting the broad regulatory parameters and standards for the financial services sector.68 This approach would give industry and financial institutions the responsibility to shape and supervise environmental behavior at the “retail” level with state involvement reserved for the most serious cases or environmental management tasks such as biodiversity conservation, which may be less amenable to private control.69

C. Overcoming Obstacles to Shared Environmental Responsibility

A major challenge to redesigning systems of environmental governance is coping with the risk that sharing responsibility with the private sector may generate new regulatory complexity and overload. The problem of regulatory overload and system crises in interventionist, command modes of regulation has been highlighted by numerous scholars including reflexive law theorists, who have advocated more subtle, flexible methods of pursuing public policy whereby regulatees learn and adjust their behavior in response to new information and incentives.70 Strategies to enroll private institutions in the regulatory process can be extremely complex, involving many agents and interests so that the efficacy of possible institutional combinations will depend heavily on the specific circumstances.71 Criteria of administrative

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69 Id.

70 For an introduction to the primary sources of reflexive law theory, see Gunther Teubner, Social Order from Legislative Noise? Autopoietic Closure as a Problem for Legal Regulation, in STATE, LAW, ECONOMY AS AUTOPOIETIC SYSTEMS: REGULATION AND AUTONOMY IN A NEW PERSPECTIVE (Gunther Teubner ed., 1992).

71 See MICHAEL JACOBS, THE GREEN ECONOMY. ENVIRONMENT, SUSTAINABLE
feasibility and economic efficiency have featured prominently in studies evaluating the ingredients of successful public policy design.\(^2\) It is important to accept that there is no "ideal type" of shared environmental governance, as the process by which the state enlists and coordinates the private sector will invariably involve a combination of regulatory processes.

The question of political feasibility is also central to proposals regarding the enrollment of the financial sector as an agent of sustainability. There are notable international differences in political-legal systems that make some regulatory options more feasible in certain nations than in others.\(^3\) The regulatory experiences of industries and authorities across capitalist countries are not interchangeable, and some reforms may not be so readily acceptable in all jurisdictions.\(^4\) Political obstacles arise because of the opposition from interests that do not perceive any financial or other advantage to them from taking better account of ecological issues and constraints in their decisions.\(^5\) Market mechanisms so far have tended to be deployed primarily to achieve environmental goals at a lower cost or improved environmental standards at the same cost and in so doing reduce the regulatory burden on business.\(^6\) They are less commonly deployed in ways that justify their promotion and change unsustainable patterns of production and consumption.\(^7\) Thus, light-handed mechanisms and "end-of-pipe" charges have often been all that are entertained.\(^8\)

Yet, in some cases there will be strong incentives to embrace reform, such as when financial organizations are concerned about


\(^{73}\) See David Vogel, National Styles of Regulation: Environmental Policy in Great Britain and the United States (1986).

\(^{74}\) On the political downside of economic tools, see Corinne Larrue, The Political (Un)feasibility of Environmental Economic Instruments, in Environmental Policy in Search of New Instruments 37, 49–51 (Bruno Dente ed., 1995).

\(^{75}\) See id.


\(^{77}\) See Energy Taxes and Emission Permits Get Mixed Response from Business, 284 ENDS Report 28 (1998) (discussing the problems with the current mechanisms in place in the energy industry and the vigorous opposition to even a modest carbon charge).

\(^{78}\) See id.
the threat of costly environmental liabilities from projects they fund or insure.\textsuperscript{79} Through more accurate corporate valuation, firms with positive environmental performances may also have advantages in capital markets.\textsuperscript{80} Furthermore, reforms to diffuse environmental law could reduce the burden of front-line regulatory controls. Companies with a neutral or positive environmental record seeking development consents from the state would hold an advantage having already passed the environmental appraisal systems of the markets. In contrast, firms associated with environmental damage could find their proposals stalled without the support of financial institutions, compelling firms to adopt more environmentally benign practices. These front-line regulatory controls would relieve government environmental regulators of the difficult cases and approvals for the remainder could be more readily processed to the benefit of business. By integrating environmental auditing and reporting into the existing corporate supervisory systems, companies could also efficiently facilitate post-project environmental monitoring. Thus, sharing environmental governance may be reconcilable with arguments for policy choices that favor lessening the regulatory burden on business and government. The political prospects for reform are also likely to be enhanced as evolving European and global legal standards on the environment create pressure on governments and industry to improve the integration of sustainable development policy in their decision-making systems.

Whilst the private sector contains potentially powerful instruments to control corporate behavior and sometimes can achieve regulatory functions more effectively than government actors, this is not to imply that the state should entirely, or even mostly abdicate its existing regulatory responsibilities. Rather, the task is to design regulatory opportunities that allow the state to draw on the capacities of other parties to create a chain of primary


\textsuperscript{80} There are numerous studies which show such a correlation: Paul Lanoie et al., \textit{Can Capital Markets Create Incentives for Pollution Control?}, 26 ECOLOGICAL ECON. 31, 34–36 (1998); Denis Cormier et al., \textit{The Impact of Corporate Pollution on Market Valuation: Some Empirical Evidence}, 8 ECOLOGICAL ECON. 135 (1993).
and secondary regulatory controls. The overall objective of shared environmental governance should be to manipulate both the market and non-market incentives of companies. This is achieved with a pyramid of strategies beginning often with flexible, reflexive modes of governance and moving to more rigorous modes of regulatory intervention and compulsion where there has been first-order mechanism failure or where critical issues are at stake. Because reliance on discursive and incentive methods of harnessing the private sector may be undermined by firms and industries where there is a conflict of interest and overriding profit objectives, there is a need for the state to retain a regulatory backdrop and invoke sanction mechanisms where companies threaten vital environmental goals.

The aims of private bodies are generally much narrower than those of government actors and may often clash with the objectives of other rightful interests. Self-regulation, voluntary agreements, and codes of conduct associated with market-based programs can be manipulated and interpreted by powerful business organizations in ways to satisfy their own ends and ensure the economic status quo is not seriously threatened. New reflexive environmental law procedures such as auditing and reporting may simply be discharged in a perfunctory, non-committal manner without leading to any real environmental improvements.

Sharing responsibility with private stakeholders may be theoretically appealing, but in reality, the dominance of already powerful economic interests may simply be legitimated and perpetuated. Even if well-meaning intentions are present, environmental objectives may still be thwarted where relevant market institutions lack sufficient expertise and resources.

A fundamental constraint on markets is that financial institutions with a "cost-benefit mind-set" assume all


82 See Maitland, supra note 81, at 132.


84 R. EDWARD FREEMAN ET AL., ENVIRONMENTALISM AND THE NEW LOGIC OF BUSINESS: HOW FIRMS CAN BE PROFITABLE AND LEAVE OUR CHILDREN A LIVING PLANET
environmental values can be reduced to underlying economic ones. Markets are very poor at determining ecological thresholds and generating long-term objectives with respect to environmental systems. Also, markets cannot easily incorporate environmental qualities such as aesthetic values and biological diversity. These "soft" qualities pose problems for markets because they are not used in production systems in the same way as tangible properties such as minerals or water. There are significant methodological difficulties to deploying surrogate market techniques to price environmental risks in the context of insurance or loans. Thus, in some instances, the only way to protect unique ecosystems threatened by polluting developments is through direct prohibitions or lesser controls rather than allowing market participants indirectly to control impacts through the price mechanism. Financial organizations should always be a means to effect environmental choices and judgments made in a political context.

The setting of broad environmental limits and other meta-policy goals must, therefore, derive from ecological, social, and economic considerations set within equitable and participatory decision-making systems. Economic analysis can help determine the cost of achieving such ecological standards but not their substantive merits, which is the province of democratically-based institutions. Research by Sagoff and Sunstein point to possible differences between people's preferences as consumers in the marketplace and those held as citizens in a political context. Whilst the "participation" of industry, financial institutions, and

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85 Id.
86 See Herman E. Daly, Allocation, Distribution, and Scale: Towards an Economics that is Efficient, Just, and Sustainable, 6 ECOLOGICAL ECON. 185 (1992).
other economic actors is crucial to a sense of shared ownership of environmental policy, financial markets cannot substitute for the traditional participatory and information processes embedded in government regulation.\footnote{91} Markets offer a different kind of "participation," because investors, shareholders, and consumers tend to exclude many interests, especially the interests of the poor. The private character of market-based regulation regimes means there could be a deficit of accountability that detracts from the suitability of this process for environmental management. Because markets are vulnerable to being distorted by power and unequal access to information and income opportunities, the state has an important responsibility to create institutional spaces for citizen participation and to provide measures to address the distributive effects of market institutions.\footnote{92} Corporate and institutional investment disclosure requirements on environmental liabilities and performance can, for instance, facilitate transparency and the accountability of financial institutional activities. Citizen participation in, and information about, the activities of state financial regulators themselves is also a necessary ingredient.

Overall, mobilizing financial organizations as co-regulators for environmental policy does not involve privatizing environmental law but rather extending environmental law into previously untapped market sectors to provide an additional layer of regulatory controls alongside the more familiar administrative ones. By drawing upon the expertise and financial resources of investors and insurers to improve project design and fund pollution cleanups, for instance, the inclusion of environmental standards in the financial services sector can enhance the overall effectiveness of environmental protection. Achievement of this goal rather than deference to the sanctity of public regulation is the important issue.

\footnote{91 See generally, John Taberner et al., The Development of Public Participation in Environmental Protection and Planning Law in Australia, 13 EnvTL. & PLAN. L. J. 260 (1996).}

\footnote{92 Id.}
D. Financial Organizations within Environmental Governance

1. Relevance of the environment to financial markets

Although environmental issues have traditionally been at the margins of decision making in the financial services sector, in recent years, financial organizations have become interested in aspects of environmental protection in terms of the use of their own internal resources and, more saliently, control of their client's environmental activity. But, current analyzes, nevertheless, indicate that interest in the environment is "still not mainstream" in the financial community.93 Extensive literature remains skeptical of the possibilities of embedding the environment in market processes. The problem partly appears to be one of ignorance. Schmidheiny has commented that "capital markets will play an important role in the search for sustainable development, but little is known about the constraints, the possibilities, and the interrelationships between capital markets, the environment, and the needs of future generations."94

The concept of financial organizations as instruments for promoting sustainability must be seen as a relative and pragmatic one because financial organizations are not in the business of putting themselves out of business for environmental and philanthropic concerns. In a variety of jurisdictions, the financial services community evolved in a political culture marked by a preference for informal and private regulation largely veiled from mass political processes.95 Increasingly, however, financial service institutions have been subject to more detailed public controls to address problems of information asymmetries and market abuse. These controls initially came through prudential regulation geared towards ensuring capital market stability, but more recently, they

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have come from consumer protection requirements. In addition to the central bank and securities commission, specialist financial authorities commonly exist to license and supervise banks, insurers, and investment companies, who share a common concern for controlling financial risks. Concerns of capital adequacy, policyholder protection, and information disclosure and transparency are pre- eminent regulatory concerns.

Traditionally, financial markets have been skeptical about environmental issues and seldom expressed a need for environmental information beyond that pertaining to the financial risks associated with project developments that could directly affect the loan security or insurability of a site. Intense market competition creates pressures on financial institutions to reduce costs and become more efficient, squeezing out consideration of expensive environmental supervisory systems except in cases of obvious credit or insurance risk. A study sponsored by the European Environment Agency suggested the invisibility or low profile of environmental issues in the financial sector has been attributable primarily to natural resources prices that do not reflect anticipated shortages. The fact that the environment is not seen as a separate “moral issue” but merely one of numerous issues occurring in the business world results in uncertainty concerning how environmental effects should be financially measured.

Financial organizations focus on providing businesses with access to capital on competitive terms. Concomitantly, corporate assets are commonly viewed by institutional investment houses as “passive pools of income-generating securities,” rather than as

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99 Edward Tasch & Stephen Viederman, New Concepts of Fiduciary Responsibility, in Steering Business Toward Sustainability 125, 130 (Fritjof Capra
resources for sustainability. The result is that to the extent environmental issues are considered, they may merely be an “add on” to normal business practices, rather than an integral factor in the culture of financial decision-making.  

Given the traditional, economically narrow orientation of financial organizations, is it unrealistic to suggest that they could become agents for promoting sustainable development? Certainly, key international policy documents, such as the United Nations’s Agenda 21 and regionally, the European Union’s (EU) recent environmental action programs, speak of future environmental regulation based on “shared responsibilities,” in which the private sector collaborates and supports governmental authorities. Its strategic location in capitalist markets means that policy-makers cannot ignore the financial services sector. Through appropriate government regulation, incentives, and information, the financial services sector could be reoriented to play a key role in the transformation to a more ecologically sustainable economy. The challenge is to identify ways in which the environment can be made more financially relevant to economic managers and correspondingly to design an appropriate legislative policy. The process of regulatory and policy reforms must address the rules and incentives governing investors and other financial entities as well as the functions of those government authorities which supervise the financial sector.

The financial services sector encompasses a large and diverse array of institutions for which the relevance of environmental issues can be very different. In general, the sector falls into three broad clusters: banking (lenders), institutional investors (equity) and insurance (risk management), although overlap exists between these categories. For lenders, the traditional concern is to minimize risk and avoid liability, thus ensuring that loan repayments are not compromised by environmental problems.

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100 Monika Griefahn, The Role of Government, in STEERING BUSINESS TOWARD SUSTAINABILITY 95, 97 (Fritjof Capra & Gunter Pauli eds., 1995).


103 See Gary Gorton & James J. Kahn, The Design of Bank Loan Contracts, 13(2)
The efficient credit approval systems of banks are equipped to weigh risks and assign a price to those risks, although smaller banks may lack sufficient in-house environmental expertise to integrate ecological issues into credit risk procedures. For equity providers, a similar downside risk exists, but scope for upside gain as the investment benefits from eco-efficiency and other environmental performance improvements in companies that aid profitability also exists. The insurance industry uses many of the same risk assessment methods relative to underwriting as debt or equity providers, but insurers are unique in being concerned with payment to assume other parties’ risks, not avoid them.

The relationship between borrowers and lenders is one of the critical points where the interests of the environment can be factored into economic decision-making. As lenders, banks can be a powerful force for promoting a long-term perspective in market behavior. Lenders often face a long-term payback period, and their concern for repayment creates, in theory, an interest in the sustainability of the borrower’s activities. This interest can be articulated where institutional processes are available that allow banks to share their expertise with, and give guidance to, their borrowers. In the United States, the threat of contaminated site liabilities under the so-called Superfund legislation helped catapult environmental concerns to the forefront of analysis of credit arrangements by financial institutions. Environmental liability has emerged as a concern for banks in various other jurisdictions.

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104 SCHMIDHEINY, supra note 94, at 10–11.
105 Id.
in the wake of widening liability rules. There are advantages for lenders who insist that project borrowers adopt appropriate environmental controls at the outset because projects that commence without adequate environmental design, which could have been undertaken more cost efficiently at the initial project design stage, can compromise the borrower's ability to repay a loan.

Environmental issues can also alter the economic assumptions that underlie an investor's decision to commit capital to an enterprise. Capital investment systems are where primary decisions regarding future development arise and thus pressures on the environment begin. Capital markets are now overwhelmingly dominated by large institutional investors, rather than by individual "amateur" shareholders. The growth of these investment funds has pooled mammoth resources capable of exerting significant leverage over corporate environmental activities. There are many reasons why the environment might be of interest to institutional investors. Pension funds and life insurance companies in particular have long-term financial liabilities, providing a structural incentive to favor long-term, sustainable investment. Further, fund managers have fiduciary responsibilities in trust law and statute to take an active interest in corporate governance. Poor environmental performance that threatens a firm's profitability forms a basis for intervention in corporate management or "taking the exit" option and switching investments. Considerable evidence indicates a growing niche market for green investment products. Moreover, empirical evidence exists of a correlation between share price movements and corporate environmental performance.

Environmental harm is also of interest to insurance companies, and insurers are becoming much more sensitive to the environmental performance of their policy-holders. The surge of


111 See Lanoie et al., supra note 80, at 35–39.

112 GUNNINGHAM & GRABOSKY, supra note 34, at 118.
claims associated with contaminated site cleanups and suspected climate-change induced disturbances has driven some insurers to scrutinize their clients according to standards often well beyond government regulatory requirements.\textsuperscript{113} Insurance can promote both the deterrence and compensation functions of environmental policy. Insurance has the ability to price various types of environmental risk and to generate funds to pay for environmental damage. In terms of deterrence, the risk of being excluded from insurance coverage or having to pay higher premiums can provide financial incentives for improved corporate environmental performance.\textsuperscript{114} There are a variety of other positive contributions that the insurance industry can offer environmental management, including assessing and publicizing various kinds of environmental risk; advising public authorities and enterprises on appropriate damage prevention and development planning restrictions; and collaborating with public authorities to improve construction standards to minimize damage from disasters.\textsuperscript{115}

2. \textit{Financial market liberalization and globalization trends}

It should be noted that in many countries the financial services sector is increasingly less organized into discrete institutional segments.\textsuperscript{116} Deregulation of the financial services sector has led to the merging of financial organizational roles. These institutional reconfigurations will invariably have an influence on the sector’s contribution to environmental governance. A particular trend in some countries has been the emergence of “financial conglomerates” of banks and insurance companies offering an extensive range of lending, investment, and other financial services.\textsuperscript{117} In the United States, for instance, the Financial

\textsuperscript{113} Id.
\textsuperscript{114} SCHMIDHEINY, supra note 94, at 64–65.
\textsuperscript{115} Ivo Knoepfel et al., The Kyoto Protocol and Beyond: Potential Implications for the Insurance Industry para 3.1 (1999), available at http://unepfi.net/iii/KYOTO-HPT-FINAL1.html (discussing the proactive role of the insurance industry in responding to climate change).
\textsuperscript{117} See Blommestein, supra note 110, at 33 (explaining that this process is known as "bancassurance").
Modernization Act of 1999\textsuperscript{118} has liberalized the ability of banks, insurers, and similar institutions to affiliate and engage in financial businesses. The Act provides for the creation of a new institution - a "financial holding company" able to offer a myriad of financial services within a single entity.\textsuperscript{119} Similar financial liberalization moves have occurred in other Western countries.\textsuperscript{120} The increasing trend toward merging activities within a single financial organization may facilitate the streamlining of environmental auditing and risk management exercises. Thus, rather than banks and insurers initiating environmental appraisals of developments separately, a single auditing process could be undertaken where lending and underwriting functions are discharged within one financial conglomerate.\textsuperscript{121} Yet, the greater convergence of financial services within a single organization may increase their exposure to systemic market risk such as the ability of a firm to diversify.\textsuperscript{122} Regulators, therefore, may need to carefully control the expansion of banks into insurance underwriting.\textsuperscript{123}

Another important recent trend in the financial services sector is its transnational character. In the last two decades, technological advances and the deregulation of capital markets in Western economies have greatly accelerated the geographic mobility of capital in its search for the most profitable investments.\textsuperscript{124} The globalization of banking, insurance, and investment services has diminished the power of governments to regulate institutions.\textsuperscript{125}


\textsuperscript{121} See Russ Banham, Pollution Protection Gets Easier, TREASURY RISK MGMT., Nov.—Dec. 1999, at 61 (discussing the relationship between environmental auditing undertaken by lenders and insurers).


\textsuperscript{124} See ANDREW WALTER, WORLD POWER AND WORLD MONEY 202–04 (1993) (discussing causes of the financial transnationalization process).

\textsuperscript{125} JOHN BRAITHWAITE & PETER DRAHOS, GLOBAL BUSINESS REGULATION 7–8
Domestic regulatory moves and local political developments perceived as threatening to economic interests can prompt the migration of funds across borders to "safe havens" or regimes appearing to offer a more benign regulatory milieu. National regulators may also face capacity and information deficits when attempting to supervise enterprises engaged in complex trans-border commercial activities. International agreements and institutions, therefore, are needed to prevent environmentally enlightened financial service providers from suffering competitive disadvantages in their transnational business. Without global standards, one bank's requirements for inclusion of environmental conditions in loan processing may be circumvented by the borrower simply taking its business to an environmentally indifferent lender.  

Whilst there is an emerging field of global regulation of financial organizations, existing international regulatory mechanisms in this sector are largely at an embryonic stage of development. At present, only the E.U. has a substantial institutional structure for the supervision of the financial sector superimposed on national regimes. Globally, existing institutions that are seeking to provide a semblance of supervision and standard-setting for transnational financial activity include the Bank for International Settlements (BIS), the Basle Committee on Banking Supervision, and the International Organization of Securities Commissions (IOSCO). But overall, the global

(2000).

126 See G. Lane & C. Normand, How can the Financial Sector Realize its Full Potential to Support Sustainable Development?, UNEP INDUSTRY & ENV'T 7, 7 (Jan/March 1999).


institutional architecture for financial regulation is informal, decentralized, and fragmented. One important emerging catalyst to boost the profile of financial institutional issues in national and international policy-making is the United Nations Environment Programme (UNEP), which has launched a Financial Institutions Initiative. The Initiative began in 1992 with the release of the "Statement by Banks on Environment and Sustainable Development," which provides a lever for banks to be more positively engaged in environmental policy. The Initiative now has over 170 members, representing financial organizations from over forty-five countries.

Nationally, similar industry standard-setting initiatives are emerging which will have global relevance given the international markets in which the financial institutions are participating. Such initiatives will become more important given the intensification of trade liberalization moves to eliminate national frontiers for financial markets. The General Agreement on Trade Services (GATS) already extends to financial regulation the General Agreement on Trade and Tariff (GATT), trade principles of Most Favoured Nation, and national treatment. Moreover, financial services are included in the specific service areas of the GATS Annexes for negotiation into particular sectoral

131 BRAITHWAITE & DRAHOS, supra note 125, at 96.
137 See also Yi Wang, Most-Favoured Nation Treatment under the General Agreement on Trade in Services: And its Application in Financial Services, 30 J. WORLD TRADE 91, 93–95 (1996).
trade agreements.\textsuperscript{138} A Financial Services Agreement, concluded in December 1997 through the latter process, aims to eliminate discriminatory and market access-impairing measures so that insurers, banks, and other financial entities of a nation have access to the financial service markets of countries.\textsuperscript{139} Clearly, the shift from government to governance will become more intertwined with internationalized patterns of policy-making involving international organizations and other supranational actors.\textsuperscript{140}

Serious development of environmental regulatory frameworks at an international level for financial institutions is a long way off. Reform is unlikely to be advanced until national models are available that can indicate the advantages and disadvantages of different regulatory approaches.\textsuperscript{141} In the field of environmental law, many policy innovations, such as the precautionary principle and economic instruments, derive from national precedents rather than international regulation. The dispersion of governmental responsibilities spawned by globalization has not necessarily diminished the role of the nation-state, which is still widely seen as the pivotal actor.\textsuperscript{142} Nation-states remain generically much more powerful than multinational corporations because of their control of territory and populations.\textsuperscript{143}

\section*{III. Institutional Investors}

\textit{A. Environmental Issues in Capital Markets}

Capital markets substantially shape the investment processes of modern economies.\textsuperscript{144} Because the investment patterns of

\textsuperscript{138} See id. at 108.


\textsuperscript{140} James N. Rosenau, \textit{Governance, Order and Change in World Politics}, in \textit{Governance without Government: Order and Change in World Politics} 3 (M. Rolén et al. eds., 1992).


\textsuperscript{142} See id. at 20–27; Paul Hirst & Grahame Thompson, \textit{Globalization in Question} 88–94 (2d ed. 1999).

\textsuperscript{143} See Weiss, \textit{supra} note 141.

\textsuperscript{144} See Juan Rada & Alex Trisoglio, \textit{Capital Markets and Sustainable Development},
capital markets shape future development and, thus, consequential environmental pressures, it is vital to reform capital market processes to promote environmentally sustainable, long-term investment. These reforms may be a highly efficient and effective means for deterring unsustainable development, which could result in enterprises, whose activities meet requirements of sustainability, being valued more highly by markets. There is uncertainty, however, regarding the viability of harnessing investment systems to promote sustainable development, and some research suggests that environmentally responsible investment may yield a lower financial return or that institutional investors may lack sufficient incentives and means to influence corporate environmental behavior. Conversely, there are indications that markets are increasingly interested in information regarding businesses' environmental activities as evidenced by the movement for ethical investment. More empirical research is needed to identify how institutional investors may effectively influence corporate environmental activities and thereby contribute to environmental regulation.

Institutional investors increasingly dominate capital markets. In recent decades, there has been a flood of institutional savings as people make private provisions for old age in the face of declining state welfare entitlements. As financial intermediaries, investors

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COLUM. J. WORLD BUS., Winter 1992, at 42, 44.

145 See id. at 49.
146 See id.
149 Lanoie et al., supra note 80, at 40.
151 See Bloomestein, supra note 110, at 116.
assist with risk reduction by pooling and diversifying assets and lowering the transaction costs of contracting and information processing. Institutional investors are not a coherent group, and there exist a vast array of investment entities, including public and private pension funds, mutual funds, life insurance companies, university foundations, and funds managed by banks. A technical distinction can be made between institutional investment per se, involving, for example, the investment actions of pension funds using their beneficiaries’ monies and retail investment, where individuals directly contribute to a mutual fund or unit trust that specializes in investing in certain market segments. In both cases a specific investment institution is making and managing investments. Within the OECD area, insurance companies are the largest investors followed by pension funds. The scale of institutionalization of investment activity has differed considerably across countries, with investments more institutionalized in the United States and the United Kingdom than in the bank-based financial systems of Japan or Germany where there is a weaker equity culture. Although they invest for different purposes and with different obligations, most institutional investors can be characterized as managers of assets on behalf of someone else to whom they owe a duty as fiduciaries. The financial assets held by institutional investors mainly comprise shares, bonds, and loans, although investments in company shares have grown rapidly.


153 See id. at 815.


158 See Brancato, supra note 150, at 7, 27–29.
Since sustainable development emphasizes maintenance of natural and human capital for future generations, the role of capital markets is plausibly of central underlying relevance to sustainability strategies. Financial markets typically provide capital to achieve a positive return or at least not a negative return. Although there is obviously a difference between financial capital and the broader notion of capital in sustainable development, financial capital is relevant, since it enables major investments to occur, such as technological and product innovations, which invariably have environmental effects of some kind. Capital markets are prone to distorting levels of economic activity depending on what has appealed to or deterred investors. Speculative bubbles in some sectors consume scarce investment resources. Whilst in other markets, potential borrowers for productive investments are deprived of funding at rates that reflect apparent risks. The institutional and policy frameworks of capital investment systems are, thus, crucial to the building of sustainable productive capacities.

The existence of adequate information for investors is one of several important preconditions for the efficient operation of capital markets as a mechanism for resource allocation. Information regarding corporate environmental performance is emerging as a salient factor in investment calculations. According to a Swedish government study, the main types of environmental-connected information of potential interest to financial institutions are: costs associated with company compliance with relevant environmental legislation; managerial and organizational environmental competence; potential liabilities


160 See id.


163 See Lanoie, et al., supra note 80, at 32.
from pollution emissions; and resource consumption.164 When new information about a company’s increased future production costs or reduced revenues arise from environmental regulation changes, investors may revise their expectations.165 A shift in market values may create strong incentives for investment in environmental care since losses of market value, the “reputational penalty,” may be larger than concomitant regulatory sanctions.166 Changes in share values may, thus, reflect estimates of changes in the net present value of expected profits. Evidence of good environmental performance may indicate to capital markets a superior ability to generate costs savings and improve revenues, whilst evidence of pollution violations and prosecution may result in markets downgrading a profits forecast.167 Existing research suggests that environmental liabilities, such as corporate spending on contaminated land cleanups, are regarded as more salient to market valuations than “beyond compliance” efforts, such as voluntary investments in energy efficiency.168 Company environmental policies and procedures also tend to be less useful to financial analysts than environmental information translated in terms of its impact on firm earnings and profitability.169

Moreover, research suggests that investor reaction to environmental information about firms depends significantly on the extent to which the information is unanticipated news predicted to affect a firm’s profitability.170 Several studies reveal negative market returns to firms in affected industries following announcements related to proposed tightening of environmental regulations.171 For example, in a study of market reaction to

165 See Lanoie et al., supra note 80 at 39.
166 Id., at 38–39.
167 Id., at 39.
170 See Lanoie et al., supra note 80 at 32.
171 See Myles S. Wallace et al., Environmental Regulation: A Financial Markets
disclosures under the United States’s Toxic Release Inventory (TRI) program, Khanna and others noted, “the largest declines in stock prices, were not targeted toward the largest emitters, but toward firms that were not ‘known’ to be polluters on the basis of prior environmental information available to investors.” Among the major studies regarding individual firm information, Muoghalu and others found a statistically significant loss of share value following the initiation of lawsuits related to the United States’s Resource Conservation and Recovery Act of 1976. Although in their study of environmental enforcement actions in Canada, Lanoie and Laplante detected no market losses when lawsuits were initiated, they did observe immediate abnormal losses between 1.65 and 2% when the firm was found culpable and fined. Conversely, Klassen and McLaughlin found a correlation between announcement of environmental awards, signifying public recognition of environmental excellence, and improved market valuations on average of 0.82%. In contrast to the foregoing analyses, several studies have investigated the market impact of comparative information, which directly compares firms with poor performance to those with positive conduct. Shane and Spicer found that firms identified in public reports as major polluters lost greater market value than those with a cleaner ranking. In a study of financial market reactions to firms ranked for their emissions under the TRI requirements, Hamilton found that the larger the number of


177 Id. at 534.
chemicals a firm reported to produce or handle, the larger loss the firm suffered in its market value over a given period. Similarly, Khanna and others detected significant negative stock market returns for firms following repeated announcements of TRI information, especially for firms whose environmental performance declined over time relative to other firms. Interestingly, Koner and Cohen discovered that firms with the largest decline in share value following announcement of TRI information subsequently reduced their pollution emissions further than other firms in the same industry sector.

Overall, current research suggests a correlation between sound environmental practices and improved market value. Investors infer that because of poor environmental performance a culpable firm will incur various costs that will diminish its profitability. The increased price of capital, thus, provides a mechanism for articulating the social and environmental costs of corporate risk-generating behavior. Nevertheless, despite more investor awareness of the salience of environmental performance to market valuation, no model has yet been formulated that systematically charts the relationship between corporate environmental practices and market value. The role of institutional investors will be crucial to the future response of capital markets to environmental performance.

B. Institutional Investor Characteristics

Institutional investors have diverse legal structures, financial objectives, and investment strategies. The main classes of investors are pension funds, life insurance companies, and investment companies. These investors pursue an array of investment models ranging from funds that are actively managed to those that rely on passive investment strategies based on index techniques. Important factors influencing investment strategies

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179 Khanna et al., *supra* note 172.


181 See id. at 112–13.

are the financial objectives of the institutional investor, the regulatory and tax regime, and risk preferences. A common characteristic of institutional investors is that they are financial intermediaries, pooling the funds of market participants and using those funds to purchase a portfolio of securities, real property, and other financial assets. Institutional investors differ from banks that merely take short-term deposits from customers, although deregulation in the financial services sector has resulted in banks increasingly participating in investment and other financial activities.

Regarding the characteristics of individual investor classes, life insurance companies concentrate on longer-term debt instruments, such as bonds and mortgage loans. Since non-life insurance companies tend to have mainly short-term liabilities that are harder to forecast, their need is for liquidity (to raise capital quickly), and accordingly, equities feature strongly in their investment portfolios. Pension regimes can be differentiated primarily between public-managed pension schemes and occupational pension schemes. Because pension funds benefit from regular inflows of funds and have long-term liabilities, they tend to concentrate their portfolios on long-term assets yielding stable returns. Pooled investment vehicles, which often take the legal form of a company, are financial intermediaries that sell shares to the public and invest the proceeds in a diversified portfolio of securities and assets. Examples of investment companies include unit trusts, investment trusts, hedge funds, and venture capital funds. Their investment strategies are wide-

(analyzing alternative approaches).

183 Blommestein, supra note 110, at 47.
184 See id. at 38–39.
185 Id. at 33. Of course, in the bank-based corporate governance systems in continental Europe and Japan, banks are often significant shareholders in their own right. See id. at 61–63.
186 See id. at 71.
187 See id. at 73.
189 See BARNARD SELIGMAN, CHOOSING AN INVESTMENT COMPANY 21 (1987).
190 See Blommestein, supra note 154, at 69.
ranging with some concentrating on equities, whilst others opt for bonds, real estate, or speculation in currency and commodity markets.191

The influence of fund managers is an important characteristic of the investment community, and strategies to mobilize investors as pathways of environmental influence must contend with the pre-eminent role of fund managers. Many investment institutions delegate responsibilities to separate and specialist fund managers.192 Fund management can be carried out internally or externally by a bank or an independent money management firm, for example. Fund managers often simultaneously manage money on behalf of a wide variety of investment entities. Delegating investment strategies to fund managers raises principal-agent problems, although internal fund managers appear to pose fewer such problems than external ones.193 A survey of British pension funds' implementation of the new Socially Responsible Investment (SRI) policy disclosure requirements under pensions legislation194 found that 27% of funds delegated authority over SRI to their fund manager, and 48% of funds requested that their fund managers take account of SRI, if such concerns were seen as financially relevant.195 Obviously, because there is considerable potential for subversion of SRI objectives through lax delegation arrangements, it is important that investment principals set clear objectives for their fund managers. These investment principals must be consistent with the institution's investment principles and objectives and establish appropriate monitoring and evaluation mechanisms.

The expansion of the institutional investment community and their increasing influence on the structure and operation of capital

191 See Portfolio Strategies, 8(24) EMERGING MARKETS WEEK 4–6 (2000).
193 Blommestein, supra note 110, at 45.
194 Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc.), Amendment Regulations, 1999, No. 1849(2)(4)(b) (Eng.).
markets and economic activity poses new policy challenges to regulators. Almost every institutional investor is governed by some form of public regulation and supervision.\textsuperscript{196} Public intervention into capital markets has typically been a response to market failures regarding information asymmetry, externalities, and monopolistic practices.\textsuperscript{197} Among the extensive menu of regulations are requirements for disclosure of reliable information to investors, fair valuation of investor purchasers, management fees, and specification of investor objectives and policies.\textsuperscript{198} Traditionally, regulatory supervision of institutional investments concentrated on solvency issues and prudential controls to ensure that institutions would be able to fulfill their respective obligations to policy-holders, plan participants, and other beneficiaries.\textsuperscript{199} The environmental dimensions of investment have hardly been a feature of investment regulation.

Risk management is an important element in public regulation of institutional investors' activities, offering a potentially useful framework for facilitating the inclusion of corporate environmental performance issues in portfolio selection. In some jurisdictions, especially Europe, public regulatory entities apply quantitative regulations of investment portfolios, such as restrictions on particular classes of investments including foreign securities, real estate, and loans. These investment ceilings serve to limit default and liquidity risks.\textsuperscript{200} In some countries, regulatory requirements for maturity and duration matching also exist to ensure longer-term liabilities, such as life insurance, can be met.\textsuperscript{201} But, because investment limits may be perceived as stifling

\textsuperscript{196} ANTHONY OGUS, REGULATION: LEGAL FORM AND ECONOMIC THEORY 15 (1994).
\textsuperscript{197} Id. (explaining economic theories of regulation).
\textsuperscript{198} See, e.g., TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 15–54 (1999).
\textsuperscript{199} See ORG. FOR ECON. COOPERATION AND DEV., INSURANCE SOLVENCY SUPERVISION (1995); R.M. PECCHIOLI, ORG. FOR ECON. COOPERATION AND DEV., PRUDENTIAL SUPERVISION IN BANKING (1987).
\textsuperscript{201} OECD, supra note 155, at 25.
financial innovation and constraining investment efficiency, other jurisdictions, such as the United Kingdom and United States, articulate risk management through an alternative "prudent person" standard.\textsuperscript{202} Although the interpretation of this standard differs in each jurisdiction, it generally requires trustees and fund managers to follow high fiduciary standards in investing funds but without government prescription of specific investment practices.\textsuperscript{203} No limits to portfolio distributions exist here save for a limit on self-investment. The prudent investment standard manifests itself in two particular ways: the diversification of investments and the pursuit of indexed modes of investment. Because of this tendency to cause uniform investment practices and herding responses, the prudent person standard has attracted criticism.\textsuperscript{204}

The diversity and complexity of investment institutions and their regulation, thus, can be seen as possibly overwhelming to environmental policy-makers interested in forging ways to reorient capital markets towards sustainable development. The systems of prudential regulation have been geared to addressing market risks and consumer protection issues, leaving little policy space for entertaining environmental issues. Nevertheless, as the following sections show, the investment community is a dynamic sector in which opportunities for environmental-oriented investment strategies will be pursued when financial rewards are perceived to be obtainable.

C. Institutional Investors and Environmental Policy

1. Growth of environmental-oriented investment

Environmentally responsible investment portfolios have emerged in considerable numbers in recent years.\textsuperscript{205} Such investments may be undertaken as part of the policies of an

\textsuperscript{202} See Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986).
\textsuperscript{203} See, e.g., Pensions Act, 1995, c. 26(2) (Eng.); see also Paul G. Haskell, The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory, 69 N.C. L. Rev. 87 (1990) (discussing the prudent person rule for investments).
\textsuperscript{204} Davis, supra note 188, at 96–98.
\textsuperscript{205} Mark Mansley, Financing the Environmental Sector, 22 UNEP INDUS. & ENV’T 28 (1999).
institutional investor, such as a pension fund, or undertaken through the retail investment markets, where individuals invest in mutual funds, unit trusts, and other specialist investment vehicles. In either case, ethical investment considers the social and environmental impact of firms alongside financial performance.  

For ethical investors, good environmental achievements may be construed as an indication of business health, whilst poor environmental performance may result in adverse company publicity or even pollution liabilities. Acting, in effect, as environmental monitors, ethical investment institutions could assist government authorities seeking more effective mechanisms to penetrate and supervise markets. In contrast to market liberalism, ethical environmental investment offers the promise of uniting economics with politics as peremptory values derived from outside market transactions arise to shape market activity.

Responsible investment is commonly articulated through ethical screening, also known as “portfolio screening,” which entails the inclusion or exclusion of stocks in investment portfolios on environmental grounds. Company subscription to voluntary environmental codes and standards can serve as useful benchmarks in the screening process. An effective screening approach entails follow-up monitoring to ensure that preferred enterprises are meeting environmental performance expectations. A second method of responsible investment is shareholder activism, in which investor shareholders seek to improve a company’s environmental behavior by means of dialogue, pressure, or support for responsible management. Shareholder activism may involve internal pressure, where the shareholder invests in a particular firm engaging in objectionable activities

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207 Schmidheiny, supra note 93, at 10–11.


with the aim to convince management to change its policy.\textsuperscript{210} Shareholder resolutions concerning social policy, governance and board composition, and voting at annual general meetings are methods by which investors seek to direct a company towards more ethically laudable goals.\textsuperscript{211}

Current figures suggest that whilst there has been no great shift in investment strategies, there is a blossoming retail investment market in environmental and social investment funds and growing commitments to ethical investment among institutional investors. In Western Europe, there were estimated to be some 250 specialist ethical investment funds (excluding religious-based funds) operating in June 2001, up from a mere fifty such funds a decade earlier.\textsuperscript{212} Among the better-regarded institutions are the Ökobanka and UmweltBank in Germany,\textsuperscript{213} the Ethical Investment Co-operative\textsuperscript{214} in the United Kingdom, and Canada’s Ethical Growth Fund.\textsuperscript{215} Insurance companies also control a number of environmental funds, such as Norway’s Storebrand Scudder Environmental Value Fund established in 1996.\textsuperscript{216} Reflecting its large equity markets, the United Kingdom accounted for the largest share with sixty-two funds.\textsuperscript{217} Perhaps, a more relevant indication of the growth and volume of the ethical investment

\begin{thebibliography}{99}
\bibitem{210} Elizabeth Judd, \textit{Investing with a Social Conscience} 10 (1990).
\bibitem{211} Amy Domini & Peter D. Kinder, \textit{Ethical Investing} 9 (1984).
\bibitem{212} Sustainable Investment Research International Group, \textit{Green, Social and Ethical Funds in Europe 2001, 2002}, at 7, at http://www.cseurope.org/uploadstore/cms/docs/fundsreport2001.pdf (on file with the North Carolina Journal of International Law and Commercial Regulation). Examples of ethical funds include: Friends Provident Stewardship Unit Trust (U.K.), Banco Samarit Fond (Sweden), and ASN Aandelensfonds (Holland). Some ethical funds have a particular environmental focus, such as Jupiter Ecology (U.K.) and KD Fonds Ökoinvest (Germany).
\bibitem{214} See Ethical Investment Co-operative, at http://www.ethicalmoney.org (last visited Nov. 3, 2002).
\bibitem{217} \textit{Id.}
\end{thebibliography}
sector is its relative market share. In the United Kingdom ethical investment in September 2001 comprised a mere 3.5% share of the investment market, compared to 13% in the United States.\textsuperscript{218} In Canada, environmentally and socially responsible investment assets were estimated in June 2000 at some C$49.9 billion, representing 3.2% of the retail mutual fund market and the institutional investment market.\textsuperscript{219}

In addition to niche investment entities, mainstream investment houses are seeking to offer environmental and social responsibility investment lines. For example, VicSuper, one of the largest public superannuation funds in Australia, in December 2001 opened an environmental investment option that allows members to channel their account balance into environmentally sound companies.\textsuperscript{220} Overall, the value of the world’s ethical investment portfolio was estimated in September 2001 at US$1.42 trillion (excluding the church sector), the United States overwhelmingly dominated, holding 92% of the portfolio.\textsuperscript{221} The emergence of several indices to track ethical investments point to the growing legitimacy of this sector. Leading ethical investment indices include the Dow Jones Sustainability Group Index (DJSGI)\textsuperscript{222} and the United Kingdom’s Financial Times Stock Exchange’s (FTSE) “ethical index.”\textsuperscript{223}

Incorporating environmental performance into the investment calculus can be complicated. Obstacles include uncertainty concerning the environmental integrity of a product or company performance and the problem of comparing corporate


\textsuperscript{221} Cerulli Associates, \textit{supra} note 218.

\textsuperscript{222} See Dow Jones Sustainability Group Index, \textit{at} http://www.sustainability-index.com (last visited Nov. 2, 2002).

\textsuperscript{223} Stephen Foley, \textit{FTSE’s “Ethical Index” to Include Oil Giants}, \textit{The Indep.}, April 12, 2001, at 19.
environmental performance.224 Difficulties may occur in defining the appropriate boundaries of corporate performance – some firms may appear to achieve superior environmental performance by sub-contracting or out-sourcing their dirtier operations, thus raising the question of whether and how the environmental impact of a company’s subsidiaries and suppliers can be included in analysis.225 These uncertainties feed the risk of firms “free riding” on the environmental achievements of others in shared market sectors. Numerous systems have been formulated for the rating or ranking of corporate environmental performance,226 but problems exist in comparing rival evaluation systems given the existence of dissimilar assessment methodologies.227 To improve the transparency of rating and ranking systems and increase the availability of high quality environmental performance data, some commentators advocate mandatory environmental disclosure schemes linked to financial reporting.228

Similar complexities permeate the definition of environmental or ethical investment. The problem with environmental investments is how to determine eligibility criteria and the transparency of such offerings. “Ethical investment” tends to be a self-awarded title; the institutions set their own criteria for what is ethical.229 For some, ethical investment products offer a commodified and privatized ethics that eschew any serious reflection on the normative issues at stake. Just as the veracity of notions of business ethics have been questioned and critiqued, so too the ethical investment movement is vulnerable to being dismissed as a façade, in which ethics are connected to profits to humanize and legitimate capitalism.230 Passively contributing to

226 See, e.g., Sustainable Asset Management, Switzerland; Storebrand-Scudder Environmental Value Fund, Norway; Index of Corporate Environmental Engagement, Business in the Environment, U.K.
227 Skillius & Wennberg, supra note 98, at 136.
228 Id. at 157–58.
ethical investment funds arguably cannot be a substitute for proper ethical deliberation occurring within mainstream political processes. As Filsner and Cooper caution: "[f]or the investor the environment is not an issue in itself. . . . Environmental awareness is simply a framework within which such issues as energy efficiency, waste management, and product design and packaging can be examined." If so, then reflexive considerations of environmental impacts within financial markets need to take their cues from the broader political system regarding the definition of appropriate environmental uses and standards. Initiatives to publish independent benchmarks or criteria for ethical investment practices can assist in providing a useful reference point for investor activity. Ethical investment associations and research services can also contribute meaningfully to the formulation of criteria and methodologies for environmental funds because they are not directly tied to the profit considerations that can impede the development of ethical positions in mainstream market institutions.

2. Institutional investors in corporate governance

Besides improving access to financial resources for green companies, ballooning investment funds have also ostensibly enhanced investors' leverage over corporate management. Through their institutional dominance of the equity market, this barrier to shareholder control has now been somewhat diluted, and powerful investors are better positioned to be corporate watchdogs and facilitate improvements in corporate governance. But,
whilst Geltman argues, "concerned investors have been at the forefront of forcing management to examine corporate environmental practices," others remain skeptical of this side role of institutional investor practice or at least believe investors need to be much more proactive in order to be effective. For professional institutional investors, modern investment strategies are said to have become "the science of constructing the optimal portfolio" with the focus on "short-term performance and liquidity rather than the fundamental value of companies." But, according to Monks and Minow, institutional investors "have two indisputable motives for paying close attention to [corporate] ownership: avoiding liability for breach of fiduciary duty and enhancing portfolio values by promoting management accountability." Because of these basic characteristics, some scholars believe investors may be able to influence corporate environmental behavior directly through pressure on corporate management or indirectly through share trading tactics. Thus, removal of specific regulatory constraints on institutional activism may make more extensive institutional influence possible.

Fund managers have an incentive to nurture good corporate governance because of their fiduciary duty to take an active role in institutions by the full exercise of their principal’s shareholder entitlements, including voting of proxies. This fiduciary duty obliges them to carefully monitor their holdings and protect the value of investments. It may necessitate balancing index fund

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236 Elizabeth G. Geltman & Andrew E. Skroback, Environmental Activism and the Ethical Investor, 22 J. CORP. L. 465, 467 (1997) (for example through shareholder proposals).


241 See Gunningham & Grabosky, supra note 34, at 113–14.

strategies with active monitoring. The nature of fiduciary duties, however, varies among institutions, and life insurance companies are not subject to fiduciary responsibilities analogous to those imposed upon pension fund trustees. Arguments advancing the regulatory role of institutional investors often focus on the possibility of enhanced shareholder control, since individual shareholders generally lack the resources or economic incentives to participate in monitoring management actions.

In contrast to individual investors, institutional funds are acquiring a role in corporate governance in several ways. A primary way is through enhanced market control derived from equity and debt holdings. As major shareholders, institutional investors have a central role in takeovers. Second, control via equity can occur through increased shareholder activism, manifested by voting decisions, resolutions, and other mechanisms for influencing management. Shareholder proposals sponsored by institutional investors are a routine tactic by which institutions seek to achieve their goals in disciplining corporate management or influencing aspects of company policy. Control through debt is more important for corporate supervision in continental Europe and Japan, where banks play a key role in monitoring finances. Holland suggests investee companies may hold important advantages over conventional state regulation: "active and effective use of this interconnected system of (corporate governance) controls may therefore reduce the need for more formal and costly additional legislation, and for extensive monitoring and implementation of sanctions by public policy.


247 Blommestein, supra note 110, at 65.
The expanding influence of institutional investors in corporate governance has been noted in various jurisdictions. In Canada, institutional investors have been reported abandoning traditional passive investment strategies, especially in relation to combating ineffectual management. In the United States, pension funds have exploited the shareholder proposal procedure provided under the Securities Exchange Act of 1934 including proposals about environmental accountability on annual meeting ballots. But, in the United Kingdom, the recent Myners report revealed "evidence of general reluctance to tackle corporate underperformance in investee companies," attributable to such factors as a culture among investor institutions that "seeks to avoid conflict" and a potential conflict of interest, where fund managers hold a financial interest in investee companies.

IV. Potential Barriers to Ethical Investment

A. Limited shareholder liability

The prophesied role of institutional investors steering markets toward sustainable development faces various legal and economic restraints. Whilst probably not insurmountable barriers, they do require government intervention to be overcome. Limited shareholder liability is one such restraint. The cardinal principle in Western corporate law is the axiom that the company is a separate legal person from the members who comprise it. A corollary

248 Id.
249 See, e.g., Del Guercio & Hawkins, supra note 246.
252 See Geltman & Stroback, supra note 235, at 483.
254 Id. at 11.
255 Id. at 14.
principle is that absent exceptional circumstances, investors in the company are not liable beyond the amount they invest. If the value of liability or other claims against the company exceeds the value of the firm’s assets, the owners risk losing only their investment in the company. The corporate law doctrine of limited liability is now legislated in nearly all jurisdictions. Corporate limited liability has the potential adverse effect of transferring uncompensated business risks to creditors and can undermine the “polluter pays” principle to the extent that insolvent firms are able to abandon environmental debts. Thus, in principle, imposing liability on institutional shareholding investors for the environmental impacts of their portfolio companies could discourage environmentally irresponsible investments.

In practice, however, extending shareholder liability would be politically contentious and could create major economic disincentives to new investment. This ceiling on liability is justified because it is seen as serving a number of beneficial functions. Limited liability is applauded for encouraging business formation by sparing investors the risk of personal financial ruin. Additionally, by limiting the risks faced by shareholders to the amount they contribute, limited liability improves the liquidity and efficiency of security markets. It also reduces the monitoring costs of shareholders; investors need no longer individually monitor management behavior to prevent losses they would otherwise incur. Concomitantly, the reduced monitoring burden enables investors to achieve a more efficient, diversified portfolio of assets to reduce their risk of business failure. These justifications for limited liability, however, have been strongly
contested and are seen by some commentators as out-weighed by the moral hazard that arises when corporations over-invest in risky activities.\textsuperscript{264} Certainly, the crushing exertion of environmental liability will, in due course, force liquidation of the enterprise,\textsuperscript{265} but not before the enterprise has inflicted severe harm from a social efficiency standpoint.

In contrast to the received wisdom of limited shareholder liability, Blumberg argues that the doctrine was introduced as a "political response to economic and political pressures, rather than as a necessary consequence of the entity concept."\textsuperscript{266} Limited liability for shareholders is in effect a subsidy for investment, insulating shareholders from the environmental risks incurred by corporations and so encouraging over-investment in hazardous activities.\textsuperscript{267} The concentration of stock ownership by a few companies or individuals suggests that the reality of shareholder and corporation separation can be a fiction. In the circumstance of a closely held corporation or corporations wholly owned by a parent corporation, it has been argued that limited liability should be abandoned.\textsuperscript{268} Major institutional shareholders, relatively well placed to obtain information and monitor the risks of companies' activities, may also be in position to influence the environmental activities of corporations.\textsuperscript{269} The victims of toxic torts and statutory violations, by contrast, arguably are less well placed to monitor and avoid the environmental risks of companies' activities. Limiting the liability of investors is also associated with shareholder passivity by "decreasing the personal responsibility on which the integrity of democratic institutions depends."\textsuperscript{270}


\textsuperscript{265} Alan Schwartz, Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship, 14 J. LEG. STUD. 689, 715 (1985).

\textsuperscript{266} Philip I. Blumberg, Limited Liability and Corporate Groups, 11 J. CORP. L. 573, 595 (1987).

\textsuperscript{267} Hansmann & Kraakman, supra note 264.

\textsuperscript{268} Blumberg, supra note 266, at 630; see also Paul Halpern et al., An Economic Analysis of Limited Liability in Corporation Law, 30 U. TORONTO L. J. 117, 148 (1980).

\textsuperscript{269} See Gillan & Starks, supra note 245.

\textsuperscript{270} MONKS & MINOW, supra note 240, at 10.
Various mechanisms have been devised to neutralize the adverse effects of limited liability short of its wholesale abandonment. These include equitable corporate-veil piercing rules and statutory exceptions purporting to override limited liability rules where actions inconsistent with the separate personality of entity and owners have been taken. Corporate veil-piercing may be permissible for a closely-held corporation, where there is greater scope for shareholder monitoring and participation in management. In general, however, courts rarely pierce the veil, which usually requires the presence of a highly dominating shareholder that has manipulated the corporate structure to defeat some public convenience or perpetrate a fraud or other crime. For example, in Anglo-American law, institutional investors and other financial institutions that behave like "shadow directors" can become liable for corporate decisions. Examples of statutory exceptions under the United States's Superfund legislation include imposing responsibility on parent companies for the pollution cleanup costs generated by its subsidiaries. But, attempts to statutorily hold shareholders directly liable for their company's environmental impact have not been entirely successful because of narrow interpretations by courts of liability producing situations.


272 See Presser, supra note 261, at 157; Carsten Alting, Piercing the Corporate Veil in American and German Law—Liability of Individuals and Entities: A Comparative View, 2 TULSA J. COMP. & INT'L L. 187, 190 (1995); Mendelsohn, supra note 271, at 1271–72.


275 See N.R. Campbell, Liability as a Shadow Director, 1994 J. BUS. L. 609.


Scholars have debated at length alternative means of achieving a balance between the economic virtues of limited liability and the need to contain its cost externalities.\textsuperscript{278} Mendelson has advocated a "capacity to control" test whereby major investors that possess a controlling influence could be held liable for corporate wrongs.\textsuperscript{279} In relation to lender liability, Superfund liability was interpreted in the seminal \textit{United States v. Fleet Factors Corp.} case as extending to a bank lender where its involvement in the financial management of the corporation gave it the "capacity to influence" decisions, despite the lack of involvement in the actual operation of the business.\textsuperscript{280} The Court of Appeals reasoned that extending liability to lenders would create disincentives for banks to extend financial assistance to businesses with potential waste problems.\textsuperscript{281} Liability for a corporation’s environmental damages could also be imposed on a shareholder when the size of its holdings gave it the capacity to significantly influence the corporation.\textsuperscript{282} Consequently, institutional investors in a controlling position would be compelled to supervise company managers more closely to minimize the company’s exposure to environmental or other liabilities. On the other hand, Mendelson argues a capacity to control test would continue to offer the efficiencies that non-controlling small investors enjoy under limited liability.\textsuperscript{283} Determination of what amounts to a controlling influence, of course, would require careful consideration in cases where shareholders hold less than a majority of the equity.\textsuperscript{284} In addition to discouraging overly risky activities, imposing liability on controlling investors would likely reduce demand for shares in companies that continue to engage in risky activities.\textsuperscript{285} Yet, a

\begin{itemize}
\item \textsuperscript{278} Mendelson, \textit{supra} note 271, at 1204–05.
\item \textsuperscript{279} \textit{Id.} at 1206.
\item \textsuperscript{280} \textit{United States v. Fleet Factors Corp.}, 901 F.2d 1550, 1557 (11th Cir. 1990).
\item \textsuperscript{282} See \textit{id.}
\item \textsuperscript{283} Mendelson, \textit{supra} note 272, at 1271–79.
\item \textsuperscript{284} It has been suggested that holding only five to ten percent of corporate shares may amount to possessing some significant control. See Victor Brudney, \textit{Equal Treatment of Shareholders in Corporate Distributions and Reorganizations}, 71 CAL. L. REV. 1072, 1073–74 n.2 (1983).
\item \textsuperscript{285} See \textit{id.}
\end{itemize}
capacity to control test could have an over-deterrence effect because by imposing liability entirely on the controlling shareholder, rather than all shareholders, it could encourage the controlling entity to deter corporate management from undertaking somewhat risky but overall socially valuable investments. For the foreseeable future, it does not appear that legislators or courts are likely to embrace any far-reaching changes to the doctrine of corporate limited liability.

B. Fiduciary Activism and Corporate Environmental Responsibility

The level of institutional activism is often not easy to determine because, as one commentator sees it, "[t]here is a lot of 'behind the scenes' or 'paddling under water' involved in influencing companies." Institutional investors theoretically gain direct power from the voting rights present in their ownership stakes, and the greater the stake in the company the greater the potential influence. This power may include the right to vote on appointment of directors, approve or reject proposed mergers, sell substantial assets, and charter amendments. Yet, because of legal constraints on concentrated ownership; fiduciary obligations that require extensive diversification to minimize risk; and a strong preference for liquidity, institutional investment agents have tended to seek portfolios comprised of fragmented holdings across a plethora of companies. This fragmentation can reduce the influence of an investor or discourage activism because the stakes may be considered too small given the size of the institution's equity holdings. A cardinal principle of creating an

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286 See id.
287 See id.
290 Id. at 400.
292 See id. at 303.
efficient investment portfolio is diversification.\textsuperscript{293} Theory suggests that rational economic actors who diversify only face undiversifiable or "systemic" risk, this being the general risk of the market as against a particular share.\textsuperscript{294} But, according to Garten, "the logic of diversification . . . may dictate otherwise."\textsuperscript{295} Holding twenty rather than 2,000 stocks may lower the cost of monitoring all portfolio companies as well as increasing the investor's share of any gain (or loss) resulting from active involvement in the affairs of each company.\textsuperscript{296}

Besides the effects of portfolio diversification, institutional passivity has been linked to uni-dimensional corporate performance indicators, such as share price movements and quarterly earnings statements, which can foster a short-term orientation among market players.\textsuperscript{297} Fund managers are typically measured on annual or quarterly appreciation of funds compared to stock indexes, serving to heighten their attention to short-term stock price movements.\textsuperscript{298} Further, "return-conscious" managers may be hesitant to risk the costs of institutional activism.\textsuperscript{299} Like entrenched corporate managers, who use control to advance their own interests at the expense of shareholders, professional money managers may fail to act properly for the interests of their beneficiaries.\textsuperscript{300} Mutual funds, designed for maximum liquidity because they offer daily sale or repurchase, are considered particularly vulnerable to short-term and passive investment decision-making.\textsuperscript{301} Because of their extended liabilities, life

\begin{thebibliography}{99}
\bibitem{294} For analysis of economic theories of systemic market risk, see E. PHILIP DAVIS, DEBT, FINANCIAL FRAGILITY, AND SYSTEMIC RISK 133–34 (1992).
\bibitem{295} Garten, supra note 239, at 624.
\bibitem{296} Id.
\bibitem{297} Rada & Trisoglio, supra note 133, at 45.
\bibitem{299} Garten, supra note 239, at 627.
\bibitem{300} Id. at 628–29.
\bibitem{301} MONKS & MINOW, supra note 240, at 201–02.
\end{thebibliography}
insurance companies and pension funds are instruments for longer-term saving over periods of twenty or thirty years. Both institutional sectors face only small liquidity risks, emanating principally from transfers and withdrawals in the case of pension funds, and premature surrenders in the case of insurers. Further, the enormous size of some funds significantly diminishes the option of full disinvestments from a company, owing to the potential adverse effect on share price. The spread of indexed portfolios also means that funds are compelled to adhere to overall market trends.

In addition to the debates regarding investor myopia, institutional investors may face obstacles when coordinating action against under-performing company management. Fragmented portfolio holdings may have the effect of reducing the influence of institutional investment funds unless investors are able to coordinate their influence. Proxy rules in some jurisdictions may hamper inter-institutional communication and coalition formation against incumbent management. For example, until recently, the Canada Business Corporations Act of 1985 allowed corporate management to bar shareholder proposals lodged "primarily for the purpose of promoting general economic, political, religious, social, or similar causes" from the management proxy circular. Overall, the regulatory trend in industrial economies has been for securities watchdogs progressively to liberalize rules restricting shareholder proposals from management’s proxy statement.

Apart from proxy rules, institutions may lack incentives to take

302 See id.
303 Davies, supra note 192, at 79.
304 Id.
306 Id.
308 R.S., 1985, c. C-44, s. 1; 1994, s. 137(5)(b).
309 This provision was repealed in February 2001. R.S., 2001, c-14, s. 59.
action individually if intervention in corporate affairs achieves small, deferred, and diffused benefits, whilst the upfront transaction costs are large.\textsuperscript{311} Macey argues that the returns from institutional investment activism are invariably shared with other investors, yet these rival investment funds may not incur any of the costs.\textsuperscript{312} Some other scholars suggest the costs of institutional activism may be over-stated.\textsuperscript{313} According to Garten, “institutional activism does not have to be expensive. Reading proxy material and voting is easy. Submitting a proposal for inclusion in the company’s proxy statement is less expensive than mounting a proxy fight. Telephoning incumbent management may be the cheapest action of all.”\textsuperscript{314} Some forms of activism, such as shareholder proposals, also offer the possibility for economies of scale for institutions holding shares in multiple companies.\textsuperscript{315} Further, through the emergence of institutional shareholder organizations, such as the United States’s Council of Institutional Investors or the Association of Canadian Pension Management, many collective action problems may dissipate.\textsuperscript{316}

In Anglo-American legal systems, Parkinson identifies two means by which institutional investors have cooperated to intervene in corporate affairs.\textsuperscript{317} These are collective action through peak associations, and informal collaboration among institutions to apply pressure on individual company boards.\textsuperscript{318} Intervention is most common in a crisis management scenario.\textsuperscript{319} In the bank-based economy of Germany, where banks often hold significant equity stakes in companies in addition to providing debt financing, banks more actively supervise corporate clients’

\textsuperscript{311} See id. at 370.
\textsuperscript{312} Jonathan R. Macey, Institutional Investors and Corporate Monitoring: A Demand-Side Perspective, 18 Managerial & Decision Econ. 601, 608 (1997).
\textsuperscript{313} Garten, supra note 239, at 627.
\textsuperscript{314} Id.
\textsuperscript{315} Black, supra note 235, at 581–84. Garten comments, “an institution can limit its lobbying efforts to one test case, which, if well publicized, may persuade other companies to accept the [shareholder] proposal.” Garten, supra note 239, at 644.
\textsuperscript{316} Id.
\textsuperscript{318} Id.
\textsuperscript{319} Id.
German banks have been known to take account of environmental concerns in their investment decision-making.\textsuperscript{321} Japanese banks have been known to oust incumbent management with their own nominees where firms have performed poorly.\textsuperscript{322} Also, in both jurisdictions, the corporate equity holders more often adopt longer-term investment positions than do institutional investors in the United States or United Kingdom.\textsuperscript{323} In the latter, collective action by institutions has covered such matters as executive compensation and proposals that directly affect shareholders' influence within the company or schemes posing major corporate change.\textsuperscript{324} Investors are less likely to intervene to change business policy, although the possibility to do so arises particularly when a company needs to replenish its finances through the capital markets.\textsuperscript{325} Cohen argues that through the use of codes of conduct and other measures, "fiduciary activism by pension and mutual funds has begun to extend beyond prosaic issues of corporate governance to encompass sensitive policies with respect to social issues and environmental management."\textsuperscript{326}

Overall, according to Davies, "the essence of the problem, if one wants to encourage more institutional activism, is how to shift the balance of advantage for institutions somewhat away from sale... and somewhat towards intervention in cases of underperforming companies."\textsuperscript{327} Institutional investors are increasingly rejecting the "Wall Street" rule, which stipulates that an investor should sell a company's stock if he or she dislikes the decisions of

\textsuperscript{320} Theodor Baums, Corporate Governance in Germany: The Role of the Banks, 40 AM. J. COMP. L. 503 (1992).


\textsuperscript{322} Macey, supra note 312, at 607.

\textsuperscript{323} MICHAEL L. GERLACH, ALLIANCE CAPITALISM. THE SOCIAL ORGANIZATION OF JAPANESE BUSINESS 29–30 (1992).

\textsuperscript{324} Davies, supra note 192, at 85.

\textsuperscript{325} See id.


\textsuperscript{327} Davies, supra note 192, at 91.
management. Because the sell option can have the effect of deprecating share prices and harming the selling institution, investors need ways to prompt managers to take actions necessary to protect investments. The growing popularity of index-tracking funds also tends to lock investors into the market and remove the exit option. Nevertheless, shifting from a sell strategy to a voice strategy may generate other structural and operational challenges for institutional investors. Where institutions have both a business and an investment relationship with firms, such a commercial symbiosis may pose a barrier to effective institutional activism in corporate governance. This dual relationship arises for banks where, in addition to holding equity, they wish to provide loans to the same firm.

For several reasons, insurers probably have a greater symbiosis with the firms in which they invest. Insurers often have an equity investment in the same company that they either sold insurance to or would like to sell insurance to in the future. There is a potential conflict of interest in these dual commercial relationships. For instance, institutional investors, such as banks and insurers, may be taciturn to assert influence in firms in which they hold shares for fear that firm managers may sever the business relationship. Thus, David and Kochhar suggest, “the increase in investment value possible through active intervention may be nullified through loss of business with the firm.” In some jurisdictions, governments have legislated to circumscribe the extent to which insurers are allowed to invest their funds in equities. Other investors, such as public pension funds and mutual funds, which do not have business relationships, may be able to play an active role in corporate governance. But, some


331 Monks & Minow, supra note 240, at 207.

332 David & Kochhar, supra note 330, at 460.

333 Id.

334 Black, supra note 235, at 595–604.
commentators, drawing inspiration from German and Japanese models of corporate governance, do not now view multiple financial relationships as a problem, but rather see them as offering superior avenues for investor influence beyond merely a shareholder voice. Recent moves in other countries to allow the creation of multi-service financial institutions may eventually allow deeper relationship investing than has been possible in recent decades.

Whatever the means of influence available, it is important that decision-makers in investment institutions have an appropriate level of expertise effectively to take account of environmental and other ethical issues in their portfolio companies. In OECD countries, there are few legal requirements for such decision-makers to develop the skills they need to discharge their investment responsibilities. Investment regulations have traditionally focused on protecting beneficiaries from gross mismanagement or incompetence rather than facilitating proactive, effective investment. Further, regulatory requirements have tended to concentrate on issues of process and procedure rather than on investment outcomes. According to a U.K. study, most pension fund trustees “do not have extensive knowledge of investment issues, and in particular do not have detailed knowledge of issues relating to their own funds.” Furthermore, this U.K. report found that few pension funds have an investment committee of in-house professionals to assist trustees. On the question of degree of expertise required by trustees, English case law has stated, “it is the duty of the trustee to conduct the business

335 Garten, supra note 239, at 610.
336 Id. at 659.
337 OECD permanent member states include Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, the European Union, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, the Slovak Republic, Spain, South Korea, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. OECD Website, at http://www.oecd.org/oecd/pages/home/displaygeneral/0,3380,EN-countrylist-0-nodirectorate-no-no-159-0,00.html (last visited Dec. 8, 2003).
339 Myners, supra note 253, at 40.
340 Id.
of the trust with the same care as an ordinary man of business would extend towards his own affairs."\(^{341}\) Under the U.S. Employment, Retirement Income Security Act of 1974, a higher standard applies. Fiduciaries are required to discharge their duties with the skill and care of someone familiar with the issues concerned.\(^{342}\) Where pension trustees are under no legal duty to become educated in investment matters and lack in-house expertise, investment decision-makers risk having insufficient capacity to evaluate critically advice from external advisers.

In the absence of appropriate specialist expertise, institutional activism may be useful only in advancing broad-based policy reforms regarding environmental management rather than solving firm-specific operational issues. This suggests certain limitations to potential models for enlisting investors as agents of environmental policy. Fund managers are recruited for their expertise in portfolio management, not for their ability to run companies—let alone advise on environmental practices. The ability of investors to access external sources of environmental expertise coupled with improved provision of corporate environmental information, such as through reporting requirements, will be crucial to facilitating institutional activism in corporate environmental policy.

\textit{C. Ethical Investment and Financial Performance}

Apart from the rules and responsibilities governing investors' interaction with corporate governance, financial incentives for ethical investing ultimately shape institutional investors' commitment to ethical investing. According to a Bank of America representative, "to promote environmental performance benefits to the financial community, it will be necessary not only to show evidence of performance but also to illustrate the financial benefits."\(^{343}\) Various studies have measured the relationship between the social or environmental responsibility of a company

\(^{341}\) Barlett v. Barclays Bank (No.1) [1980] 1 All ER 139, 140, Ch. 515, at 531, per Brightman J.

\(^{342}\) As defined by regulations made by the Department of Labor, 29 CFR § 2550.404a-1 (2002).

and its economic achievements. Proponents of ethical investing dispute the notion that incorporation of ethical principles into investment decisions compromises financial returns. Bromberg claims that because of the “exceptional returns and widespread popularity” of some ethical investment funds, “profit-seeking investors . . . have unwittingly become the strongest proponents of ethical investment strategies.” Yet, if environmentally responsible funds offer their investors good market rates of return, then why create them? If it is profitable to be environmentally responsible, then all that would need to be done is to enliven corporate managers to be smarter profit maximizers.

Debates over the differences in the risk/return ratio between traditional and ethical investments have been the most contentious issue in assessing green financing. According to modern portfolio theory, fund managers who engage in traditional investing are solely concerned with protection of funds through the attainment of the highest possible return on an investment, representing some acceptable degree of risk. Being preoccupied with risk and return, the traditional fund manager will seek to diversify investments in order to lower risk and increase yield. Rational investment demands that a given investment provide a higher rate of return to compensate for increased risk such as when risk and return are positively correlated. Against this theory, ethical investment is said by some to involve a less attractive risk/return ratio than traditional investing if capital markets are efficient. Langbein and Posner argue that ethical investment entails higher risks because portfolios designed in accordance with ethical principles are less diversified, and thus contain more risk than


portfolios based on profit maximization. Ethical investment portfolios are less diversified because the use of negative screens excludes investment in certain stocks. Langbein and Posner also suggest that the additional administrative burden of stock selection and monitoring raises the transaction costs of ethical investment strategies.

Underpinning modern portfolio theory is the assumption that capital markets operate efficiently. Several characteristics of capital markets are relevant to the efficiency issue, including highly imperfect information that can be costly to collect; the existence of principal-agent relationships that create agency costs; and important externalities of investment decisions. Research suggests that because inefficient speculative booms disturb capital markets, it may be possible for ethical investment strategies to maximize income. Shiller argues that in practice many investment decisions are based on emotion or impression rather than derived from objective information. Hylton asserts that investors typically "chase trends," thereby creating "speculative booms or 'bubbles' that move prices away from fundamentals." Inefficient markets undermine the separation theorem, an important corollary of portfolio management theory. The theorem holds that investors will maximize their incomes by separating investment and spending decisions, in other words, the criteria governing firm investment decisions as against the investor's personal consumption tastes. By maximizing income, in theory, investors will then have more to spend in a charitable way than

349 Id. at 77–89.
350 Id. at 94.
351 Id. at 77–79.
352 Id. at 93.

would be possible if they engaged in sub-optimal efficiency strategies by mixing investment and spending decisions. But, under inefficient capital markets, theory suggests participating ethical investors possibly can maximize their investment income, whilst engaging in consumption in direct contravention of the separation theorem.\footnote{Hylton, supra note 355, at 27.}

Data regarding the actual performance of ethical investment is ambiguous partly because of the threshold problems of formulating appropriate benchmarks and timeframes. According to Hylton’s analysis, “the [ethical investment] funds do not appear to ‘beat’ the traditional market consistently . . . but the fact that some funds outperformed the market may be further evidence in support of the inefficiency hypothesis."\footnote{Id. at 31.} During the 1990s, ethical investment, especially in relation to the environment, gained greater legitimacy in sharemarkets. As noted earlier, in September 1999, the Dow Jones Indexes launched the Dow Jones Sustainability Group Index (DJSGI),\footnote{See Dow Jones Sustainability Group Index, available at http://indexes.dowjones.com/jsp/index.jsp (last visited Oct. 27, 2002).} which reportedly outperformed the Dow Jones Global Index between 1993 and 2000 by growing some 180% compared to growth of only 125% for the Global Index.\footnote{See European Commission, Green Paper: Promoting a European Framework for Corporate Social Responsibility, at 9 (July 2001), available at http://www.eiro.eurofound.ie/2001/07/feature/EU0107228F.html.}

The question of relative financial performance between ethical and traditional investment is also germane to claims that policies that favor ethical investment may be illegal when practiced by general institutional investors, such as occupational pension funds.\footnote{John H. Langbein, Social Investing of Pension Funds and University Endowments: Unprincipled, Futile, and Illegal, in Disinvestment: Is it Legal? Is it Moral? Is it Productive? 16 (John H. Langbein et al. eds., 1985); see also James J. Angel & Pietra Rivoli, Does Ethical Investing Impose a Cost Upon the Firm? A Theoretical Perspective, 6 J. INVESTING, Winter 1997, at 57.} Certainly in some jurisdictions, general institutional investors, like those not privately established specifically as an ethical investment vehicle, may be reluctant to favor ethical investment because of legal rules both in equity and statute which
govern fiduciary behavior in private welfare and pension funds. Trustee investors, having the legal fiduciary responsibility to exercise prudence and due diligence, may find the least risky course is to mimic the investment strategies of their peers. As noted above, because environmentally responsible investments may eliminate many potential investment choices, they have been criticized for being more risky without providing for correspondingly higher expected returns.\textsuperscript{362} Hutchinson and Cole have argued that an ethically sensitive, as opposed to dictated, investment policy can be compatible with financial objectives and trust law considerations, when ethical considerations are invoked to select from economically comparable investment alternatives.\textsuperscript{363}

At a theoretical level, trust law has been viewed by some commentators as potentially offering the ideal legal framework for encapsulating our environmental responsibilities to the future. Because trust law embodies the well-established notion of responsible action on behalf of another, Scott argues it can provide a basis for articulating our obligations to future generations through requirements to protect and sustainably manage environmentally significant goods.\textsuperscript{364} Trust law precedents, such as duties to safeguard trust principal and avoid speculative, risky investments, can be construed as congruous with sustainability precepts to preserve natural capital and act in a precautionary manner.\textsuperscript{365} Even the trust doctrine of enhancing portfolio diversification, argues Scott, can be construed as consistent with sustainable development, since by "continuing to convert natural into human-made capital, the portfolio held in trust gradually loses diversity and becomes vulnerable to catastrophe."\textsuperscript{366} The challenge for policy-makers is to design institutional arrangements that can harness the insights of trust doctrine into practical standards for


\textsuperscript{364} See Anthony Scott, \textit{Trust Law, Sustainability, and Responsible Action}, 31 Ecological Econ. 139; see also Edith Brown Weiss, \textit{In Fairness to Future Generations: International Law, Common Patrimony, and Intergenerational Equity} (1989).

\textsuperscript{365} Scott, supra note 364, at 145–49.

\textsuperscript{366} \textit{Id.} at 149.
the conservation of environmental resources.

Current jurisprudence falls short of embodying such an ideal of intergenerational equity. Extensive debate both in the courts and among scholars regarding the legality of ethical investment exists. To illustrate, in the United Kingdom, notions of fiduciary responsibility in equity were interpreted in the seminal cases of Cowan v. Scargill (1984), Martin v. City of Edinburgh District Council (1988), and Harries v. Church Commissioners of England (1992). These cases constrained pension fund trustees from considering ethical factors in investment policy. In terms of general trust law, the basic proposition was stated by Megarry V-C in Cowan v. Scargill as: "when the purpose of the trust is to provide financial benefits for the beneficiaries... the best interests of the beneficiaries are normally their best financial interests." In reaching this view, Megarry emphasized the trustees' duty to consider diversification of investments and to take such care as an ordinary prudent person would in such circumstances.

However, Megarry acknowledged that in rare situations the notion of "benefit" might mean that if all the beneficiaries of the trust were adults with strict moral views, then receiving significant investment returns from sinful activities they disapproved of would not be to their benefit. This approach was upheld in Martin, where Lord Murray found that councillors serving as trustees, who sought to eschew investments in apartheid South Africa, were in breach of trust. However, he appeared to qualify the basic fiduciary principle by noting that to ask the trustee to "divest himself of all personal preferences, of all political beliefs,

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371 Cowan, 1 Ch. at 287 (involving investment policy of a miner's pension fund, and a proposal that the policy should exclude investment in energies competing with coal).
372 Id. at 289.
373 Cowan, 2 All E.R. at 761.
374 Id. at 762.
and of all moral, religious or other conscientiously held principles” was neither “reasonable” nor “practicable.” Thus, trustees would be expected to recognize their own preferences and attempt to act fairly and impartially. In Harries v. Church Commissioners of England, which involved a dispute over the investment policy of church funds, Nicholls V-C appeared more sympathetic to ethical considerations than in earlier cases, suggesting that trustees may accommodate views on moral objectives, such as eschewing sin stocks, provided that this did not involve a significant risk of financial detriment.

In the United States, argument has focused on whether ethical investment through pension funds is contrary to the seminal Employee Retirement Income Security Act of 1974 (ERISA). ERISA sets minimum standards for pension plans in private industry, including standards of accountability as plan fiduciaries. Specifically, it imposes a duty on pension fund managers to exercise a “prudent [person] standard of care” and to discharge their duties “solely in the interests of the participants and beneficiaries.” ERISA also requires “diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.” Although ERISA is silent on ethical investment portfolios, Langbein and Posner believe that such a portfolio would violate ERISA’s fiduciary duties because the minimal diversification typical of ethical investment involves greater risks without the

376 Id.
379 Public pension funds are regulated by state governments, and state laws prescribe the investments such funds may pursue, often adopting the “prudent person” fiduciary standard. See Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 Colum. L. Rev. 795, 800 (1993).
prospect of greater returns. They also oppose ethical investment because it politicizes investment decisions, although they concede that if beneficiaries are informed of the increased risks and costs of such a fund, the investment portfolio might comply with statutory requirements. According to the Restatement (Third) of Trusts, "what little case law there is [on ethical investment] is not illuminating," and "fiduciary issues involved in the pension fund context vary considerably with the nature of the pension plan." Thus, in relation to a defined contribution plan, it has been argued that "where the workers put in a set amount and get back whatever the returns add up to, there is a stronger argument for allowing beneficiaries to make social investing decisions." However, in relation to a defined benefit plan, where the company promises to pay a certain benefit, "[i]t may not be possible to allow individual plan participants to make social investing decisions because they are not the ones who will feel the consequences."

Recently, the U.S. Department of Labor’s regulations and interpretations regarding the application of fiduciary duties under ERISA were clarified. In 1998, the Office of Regulations and Interpretations advised that the statute does not preclude consideration of collateral ethical benefits, so long as financial return is not compromised. It stated: "A decision to make an investment or to designate an investment alternative may not be influenced by non-economic factors unless the investment ultimately chosen for the plan, when judged solely on the basis of its economic value, would be equal to or superior to alternative available investments." It continued by stating that a designated socially responsible mutual fund would not contravene ERISA so long as the fund operated within the bounds of ERISA’s fiduciary

384 Langbein & Posner, supra note 349, at 104–07.
386 MONKS & MINOW, supra note 240, at 223.
387 Id.
389 Id.
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standards. The Office’s advisory position appears somewhat narrower than the view taken in Board of Trustees of Employee Retirement System of the City of Baltimore v. Mayor and City Councillors of Baltimore,\(^{390}\) where the court found that a city ordinance requiring a municipal authority pension fund to disinvest from companies engaged in business in South Africa did not cause trustees to violate their prudential investment duties as long as the cost of investing according to social responsibility precepts was \textit{de minimis}.

Thus, across various jurisdictions, investment trustees can be seen as subject to an overriding duty to act in the best interests of trust beneficiaries, and this is normally understood as the best financial return on investments subject to a degree of prudence. Because of media criticism alleging poor financial performance of some ethical funds, the “best financial return” duty can thus readily be understood as investment in “old economy” companies.\(^{391}\) The important criteria to satisfy fiduciary obligations are that the ethical investment policy does not lower the expected return of the plan’s assets; there is sufficient portfolio diversification; the policy can be implemented without burdensome administrative procedures; and there is wide member acceptance of the policy. If “financial benefits” can be understood as measured on a longer time frame, then environmental investment preferences need not be seen as inconsistent with a financial benefits test and indeed may be a superior way of maximizing economic return to beneficiaries.

The prudential standard has the flexibility to be more broadly interpreted to encompass social and environmental criteria.\(^{392}\) Of course, where an investment fund is established explicitly as an ethical investment vehicle, then the trust law constraints against green investment diminish so long as the optimal financial return is pursued within the agreed framework.\(^{393}\) It must also be


\(^{391}\) See, e.g., Kathryn Cooper & Robert Winnett, \textit{Is Vice more Profitable than Virtue?}, \textit{SUNDAY TIMES} (London), July 16, 2000, at 3.


\(^{393}\) In \textit{Harries v. Church Comm’rs of Eng.}, Nicholls V-C noted, “trustees would be entitled, or even required, to take into account non-financial criteria . . . where the trust
recognized that the nature of fiduciary duties varies among investment entities. Life insurance companies, which are the largest investors in OECD countries,\(^{394}\) are not subject to fiduciary responsibilities equivalent to those imposed upon pension fund trustees, but they are commonly subject to minimum solvency and asset liquidity requirements.\(^{395}\)

Overall, if institutional investors are to be successfully mobilized by the state as a mechanism for promoting sustainable development, it appears governments will not be able to rely on existing market processes and traditional private law controls. Institutional investment is one of the key nodal points in the market, where, through government incentives and directions, economic and environmental decision-making can be integrated in accordance with the requirements of sustainable development. Specific interventions are needed to improve the market’s transparency of corporate environmental performance information. In addition, measures are needed to reduce the structural bias against ethical investment and investor reluctance to be involved in corporate governance. In addition to the improved corporate environmental disclosure and reporting obligations already discussed, there are a number of specific practical reforms worth pursuing.

**D. Environmental Regulation and Investment Funds**

1. **Role of financial services regulation**

For the bulk of investment institutions not specifically constituted as ethical investment vehicles, in the absence of compelling evidence of the relevance of environmental performance to economic performance, some form of government intervention is required to facilitate green investment. Self-regulation, rather than government direction, has been the approach traditionally favored by the investment community for accommodating public interest concerns.\(^{396}\) Financial reform in

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\(^{394}\) See Org. for Econ. Cooperation & Dev., supra note 156.


\(^{396}\) European Parliament Fact Sheets 3.4.3 on Banking, Insurance, and Securities,
recent decades has tended to be shaped by the "financial repression" thesis, namely that governmental economic intervention in the form of interest rate determinations and other financial controls provokes capital flight, fragmented capital markets, and other inefficiencies.\textsuperscript{397} Subsequent financial liberalization reforms, limiting government involvement in oversight and prudential regulation, have, however, spawned extreme market volatility and speculative booms inimical to environmentally and socially optimal financial performance.\textsuperscript{398}

Whilst there is no apparent move worldwide to re-engineer heavy governmental involvement in macro-economic policy and the financial services sector, reform of investment systems to accommodate ethical development concerns is emerging as a political issue in a number of countries. The landmark New Zealand Superannuation Act of 2001, for instance, proposes that the national Superannuation Fund managers must, in formulating their investment policies and standards, consider ethical investment issues and must avoid harming New Zealand's reputation as a responsible member of the world community.\textsuperscript{399} Investor and consumer sentiment is becoming more receptive to such plans. According to a British survey conducted by the Ethical Investment Research Service, seventy-three percent of respondents believed that their pension scheme should have an ethical policy.\textsuperscript{400} Beyond omnipresent regulatory stipulations, governments may be able to influence the investment decisions of

\textsuperscript{397} RONALD I. MCKINNON, MONEY AND CAPITAL IN ECONOMIC DEVELOPMENT 68 (1973); EDWARD S. SHAW, FINANCIAL DEEPENING IN ECONOMIC DEVELOPMENT 12 (1975); Glenn Yago, Financial Repression and the Capital Crunch Recession: Political and Regulatory Barriers to Growth Economics, in ECONOMIC POLICY, FINANCIAL MARKETS, AND ECONOMIC GROWTH 81, 87–89 (Benjamin Zycher & Lewis C. Solomon eds., 1993).

\textsuperscript{398} The Asian financial crisis of the late 1990s is a notorious example of these problems. See D.C. Cole & Betty F. Slade, The Crisis and Financial Sector Reform, 15 ASEAN ECON. BULL. 338 (1998); see also Don Goldstein, Uncertainty, Competition and Speculative Finance in the Eighties, 29 J. ECON. ISSUES 719 (1995).

\textsuperscript{399} New Zealand Superannuation Act, 2001, § 61(d) (N.Z.).

\textsuperscript{400} Neasa MacEarlean, How to do the Decent Thing With Your Old-Age Money, THE OBSERVER, Nov. 15, 1998, at 18.
fund managers through discrete requirements for disclosure of
corporate environmental performance to shareholders and
financial markets. Without some form of state intervention, it may
be left to fund members and consumer pressure to encourage
investment bodies to support environmentally sound companies
and industries. Such a solution is too random and uncertain to
provide a proper basis for articulating environmental governance
through financial organizations.

Promotion of a more receptive climate for ethical investment
should begin with the diffusion of environmental standards into
the overall regulatory architecture for the financial sector. This is
consistent with the principle of integration of environment and
development that underlines sustainable development. Government financial regulators that supervise institutional
investors and other financial entities should not be making
decisions isolated from environmental conditions that underpin the
long-term health of companies and financial markets. Government
licensing of financial institutions provides an obvious pathway to
impose standards and objectives for environmentally responsible
decision-making. Unfortunately, a paucity of precedents for
systematically embedding environmental policy into financial
services regulation exists, and the issue remains largely confined
to the periphery of government policy debate and academic
research.\textsuperscript{401}

Recently, a number of nations have moved to overhaul their
legal frameworks for the financial services sector, thereby raising
new opportunities for the referencing of environmental concerns in
the regulatory framework for this sector. Proposals for inclusion of
environmental standards emerged during the passage of the United
Kingdom's Financial Services and Market Act of 2000, which
integrated and streamlined the country's financial services
industry under the auspices of a single regulator, the Financial
Services Authority (FSA).\textsuperscript{402} The Act equips the Authority with a
full range of statutory powers for the approval and control of
financial organizations and services, including banks, insurance
companies, and many other institutions previously governed by a

\textsuperscript{401} See, e.g., Benjamin J. Richardson, \textit{Financial Institutions for Sustainability}, 8

\textsuperscript{402} Financial Services and Markets Act, 2000, c.8, § 1 (Eng.).
specific statute.\textsuperscript{403} During the preparation of the legislation, the U.K. Social Investment Forum (UKSIF) protested to the House of Commons Environmental Audit Committee due to the absence of any environmental appraisal of the Bill.\textsuperscript{404} The UKSIF proposed modifications to the FSA’s mandate, including a requirement to facilitate best practice in environmental risk management and to promote the provision of environmental investment and lending products.\textsuperscript{405} The government rejected these proposals, leaving the FSA with only the vague remittance in the final Act to address indirectly the environment, if it so chose, via its “public awareness objective.”\textsuperscript{406} Absent a specific mandate, the FSA, at best, might issue guidance notes on environmentally prudent investment practices.\textsuperscript{407} This has already been attempted by the Department for Environment and the Corporation of London. Their \textit{London Principles of Sustainable Finance}, issued in August 2002, recommended that financiers: “reflect the cost of environmental and social risks in the pricing of financial and risk management products; . . . [and] [e]xercise equity ownership to promote high standards of corporate social responsibility by the activities being financed.”\textsuperscript{408} But, current political realities make it unlikely that a financial regulator in Britain or elsewhere would seek to impose general environmental obligations on financial markets despite the general movement away from a self-regulatory culture in this sector in recent years.

Despite such a lacuna at a meta-policy level, there are some specific measures that financial regulators could introduce to

\textsuperscript{403} \textit{id.} at \textsection 2.

\textsuperscript{404} Nor was reference made Treasury’s consultation document, the \textit{Financial Services and Markets Bill: A Consultation Document} (July 1998).


\textsuperscript{406} Financial Services and Markets Act, 2000, c. 8, \textsection 4(2) (Eng.).


stimulate environmentally sensitive investment and to encourage institutional participation in corporate governance. It is inconceivable that regulation could ever actually instruct institutional investors when to make ethical investments, since this is essentially a commercial judgment made by institutions on a case-by-case basis. Regulation, however, could feasibly require institutions to state their positions in relation to their corporate investments and to adopt measures to reduce the free-rider impediments to collective action. For instance, governments could liberalize the formal channels currently available for shareholders to intervene in corporate governance processes, such as the proxy context and the shareholder proposal under securities regulations. Financial regulators could review share ownership restrictions so as to ease limitations on significant holdings and relax the portfolio diversification rules that can impede investor activism.

Further, investment institutions could be required to register their share votes, so as to encourage institutions to formulate and express a view on all issues put to a vote at shareholder meetings. However, because institutions might simply delegate voting decisions to fund managers in the matters under consideration, additional measures would be needed. One possibility suggested by Gilson and Kraakman is the appointment of minority independent directors to corporate boards nominated by institutional investor groups rather than enterprise management. The expert independent directors would function as well-informed monitors of portfolio companies, providing a meaningful check upon management and affording a valuable source of external expertise. This suggestion may be a more practical alternative to existing proposals to extend generally the accountability of corporate management to other stakeholders beyond the equity holders. Commentators predict that

409 See Geltman & Skroback, supra note 236 (discussing some useful reforms).
410 Davies, supra note 192, at 92.
411 Gilson & Kraakman, supra note 306, at 872–73.
412 Id. at 873
introducing a stakeholder approach to corporate governance risks shifting power to management because of the difficulties in providing a means of balancing and reconciling the array of additional interests at stake.\footnote{414}{\textit{Enterprise and Community: New Directions in Corporate Governance} 4–5 (Simon Deakin & Alan Hughes eds., 1997).}

Besides mandatory voting and reorganization of non-executive director roles, taxation incentives can be used to stimulate a stronger future orientation in investment choices.\footnote{415}{Rada & Trisoglio, supra note 133, at 48.} The broad approach should be to reward capital gains and discourage dividends that divert funds away from investment to spending.\footnote{416}{Id.} Government can give the private sector an incentive to invest in longer-term projects by lowering taxes for long-term investments, while raising taxes on short-term trading profits.\footnote{417}{Id.} To counteract the risk that shareholders may respond by selling shares rather than waiting for dividends, it has been suggested that variable tax treatment could be introduced depending on the holding periods for shares.\footnote{418}{Id.} For instance, capital gains tax rules could be altered to ensure a relative penalty for rapid turnover of shareholdings.\footnote{419}{See id.}

The Netherlands has gone the furthest in taxation reform to stimulate ethical investment. The Dutch Green Investment Directive was issued by the government in 1995 to provide tax deductions for interest payments and dividend yields from approved environmental investment funds.\footnote{420}{See Green Investments Granted Tax-Free Status in Holland, 51 ECONews (June 1996), http://www.earthfuture.com/econews/back_issues/96-06.htm.} To qualify, the fund must invest at least seventy percent of its assets in environmentally friendly projects determined to be acceptable by the Dutch environmental agency.\footnote{421}{Id.} Projects currently government certified include renewable energy, organic agriculture, and environmental technology.\footnote{422}{See David Rosenberg, \textit{Investing in a Sustainable Future}, INT’L GREEN PLANNER (Res. Renewal Inst., S.F., Cal.), Fall/Winter 1996/1997, at http://www.rri.org/newsletters/newsfall96/newsfall96.html (on file with the North Carolina Journal of}
gains in funding progressive new projects that were formerly perceived as risky with limited return. Recent studies suggest the Dutch scheme has been very successful in generating increased investment in environmental projects through the delivery of sizeable tax advantages to green savers and investors. The Dutch innovation points to possible solutions in the broader problems of determining ethical investment criteria and enhancing investors’ access to environmental expertise. In addition to providing guidance and advice on environmental investment strategies, an investment certification body could assist in positing eligibility criteria for investment tax advantages, generating considerable economies of scale which would reduce both investors’ and corporations’ costs.

2. Ethical investment policy disclosure obligations

So far the most promising reforms adopted to promote environmentally responsible investment are regulations adopted in several E.U. states and Australia that require certain investors to disclose their stance on environmentally and socially responsible investment. The U.K. government was the first to take this approach. Despite some misgivings from the National Association of Pensions Funds, in July 1999, the U.K. government issued a regulation under the Pensions Act of 1995, directing private pension fund trustees to disclose their policies on socially responsible investment and on the exercise of shareholder rights, including voting rights. The earlier government Green Paper stated: “trustees should be free to consider moral and social issues


in relation to their investments, provided trustees adhere to the obligations placed on them by trust law and always put the beneficiaries' interests first.\textsuperscript{427} The changes to the Pensions Act were spearheaded by the All-Party Parliamentary Group on Socially Responsible Investment formed in January 1998 to promote debate and legislative change for ethical investment.\textsuperscript{428} The regulation does not, however, require trustees to adopt an ethical investment policy.\textsuperscript{429}

The important empirical question that must be investigated is whether the U.K. pensions law reform has actually contributed to an increase in ethical investment. It is too early to answer authoritatively this question because the amendment has only been in effect since July 2000. The U.K. Social Investment Forum reported in October 2000 that fifty-nine percent of British pension funds and local municipal funds had incorporated ethical investment principles into their investment process, such as at the level of policy (e.g., in the statement of investment principles), engagement, by shareholder agreement tactics (e.g., exercise of voting rights), and by more active monitoring (e.g., trustees giving directions to their fund manager).\textsuperscript{430} Another survey commissioned by JustPensions revealed that many pension fund trustees were not properly monitoring their fund managers, to whom they had delegated responsibility for implementing their ethical investment policies.\textsuperscript{431} A later survey in 2001 conducted by Friends of the Earth revealed that ninety percent of the 100 largest occupational pension funds mentioned ethics in their statements of investment principles but also found that the quality of many statements was


\textsuperscript{429} U.K. Social Investment Forum, \textit{supra} note 405.


poor. Only a minority could demonstrate they were monitoring and reporting to trustees on ethical issues.\textsuperscript{432} There is an important difference between having a policy and being able to show that it is being implemented.

The United Kingdom's ethical investment reforms have provided the model for a suite of pension reforms in other European countries in the last two years.\textsuperscript{433} Legislation requiring fund managers to disclose or take account of environmental, social, or ethical considerations in their investment policies has arisen in France, Germany, Sweden, and Belgium.\textsuperscript{434} Several other governments are considering analogous reforms. Interestingly, these reforms have not been directly inspired by European Union legislation. The European Community's proposed directive on the activities of institutions for occupational retirement provision did not include any environmental disclosure provisions, although an amendment of the Commission's proposal was later advanced in the European Parliament.\textsuperscript{435} This amendment sought to provide an obligation to consider "ethical and socially responsible investment principles" in Article 12(1) disclosures of investment policy requirements.\textsuperscript{436} Elsewhere, in July 2001, the European Commission published a Green Paper on \textit{Promoting a European Framework for Corporate Social Responsibility} as a basis for further debate on the subject.\textsuperscript{437}

In France, the February 2001 law on employee savings funds created a framework for long-term employee savings with the possibility of incorporating ERI concepts. Disclosure is optional


\textsuperscript{433} See Cowe, infra note 456, at 22.

\textsuperscript{434} \textit{Id.}


for fund managers of Employees Savings Funds, and an agreement between employers and trade unions is necessary to create these funds.\footnote{Projet de loi sur l’épargne salariale, 7 February 2001, No.2001–152, article 21.} The legislation provides:

[I]f appropriate, the law details social, environmental or ethical concerns that the fund manager has to respect when buying or selling securities or while exercising rights that are related to securities ownership. The annual reports of the funds shall address the application of these factors, under conditions defined by the Commission des Opérations de Bourse.\footnote{This quotation, in the original French: Le règlement précise, le cas échéant, les considérations sociales, environnementales ou éthiques que doit respecter la société de gestion dans l’achat ou la vente des titres, ainsi que dans l’exercice des droits qui leur sont attachés. Le rapport annuel du fonds rend compte de leur application, dans des conditions définies par la Commission des opérations de bourse.}

Further, France’s June 2001 law creating the Pension Reserve Fund (150 billion euros by 2020) goes a step further. The Directorate must report annually to the Board of Trustees how it has taken into account social, environmental, and ethical considerations in the management of the funds.\footnote{Id.} The relevant legislative provision provides that the executive board “implements the investment policy directions and supervises their correct application. It regularly reports to the supervisory board and in this manner it describes the way the general investment policy directions of the funds have taken social, environmental and ethical concerns into account.”\footnote{The quotation, in the original French: Il met en œuvre les orientations de la politique de placement. Il contrôle le respect de celles-ci. Il en rend compte régulièrement au conseil de surveillance et retrace notamment, à cet effet, la manière dont les orientations générales de la politique de placement du fonds ont pris en compte des considérations sociales, environnementales et éthiques.}

Ethical investment also features in Germany’s new pension legislation promulgated in May 2001.\footnote{Projet de loi portant diverses dispositions d’ordre social, éducatif et culturel. 28 June 2001, Chapitre Vbis, article L.135–8.} New occupational pension

\footnote{See Pension Reform Unveiled, 322 EUR. INDUS. REL. REV. 22 (Nov. 2000).}
schemes have to fulfill a number of criteria, including the disclosure of ethical investment policies, in order to qualify for tax deductions.\textsuperscript{443} The reforms state that “the pension fund shall provide written information regarding whether and how ethical, social, and environmental considerations are taken into account regarding the use of the contributions received.”\textsuperscript{444} The legislative phraseology is very similar for personal pension plans.\textsuperscript{445} The disclosure regulations, in effect since August 2001, have not been widely welcomed by the pension funds because of the perceived onerous reporting obligations. Some funds have attempted to circumvent the requirements by simply stating that they do not use ethical investment criteria.\textsuperscript{446}

Since January 2001, Swedish state-run pension funds have been required to incorporate ethical investment criteria in their investment strategies and report to the government annually with respect to how they are fulfilling this policy.\textsuperscript{447} The obligations apply to the five largest state-controlled pension funds in Sweden.\textsuperscript{448} The government’s stated policy is that “investment activities shall take environmental and ethical considerations into account without lowering the overall objective of a high return.”\textsuperscript{449}

There is also the possibility of governments investing their own revenue in green industries. For example, the Norwegian Ministry of Finance in January 2001 established an Environmental Fund financed from state petroleum revenues to invest in

\textsuperscript{443} See id.
\textsuperscript{444} “Der Pensionsfonds muss die Versorgungsberechtigten schriftlich darüber informieren, ob und wie er ethische, soziale und ökologische Belange bei der Verwendung der eingezahlten Beiträge berücksichtigt”: Betriebliche Altersvorsorge: article 10, §115, #4, Änderung des Versicherungsaußsichtsgesetzes.
\textsuperscript{445} Private Altersvorsorge: article 7, §1, #9, Gesetz über die Zertifizierung von Altersvorsorgeverträgen.
\textsuperscript{446} Misinterpretation of SRI Disclosure Regulations for Private Pensions Schemes Block the German SRI Market, European Sustainable and Responsible Investment Forum (2001), http://www.eurosif.info.info./news.shtml.
\textsuperscript{448} Id.
environmentally sound equity instruments. Elsewhere, in January 2001, the Belgian Council of Ministers also advanced a regulation similar to the United Kingdom’s pension fund disclosure law, requiring occupational pension funds to reveal how, and whether, they weigh the ethical, environmental, and social performance of their investment portfolios.

Apart from the problem of establishing mechanisms to monitor whether investors actually implement professed ethical investment policies, there is also the dilemma, unresolved by the recent European pensions reforms, of defining ethical investment criteria. As noted earlier, “ethical investment” tends to be a self-awarded title, and no single authoritative definition of it or similar terms exists in any country’s laws or policies apart from the Dutch ethical investment taxation incentive regime. The introduction of the German reforms has been hampered because of confusion among regulators and consumers as to what qualifies as ethical investment. Moreover, the problem of defining the appropriate boundaries for assessing corporate environmental performance, taking into account the role of subsidiaries and franchise networks, is also unresolved by recent E.U. ethical investment reforms.

Current evidence suggests that in several countries, notably France and Sweden, the ethical investment market has matured in the wake of these pensions reforms. Yet, the European Sustainable and Responsible Investment Forum, which has been monitoring the reforms, argues that there is a danger the disclosure rules will become a public relations exercise as there are insufficient concomitant obligations on funds to actually explain


451 Projet de loi relative aux pensions complémentaires, Article 42, Chapitre 8: Transparence.


454 Polonsky, supra note 413, at 151.

how their ethical investment policies are implemented and taken into account.\textsuperscript{456} There is also the issue of whether ethical investment regulations should extend beyond pension funds to other classes of investment, such as those managed by insurance companies.\textsuperscript{457} A U.K. survey conducted in 2000 found that none of the insurers questioned had any ethical investment policy or practice.\textsuperscript{458} Significantly, Australia has recently adopted new regulations on ethical investment that go beyond the European examples in terms of market coverage and depth of disclosure.\textsuperscript{459}

As with Europe, assets of ethical investment funds in Australia have surged in recent years by some 500% between 1996 and 2001—many fold higher than assets of managed funds as a whole.\textsuperscript{460} Although a PriceWaterhouseCoopers study commissioned by Environment Australia (the main federal government environmental agency) suggested a low level of environmental awareness among mainstream Australian financial organizations,\textsuperscript{461} government authorities are taking the issue seriously. Environment Australia recently established within its Sustainable Industries Branch a unit for “Sustainable Development and the Financial Services Sector” with the stated aim to “facilitate the integration of sustainability issues into the services, products, and operations of the financial services sector.”\textsuperscript{462}

Environment Australia contributed to the drafting of the Financial Services Reform Act of 2001 (FSRA), which introduced new ethical investment disclosure requirements for financial

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\item Id.


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organizations. The FSRA came into effect on March 11, 2002; although there is a two-year transitional compliance period for industry participants, it will apply immediately to any new class of product offered. The legislation is more ambitious than the European reforms in that it applies to a more extensive range of investment products including superannuation products, such as pensions, managed investment products, and investment life insurance products. The FSRA obliges financial product issuers to include in their Product Disclosure Statements (PDS) information about the extent to which labor standards and environmental, social, or ethical considerations are taken into account in the selection, retention, or realization of the investment. The Australian Securities and Investments Commission (ASIC) is empowered to issue “guidelines that must be complied with where” a PDS asserts that environmental, social, or ethical considerations are considered in the “selection, retention, or [realization] of the investment.” During the parliamentary debates, Senator Murray commented:

If a promoter claims that the company’s investment choices are made, taking into account environmental, ethical and other non-financial considerations, where is the investor to go to confirm that claim? It will be up to ASIC to have a look at the ethical investments that are presently on offer and to evaluate the sorts of criteria for disclosure that their prospectuses make—in other words, to provide a guidance note or guidelines.

Regulations promulgated under the FSRA detail the financial product disclosure requirements, including the obligation to disclose “the extent to which” social and environmental considerations are taken into account. The FRSA also includes an obligation to disclose if these matters are not taken into account at all or if they are, what matters the product issuer considers to be labor standards or environmental, social, or ethical considerations.

464 Id.
465 Id.
466 Id. at § 1013DA.
Finally, the FSRA requires an explanation of the extent to which such considerations are actually taken into account in investment decisions. In this respect the Australian reforms promise greater accountability and market coverage than the European examples.

Many of the foregoing reforms ultimately depend on improvements to systems of corporate accounting and reporting to ensure that environmental impacts can be effectively translated into financial analyses and used in investment calculations. Better alignment between corporate goals and societal welfare requires a system in which more and different information is available to guide valuation and investment decisions. Accounting rules need to be modified to better reflect corporate environmental performance, and public disclosure needs to be extended to ease the cost of assessing real corporate value. Improved access to information and greater transparency of decision-making are central features of the new reflexive modes of regulation that are accompanying or displacing some traditional command styles of environmental control. Economic instruments to convey the costs and benefits of corporate environmental performance are also needed to enable investors to better gauge the sustainability and profitability of companies. These other necessary reforms to support investors' role in environmental governance are canvassed in the next part.

V. Additional Legal and Policy Measures for Promoting Environmentally Responsible Investment

A. Economic Instruments

1. Instrument options and implementation

Economic instruments have figured prominently in environmental law reform debates. Apart from their flexibility and cost efficiency advantages, economic instruments promise a more effective way of diffusing environmental policy. Their ability to communicate information regarding the environmental

Corporations Regulations, 2001, cl. 7.9.14C (Austl.).


costs and benefits of economic activity can feed into the decision-making systems of financial markets. If governments are not prepared to penalize polluters by making them pay for their environmental impacts, investors and other financial institutions can hardly be expected to respond in kind. Economic instruments have been defined broadly as “instruments that affect costs and benefits of alternative actions open to economic agents, with the effect of influencing behavior in a way that is favorable to the environment.” The major types of economic instruments are taxation instruments and tradeable emission allowances. Since the early 1970s, the Organization for Economic Cooperation and Development (OECD) has been an active proponent of economic instruments. At a regional level, the E.U. has also emerged as an enthusiastic proponent; its Fifth Environmental Action Programme called for a “broadening of the range of instruments” as one of its key priorities. In 1997, the European Commission published a Communication on Environmental Taxes and Charges in the Internal Market.

Arguments for economic instruments are commonly presented in terms of their advantages over command and control regulations, which are seen as administratively complex and costly. By decentralizing resource allocation and pricing decisions, economic instruments promise greater consumer and producer flexibility and can promote the economically efficient allocation of scarce resources. The most prevalent argument


474 European Commission, supra note 63, at 101.

475 Communication on Environmental Taxes and Charges in the Internal Market, COM(97).

476 See Robert B. Stewart, Economic Incentives for Environmental Protection: Opportunities and Obstacles, in Environmental Law, the Economy and Sustainable Development 171 (Richard L. Revesz et al., eds., 2000).

477 See OECD, supra note 471, at 14.

478 See generally Bändi, supra note 57, at 201.
made for economic instruments is their cost effectiveness compared to command regulation. In theory, economic instruments allow society to achieve the same environmental outcome at a lower cost or achieve environmental improvements at the same cost. The methodological pluralism of economic instruments allows industries to save costs because each business can tailor its own means of reducing pollution. Command regulations, by contrast, tend to specify strict limits on certain inputs, such as use of fuels and adoption of particular control technologies at facilities, such as waste treatment.

Until quite recently, the extensive public discussion concerning economic instruments had not been followed by governmental commitment to implement such instruments. Even today, no jurisdiction provides a legislative framework for systematic use of economic instruments in environmental management. Governments have concentrated on implementing “defensive measures” in which the most “blatant environmentally detrimental economic incentives” have been removed, such as subsidies for resource consumption. Technical problems of instrument design also appear to have slowed the up-take of economic instruments. Grabosky and Braithwaite suggest methodological uncertainties including “the logistic impossibility of auditing honest measurement of emissions on which charges would be based.” The correct setting of pollution or resource charges can be especially complex, requiring identification of users and their level of environmental impact. Another explanation for the slow uptake of economic instruments is their “political unfeasibility.” Economic instruments magnify the costs of environmental policy whereas costs under command regulation are less transparent and hence less readily

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479 See generally Keohane et al., supra note 76.


484 Larrue, supra note 72, at 45–49.
objectionable. Opposition has come from the social welfare lobby which is concerned about socially regressive "user pays" environmental taxes\textsuperscript{485} or pollution "hotspots" arising from emission trading schemes.\textsuperscript{486} The environmental movement traditionally has been suspicious of economic instruments because of their association with degrading market processes.\textsuperscript{487} Industry also has sometimes been an intransigent influence; the user pays and polluter pays—concepts that underpin economic instruments—make them unpopular with companies fearing increased production expenses and competitive disadvantages.\textsuperscript{488}

There have been, however, other developments and pressures in recent years that have facilitated adoption of economic instruments in environmental policy, and they are becoming accepted as a legitimate policy tool. During the 1990s, governments became more receptive to economic instruments partly due to improved information and understanding generated by government inquiries, academic studies, and pilot projects.\textsuperscript{489} For example, in an effort to explore promising potential applications of economic instruments, in 1994, the Canadian Ministers of the Environment and Finance established a Task Force on Economic Instruments and Disincentives to Sound Environmental Practices.\textsuperscript{490} The Australian and Canadian


\textsuperscript{486} See Nina Schuyler, Clean Air, Inc. CAL. LAWYER, July 1995, at 39.

\textsuperscript{487} For example, Schumacher sermonized that free markets "take[] the sacredness out of life, because there can be nothing sacred in something that has a price." E.F. SCHUMACHER, SMALL IS BEAUTIFUL: ECONOMICS AS IF PEOPLE MATTERED 43 (1973).


\textsuperscript{490} TASK FORCE ON ECONOMIC INSTRUMENTS AND DISINCENTIVES TO SOUND ENVIRONMENTAL PRACTICES, ECONOMIC INSTRUMENTS AND DISINCENTIVES TO SOUND ENVIRONMENTAL PRACTICES: FINAL REPORT (1994).
governments, for instance, have been studying and piloting trading market systems to assess the feasibility of a national emission trading market. Governments have also warmed to economic instruments as a consequence of moves to commercialize state services and assets in the field of water and energy supply. Ongoing concerns with full cost-recovery in service and supply have meant that policy-makers could not easily ignore the potential role of the market for promoting the efficient allocation of resources.

The growing profile of market methodologies and instruments through studies, inquiries, and international experience has led to their increasingly formal acknowledgement in national policy and law. Typical of the new approach is the Canadian Environmental Protection Act’s general mandate to authorities to introduce economic instruments. In Britain, even though the Conservative government in 1992 boldly announced, “[i]n [the] future, there will be a general presumption in favour of economic instruments,” it was not until the Blair Labour government and the Lord Marshall report that the agenda advanced significantly.

Today, there are three domains where market-based approaches to environmental policy have been deployed with some rigor. The micro-economic restructuring of the water and energy sectors in many countries has been accompanied by an introduction of higher consumption charges. These charges could improve environmental quality through the prospect of better accountability and higher user-pays water charges, which should

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493 It states: “The Minister may establish guidelines, programs and other measures for the development and use of economic instruments and market-based approaches to further the purposes of this Act, respecting systems relating to: (a) deposits and refunds; and (b) tradeable units.” Environmental Protection Act, S.C., ch. 33, § 322 (1999) (Can.).

494 COMMITTEE, THIS COMMON INHERITANCE: THE SECOND YEAR REPORT, 1992, Cm. 2086, at 35.

495 GOVERNMENT TASK FORCE ON THE INDUSTRIAL USE OF ENERGY, supra note 489.
deter profligacy. The second sector where economic instruments have been featured is natural resources management, especially for water and fisheries, where individual transferable harvesting quotas have been introduced in response to the demonstrable failure of technological input rules. In this respect, Australia and New Zealand have considerable experience with tradeable resource management rights. Thirdly, market mechanisms have penetrated pollution regulation through the introduction of load-based levies, performance bonds, and tradeable emission schemes. Environmental taxes have been widely applied within the E.U. with the Benelux and Scandinavian countries having the most extensive practice. By contrast, marketable rights schemes have been preferred in the United States, examples being the bubble and offset emissions-rights programs for specific industrial plants formulated administratively by the federal Environmental Protection Agency since the mid-1970s, and the acid rain abatement program introduced by the 1990 amendments to the Clean Air Act. European interest in marketable permits has focused on their application for controlling greenhouse gas emissions as a way of meeting anticipated obligations under the Kyoto Protocol. In April 2002, the United Kingdom introduced a limited trading system for carbon emission allowances among the country’s largest industrial firms.

499 Id.
500 OECD, supra note 485, at 51, 56.
503 Green Paper on Greenhouse Gas Emissions Trading within the European Union, COM(00)87 final at 7–9.
504 See Richardson & Chanwai, supra note 488.
2. Constraints to economic instruments

A significant regulatory gap can exist between the theoretical virtues of taxes and trading mechanisms and the practical difficulties encountered by governments in implementing proposals. To function within the economic system, the environmental consequences of development activity need to be revealed in the language of prices and put into a form that allows decisions to be made. Teubner argues that economic instruments do not necessarily translate into concrete incentive measures for corporate actors. Rather, he argues these economic instruments may produce "only an outside noise, as extremely vague measures," which are distorted by intra-organizational corporate decision-making and market dynamics. On the other hand, Orts argues that "compared to command-and-control regulations, market-based environmental regulations are more often in harmony with the vision of reflexive law." Taxes and tradeable permits, for example, should encourage businesses to consider more carefully the relative costs of compliance. But, to the extent that the legal system arbitrarily determines the economic prices and signals to be communicated, the less "reflexive" economic policy instruments become.

Beyond potential implementation weaknesses, economic instruments may be criticized for failing to engage the underlying contradictions between capitalism and ecological systems. The core problem with reliance on economic policy instruments is the inaccessibility of many environmental functions and values to the market mechanism. The values of nature are complex, varied, and inter-connected. The concept of Total Economic Value has been advanced by ecological economists to explain that many environmental values, although ultimately economically important in terms of maintaining life support systems, have no direct use value. De Groot suggests that market values articulated by taxes

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506 Id.

507 Orts, supra note 469, at 1269.

508 Id. at 1271.

and tradeable permits, for example, have a blind spot. The blind spot is that these market values capture only a small subset of the spectrum of nature's values with existence values and option values, for example, remaining largely beyond the purview of economic instruments. The market is a mechanism that allocates resources among traders, but the conditions necessary for markets to flourish in relation to environmental goods are not easily obtained. The complex properties of ecological systems make it difficult to create well-defined marketable rights to environmental goods. Also, sufficient information about environmental goods is often lacking, and the transaction costs of establishing institutional arrangements to combat these problems may be “forbiddingly large.”

These conclusions, however, do not mean that there should be no place for economic instruments in environmental management. What is required is more analysis of the merits of specific instruments in specific contexts and the overall combination of policy instruments in regulatory regimes. Administrative mechanisms, agreements, education, and other tools will invariably continue to have a role in the environmental policy-making state. Apart from their direct effect on industrial polluters, it is essential to appreciate the potential down-stream effects of economic instruments in stimulating environmental interest among financial service organizations. Environmental taxes would directly affect company balance sheets and, thus, influence financial markets' analysis of companies. Financial institutions would be expected to support environmental taxes because as low-energy users they would not be heavily affected by new charges and would benefit from taxes that address global warming, which is a major concern for insurers. Where environmental taxes are based on the polluter-pays principle, a reduction of taxes for environmental-friendly financial products, such as eco-

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511 Id.
513 Delphi International, supra note 66, at 64-65.
investments, should help. In relation to tradeable permits, companies that are able to generate cost savings through trade in pollution permits could become more attractive investment opportunities for financial organizations.

B. Corporate Environmental Management Systems

In addition to economic instruments, environmental management systems (EMSs) developed for businesses can be an important mechanism for facilitating commitment to environmental issues among institutional investors. Not only may corporate adoption of EMSs assist investors to better gauge the environmental credentials of companies considered for funding, but investment institutions may also wish to adopt an EMS as a way to improve their own in-house environmental management. In essence, EMSs are formal structures of processes and standards that corporations adopt in order to improve in-house treatment of flows of materials and energy and to provide a framework for companies to identify, evaluate, and regulate their environmental risks. Supporting the development of EMSs is a variety of new company-based environmental management tools, notably environmental accounting and auditing, life-cycle assessment, environmental reporting, and formulation of environmental performance indicators. Companies desiring to maintain access to markets subject to increasing government regulation can stimulate the early introduction of EMSs.

There are a burgeoning number of off-the-peg EMSs. They may be sourced in national models, such as the British Standard on Environmental Management Systems (BS 7750) or derived from industry-sponsored codes, such as the Business Charter for Sustainable Development (1991). The non-profit sector has also

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developed corporate environmental standards, such as the CERES Principles (originally known as the Valdez Principles)\textsuperscript{517} formulated in 1990 by the Coalition for Environmentally Responsible Economies (CERES).\textsuperscript{518} Sometimes EMS initiatives may be organized sectorally, such as the chemical industry's renowned Responsible Care Program (1989).\textsuperscript{519} Initiated by the Canadian Chemical Producers' Association, Responsible Care contains principles and rules contained in codes of conduct, which aim at improving enterprises' performances on health, safety, and environmental protection.\textsuperscript{520} The development of this and other EMSs promises higher levels of compliance because industry feels some sense of "ownership" for the resulting norms. Apart from production cost advantages, market advantages may accrue from the improved profile of companies among consumers interested in purchasing environmentally friendly products and services.\textsuperscript{521}

Globally, perhaps, the leading EMSs are those of the International Standardization Organization (ISO). Founded in 1947, the ISO is a worldwide association of national standards authorities that seek to promote harmonization of technical standards so as to facilitate technology exchange and trade.\textsuperscript{522} The ISO has no authority to impose its standards on members, and businesses and government authorities voluntarily adopt the standards. These standards, however, might be "in effect" if countries require ISO certification for access to their markets.\textsuperscript{523} In 1993, the ISO moved to create an explicit EMS standard in the form of the ISO 14000 series, which provides the primary

\textsuperscript{517} See generally David Lebedoff, Cleaning Up: The Story Behind the Biggest Legal Bonanza of Our Time (1997).


\textsuperscript{519} Chemical Manufacturers Association, Responsible Care Guiding Principles (1998).

\textsuperscript{520} Canadian Chemical Producers' Association, A Primer on Responsible Care and Sustainable Development (1994).


framework for addressing, inter alia, management system principles and techniques, environmental auditing, and life cycle assessment. All the ISO 14000 series are in the form of "guidance" except ISO 14001, which establishes various criteria for certification, including development of an environmental policy statement; corporate plans to achieve environmental goals and to comply with legislation; and monitoring systems. The aim is a process by which businesses may reflexively learn to identify and eliminate environmentally damaging activities. In effect, the ISO standards provide "a common environmental terminology...[a] 'lingua franca' of environmental management," which can prove valuable to multinational firms operating in countries with divergent regulatory frameworks. ISO registration has occurred across a vast range of sectors, including financial organizations.

In the E.U., an important regulation aimed at stimulating companies voluntarily to improve their environmental performance is the Eco-Management and Audit Scheme (EMAS) of 1993. The scheme differs from the ISO 14000 series because it aims to promote continuous environmental performance improvements of industrial activities, and it requires public disclosure of auditing results. Industries participating in the 14001 scheme voluntarily agree to install a site-based EMS and prepare performance reports to be verified by a certified environmental auditor at least once every three years. If the detailed standards are met, the industry can market an approved product.

524 See generally ISO 14001: CASE STUDIES AND PRACTICAL EXPERIENCE (Ruth Hillary, ed. 2000).


527 See generally Hillary, supra note 524.


529 Hillary, supra note 524, at 285.

530 The EMAS Regulation stipulates that the environmental management system must comply with detailed requirements stated in the Annex to the regulation: Council Regulation 1836/93 Article 3(c), 1993 O.J. (L 168) 1, 3.
emblem in its advertisements and other promotion schemes. A written statement verified by an independent auditor, outlining the company’s management policy must also be made available for public scrutiny.531 Besides the unprecedented government specification of corporate environmental management and auditing standards, the use of private auditors in the verification process also marks an important step toward reducing administrative burdens by sharing regulatory tasks with the non-government sector. Orts cites the EMAS as a good example of a reflexive environmental law because it encourages awareness-raising and disclosure by industry of environmental impacts.532 The incentive for companies to participate is the prospect of enhanced green credentials and the potential for more efficient business operations.533

The ISO standards, EMAS, and industry-generated codes of practice can provide a wealth of surrogate environmental standards and information that institutional investors and other financial organizations could avail in assessing the risks of prospective customers and investment opportunities.534 There is already evidence that insurance markets are acknowledging firms’ accreditation to EMSs when underwriting and determining coverage. For instance, significant discounts on environmental liability insurance premiums have been offered to chemical manufacturers that subscribe to Responsible Care.535 Stenzel reports that banks may offer finance on preferential terms for clients with a certified EMS.536 Davies suggests, "by looking for ISO 14001 registration in loan applications, banks can determine

531 Council Regulation 1836/93, supra note 528, art. 5.
532 Id.
534 How to Open Pollution Coverage Market—Make Policy Contingent on Obeying Environmental Code, INS. ADVOC., Apr. 5, 1997, at 10.
535 David Hunter, Responsible Care Earns Discount on ELL Premiums, 159 CHEM. WK. 11, 11 (1997); Ellen Rafferty, Participants in Responsible Care Offered an Insurance Discount, 105 CHEM. ENG’G 48, 48 (1998).
several facts relevant to the health of their loan portfolios.\textsuperscript{537} But, because ISO and other EMSs tend to look at existing rather than future environmental performance, they need to be supplemented with regular verification by certifiers if they are to be of maximum value to investors, lenders, and insurers concerned about future environmental risks.

The participation of financial organizations themselves in relevant EMSs is also crucial. Extending or copying off-the-shelf EMSs to encompass financial services and products could facilitate the development of environmental competencies in financial organizations. Already a number of banks are achieving their own ISO 14001 certification. For example, Swiss Bank UBS was the first bank to have its lending business certified on a global basis.\textsuperscript{538} Although EMAS was originally intended only to apply to industrial businesses, an amendment in 2001 broadened the scheme to encompass financial services.\textsuperscript{539} The principal problem with the original 1993 EMAS Regulation was its narrow focus on industrial sites rather than environmental policies and management practices at a company-wide level. The need to open the EMAS Regulation to the financial sector was not acknowledged for several years.\textsuperscript{540} The original EMAS model allowed governments to extend the EMAS provisions to “sectors outside industry,” including “the distributive trades and public service”, but solely “on an experimental basis.”\textsuperscript{541} Austria for example enacted a regulation in 1996 allowing its banking and insurance industry to participate in EMAS,\textsuperscript{542} and Germany did the same in February

\textsuperscript{537} Chris Davies, \textit{What ISO 14001 Means for the Banking Industry}, 106 CAN. BANKER 8, 8 (1999).


\textsuperscript{539} See Council Regulation 761/2001 Allowing Voluntary Participation by Organisations in a Community Eco-management and Audit Scheme (EMAS), O.J. (L 114).


\textsuperscript{541} Council Regulation 1836/93, \textit{supra} note 526, art. 14.

\textsuperscript{542} ASS’N FOR ENVTL. MGMT. IN BANKS, SAVINGS BANKS, & INS. COS., \textit{TIME TO ACT} 11, 71 (1998).
But the site-based focus of the 1993 EMAS Regulation meant it could not readily address the environmental effects of the external business relations of banks and investors— that is to their borrowers and investment companies. Under Annex VI of the reissued EMAS Regulation of 2001, it is stated that participating organizations shall consider all environmental aspects of their activities, including “indirect environmental aspects” arising from “capital investments, granting loans and insurance services.”

The new EMAS Regulation provides that it can be applied to an entire organization’s operations, thus, overcoming the site-based focus of the original scheme. This is significant because analyzing a financial organization’s direct impact on the environment, such as energy consumption and waste emission, is quite different from considering the impact on its customers, which will be much more extensive.

Whilst the propagation of corporate EMSs provide a framework for reflexive management and environmental self-organization, there are several constraining factors. From a regulatory perspective, EMSs may be unsatisfactory to the extent that they favor private over public interests, and where accepted by authorities as justifying regulatory relief, they may reduce legal protection to community interests and diminish local participation in environmental decision-making. In addition, free-riding third-parties cannot be forced to comply at all given the voluntary nature of the process, unless governments legislate minimum environmental standards and allow early contracting parties to

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545 Council Regulation 761/2001, supra note 539, annex VI, cl. 6.3(b).

546 Id. at art. 3(2).


secure certain advantages. Furthermore, the very goals selected by a company as the basis of its EMS may be modest, so that desired standards can be achieved without substantial cost. Some EMSs such as ISO 14001 do not mandate public disclosure but merely give guidance on communicating environmental practice. These characteristics suggest not all EMSs in their current form can be readily integrated with public environmental governance systems where the availability of regulatory relief would depend on providing mechanisms for external scrutiny and proof of compliance. Greater involvement of environmental organizations in the design of EMS standards may assist in making them more publicly acceptable.

C. Environmental Reporting

1. Factoring the environment into corporate financial reporting

Apart from economic instruments and corporate EMSs, a third arguably necessary reform to facilitate investment institutions’ engagement with environmental issues is obligations on businesses to periodically report on their environmental performance. It is an axiom that capital markets need reliable information to accurately price securities and allocate capital efficiently. The investment literature emphasizes the importance of investors, banks, and other financial service providers having timely, meaningful, and relevant information to support investment decisions. Effective investor involvement in

549 See NASH & EHRENFELD, supra note 547 (discussing the nature of environmental management systems that are being implemented by industries).

550 See Stenzel, supra note 536, at 284 (discussing problems with the ISO 14001’s environmental goals).

551 NASH & EHRENFELD, supra note 547, at 11.


553 See Stenzel, supra note 536, at 279.


555 See, e.g., GLORIANNE STROMBERG, REGULATORY STRATEGIES FOR THE MID-90S—RECOMMENDATIONS FOR REGULATING INVESTMENT FUNDS IN CANADA (1995); Merton H. Miller & Kevin Rock, Dividend Policy under Asymmetric Information, 40 J.
corporate governance is also linked to extensive access to corporate information.\textsuperscript{556} Improvements in the level and dissemination of corporate environmental information is central to the advancement of reflexive styles of law that seek to change from within organizational cultures and practices. Disclosure of environmental information can help inform investors about a firm's environmental activities and impacts, which is especially important where such factors may affect enterprise earnings and profitability.\textsuperscript{557} Requiring firms to disclose environmental costs under securities laws and other company-directed legislation can facilitate investors' and other stakeholders' scrutiny of the firms' environmental behavior. In theory, if accurate information is made public, market forces can respond by factoring environmental costs and performance into company valuations.

Corporate communication of environmental behavior may occur in various ways, including disclosure through financial reporting systems mandated by statute and stock exchange listings, and disclosure requirements to environmental regulators.\textsuperscript{558} The main corporate communication devices, however, are company annual and interim reports, which are produced to meet statutory reporting requirements and to provide the shareholders with a statement of how the organization has been managed on their behalf.\textsuperscript{559} Traditional corporate reporting statements have not adequately captured the financial consequences of companies' environmental management. Corporate accounting has been associated with myopic, profit-centered performance measurement, and promotion of a stock market focus on bottom-line profit and standards such as earnings-per-share.\textsuperscript{560} Reliable


\textsuperscript{559} See id.

\textsuperscript{560} See \textit{GREEN REPORTING: ACCOUNTANCY AND THE ENVIRONMENTAL ISSUES IN
measures of an enterprise’s overall environmental performance have yet to be formulated or standardized, although the accounting profession increasingly acknowledges the need to reform its appraisal methodologies in this regard.561

Corporate environmental reporting so far has occurred mostly on a voluntary basis.562 Consequently, the scope and quality of corporate disclosure is uneven, although there is a trend toward production of stand-alone environmental reports and the degree of environmental reporting by firms is generally increasing in most jurisdictions. The quality and comprehensiveness of voluntary reports has often been subjective, reflecting management’s perception of interests and needs.563 The glossy pictures and rhetorical flourishes of many reports testify to advertising and public relations motivations rather than information, transparency and accountability.564 Reports tend to be descriptive, characteristically self-laudatory, and frequently confined to rather uninformative declarations of good intent.565 In terms of reporting levels, a survey by KPMG in 1999 suggested that internationally about twenty-four percent of major companies release environmental reports.566 Reporting has tended to be most common in sectors such as mining, energy and water utilities, and industrial and consumer goods companies. The UNEP Sustainability Benchmark Surveys have also found improvements in a wide range of industry sectors across different countries.567

ACCOUNTING, supra note 231.


562 See NASH & EHRENFELD, supra note 547.


564 See generally James Guthrie & Lee D. Parker, Corporate Social Disclosure Practice: A Comparative International Analysis, 3 ADVANCES IN PUB. INT. ACCT. 159 (1990).

565 See C. Deegan & M. Rankin, supra note 563, at 52, 62.


Company size has been identified as an important variant, with large companies much more likely to engage in environmental reporting than small and medium-sized enterprises.\footnote{See Carol A. Adams et al., \textit{Corporate Social Reporting Practices in Western Europe: Legitimating Corporate Behaviour?}, 30 \textit{BRIT. ACCT. REV.} 1, 12 (1998).}

Perhaps, because much voluntary corporate environmental reporting tends to be of an unreliable and suspect nature, it has yet to make a fundamental impact on market perceptions of companies. Reported information is largely useless to investors unless it is concrete data that can be translated into financial terms. Financial institutions are more concerned with attempting to forecast the financial effects of companies' future environmental-related performance than in reviewing their current or past performance.\footnote{Giovanni Azzone et al., \textit{A Stakeholders' View of Environmental Reporting}, 30 \textit{LONG RANGE PLAN.} 699, 703 (1997).} Information regarding asset impairment, liabilities, and prospective environmental expenditures are likely to be of much greater interest to financial institutions than mere policy statements and aspirations.\footnote{See id.}

Reporting by financial institutions' on their own environmental impacts is also crucially important for effective environmental governance. According to a 1997 report to the European Commission, "there is little practical interaction between environmental reporting systems and the financial services sector."\footnote{Delphi International Ltd., \textit{supra} note 66, at 43.} A paucity of environmental reporting in the financial services sector has been noted in some surveys.\footnote{See Riva Krut & Ashley Moretz, \textit{The State of Global Environmental Reporting: Lessons from the Global 100}, 7 \textit{CORP. ENVTL. STRATEGY} 85, 88 (2000).} A 1999 review of 350 major companies in the United Kingdom conducted by the Pensions and Investment Research Council found that only seven of the fifty financial sector organizations in the sample produced a separate environmental report.\footnote{Pensions and Investment Research Council, \textit{Environmental Reporting 1999: The PIRC Survey of the FTSE 350} (1999), as cited in Geoff Lane, \textit{How Can the Financial Sector Realize its Full Potential to Support Sustainable Development?}, UNEP IND. & ENVTL., Jan.–Mar., 1999, at 7, 8–9.}

Institutional investors, like other business entities, are subject to a
range of financial reporting requirements, and the inclusion of environmental statements could help raise the status of environmental policy in fund managers’ calculations. The German banking and insurance sectors have demonstrated perhaps the strongest commitment to environmental reporting, but have acknowledged the difficulties in extending environmental accounting from a financial organization’s internal environmental effects (e.g., use of energy and waste) to accounting for the indirect environmental effects of its financial decisions (e.g., loans and insurance).\(^{574}\)

Not all commentators agree that extending environmental reporting among market institutions is worthwhile.\(^{575}\) The analytical and technical methodologies of accounting have provoked some reservations.\(^{576}\) For Cooper, conventional accounting displays dichotomies that are overly simplistic and inadequate to reflect the complexity of environmental issues.\(^{577}\) Mouck\(^{578}\) and Power\(^{579}\) see financial reporting as serving to depoliticize public interest concerns for corporate accountability. Gray, resonating the juridification thesis of Teubner, fears that there are grave dangers in embracing a “calculative” approach to sustainability given that calculation methodologies might problematically amplify instrumental and scientific solutions.\(^{580}\) Similarly, Power sees regulated accounting systems as extending

\(^{574}\) Association for Environmental Management in Banks, Savings Banks and Insurance Companies, supra note 543, at 10.


\(^{576}\) See Maunders & Burritt, supra note 575.

\(^{577}\) See Cooper, supra note 575.

\(^{578}\) See Mouck, supra note 575.

\(^{579}\) See Power, 4 ACCT. AUDITING & ACCOUNTABILITY J., supra note 575.

\(^{580}\) Gray, supra note 575, at 415–16.
the colonization of society by technocrats at the expense of creating spaces for the debating of fundamental values.\footnote{581} However, by cautioning against regulation of environmental accounting, these critiques tend to reinforce the status quo based on voluntarism and market forces with respect to accounting innovations. Whilst, obviously, environmentalism involves much larger political and philosophical questions about corporations and the market than financial reporting systems can ever convey, this should not deny the contribution reporting and other information tools can make to sustainable economies. Lehman, for example, views corporate environmental accounting as much more than information provision—to him it is a “moral discourse” that can serve to “evaluate and explain data” and thereby promote a more transparent and accountable system of corporate governance.\footnote{582} The challenge is to ensure that the reinvigoration of reporting systems is framed by proper public debate and government regulation rather than become a process monopolized and neutralized by industry and accountancy bodies interested in maintaining the status quo. The recent Enron scandal has highlighted the grave risks corporate reporting systems face from vested interests, and the consequential huge damage that malfunctioning corporate governance can inflict on employees’ pension savings.\footnote{583}

The whole process of environmental reporting is redundant if it has no real effect on organizational behavior. The ultimate test for the value of environmental reporting information is its effect on decision-making. This, of course, can be difficult to measure. Perfunctory corporate environmental reporting is not the goal, but rather reporting should serve as a basis for the formulation and implementation of business environmental policy by management, and as an information base for consultation with investors and other corporate constituencies interested in its environmental performance. Green accounting and reporting efforts also do not simply have to be seen as instrumental regulatory compliance, but

can be an element in a reflexive arena of review, negotiation, and change. The actual process of collecting and assimilating information can be just as important in shaping organizational change as the very existence of the final report.

2. Regulating corporate environmental reporting

The proliferation of environmental reporting approaches has encouraged governments to create standardized reporting formats to enable comparison between firms. This has involved provision of guidance on voluntary environmental reporting standards and, less commonly, imposition of government specifications.584 In recent years, for instance, environmental authorities in Australia, Japan, and Finland have issued environmental disclosure and reporting guidelines for businesses.585 The business sector remains generally skeptical and even hostile to regulatory intervention on environmental reporting, especially in mainstream company law statutes, and has preferred retention of a voluntary approach.586 Yet, pressure from financial regulators and environmental groups has brought more formal regulatory solutions. Thus, in 2001, the European Commission issued a recommendation on regulating corporate environmental reporting.587

Traditionally, there has been scope indirectly to incorporate environmental issues within the general company law disclosure obligations to shareholders of material financial matters or capital expenditure. However, environmental disclosure through financial reporting has tended to stress pollution damage liabilities and capital expenditure, with scant attention to provisioning for potential liabilities, capitalizing on environmental assets,


accounting for intangible assets, and estimated pricing of externalities. Explicit reference to environmental matters in regulation is rare. Among European nations, mandatory environmental reporting has been instituted in various forms in the Netherlands, Norway, Sweden, and Denmark. In the United Kingdom, the Company Law Review Steering Group recently proposed a new framework of statutory accounts and reports that would cover environmental issues as part of the objective to widen the scope of reporting to cover "the qualitative, or 'soft,' or intangible, and forward looking information." In Canada, the Securities Commissions oblige public corporations to report the current and anticipated financial or operational effects of environmental protection requirements in an Annual Information Form. This complements other Canadian environmental reporting systems such as the country's National Pollutant Release Inventory, established in 1992, which requires businesses to report on releases and transfers of many substances.

Sometimes the reporting requirements are contained within environmental legislation rather than company law. Denmark's environmental reporting rules, enacted in 1996 under the Environmental Protection Act, direct certain companies to publish environmental reports (known as "green accounts") for each production site. Legislation mandating environmental reporting for specific categories of companies was also introduced in 1998 in the Netherlands by an amendment to the Environmental Protection Act.

588 Delphi International Ltd., supra note 66, at 42.
589 KPMG, supra note 566, at 8.
591 KPMG, supra note 566, at 8.
592 See also Bradley C. Karkkainen, Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?, 89 GEO. L. J. 257, 348 (2001) (finding that although its list of reported pollutants is shorter, Canada's NPRI covers more industries and activities than the United States TRI).
Management Act of 1993.595 There is, however, a risk that by separating environmental information from so-called financial information in reporting systems that the financial implications of corporate environmental performance will be obfuscated.596 Although corporate financial reports are designed primarily to report to regulators and investors on financial activities, they are also one of the major sources of information used by a wide range of users including environmental pressure groups.597 The imperatives of diffusing environmental policy through economic institutions arguably requires that environmental reporting mechanisms be embedded in mainstream corporate governance so that the links between environmental and market performance can be readily analyzed.

But, the main problem for many governments has not been one of choosing between environmental law or company legislation for nesting environmental reporting requirements but the absence of any regulatory stipulations for environmental reporting. The industry preference for voluntary environmental reporting is partly because of the additional costs of reporting requirements, especially for small businesses, and the risk that disclosure could expose a firm and its officers to prosecution where there is evidence of non-compliance with regulations.598 There is also the corporate fear that reporting on environmental performance will place themselves under greater media and market scrutiny.599 These concerns, however, may be somewhat unjustified as research suggests that enterprises with more extensive environmental disclosures in their financial reports, prior to a catastrophe with industry-wide implications, tend to face less adverse market reactions than enterprises without such disclosures.600 It appears that investors construe more extensive

595 Emtairah, supra note 594, at 28–30.
596 Id.
597 Clare Roberts, Environmental Disclosures in Corporate Annual Reports in Western Europe, in Owen, supra note 231, at 139.
598 ECOMANAGEMENT: THE ELMWOOD GUIDE TO ECOLOGICAL AUDITING AND SUSTAINABLE BUSINESS 23 (Ernest Callenbach et al., 1993).
599 Id.
disclosures as a positive signal of a firm’s ability to manage its exposure to changing regulatory burdens.601

Arguably the most comprehensive environmental disclosure regime contained within financial services regulation is the United States’s Securities and Exchange Commission (SEC) reporting requirements. The Securities Act of 1933602 and the Securities Exchange Act of 1934603 provide a structure for market supervision under the auspices of the SEC.604 Under regulations that arose in the early 1970s, the SEC’s disclosure rules have become both “more particular and more insistent about the need for disclosure of environmental liabilities and obligations” by registered companies.605 The principal vehicle for disclosure is the annual 10-K filing statement, although environmental information must also be communicated through the quarterly 10-Q form and the 8-K form.606 The environmental disclosure requirements operate at several levels. First, there are affirmative disclosure duties under Regulation S-K, adopted by the SEC in 1982:607 environmental issues are contained in Item 101 (Description of Business),608 Item 103 (Legal Proceedings),609 and Item 303 (Management’s Discussion and Analysis of Finance and Results of Operations).610 Central to the SEC’s environmental disclosure requirements is the concept of “materiality.”611 Most critically, section 101 obliges registrants to disclose “the material effects that

601 Id. at 375.
608 § 229.101.
609 § 229.103.
610 § 229.303.
611 § 229.101.
compliance" with government environmental regulations "may have upon the capital expenditures, earnings, and competitive position of the registrant and its subsidiaries."\textsuperscript{612}

Whilst the SEC reporting rules facilitate access to environmental cost estimates, criticisms have been made that the estimates themselves may be unreliable as registrants may experience difficulties in quantifying their potential environmental liabilities, and there can be ambiguity defining the ambit of "compliance costs."\textsuperscript{613} In evaluating reports, the Commission's policy has been to rely on the accounting principles promulgated by the Financial Accounting Standards Board (FASB).\textsuperscript{614} The Statement of Financial Accounting Standards issued by the Board gives businesses significant discretion in determining liability estimates, thereby potentially allowing firms to understate environmental liabilities.\textsuperscript{615} The SEC has on occasion intervened, such as with the publication of an Interpretative Release in 1989, giving guidance on disclosure of uncertainties and contingent, future, material expenditures.\textsuperscript{616} In essence, the SEC states that companies must disclose a known potentially material problem unless it can determine that the event is unlikely to occur or, if it does occur, the effects are unlikely to be material.\textsuperscript{617} An independent study of 234 companies in twelve industries revealed that, although there has been a significant increase in environmental reporting since 1989, the overall quality of environmental disclosures was low with high levels of quality

\textsuperscript{612} § 229.101(c)(xiii).

\textsuperscript{613} Luis Martins et al., Assessing Corporate Environmental Performance, in CAPRA & PAULI, supra note 99, at 65, 73.

\textsuperscript{614} See generally, FINANCIAL ACCOUNTING STANDARDS BOARD HOMEPAGE at http://www.fasb.org (last visited Nov. 2, 2002). Since 1973, the FASB has been the designated organization in the private sector for establishing standards of financial accounting and reporting in the United States. FASB FACTS at http://www.fasb.org/facts (last visited Nov. 2, 2002).

\textsuperscript{615} FASB, ACCOUNTING FOR CONTINGENCIES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5 (1976); FASB, REASONABLE ESTIMATION OF THE AMOUNT OF A LOSS: STATEMENT OF FINANCIAL ACCOUNTING STANDARDS INTERPRETATION NO.14 (1976).


disclosure only in certain sectors. The Enron scandal will undoubtedly serve to further increase pressure on regulators to be more vigilant in scrutinizing the quality of reported information. Registrants who violate the securities law also face onerous civil or criminal statutory penalties, and security-holders can bring a cause of action for loss arising out of material misstatements or omissions.

VI. Conclusion

Sharing environmental governance with institutional investors encourages investors to favor environmentally sound companies and to use their financial leverage to make corporate management and policy more mindful of environmental resource use and pollution concerns. Enlisting institutional investors as a mechanism for sustainable development in capital markets raises various complex issues of corporate governance, problems of environmental valuation and reporting, and economic questions concerning the behaviour of capital market systems. This Article has emphasized the growing importance of ethical investment strategies among institutional investors and the financial relevance of environmental issues to corporate values. Whilst a number of structural and legal barriers to institutional activism have been identified, there also exist some possible regulatory and policy solutions, ranging from reforms of corporate governance and financial services regulation to complementary reforms involving the use of economic instruments and corporate environmental management systems.

One reform area of considerable potential highlighted by this Article is corporate accounting and reporting. The pioneering work of the United States's Securities and Exchange Commission in corporate environmental reporting marks a shift in this aspect of company law from the private law domain into the public law realm. Through improved environmental accounting and auditing, corporate environmental performance can be better verified and information effectively communicated to capital markets, which in

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620 Crough, supra note 617, at 49.
turn can create financial incentives for performance improvements. If environmental audits and reports are to be meaningful, it is essential that they reflect an enterprise’s full range of operations, including relationships with subsidiaries and franchise networks that may otherwise be exploited by the parent company to disguise its overall environmental impacts. Extension of auditing and reporting requirements to financial institutions is also vital, as this will encourage greater reflection and possibly decision-making adjustments in light of the revealed environmental impacts. The revisions to the E.U.’s EMAS Regulation to incorporate the financial services sector is a landmark reform that will be important in coming years to monitor how investors and other financial entities respond.

Procedural reforms that stimulate greater reflection and understanding of the relevance of environmental conditions among investors are crucial to providing a means of integrating economic and environmental policy in the spirit of sustainable development. Recent reforms in Europe and Australia on disclosure of ethical investment policies are beginning to provide a regulatory framework for such activities. In turn, institutional investors can become a mechanism for diffusing environmental awareness in general market activity. Future detailed empirical research will be necessary to assess how investment institutions respond to ethical investment policy disclosure obligations, specifically whether such obligations lead to more ethical investment. Similarly, as governments increasingly adopt economic instruments as a means of environmental policy, empirical research is needed on how such reforms influence the investment community. It would also be useful to investigate the possible differences in the environmental responsiveness of each investment sector, such as pension funds and life insurance companies.

This Article has given examples of initiatives in various countries to extend environmental policy into the institutional investment community and financial markets generally. However, extensive and systematic practice in this area is obviously not yet occurring and may be some years away. The development of more shared environmental governance with financial organizations will depend on several conditions. Well-developed financial markets and the presence of rigorous financial regulatory structures that address problems of information disclosure and risk management
are essential because they provide a framework onto which environmental concerns, such as pollution liabilities and environmental costs, can be effectively grafted. Second, the presence of specialist financial institutions that cater to niche markets, such as ethical investment funds, can provide a platform of experience and knowledge to feed more mainstream changes in this sector. The most advanced reforms have tended to occur in countries with a history of such specialist institutions, such as the United Kingdom’s Social Investment Forum. Third, the performance of traditional environmental law systems is important. Countries with a long history of environmental regulation with well-developed systems, such as the United Kingdom and Australia, are more likely to be aware of the pitfalls and limitations of current approaches and the concomitant need to explore new styles of environmental governance in order to promote sustainability. Fourthly, the prospects of reform will also be shaped by the growing transnational character of the financial services sector. The globalization of banking and investment services is reducing the power of states individually to regulate financial institutions. If regional or global regimes can be developed that place environmental obligations on all investors and other financial service providers, then the conditions for domestic reforms in this direction will improve.

In conclusion, it is important to realize that institutional investors and other financial institutions will only be a part of the environmental regulation process. Even with the reforms outlined in this Article, institutional investors clearly lack the environmental expertise to become intimately involved in shaping corporate environmental performance. Further, merely aggregating the preferences of investors through the market is not an appropriate means for determining society’s overall environmental goals. The effective utilization of investors and capital markets in environmental governance depends ultimately on the establishment of proper strategies for sustainable development and a regulatory framework for translating such strategies into economic decision-making systems. Such standards and goals will likely be communicated, in part, through existing government financial regulators, whereby environmental considerations are integrated into the web of prudential regulation.