

Working Paper

Public Pensions and the Promise of Shareholder Activism for the Next Frontier of Corporate Governance: Sustainable Economic Development

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Ross School of Business Working Paper Series
Working Paper No. 1080
March 2007

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Public Pensions and the Promise of Shareholder Activism for the Next Frontier of Corporate Governance: Sustainable Economic Development

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Work in progress. Comments welcome at dwhess@umich.edu

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1 Introduction

The Wall Street Journal recently reported that 2006 saw the concept of shareholder democracy return “with a vengeance.”² The most talked about development was the push to allow shareholders to directly nominate candidates for the board of directors.³ Increased shareholder power was also seen in the reinvigoration and success of shareholder proposals since the corporate scandals of Enron, WorldCom, and others in 2001-2002.⁴ For example, proposals on board declassification have received such strong support from shareholders⁵ that the CEO of proxy advisory firm Institutional Shareholder Services (ISS) now advises corporations not to even attempt to fight these proposals.⁶

Not only are shareholders’ uses of their powers generally expanding, but their concept of what is a legitimate corporate governance issue is also expanding. Although still subject to much debate and controversy, governance no longer only includes traditional issues of CEO compensation, board structure, and anti-

² Henry G. Manne, *The ‘Corporate Democracy’ Oxymoron*, WALL ST. J., January 2, 2007, at A23.

³ In 2006, the Second Circuit Court of Appeals ruled that American International Group (AIG) must include in its proxy materials a shareholder proposal sponsored by the pension plan of American Federation of State, County, and Municipal Employees (AFSCME) that—if supported by a majority of shareholder votes—would allow shareholders to directly nominate candidates for the board of directors in some circumstances. *AFSCME v. AIG*, 2006 WL 2557941. In 2003, the SEC sought public comment on proposed changes to the proxy rules related to shareholder nominated directors. This proposal became the subject of significant debate in the academic legal community. See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Lucian Arye Bebchuk., *The Case for Shareholder Access to the Ballot*, 59 BUS. LAWYER 53 (2003); Martin Lipton & Steven A. Rosenblum, *Election Contests In the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003). As of this writing, the SEC has not announced its final position with respect to *AFSCME v. AIG*.

⁴ Martin Lipton, *Some Thoughts for Boards of Directors in 2006*, 14 CORP. GOVERNANCE ADVISOR 1, 7-8 (2006)

⁵ Proposals on board declassification have averaged over 60% of the vote in 2004 to 2006. Joan Warner, *Get Ready for a Red-Hot Season*, DIRECTORSHIP, December 2006/January 2007, at 1, 4.

⁶ Joan Warner, *supra* note 5, at 26. Likewise, the last two years have seen a dramatic increase in the number of proposals filed on majority elections for directors and the number of votes they have received. INSTITUTIONAL SHAREHOLDER SERVICES, 2006 POST SEASON REPORT 3-4 (2006), available at www.issproxy.com/pdf/2006PostSeasonReportFINAL.pdf. Although only a small minority of corporations currently uses majority voting, some expect it to become the norm within a few years. Joan Warner, *supra* note 5, at 26.

takeover devices, but also includes so-called non-financial criteria,⁷ or in other words, sustainability.⁸ Thus, for many investors, governance issues are transforming into “Environmental, Social, and Governance” (ESG) issues. The basis of the ESG movement is less about the *values* investing commonly associated with the socially responsible investing (SRI) funds, and more about long-term *value* investing focused on reduced risk and improved shareholder value.⁹

Just as 2006 may be seen as a breakout year for corporate governance activism, it was also the year for ESG issues. Shareholders sponsoring proposals on social and environmental issues enjoyed their most successful year to-date.¹⁰ This success coincided with the increased visibility of the importance of non-financial matters to some shareholders. For example, in April 2006, United Nations Secretary-General Kofi Annan unveiled the *Principles for Responsible*

⁷ INSTITUTIONAL SHAREHOLDER SERVICES, 2006 GLOBAL INSTITUTIONAL INVESTOR STUDY: CORPORATE GOVERNANCE: FROM COMPLIANCE OBLIGATION TO BUSINESS IMPERATIVE 58-59 (2006), available at <http://www.issproxy.com/globalinvestorstudy/index.jsp>.

⁸ See Stuart L. Hart and Mark B. Milstein, *Creating Sustainable Value*, 17 ACAD. MGMT. EXEC. 56, 56 (2003) (“A sustainable enterprise is one that contributes to sustainable development by delivering simultaneously economic, social, and environmental benefits.”)

⁹ See THE GLOBAL COMPACT, WHO CARES WHO WINS: CONNECTING FINANCIAL MARKETS TO A CHANGING WORLD i (2004), available at http://www.unglobalcompact.org/Issues/financial_markets/who_cares_who_wins.pdf (stating that corporations with better performance on ESG issues can “increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets, while at the same time contributing to the sustainable development of the societies in which they operate. Moreover, these issues can have a strong impact on reputation and brands, an increasingly important part of company value.”); ONVALUES INVESTMENT STRATEGIES AND RESEARCH LTD., CONFERENCE REPORT: INVESTING FOR LONG-TERM VALUE: INTEGRATING ENVIRONMENTAL, SOCIAL AND GOVERNANCE VALUE DRIVERS IN ASSET MANAGEMENT AND FINANCIAL RESEARCH 2 (2005), available at http://www.unglobalcompact.org/Issues/financial_markets/zurich_rep.pdf (reporting the outcomes from a conference attended by members of various major financial institutions and finding that “There was a remarkable degree of agreement among participants that ESG factors play an important role in the context of longer-term investment strategies and that the financial industry must improve their consideration in research and investment processes.”). With respect to risk, some point out that many of the “really big discontinuous shifts in share price” are due to issues related to a firm’s social performance. Raj Thamotheram, *A Critical Perspective on Activism: Views From a Pension Professional*, in RESPONSIBLE INVESTMENT 295, 299 (Rory Sullivan and Craig Mackenzie, eds., 2006). For a framework for understanding the tensions between short-term results and long-term growth and how managers must stop viewing sustainability as a “one-dimensional nuisance” but as a “multidimensional opportunity,” see generally Hart & Milstein, *supra* note 8.

¹⁰ Barry B. Burr, *Social, Green Proposals Feel the Love*, PENSIONS & INVESTMENTS, Oct. 16, 2006, at 8.

Investment by ringing the opening bell at the New York Stock Exchange.¹¹ These principles require investors to consider ESG issues in their investment analysis and decision-making, to be active owners—including voting on proposals and engaging with corporations—and to press for consideration of ESG issues throughout the financial industry.¹² For others, the increased profile of climate change issues has also increased its importance to investors.¹³

Also in 2006, both the Conference Board and the Business Roundtable's Institute for Corporate Ethics issued reports detailing the harms of the stock market's short-term focus and urging that action be taken to refocus corporations on the long-term.¹⁴ Krehmeyer and colleagues define short-termism as an "excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation."¹⁵ Although commentators have discussed the problem of short-termism since the early 1980s, the issue is receiving priority again due to the scandals of 2001-2002 showing its harmful effects and, more importantly for purposes of this article, the greater recognition given to the potential positive impact of ESG factors on long-term performance.¹⁶ In other words, sustainable economic development is receiving greater recognition as an issue of long-term shareholder value.¹⁷ These issues come together under the term "long-term responsible investing" (LTRI).¹⁸

¹¹ UNITED NATIONS PRINCIPLES FOR RESPONSIBLE INVESTMENT, available at www.unpri.org/principles.

¹² *Id.*

¹³ Charles J. Bennett, *Risk and Opportunity in the Gathering Climate Change Storm*, CONFERENCE BOARD EXECUTIVE ACTION REPORT, No. 228, February 2007, at 2 (noting the increased "frequency, pace, and profile" of climate change-related actions coming from the media, governments (state, local and national), the scientific community, financial institutions, and corporations).

¹⁴ MATTEO TONELLO, REVISITING STOCK MARKET SHORT-TERMISM, Conference Board Research Report (2006); DEAN KREHMEYER ET AL., BREAKING THE SHORT-TERM CYCLE: DISCUSSION AND RECOMMENDATIONS ON HOW CORPORATE LEADERS, ASSET MANAGERS, INVESTORS, AND ANALYSTS CAN REFOCUS ON LONG-TERM VALUE, available at www.darden.edu/corporate-ethics/pdf/Short-termism_Report.pdf.

¹⁵ Krehmeyer et al., *supra* note 14, at 3.

¹⁶ Tonello, *supra* note 14, at 5 & 9.

¹⁷ See Dow Jones Sustainability Indexes website, *Sustainability Investment*, available at http://www.sustainability-indexes.com/06_html/sustainability/sustinvestment.html ("the concept of corporate sustainability is attractive to investors because it aims to increase long-term shareholder value.")

¹⁸ See Raj Thamootheram, *supra* note 9, at 296 (utilizing the LTRI term); Danyelle Guyatt, *Meeting objectives and resisting conventions: A focus on institutional investors and long-term responsible*

Heavily involved in all of these developments are public pension funds. These state and local government pensions collectively control approximately 10 percent of the US equity market.¹⁹ Many legal scholars envisioned a positive role for these institutional investors as monitors of corporate management and encouraged reforms to strengthen their “shareholder voice.”²⁰ Public pensions were singled out for this role due to their lack of a commercial relationship with corporate management that could create a conflict of interest,²¹ and later for their long-term, economy-wide interests.²² Some commentators cited public pensions for the recent success of social and environmental proposals.²³ Others, however, are leery of granting these institutional investors additional power. These critics argue that public pension funds will use any increased powers to take actions based on the private interests of politicians or special interest groups and not based on serving the best interests of the corporation and other shareholders.²⁴ Likewise, Delaware Vice-Chancellor Leo Strine, Jr. argues that individual

investing, 5 CORP. GOV.: AN INTL. J. OF BUS. & SOCIETY 139, 139 & 147n.1 (2005) (adopting the LTRI term). There are a wide variety of terms used to describe the use of environmental and social factors in investment decision making, including socially responsible investing, ethical investing, non-financial investment criteria, enterprise risk considerations, SEE (social, environmental and ethics factors), and others. Charles J. Bennett et al., *Expanding the Investment Frontier: Factoring Environmental, Social and Governance Criteria into Investment Analysis*, CONFERENCE BOARD RESEARCH REPORT 31 (2005). The LTRI term seems to best capture the investment interests of public pension funds. Alternatively, the term “sustainable development investing” (SDI) also serves this purpose.

¹⁹ CONFERENCE BOARD, THE 2005 INSTITUTIONAL INVESTMENT REPORT 27 (2005). In 2003, public pension funds controlled \$2.2 trillion in assets, including \$1.3 trillion in equity. *Id.* at 9, 15.

²⁰ See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 813, 886 (1992). The debate over the role of institutional investors in corporate governance developed significant attention in the early 1990s when these institutions started gaining a significant hold over the US equity market. Collectively, institutional investors (including mutual funds, insurance companies, private pensions, and foundations) owned 41% of the US equity market in 1990. Conference Board, *supra* note 19, at 29. By 2003, institutions owned 59% of the total market and 69% of the largest 1,000 US corporations. *Id.* at 29 & 34.

²¹ John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1367-68 (1991).

²² JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC (2001) [hereinafter Hawley & Williams, *Fiduciary Capitalism*]

²³ Burr, *supra* note 10, at 8.

²⁴ See, e.g., Lipton & Rosenblum, *supra* note 3, at 78-79; Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUMBIA LAW REVIEW 795 (1993); see also *infra* note 225 and accompanying text.

investors are lamenting that corporations are becoming “a therapy couch for politically-motivated institutional investors to vent their causes of the moment.”²⁵

This article brings together these developments in shareholder activism and the “next frontier” of corporate governance²⁶—that is, the environmental and social aspects of the expanded definition of corporate governance—to explore the role of public pensions under a “new governance” regulatory approach focused on sustainable economic development. As recognized over 30 years ago by Christopher Stone,²⁷ traditional legal mechanisms have significant limits in regulating corporate behavior related to environmental and social performance.²⁸ In response, there is a movement towards utilizing more decentralized regulatory mechanisms that are part of a “new governance” approach.²⁹ These changes are most pronounced in environmental regulation, where regulators recognize the limits of command-and-control regulation and seek to utilize flexible, innovative approaches.³⁰ In this article, I argue that public pension funds—even with the criticisms leveled at them mentioned briefly earlier—have the potential to serve a valuable role in this new regulatory approach.

This article proceeds by describing new governance regulation, including why such an approach is necessary for sustainable economic development issues, and then discussing a role for public pensions under such an approach. The next part takes a look what public pensions are currently doing in the area of LTRI. I find that although some funds are making progress, overall their actions are limited and may actually be contributing to the short-termism problem. The following part proposes that public pensions should be required to disclose how, if at all, they incorporate LTRI issues into their investment policy and how that

²⁵ Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuck’s Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1766 (2006). Commentators often combine union and public pensions together when raising these criticisms. In this paper, however, I focus only on public pensions. With respect to the shareholder activism of union pension funds, see generally Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998); Randall S. Thomas & Kenneth J. Martin, *Should Lab or Be Allowed to Make Shareholder Proposals?*, 73 WASH. L. REV. 41 (1998);

²⁶ Institutional Shareholder Services, 2006 Investor Study, *supra* note 7, at 58 (asking if corporate social responsibility is the “next frontier” of corporate governance for investors).

²⁷ CHRISTOPHER D. STONE, *WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR* (1975)

²⁸ See *infra* notes 48-51 and accompanying text.

²⁹ See *infra* notes 52-62 and accompanying text.

³⁰ Bradley C. Karkkainen, *Default Rules in Private and Public Law: Extending Default Rules Beyond Purely Economic Relationships: Information-Forcing Environmental Regulation*, 33 FLA. ST. U.L. REV. 861, 861-63 (2006) [hereinafter Karkkainen, *Default Rules*]

policy is implemented. This proposal is based on a UK law that went into effect in 2000. This part also considers the response of UK pensions to that requirement and discusses the expected benefits of such a law in the US. In addition, I discuss what other pension fund governance reforms may be necessary to ensure the success of the law.

2 New Governance Regulation and Long-Term Responsible Investment

The regulatory goal that I address in this paper is to ensure that corporations are focused on long-term value creation through sustainable economic development. At a general level, this is not a controversial goal. For example, Delaware Vice-Chancellor Leo Strine, Jr states that elected government officials of both parties and “most individual investors”:

. . . do not see corporations as having solely the social purpose of benefiting investors as investors. Rather, they understand and embrace the historical reality that the corporate form was authorized as an instrumental means of enhancing the well-being of our society as a whole and not simply as a means to make investors rich and immune from liability for corporate acts. Although many traditionalist policymakers would concede that making managers more directly accountable to stockholders is a useful means to achieve the larger objective of increasing societal wealth, they do not conflate the goal of a durably wealthier society with the short-term interests of investors in higher stock prices. Indeed, they are concerned that tilting the direction of corporate policy toward short-term thinking is counterproductive, not simply for investors but for other important constituencies such as employees and communities.³¹

With respect to the failures of long-term value, Tonello states that an “excessive focus on quarterly results, scarce attention to value-creation strategies, and failure to probe deeply enough into long-term performance are believed to be

³¹ Strine, *supra* note 25, at 1769. Strine goes on to state “Existing American corporate law bears out the popularity of these traditionalist views. Most U.S. states permit corporate directors to consider the interests of constituencies other than stockholders. Even Delaware law has long made clear that directors have wide leeway to pursue the course of action they believe in good faith to be in the longterm best interests of stockholders, even if that means forsaking other tactics that might increase stock value in the short term.” (footnotes omitted). *Id.* While commenting that it is uncontroversial to state that regulatory policy should ensure a focus on the long-term, SEC Chairman William H. Donaldson stated “I realize that speaking out on the need for a longer-term approach to investment analysis is akin to speaking out in favor of baseball, hot dogs, and apple pie – it’s something (almost) everyone supports, in an abstract way.” William H. Donaldson, *Speech by SEC Chairman: 2005 CFA Institute Annual Conference*, available at <http://www.sec.gov/news/speech/spch050805whd.htm>.

leading to a kind of ‘short-termism’ which damages market credibility and depresses today’s economic development.”³² A clear example of this problem comes from a recent survey of over 300 public corporation financial executives that found that 80 percent of these respondents would decrease discretionary spending in such areas as research-and-development and plant maintenance in order to meet quarterly earnings targets.³³ The researchers also found that managers would often reject positive net present value projects if it meant missing their earnings targets for the current quarter.³⁴

This short-termism not only leads to scandals such as Enron,³⁵ but also causes unsustainable economic development.³⁶ Sustainable development is commonly defined as “development that meets the needs of the present without compromising the ability of future generations to meet their own needs.”³⁷ Rather than seeking to halt development, sustainable development recognizes that economic growth is necessary to meet the “needs and aspirations” of the present, as well as future generations.³⁸ However, principles of equity and environmental protection must guide that development.³⁹

³² Tonello, *supra* note 14, at 5.

³³ John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. OF ACCOUNTING AND ECON. 3, 32-35 (2005). These researchers believe that these percentages are likely lower than actual practice, as respondents may be unwilling to admit such actions even in a survey. *Id.* at 36. Interviews conducted by the researchers confirmed these findings, with one manager admitting that their firm would needlessly terminate company-trained employees to meet earnings targets. *Id.* at 68-69.

³⁴ *Id.* at 37-39.

³⁵ See generally Lawrence E. Mitchell, *Lessons from Enron, How did Corporate and Securities Law Fail? The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189 (2003).

³⁶ For example, although there may be general support amongst investment professionals for the belief that proactive management of social and environmental risks has a material impact on long-term market value, there is not support for the belief that management of such risks will have a material impact on short-term market value. Rory Sullivan et al., *Does a Focus on Social, Ethical and Environmental Issues Enhance Investment Performance*, in RESPONSIBLE INVESTMENT 56, 58 (Rory Sullivan and Craig Mackensie, eds., 2006). Thus, excessive focus on the short-term causes limited consideration of these issues.

³⁷ WORLD COUNCIL FOR ECONOMIC DEVELOPMENT, OUR COMMON FUTURE 43 (1987). For a review of how academics and practitioners have attempted to define the term “sustainable development” and a discussion of the values and principles behind the term, see generally Robert W. Kates et al., *What is Sustainable Development?*, ENVIRONMENT, April 2005, at 8

³⁸ WORLD COUNCIL FOR ECONOMIC DEVELOPMENT, *supra* note 37, at 40; see also Robert C. Paehlke, *Sustainability*, in ENVIRONMENTAL GOVERNANCE RECONSIDERED: CHALLENGES, CHOICES, AND OPPORTUNITIES (Robert F. Durant et al., eds) 29, 60 (2004). (stating—in reference to constraints on economic growth from a sustainability perspective—that “limits and restraint

Some corporations are attempting to put these principles of economic prosperity, environmental integrity, and social equity, into action through value creation, environmental management, and corporate social responsibility.⁴⁰ External pressures, such as the short-term pressures from investors and analysts, may impede these corporations efforts to implement those principles. Some investors, however, do not see environmental management and corporate social responsibility as being in conflict with long-term value creation, but as necessary components of it.⁴¹ These beliefs are bolstered by research showing that there is a positive relationship between corporate social performance (CSP) and corporate financial performance (CFP).⁴² Investing on such beliefs is distinct from an investment approach that incorporates ESG issues into investment decision making based on moral judgment of a corporation's actions.⁴³ Indeed, there is uncertainty in what to name this movement of incorporating extra-financial factors into investment analysis, which I refer to here as LTRI.⁴⁴ It is clear that "ethical" investing⁴⁵ and even the term socially responsible investing (SRI) brings

may be the wrong terms here: it is better perhaps to speak of a growing need for energy-, materials-, and land-use efficiency. In the long term, sustainability is preferable not only socially and environmentally, but economically as well.")

³⁹ WORLD COUNCIL FOR ECONOMIC DEVELOPMENT, *supra* note 37, at 40; Kates et al., *supra* note 37, at 11.

⁴⁰ Pratima Bansal, *Evolving Sustainably: A Longitudinal Study of Corporate Sustainable Development*, 26 STRATEGIC MGMT. J. 197, 198-200 (2005).

⁴¹ See *supra* note 9 and accompanying text.

⁴² For reviews, see José Allouche & Patrice Laroche, *A meta-analytical examination of the link between corporate social and financial performance*, 57 REVUE FRANÇAISE DE GESTION DES RESSOURCES HUMAINES 18, 33 (stating that their meta-analysis results "show conclusively that CSP has a positive impact on corporate financial performance") (2005); Marc Orlitzky et al., *Corporate Social and Financial Performance: A Meta-Analysis*, 24 ORG. STUDIES 403, 427 (2003) (presenting results of a meta-analysis of 52 studies and finding that corporate social performance and corporate financial performance have a bi-directional, positive relationship); Joshua D. Margolis and James P. Walsh, *Misery Loves Companies: Rethinking Social Initiatives by Business*, 48 Admin. Sci. Q. 268, 274 (2003) (reviewing over 100 studies on the CSP-CFP link and finding that almost half show a positive relationship when CSP is an independent variable, only a handful show a negative relationship, and the remainder have a no significant results or a mixed results).

⁴³ See *infra* note 87 and accompanying text (distinguishing long-term investing and universal ownership from some forms of socially responsible investing).

⁴⁴ See *supra* note 18 and accompanying text.

⁴⁵ In general, there seems to be a trend away from using the word "ethical", as was used in the acronym SEE (social, ethical and environmental). See Jill Francis Solomon & Aris Solomon, *Private Social, Ethical, and Environmental Disclosure*, 19 ACCOUNTING, AUDITING & ACCOUNTABILITY J. 564, 583 (2006) (providing quotations from investment professionals that "ethical" is inappropriate terminology in investing because we can all disagree on what is "ethical")

up negative connotations. As an example, the executive director of one large public pension fund informed me that the SRI term “terrifies” the fund’s trustees, but the trustees are apparently comfortable with many of the ideas behind SRI, as they approve initiatives on sustainability and governance that avoid the use of that term.⁴⁶ What “terrifies” those trustees, seems to horrify those that critique this movement.

Many argue that corporate management should follow only the basic mandates of the law and they should not cede to the demands of investor groups that pressure companies to exceed the basic requirements of the law, as that would be engaging in inappropriate political action.⁴⁷ This argument, however, inappropriately assumes two things. First, it assumes that the investors applying the pressure are acting from self-interested political beliefs rather than a belief that higher social and environmental performance will improve long-run performance. Second, it assumes that the law is an effective and efficient regulator of corporate behavior related to sustainable development. In this paper, I focus on the latter false assumption as motivation for my proposal, but the implementation of that proposal draws on the first.

Traditional legal mechanisms⁴⁸ have significant limits when attempting to regulate the issues that relate to a firm’s environmental and social performance. Although traditional regulation has clearly improved corporate behavior, it has reached its limits in many ways.⁴⁹ These failings have been well-documented elsewhere and include arguments of inefficiency, over-regulation, normative legitimacy, delay in responding to new harms or changing societal expectations, enforcement issues, and being limited to focusing on compliance with minimum standards rather than encouraging corporations to seek higher standards that are within their capabilities and resource constraints.⁵⁰ Overall, traditional regulation

and “Well you see you are OK if you stay with a phrase like “Socially responsible” and never introduce the word “ethics!””).

⁴⁶ Executive director response to a pension fund survey described *infra* Part III.2.

⁴⁷ The classic statement of the position comes from Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG., Sept. 3, 1970, at 32; see also *Profit and the Public Good*, ECONOMIST, Jan. 22, 2005.

⁴⁸ Traditional legal mechanisms refer to command-and-control regulation or “first generation” regulation. See Karkkainen, *Default Rules*, *supra* note 30, at 861-62.

⁴⁹ See Daniel J. Fiorino, *Rethinking Environmental Regulation: Perspectives from Law and Governance*, 23 HARV. ENVTL. L. REV. 441, 442 (1999) (“Most observers would agree that we are at a point of diminishing returns; whatever we have achieved so far with the current model of environmental regulation, we will achieve less for the level of effort expended from here forward.”)

⁵⁰ An early, and well-known, critique of the limits of traditional legal mechanisms is found in Stone, *supra* note 27, at 93-110. For reviews of these criticisms, see David Hess, *Corporate Social*

simply encourages compliance with set standards of acceptable behavior, which has a tendency to push corporations to “leav[e] rationality, innovativeness, and societal interests behind.”⁵¹

Due to these limitations, regulators have sought out new regulatory approaches to complement traditional legal approaches. This movement away from command-and-control regulation and towards a “second generation” approach has been gaining significant momentum in environmental regulation,⁵² as well as in such areas as occupational health and safety,⁵³ food safety,⁵⁴ and employment discrimination.⁵⁵ In general, this second generation approach may be referred to as “new governance” regulation.⁵⁶ As the name suggests, when applied to corporations, new governance regulation focuses less on directly regulating corporate behavior—such as through traditional command-and-control models—and more on influencing the governance of corporations. Although new governance scholarship is not based in a single socio-legal theory, Lobel has identified commonalities in implementation. First, this approach is participatory

Responsibility and the Law, in CORPORATE SOCIAL RESPONSIBILITY (JOSÉ ALLOUCHE, ED.)154, 158-63 (2006); CHRISTINE PARKER, THE OPEN CORPORATION: EFFECTIVE SELF-REGULATION AND DEMOCRACY 8-12 (2002); see also Daniel J. Fiorino, *Toward a New System of Environmental Regulation: The Case for an Industry Sector Approach*, 26 ENVTL. L. 457, 460-66 (1996) (arguing that environmental regulation suffers from “three major structural defects: fragmentation by medium, statutory overregulation, and agency confrontation”); Karkkainen, *Default Rules*, *supra* note 30, at 862 (arguing that environmental regulation is “often costly to implement, inflexible, insensitive to local variations in the economic costs and environmental benefits associated with achieving a specified level of environmental performance, and, in some circumstances, they may stifle innovation”).

⁵¹ Wade-Benzoni et al., *Barriers to Resolution in Ideologically Based Negotiations: The Role of Values and Institutions*, 27 ACAD. MGMT. REV. 41, 48 (2002). For an empirical study supporting this statement, see Tenbrunsel et al., *Understanding the Influence of Environmental Standards on Judgments and Choices*, 43 ACAD. MGMT. J. 854 (2000).

⁵² Robert F. Durant et al., *Introduction* in ENVIRONMENTAL GOVERNANCE RECONSIDERED: CHALLENGES, CHOICES, AND OPPORTUNITIES 1, 1 (Robert F. Durant et al., eds., 2004).

⁵³ Orly Lobel, *Interlocking Regulatory and Industrial Relations: The Governance of Workplace Safety*, 57 ADMIN. L. REV. 1071 (2005)

⁵⁴ Cary Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals*, 37 LAW AND SOCIETY REVIEW 691 (2003)

⁵⁵ Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 475–76 (2001)

⁵⁶ See Bradley C. Karkkainen, *Reply, “New Governance” in Legal Thought and in the World: Some Splitting as Antidote to Overzealous Lumping*, 89 MINN. L. REV. 471, 471–72 (2004); Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004) (providing an overview and synthesis of the work in this area).

in that there is a role for all sectors of society (state, market, and civil) at all stages of regulation, from the development of standards to enforcement.⁵⁷ Multiple actors are encouraged to work together to identify common values and goals, and seek consensus rather than focus on “a winner-takes-all approach.”⁵⁸ Following from this participatory approach, new governance regulation is decentralized, which promotes experimentation and utilization of local knowledge.⁵⁹ This also permits meaningful deliberation between the interested actors⁶⁰ and encourages a system that is continually updated based on new knowledge.⁶¹ Finally, these regulatory initiatives may cut across multiple policy domains.⁶²

A general category of a new governance approach directed towards investors (and others) for the purpose of improving corporate sustainability is the disclosure of information related a firm’s performance on environmental and social issues.⁶³ One such example is the Toxics Release Inventory (TRI) of the Emergency Planning and Community Right-to-Know Act.⁶⁴ The TRI requires companies in certain industries to publicly disclose their plants’ emissions of listed pollutants.⁶⁵ A second example is sustainability reporting. These are annual reports published by corporations and available to the public that disclose information on the firm’s entire economic, environmental, and social performance. In contrast to the TRI, sustainability reporting is voluntary in the United States.⁶⁶ In addition, the information reported is not standardized and is

⁵⁷ Lobel, *supra* note 56, at 371-76

⁵⁸ *Id.* at 376-79. Negotiated rulemaking is an example of an attempt to achieve collaboration. *Id.* at 377.

⁵⁹ *Id.* at 381-383.

⁶⁰ *Id.* at 384.

⁶¹ *Id.* at 395-400.

⁶² *Id.* at 385-87.

⁶³ *See, e.g.,* Archon Fung, *Deliberative Democracy and International Labor Standards*, 16 GOVERNANCE 51 (2003); David Hess, *Social Reporting: A Reflexive Law Approach to Corporate Social Responsiveness*, 25 J. CORP. L. 41 (1999); Eric W. Orts, *Reflexive Environmental Law*, 89 Nw. U. L. Rev. 1227 (1995); *see also* Lobel, *supra* note 56, at 371-76.

⁶⁴ EMERGENCY PLANNING AND COMMUNITY RIGHT-TO-KNOW ACT OF 1986, §§ 301-330, 42 U.S.C. §§ 11001-11050 (1994).

⁶⁵ EMERGENCY PLANNING AND COMMUNITY RIGHT-TO-KNOW ACT OF 1986, §313, 42 U.S.C. § 11023 (1994).

⁶⁶ France is the first country to require corporations to disclose a comprehensive social report. For a critique and France’s law, see Lucien J. Dhooge, *Beyond Voluntarism: Social Disclosure and France’s Nouvelles Regulations Economiques*, 21 ARIZ. J. INT’L & COMP. LAW 441 (2004).

often qualitative.⁶⁷ The primary attempt to develop standards for these reports is the Global Reporting Initiative (GRI),⁶⁸ whose standards are used by over 1,000 organizations worldwide.⁶⁹

For both the TRI and the sustainability reporting, a key goal of the regulation is to make information available to other actors for their use in the marketplace or the political arena.⁷⁰ For example, there is evidence that corporations that are comparatively high polluters based on their disclosed TRI data suffer significant stock market declines.⁷¹ With this new information on a firm's environmental performance, investors reacted negatively based on the belief that the data indicated operational inefficiencies, poor management at the firm, or that the disclosure itself will negatively impact the corporation's reputation or lead to tighter environmental regulation.⁷² For other actors, such as local interest groups, the TRI data is just one more piece of information to use in their interactions with corporations over the corporation's complex "license to operate."⁷³

Overall, through mandatory disclosure of information related to a firm's environmental performance, the TRI seeks to achieve new governance goals by empowering the corporation's stakeholders (e.g., community members, consumers, investors) to pressure and work with corporations in an attempt to find workable solutions based on each corporation's specific situation and on current knowledge. Under this system, the government's role is limited to developing and

⁶⁷ For a critique of social reporting in the United States, see generally David Hess & Thomas W. Dunfee, *The Kasky-Nike Threat to Corporate Social Reporting: Is a Standard of Optimal Truthful Disclosure a Solution?* 17 BUS. ETHICS Q. 5 (2007).

⁶⁸ Global Reporting Initiative, www.globalreporting.org.

⁶⁹ *GRI Press Release*, available at <http://www.globalreporting.org/NewsEventsPress/PressResources/PressReleasesG3Release.htm>

⁷⁰ See Mark Stephan, *Environmental Information Disclosure Programs: They Work, But Why?* 83 SOCIAL SCIENCE Q. 190 (2002).

⁷¹ See Swaminathan G. Badrinath and Paul J. Bolster, *The Role of Market Forces in EPA Enforcement Activity*, 10 J. OF REGULATORY ECON. 165 (1996); James Hamilton, *Pollution as News: Media and Stock Market Reactions to the Toxics Release Inventory Data*, 28 J. OF ENVTL. ECON. & MGMT 98 (1995); Madhu Khanna et al., *Toxic Release Information: A Policy Tool for Environmental Protection*, 36 J. OF ENVTL. ECON. & MGMT 243 (1998); Shameek Konar, and Mark A. Cohen, *Information as Regulation: The Effect of Community Right to Know Laws on Toxic Emissions*, 32 J. OF ENVTL. ECON. & MGMT 109 (1997).

⁷² Bradley C. Karkkainen, *Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?* 89 GEORGETOWN L. J. 257 (2001).

⁷³ Neil Gunningham, et al., *Social License and Environmental Protection: Why Businesses Go Beyond Compliance*, 29 LAW & SOCIAL INQUIRY 307, 328-29 (2004)

enforcing the requirements of disclosure and not in directly regulating the environmental performance of corporations.

These information-based regulations do have significant limitations. Commentators have labeled the TRI as “moderately effective”⁷⁴ because the TRI data fail to capture a firm’s total, current environmental performance, including the nature of the environmental and health hazards caused by the listed pollutants.⁷⁵ Beyond anecdotal evidence, sustainability reporting has yet to have any demonstrated impact on corporate social performance due to such factors as it being a voluntary program without standardized indicators for reporting.⁷⁶ Overall, these deficiencies have made sustainability reports of limited use to investors.⁷⁷

Both of these programs—and new governance approaches in general⁷⁸—rely on the involvement of third parties for their success. These potential third parties include non-governmental organizations (public interest groups), consumers, commercial partners, financial institutions (e.g., banks and insurance companies), consultants, and institutional investors.⁷⁹ As Gunningham and colleagues warn, however, drawing in third parties to assist as surrogate regulators “is a process with many pitfalls and, unless skillfully done, can result in negative rather than positive effects.”⁸⁰ In this article, I limit my focus to only the potential role of the institutional investor category of public pension funds for improving the environmental and social performance of corporations in a manner that is more effective, efficient, legitimate, and flexible, than the alternative of continually expanding traditional regulatory methods. Pension funds fit into the new governance model by directly impacting corporations through their investment decisions and engagement, and to the extent these actions improve corporate disclosure, they advance the general effectiveness of disclosure-based policies, such as voluntary sustainability reporting.

⁷⁴ David Weil et al., *The Effectiveness of Regulatory Disclosure Policies*, 25 J. OF POLICY ANALYSIS & MGMT. 155, 170-72 (2006).

⁷⁵ For a review of criticisms of the TRI, see Karkkainen, *Information as Regulation*, *supra* note 72; Alexander Volokh, *The Pitfalls of the Environmental Right-to-Know*, 2002 UTAH L. REV. 805.

⁷⁶ For a review of the accounting literature analyzing sustainability reporting, see Hess & Dunfee, *supra* note 67, at 7-10.

⁷⁷ See Solomon & Solomon, *supra* note 45, at 573-75.

⁷⁸ See *supra* notes 57-58 and accompanying text (discussing the participatory and collaborate nature of new governance approaches).

⁷⁹ See Neil Gunningham et al., *Harnessing Third Parties as Surrogate Regulators: Achieving Environmental Outcomes by Alternative Means*, 8 BUS. STRATEGY & ENVIRONMENT 211, 212-219 (1999) (discussing the potential role for each of these groups).

⁸⁰ *Id.* at 212.

2.1 Why Harness Public Pension Funds as Surrogate Regulators?⁸¹

Public pension funds are a key institutional investor category in discussions related to LTRI issues for several reasons. First, they lack a conflict of interest with corporations that other institutional investors may have, such as managers of corporate pension funds.⁸² This independence makes public pension funds more likely to challenge management on controversial issues. Second, these pension funds are investing to provide retirement benefits for current and future government employees. Thus, they have a strong interest in the long-term return on their investments. Third, due to the increasing size of some of these funds—as of September 2005 there were over 50 public pensions holding over \$10 billion in assets⁸³—and the fact that their holdings often cover the entire market, some refer to large public pensions as “universal owners,” which means that the economy-wide issues of the nation and the portfolio-wide issues of the pension fund are essentially the same.⁸⁴ Thus, whereas managers may not support spending on workforce education or protection of the environment due to the limited direct benefits to their companies, some public pensions will directly capture those benefits to the economy from the increased positive externalities of education and the reduced negative externalities from environmental protection.⁸⁵

Although the long-term investing and universal ownership aspects of public pensions have placed them in alignment socially responsible investors (SRI) in some situations, there are significant differences. First, not all universal owner concerns even overlap with long-term investing concerns. For example, although the economy-wide concerns of a universal owner would be appropriate for a fund with indexed investments representing a large share of the market, those concerns are not necessarily appropriate for a long-term investor without such indexed holdings.⁸⁶ Second, long-term investors and universal owners

⁸¹ The title of this subsection is based on Gunningham et al, *supra* note 79.

⁸² Coffee, *supra* note 21, at 1367-68.

⁸³ Based on data from *Pensions & Investments*' website, available at www.pionline.com/page.cms?pageId=624.

⁸⁴ James P. Hawley & Andrew T. Williams, *The Emergence of Universal Owners: Some Implications of Institutional Equity Ownership*, CHALLENGE, July-August 2000, at 43, 45 & 54. In addition, the use of an indexing strategy, or large ownership positions that prevent selling a company's shares without a negative impact, push firms to exercise voice rather than use an exit strategy. *Id.* at 45.

⁸⁵ *Id.* at 47-49.

⁸⁶ HERMES INVESTMENT MANAGEMENT, LTD., HERMES' RESPONSE TO THE MARATHON CLUB'S DISCUSSION PAPER — “LONG-TERM, LONG-ONLY INVESTING” 4 (2006), available at http://www.hermes.co.uk/pdf/corporate_governance/commentary/commentary_06/Marathon_LTL_O_Hermes_response_300606.pdf,

concerns do not overlap with those social investors making decisions based solely on their views of the morality of a corporation's practices or products.⁸⁷

The concerns of long-term investors and universal owners do overlap, however, with those SRI investors that believe that these so-called extra-financial issues reduce risk and produce greater returns over the long-term. This form of social investing has evolved from the use of negative screens (e.g., refusing to invest in tobacco companies), to positive screens (e.g., investing in a company because of its positive environmental performance), to engagement with the company. Shareholder engagement with the company—directly or indirectly—is the main role envisioned for public pension funds under this new governance model. As explained further below, it is expected that public pensions' greatest impact will be indirect. Rather than directly engaging with a significant number of corporations, public pensions will have an impact by influencing the engagement practices of their money managers. In addition, any actions they take that influence the production of sustainable investing research and corporate disclosures will benefit other potential actors in the financial and consumer markets, as well as in the political arena.

3 Public Pension Funds and LTRI: Evaluation of Current Practices

Public pensions are active in LTRI issues in several different ways. First, several public pension funds are currently active in filing shareholder proposals on social and environmental issues (which includes negotiations with corporations to seek an agreement that causes the filer to withdraw the proposal). The most active are the five New York City retirement funds that act collectively through the City Comptroller, who votes proxies on behalf of the funds and directs their shareholder initiatives.⁸⁸ In 2005 and 2006, the New York City funds filed social and environmental proposals at over 70 corporations.⁸⁹ These proposals covered

⁸⁷ For example, Christian Brothers Investment Services controls over \$4 billion in investments for Catholic institutions and invests based on the guidelines established by the United States Conference for Catholic Bishops. CHRISTIAN BROTHERS INVESTMENT SERVICES WEBSITE, SRI POLICY DEVELOPMENT, available at www.cbisonline.com/page.asp?id=160. The guidelines require the “refusal to invest in companies whose products and/or policies are counter to the values of Catholic moral teaching or statements adopted by the Conference of bishops”; which, for example, includes refusal to invest “in companies that manufacture contraceptives or derive a significant portion of its revenues from the sale of contraceptives, even if they do not manufacture them.” UNITED STATES CONFERENCE FOR CATHOLIC BISHOPS, PRINCIPLES FOR USCCB INVESTMENTS, Principle III.A. available at www.usccb.org/finance/srig.shtml; UNITED STATES CONFERENCE FOR CATHOLIC BISHOPS, USCCB INVESTMENT POLICIES, POLICY I.B. available at www.usccb.org/finance/srig.shtml.

⁸⁸ New York City Comptroller, *Bureau of Asset Management Website*, available at www.comptroller.nyc.gov/bureaus/bam.

⁸⁹ *The 2005 Proxy Initiatives of the New York City Pension Funds 1*, available at http://www.comptroller.nyc.gov/bureaus/bam/corp_gover_pdf/2005-shareholder-report.pdf; *The*

such issues as the McBride Principles,⁹⁰ sexual orientation anti-bias policies, sustainability reports, and international labor standards.⁹¹ Other pension funds were significantly less active. The Minnesota State Board of Investments filed proposals on drug re-importing at four different pharmaceutical companies in each 2005 and 2006.⁹² The New York State Comptroller, on behalf of the state common retirement fund, co-sponsored six proposals in 2006 on topics such as greenhouse gases and employment discrimination.⁹³ In addition, the Connecticut Retirement Plans and Trust Fund has filed proposals related to disclose of climate change risk and international labor.⁹⁴

Second, pension funds are active through collaborative shareholder groups to push for changes at corporations without filing shareholder proposals and to lobby for regulatory changes. Several public pension funds—CalPERS, CalSTRS, Connecticut Retirement, New York City Employees, New York City Teachers, and New York State Common—belong to the Carbon Disclosure Project.⁹⁵ This is an international group of institutional investors that make an annual request for greenhouse gas emissions disclosure from the largest corporations worldwide.⁹⁶ Other pensions are involved in more focused projects such as the Ohio Public Employees Retirement System’s involvement in a project on the long-term profitability of the pharmaceutical industry.⁹⁷ State treasurers or comptrollers

2006 Proxy Initiatives of the New York City Pension Funds 2-3, available at http://www.comptroller.nyc.gov/bureaus/bam/corp_gover_pdf/2006-shareholder-report.pdf.

⁹⁰ See *infra* note 123 and accompanying text (providing a brief description of the principles).

⁹¹ 2005 Proxy Initiatives of New York City, *supra* note 89, at 3-5.

⁹² Based on data contained in *Checklist of 2005 Shareholder Proposals*, CORPORATE SOCIAL ISSUES REPORTER, June/July 2005, at 17-24; and *Checklist of 2006 Shareholder Proposals*, CORPORATE SOCIAL ISSUES REPORTER, June/July 2006, at 19-24. Under current SEC rulings, those companies may now properly exclude those proposals from the proxy materials. ISS, *SEC Staff Issue First Decisions of 2007 Proxy Season*, CORPORATE SOCIAL ISSUES REPORTER, Feb. 2007, at 12, 12 -13.

⁹³ NEW YORK STATE AND LOCAL RETIREMENT SYSTEM, COMPREHENSIVE ANNUAL FINANCIAL REPORT 68 (2006)

⁹⁴ CERES, *Press Release: Investors Win Agreement From Ford Motor Co. To Prepare Climate Risk Report*, March 31 2005, available at http://www.ceres.org/news/news_item.php?nid=93; Dan Haar, *State Treasurer is Reform Activist*, HARTFORD CURRENT, January 24, 2005.

⁹⁵ Carbon Disclosure Project website, Signatories, available at www.cdproject.net/cdp4signatories.asp. In addition to these pension funds, the state treasurers of California, Maine, Maryland, Oregon, North Carolina and Vermont, are also members. *Id.*

⁹⁶ Carbon Disclosure Project website, *About Us*, available at www.cdproject.net/aboutus.asp

⁹⁷ Phrama Futures website, *About Pharma Futures*, available at <http://www.pharmafutures.org/beta/about/>. The pharmaceutical industry’s long-term profitability is stated as being important to “Pension funds who have a long-term sector exposure and

from nine different states (including California, Connecticut, and New York) signed a letter through CERES demanding that the SEC do more with respect to corporate disclosures related to climate change.⁹⁸ The same pension members of the Carbon Disclosure Project—with the exception of CalSTRS and the addition of the Illinois State Board of Investment—belong to the United Nation’s *Principles of Responsible Investment*.⁹⁹ Finally, seven state treasurers, CalPERS, CalSTRS, and the Illinois State Board of Investment have signed an “investor action plan” on climate change supported by the Investor Network on Climate Risk.¹⁰⁰

Third, some pension funds are directly involved in social and environmental issues through their investments. CalPERS has an environmental investments initiative which includes various projects on screening firms for environmental performance and investing in environmentally friendly technologies.¹⁰¹ In addition, CalPERS restricts or prohibits investments in countries with poor records on issues such as financial transparency, political stability, and labor practices.¹⁰² CalSTRS recently joined the Enhanced Analytics Initiative, which seeks to improve analyst research on LTRI issues.¹⁰³ Many other pensions have negative screens on their investments, but, as discussed further below, those appear to be on a limited number of issues and do little to further the

particularly those whose the [sic] end customer is the member for whom they seek both solid investment returns and better healthcare value.” Phrama Futures website, *Objectives*, available at <http://www.pharmafutures.org/beta/about/objectives.asp>. See also Sophia Tickell, *Pharma Futures: Investor Analysis of the Future of the Pharmaceutical Sector*, in RESPONSIBLE INVESTMENT 273 (Rory Sullivan and Craig Mackensie, eds., 2006)

⁹⁸ CERES, *Press Release, \$1 trillion of investors call on SEC to require corporate disclosure on financial risks of climate change*, June 14, 2006, available at http://www.ceres.org/news/news_item.php?nid=197. Additional signatories included SRI funds, churches, and union pension funds. Id.

⁹⁹ See *supra* notes 11-12 and accompanying text.

¹⁰⁰ Investor Network on Climate Risk website, *10-Point Investor Action Plan*, available at <http://www.incr.com/index.php?page=20>

¹⁰¹ CalPERS website, *Environmental Investments Initiative*, available at <http://www.calpers.ca.gov/index.jsp?bc=/investments/environ-invest/home.xml>

¹⁰² CalPERS, *Agenda Item 7B*, February 20, 2007, available at <http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/200702/item07b-00.pdf>. CalPERS has three emerging market investment managers. For the time period April 1, 2002, to December 31, 2006, two of the three managers had lower returns on the CalPERS’ restricted portfolio than those managers did for other clients without those restrictions. Id. at 2-3.

¹⁰³ See *infra* notes 223-24 and accompanying text (providing a brief description of the Enhanced Analytics Initiative).

regulatory goal of improving sustainable economic development at all corporations.¹⁰⁴

Overall, there seem to be only a limited number of pension funds actively involved in LTRI issues. In addition, these and other funds that purport to be working towards sustainable development may be taking other actions in their investment practices that actually work against it.¹⁰⁵ The next sections discuss the LTRI activities of those pension funds beyond the New York, California, and Connecticut funds described above, and also discuss those activities by pension funds that may actually work against LTRI.

3.1 Overview of Public Pension

To understand how public pensions function, it is useful to conduct a brief review of their governance and investment decision-making process. Public pensions are governed by a board of trustees. Board members typically fall into one of three categories based on how they were selected to serve on the board: trustees elected by plan members, *ex officio* trustees (e.g., state treasurer or city comptroller), and trustees appointed by a government official or committee. The average board has 36% elected trustees, 15% *ex officio* trustees, and 44% appointed trustees.¹⁰⁶ However, there is wide variation in practice. For example, 28% of public pension boards in one study did not have any member-elected trustees, while 32% had a majority of elected trustees.¹⁰⁷ CalPERS, for example, has 6 elected trustees, 4 *ex officio* trustees, and 3 appointed trustees.¹⁰⁸ The CalPERS board has responsibility for the funds' investments, but that is not the case for all pension plans. The Florida Retirement System, for example, has its assets managed by the State Board of Administration (SBA). The SBA's board consists of the Governor, the Attorney General, and the State Chief Financial Officer.¹⁰⁹ Likewise, in Connecticut, the various public retirement plans have their assets invested by the Connecticut Retirement Plans and Trust Funds, which has the State Treasurer as the sole trustee.¹¹⁰ In both Florida and Connecticut there

¹⁰⁴ See *infra* notes 120-27.

¹⁰⁵ See *infra* Part III.2.3.

¹⁰⁶ David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. DAVIS L. REV. 187, 195 (2005)

¹⁰⁷ *Id.* at 221.

¹⁰⁸ *Id.* at 195.

¹⁰⁹ The Chief Financial Officer is an elected position that takes on the roles of the state treasurer and state comptroller. Florida Department of Financial Services Website, *Chief Financial Officers of the State of Florida*, available at www.fldfs.com/Treasurer/Bio/CFO_FLDFS.asp

¹¹⁰ Denise Nappier, *Investment Policy Statement for the State of Connecticut Retirement Plans & Trust Funds Investment Policy* 4-5 (2002).

is an Investment Advisory Council that may comment on investment policy or selection of investment services providers.¹¹¹

The board of the pension plan or the investment board determines the investment policy (e.g., levels of acceptable risk) and the asset allocations of the plan's assets. Typically, the Executive Director or Chief Investment Officer, as well as an investment consultant, will assist the board in these decisions. After these decisions are made, the pension fund will hire (and then continually monitor) a combination of internal (pension fund staff) and external investment managers to make the actual investments.

3.2 LTRI and the Majority of Public Pension Funds

To get a better understanding of what public pensions are doing with respect to LTRI, I conducted a survey of public pension trustees in the fall of 2006. A total of 64 trustees responded to the survey representing 58 different pension systems from 22 different states. These 58 pension funds controlled over \$560 billion in assets. They ranged in size from those controlling approximately \$20 million to several controlling over \$20 billion (the average fund controlled \$9.6 billion and the median fund controlled approximately \$1.5 billion). In the discussion below, reference to “large” funds means those funds with over \$1 billion in assets, and “small” funds are those with under \$1 billion. The use of external money managers was common, as 67% of the funds had 100% of their assets managed externally and 79% had over 80% of their assets managed externally. Other information reported below is based on my review the 2005-2006 Comprehensive Annual Financial Reports (CAFR)¹¹² and websites of the 33 public pension funds with over \$20 billion in assets in September 2005.

3.2.1 Proxy Voting

The minimum level of activity for a pension fund to be a responsible owner is to vote its proxies in an informed manner on social and environmental shareholder proposals. The first step in this process is the development of proxy voting guidelines for use by internal and external money managers. The development of guidelines by pension plans, or at least the awareness of these policies by trustees,¹¹³ is limited. Only 29% of respondents indicated that they

¹¹¹ In Connecticut, the investment advisory board has 2 ex officio members, 5 appointed members, and 5 union elected members. State of Connecticut, *Investment Advisory Council*, available at <http://www.state.ct.us/ott/IACbrochure.pdf>. In Florida, the Investment Advisory Council is appointed by the board. *SBA website*, available at http://www.sbafla.com/about_iac.aspx.

¹¹² For a description of CAFRs, see *infra* 179-80.

¹¹³ This survey question asked trustees if the pension had guidelines on the four different issues listed above. They were not provided with the option of selecting “don’t know” for this question. Thus, it is possible that a pension plan has voting guidelines on these matters but the responding trustee was not aware of them.

were aware of a policy on corporate governance issues (39% of large funds and only 20% of small funds), 10% on environmental issues (14% of large; 7% of small funds), and 17% on other social issues (29% of large; 7% of small funds). When asked if external managers were provided with clear guidance on how to vote proxies, 53% of respondents responded affirmatively, 35% said “no,” and the remaining 12% of funds did not know. Some funds abstain from getting involved in proxy voting at all. For example, one respondent stated that the board has “external managers vote the proxies as they see fit” and another that “we always vote with management.” These results are consistent with a recent survey finding that 73% Canadian investment managers “exercised discretion over 85% or more of pension plan client proxies.”¹¹⁴

Many commentators point to the influence of Institutional Shareholder Services (ISS) and other proxy advisory firms in determining the success of a shareholder proposal.¹¹⁵ Some criticize this influence because ISS is an organization without accountability to the pension beneficiaries.¹¹⁶ In this sample, 26% (33% of large funds) indicated they relied on external advice or guidelines for voting proxies.¹¹⁷ Approximately half of those indicating that they use an external advisor indicated that they relied, at least in part, on guidelines from ISS.

A review of the largest pension funds’ publicly available information provides additional information. Although many pensions (approximately half of the websites I reviewed) do not provide any information on their proxy voting guidelines online, others not only posted guidelines that covered social issues in some detail, but also have their actual votes at each corporation available to the public online (e.g., CalPERS, CalSTRS, Ohio Public Employees, Wisconsin Investment Board). Some pension funds have detailed voting policies on corporate governance issues, but are virtually silent with respect to social issues. Others, such as the Colorado Employees Retirement System, have a detailed policy on corporate governance issues, but have a blanket policy of abstaining on all social issues.¹¹⁸

¹¹⁴ CANADIAN SHAREHOLDER ASSOCIATION FOR RESEARCH AND EDUCATION, 2006 KEY PROXY VOTE SURVEY 10 & 48 (2007), available at www.share.ca.

¹¹⁵ Hawley & Williams, *Fiduciary Capitalism*, *supra* note 22, at 31.

¹¹⁶ *Id.*

¹¹⁷ 9% of respondents indicated that they did not know.

¹¹⁸ *Colorado PERA Voting Proxy Policy 7* (2006), available at www.copera.org/pdf/Policy/proxy_voting.pdf (“PERA with *Abstain* on all social issues, and will only vote on financial issues.”) In relation to the discussion in Part II with respect to sustainability reporting, it is interesting to note that several of these funds’ proxy guidelines support proposals requiring corporations to provide disclosure on environmental issues. *See, e.g.*, OHIO PUBLIC EMPLOYEES RETIREMENT SYSTEM, CORPORATE GOVERNANCE POLICY STATEMENT AND

Overall, there is a wide range of practice in the voting of proxies. However, based on my survey results and review of proxy voting guidelines, it seems that most pensions do not take an active role in voting on shareholder proposals on social and environmental issues.

3.2.2 *Socially Responsible Investing*

The survey also asked pension trustees about “socially responsible investment” practices. This, however, was probably a poor choice of wording given its negative connotation amongst some.¹¹⁹ Technically, SRI is a widely used practice, as 28% of pensions indicated having some type of investment restriction (negative screen). The most common restrictions were those on investments in “terrorist” nations,¹²⁰ Sudan,¹²¹ tobacco,¹²² and the McBride Principles (on ending religious discrimination in Northern Ireland).¹²³ These restrictions are typically

GUIDELINES 14 (2004) (“OPERS supports proposals asking for environmental reporting, provided the proposals do not require the disclosure of proprietary information or cause an undue financial burden on the company.”); STATE OF WISCONSIN INVESTMENT BOARD, DOMESTIC PROXY VOTING GUIDELINES 23 (2006) (stating that “SWIB will support increased reporting if: (1) a company’s product or service has the potential to affect the environment adversely; (2) the company has been the subject of adverse publicity or litigation because of its environmental policies; and (3) the company has failed to provide adequate information, as determined by SWIB staff, about its environmental practices to shareholders.”). Others have policies against additional environmental reporting. See OHIO STATE TEACHERS RETIREMENT SYSTEM, STOCK PROXY VOTING POLICY 6 (2006) (“STRS will vote against resolutions requiring a report on environmental issues provided the company complies with all laws regarding environmental reporting.”)

¹¹⁹ See *supra* note 45 and accompanying text; see also Institutional Shareholder Services, 2006 Investor Study, *supra* note 7, at 58.

¹²⁰ As an example from a pension fund that was not included in the survey, see VERMONT PENSION INVESTMENT COMMITTEE, VPIC POLICY ON INVESTMENTS IN TERRORIST OR GENOCIDE LINKED COUNTRIES (November 29, 2006), available at www.vermonttreasurer.gov/documents/retireVPIC/policy/3-006_TerroristGenocidePolicy.pdf (adopting a an investment policy that seeks “to avoid investments in companies operating in a country engaged in the sponsorship of terrorism or genocide as identified by the U.S. State Department”).

¹²¹ See Lucien J. Dhooge, *Condemning Khartoum: The Illinois Divestment Act and Foreign Relations*, 43 AM. BUS. L.J. 245, 274-75 (2006) (citing states that have laws that either require or permit public pensions and state investment boards to divest from companies doing business in Sudan).

¹²² See Elizabeth Wine, *CalPERS to Sell Tobacco Holdings*, FIN. TIMES, Oct. 19, 2000, at 27 (reporting that CalPERS’s board voted to divest its \$525 million holdings in tobacco investments); MINNESOTA STATE BOARD OF INVESTMENT, 2005 ANNUAL REPORT 49 (2006) (stating that in 1998 the investment board voted to divest holdings in any company that obtains more than 15% of its revenue from consumer tobacco products).

due to state legislative action. For example, Florida state law has requirements based on the McBride Principles and prohibitions on investments in companies that do business with Cuba.¹²⁴ Others are more specific, such as a police and fire pension fund stating that it would not investment in companies that promote violence against police in music or video games. When asked specifically about an SRI policy, 10% of funds indicated that they had a policy on SRI. However, for at least two of those respondents, that policy was a prohibition against it.

Overall, pension funds are not active in social investing. Although reports on social investing by the Social Investing Forum, for example, claim that public pensions are actively involved in SRI,¹²⁵ that does not appear to be the case on a widespread basis or beyond negative screening restrictions imposed by state law on a limited set of issues. In fact, some argue that use of social investing in general—which the Social Investment Forum places at almost one out of every ten dollars under professional management¹²⁶—is significantly overstated.¹²⁷ In addition, it is important to note that these issues that are the basis of existing SRI do little to promote sustainable economic development amongst a large number of corporations.

3.2.3 *Impact on Asset Managers*

Through their asset managers, public pensions may be furthering the problem of short-termism. Currently, the US lags behind the rest of the world in incorporating extra-financial information into investment decisions.¹²⁸ A recent survey of investment managers—including some of the largest managers for US pension funds—found that only 11 percent of respondents believed that

¹²³ For a discussion of the history of the MacBride Principles and their adoption by public pension funds, see Christopher McCrudden, *Human Rights Codes for Transnational Corporations: What Can the Sullivan and MacBride Principles Tell Us?*, 19 OXFORD J. OF LEGAL STUDIES 167, 178-198 (1999).

¹²⁴ FLA. STAT. CH 121.153 (2001) (“the Board of Administration shall invest the assets of the System Trust Fund in such a manner that the investments in institutions doing business in or with Northern Ireland shall reflect the advances made by such institutions in eliminating discrimination”); FLA. STAT. CH 121.153 (2001) (prohibiting investments in companies doing business in or with Cuba).

¹²⁵ SOCIAL INVESTMENT FORUM, 2005 REPORT ON SOCIALLY RESPONSIBLE INVESTING TRENDS IN THE UNITED STATES 12-13 (2006), available at www.socialinvest.org/areas/research/trends/sri_trends_report_2005.pdf.

¹²⁶ Social Investment Forum, *supra* note 125, at iv.

¹²⁷ See Alicia H. Munnell and Annika Sunden, *Social Investing: Pension Plans Should Just Say “No,”* in PENSION FUND POLITICS: THE DANGERS OF SOCIAL INVESTING 13, 14-19 (Jon Entine, ed., 2005)

¹²⁸ Thamotheram, *supra* note 9, at 296.

mainstream practice would include the integration of social and environmental factors into corporate performance indicators within the next 5 years.¹²⁹ By contrast, for European, Canadian, and Australian respondents, the affirmative response rate was between 60% and 90%.¹³⁰ A follow up survey also found US investment managers to be lower than the global average in believing that climate change, environmental management, human rights, and sustainability, are currently material or will be material within the next five years.¹³¹ Going forward, only one-third of US investment managers expect to see an increase in client demand for the integration of ESG issues into investment practices in the next three years and only one-fifth expect to see clients demand new products based on ESG analysis.¹³²

Public pension funds seem to be doing little to change these expectations of investment managers. Pension funds influence external investment managers' engagement on ESG issues with companies through the managers' selection, their initial contract, their compensation structure, and through regular review meetings.¹³³ The current message through these four channels is that managers will be rewarded for meeting specific benchmarks or beating their competition.¹³⁴ Krehmeyer and colleagues note the problem of pension funds evaluating their asset managers on a quarterly basis, which continues the short-termism cycle.¹³⁵ In my survey, 70% of the funds review external managers' performance quarterly (19% do annual reviews). This, of course, does not mean that a manager is at risk of being fired for one or two quarters of poor performance, but being evaluated and possibly compensated based on quarterly performance clearly has the potential to focus managers only on short-term investment performance related to the relevant benchmark.¹³⁶ In addition, such a process makes it highly unlikely

¹²⁹ MERCER INVESTMENT CONSULTING, 2005 FEARLESS FORECAST: A CONSENSUS FORECAST OF US AND GLOBAL CAPITAL MARKETS AND INDUSTRY TRENDS 5 (2005).

¹³⁰ Thamotheram, *supra* note 9, at 296.

¹³¹ MERCER INVESTMENT CONSULTING, 2006 FEARLESS FORECAST: WHAT DO INVESTMENT MANAGERS THINK ABOUT RESPONSIBLE INVESTMENT? 5-6 (2006).

¹³² *Id.* at 7-8.

¹³³ Thamotheram, *supra* note 9, at 296 & 298.

¹³⁴ See *id.* at 307.

¹³⁵ Krehmeyer et al., *supra* note 14, at 14

¹³⁶ PAUL MYNERS, INSTITUTIONAL INVESTMENT IN THE UNITED KINGDOM: A REVIEW 53 (2001), available at www.hm-treasury.gov.uk/documents/financial_services/securities_and_investments/fin_sec_mynfinal.cfm. (noting that quarterly reviews in combination with the lack of clear timeframes have the "potential to encourage managers to adopt an investment approach which does not reflect either their clients' wishes or their long-term interests"). An ethnographic study of private and public pension funds

for the managers to focus on the long-term,¹³⁷ which is necessary for adopting new investment approaches based on environmental and social issues.¹³⁸ Without a clear message from pension trustees that consideration of LTRI issues is not simply a “fad” and that money managers will not be punished for a short-term performance short-fall due to the integration of LTRI information into their investment decisions, investment managers will not devote significant resources to these practices.¹³⁹

3.3 Pension Fund Trustees and LTRI: The Hurdles

The survey also asked the trustees to indicate which factors influenced their fund’s decision not to engage in SRI. The most common response was that the trustees believed it was not appropriate for them to make investment decisions for the fund based on ethical issues (45% selected this factor). This reflects the association of SRI with ethical investors and not the ESG, LTRI, or extra-financial criteria investment movement.¹⁴⁰ It also reflects a concern by trustees that consideration of such factors is a breach of fiduciary duties. In fact, two trustees provided a write-in response specifically indicating that concern. The first subsection below addresses those issues.

As for additional factors influencing the decision not to engage in SRI, trustees indicated that they believed SRI would reduce returns (36%), they were not under pressure from the plan membership to develop SRI policies (33%), they lacked of knowledge (22%¹⁴¹), or it was viewed as too expensive (15%). Only two trustees indicated that they did not have an SRI policy because they thought the plan membership would be against it. Among the open-ended responses provided by the trustees, one mentioned “fear of change” by the board. Although only one trustee thought to mention this fear, this concern is reflected in trustees’ beliefs about the impact of social investing on returns and their general

finds evidence of the challenge of thinking long-term with respect to asset managers (both internal and external) when trustees are barraged with short-term information. WILLIAM M. O’BARR AND JOHN M. CONLEY, *FORTUNE & FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING* 168-72 (1992). For example, one interviewee described the process of reviewing asset managers’ monthly performance reports but also stating that at their pension fund they “don’t try to fire managers over short periods of time.” *Id.* at 169. The authors noted the use of the word “try” and wondered how often the interviewee’s pension fund was successful in resisting a focus on the short-term. *Id.* Overall, O’Barr and Conley conclude that “to focus seriously on the long term is an act of intellectual originality that goes against the cultural grain.” *Id.* at 168.

¹³⁷ Krehmeyer et al., *supra* note 14, at 9.

¹³⁸ See *infra* notes 219-220 and accompanying text.

¹³⁹ Guyatt, *supra* note 18, at 143-45.

¹⁴⁰ See *supra* notes 45 & 87 and accompanying text.

¹⁴¹ Only one large pension fund indicated lack of knowledge as factor.

knowledge of these practices. These concerns are addressed in the subsection below on conservative decision making by trustees.

3.3.1 Breach of Fiduciary Duties

Trustees may decline to incorporate sustainability factors into their investment practices due to a belief that it would be a breach of their fiduciary duties. The state laws establishing each pension fund typically also state the fiduciary duties of the trustees, which can be categorized as the duties of loyalty and prudence. These duties also exist as common law duties as set forth in the Restatement (Third) of Trusts. With respect to the duty of prudence, state statutes will establish either a prudent person standard (requiring trustees to consider each investment in isolation) or a prudent investor standard (requiring trustees to consider each investment as part of an investment portfolio).¹⁴² The trend is towards adopting the prudent investor standard,¹⁴³ as seen by forty-three states having adopted some variation of the Uniform Prudent Investor Act (UPIA).¹⁴⁴ Included within the duty of prudence is the duty of care, which requires trustees to “to exercise reasonable effort and diligence in making and monitoring investments for the trust.”¹⁴⁵ The duty of loyalty requires that the trustees “administer the trust solely in the interests of the beneficiaries.”¹⁴⁶

Some state statutes modify or seek to clarify the content of these duties through additional provisions. For example, in Nebraska, the law on the duties of the Investment Council states that “No assets of the retirement systems . . . shall be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives.”¹⁴⁷ By contrast,

¹⁴² CAROL V. CALHOUN ET AL., GOVERNMENTAL PLANS ANSWER BOOK § 7.10 -7.13 (2d ed. 2007). Some states blend the two standards together. *Id.*

¹⁴³ *Id.* at § 7.13

¹⁴⁴ FRESHFIELDS BRUCKHAUS DERINGER, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT 103 (2005), available online at http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf; see also RESTATEMENT (THIRD) OF TRUSTS § 227 (1992) (establishing a prudent investment standard).

¹⁴⁵ RESTATEMENT (THIRD) OF TRUSTS § 227 comment d (1992).

¹⁴⁶ RESTATEMENT (THIRD) OF TRUSTS § 78 (1) (Tentative Draft No. 4, 2005); see also UNIFORM PRUDENT INVESTOR ACT § 5 (“A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries”).

¹⁴⁷ NEB. REV. STAT. § 72-1239.01(3) (2003); see also KAN. STAT. ANN. § 74-4921(3) (1993) (“No moneys in the fund shall be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives”). Calhoun et al. argue that the Kansas statute is unclear on whether it prohibits consideration of social issues in all instances, or only when it is expected to have a negative impact on the investment’s return. Calhoun et al., *supra* note 142, at § 7-31.

Connecticut state law provides that the State Treasurer “may” consider “the social, economic and environmental implications of investments of trust funds in particular securities.”¹⁴⁸

The Restatement (Third) of Trusts discusses social investing in its commentaries, but it does not provide a clear statement on its appropriateness under a trustees’ fiduciary duties.¹⁴⁹ These comments, however, rely primarily on academic articles discussing trustees’ fiduciary duties in the context of social investing based on negative screens—with most of these articles relating to institutional investors divesting from corporations conducting business in apartheid South Africa in the 1980s.¹⁵⁰ As discussed above, social investing may be based either on ethical values or as a strategy to increase value through decreased risk and higher return.¹⁵¹ Although social investing based on ethical values and the use of negative screening is also likely not a violation of fiduciary duties,¹⁵² an investment strategy based on utilizing environmental and social factors to increase value is clearly not a violation of a trustee’s fiduciary duties.¹⁵³ In fact, a recent survey of the law by the law firm Freshfields Bruckhaus Deringer argues that it would be a violation of fiduciary duties not to consider such issues in certain situations.¹⁵⁴

¹⁴⁸ CONN. GEN. STAT. § 3-13d (2002).

¹⁴⁹ See RESTATEMENT (THIRD) OF TRUSTS § 227 general notes comment c (1992)

¹⁵⁰ See *id.* (citing such work as Joel C. Dobris, *Arguments in Favor of Fiduciary Divestment of ‘South African’ Securities*, 65 NEB. L. REV. 209 (1986); Jerry and Joy, *Social Investing and the Lessons of South Africa Divestment: Rethinking the Limitations on Fiduciary Discretion*, 66 OR. L. REV. 685 (1987); Troyer et al., *Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds*, 74 GEORGETOWN L. J. 127 (1985)).

¹⁵¹ See *supra* note 9 and accompanying text.

¹⁵² See *infra* notes 155-60 and accompanying text.

¹⁵³ Freshfields Bruckhaus Deringer, *supra* note 144, at 102-116 (reviewing the consideration of ESG issues in investment decision making under ERISA, the Restatement (Third) of Trusts, and the UPIA); Calhoun et al., *supra* note 142, at §7-31 (“No one questions the right of a pension fund to avoid investment in tobacco stocks based on the trustees’ reasonable belief that the risks associated with tobacco stocks, in relationship to their returns, make them a poor investment”).

¹⁵⁴ Freshfields Bruckhaus Deringer, *supra* note 144, at 11-14. The United Nations Environment Programme Finance Initiative’s Asset Management Working Group commissioned the Freshfields Report. *Id.* at 6. This report reviews fiduciary duty requirements in nine different countries. *Id.* at 6. The objective of the study was to answer the following question: “Is the integration of environmental, social and governance issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) voluntarily permitted, legally required or hampered by law and regulation; primarily as regards public and private pension funds, secondarily as regards insurance company reserves and mutual funds?” *Id.*

Social investing may potentially violate the duty of loyalty if investment returns are sacrificed for the primary purpose of providing benefits (social or financial) to a third party,¹⁵⁵ or the trustees are using the plan's assets to further their own political agenda.¹⁵⁶ Both statements need to explanation, however. First, the duty of loyalty is not violated when the purpose of social investing is long-term value creation consistent with the duty of prudence, which is the case with LTRI.¹⁵⁷ In this situation, the benefits accruing to the third parties are not the primary purpose of the investment decision, but are due to the recognition that the proper management of such social and environmental matters may decrease risk and increase value for the corporation (and the pension fund's investment portfolio). Second, it is permissible to consider collateral social benefits when the costs are minimal. In one of the few cases considering social investing by public pension funds, the court in *Board of Trustees of the Employees' Retirement System of Baltimore v. Mayor of Baltimore*¹⁵⁸ held that a city ordinance preventing the city pension funds from investing in companies doing business with apartheid South Africa would not cause the trustees to violate their fiduciary duty of loyalty. This ruling was based, in part, on the finding that the costs of such a strategy were *de minimis*.¹⁵⁹ Third, trustees may act upon "fundamental and generally accepted ethical principles"—which is distinct from a trustee's personal social and political beliefs—and not be in violation of the duty of loyalty or the duty of prudence,¹⁶⁰ which is discussed next.

In *Employees' Retirement System of Baltimore*, the court also found that the city ordinance did not alter the trustees' duty of prudence.¹⁶¹ In making this ruling, the court relied on the treatise *Scott on Trusts*.¹⁶² The court cited *Scott* for

¹⁵⁵ UNIFORM PRUDENT INVESTOR ACT § 5 comments ("No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries - for example, by accepting below-market returns - in favor of the interests of the persons supposedly benefited by pursuing the particular social cause"); see also RESTATEMENT (THIRD) OF TRUSTS § 78 reporter's notes comment f (citing with approval the above quote from the Uniform Prudent Investor Act).

¹⁵⁶ RESTATEMENT (THIRD) OF TRUSTS § 227 comment c ("in managing the investments of a trust, the trustee's decisions ordinarily must not be motivated by a purpose of advancing or expressing the trustee's personal views concerning social or political issues or causes").

¹⁵⁷ See *infra* note 163 and accompanying text.

¹⁵⁸ 562 A.2d 720 (1989), cert. denied, 110 S. Ct. 1167 (1990).

¹⁵⁹ *Id.* at 738.

¹⁶⁰ SCOTT ON TRUSTS, § 227.17 (4th ed. 2001). Scott goes on to state that trustees "may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility." *Id.*

¹⁶¹ *Employees' Retirement System of Baltimore*, 562 A.2d at 735-38.

¹⁶² *Id.* at 737.

the proposition that it is reasonable for a trustee to believe that a more socially responsible corporation will perform better over the long-run.¹⁶³ In addition, the court also cited *Scott* for the idea that regardless of the impact of social performance on financial performance, “the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of funds in a manner detrimental to society.”¹⁶⁴ This holding was qualified, however, in that it must also only involve *de minimis* costs,¹⁶⁵ which is not a factor mentioned in *Scott*.¹⁶⁶

These statements are also consistent with the *Uniform Management of Public Employee Retirement Systems Act* (UMPERSA) and private pension trustees’ fiduciary duties under the *Employee Retirement Income Security Act of 1974* (ERISA). Both UMPERSA and the Department of Labor state that the consideration of collateral benefits through socially responsible investing is consistent with a trustee’s fiduciary duties if the investment has an expected rate of return commensurate to alternative investments of similar risk.¹⁶⁷

Overall, it is clear that the practice of long-term responsible investing with a goal of sustainable economic development would not be in violation of a trustee’s fiduciary duties. Freshfields Bruckhaus Deringer summarize their review of US law by stating that “there appears to be a consensus that, so long as ESG considerations are assessed within the context of a prudent investment plan, ESG considerations can (and, where they affect estimates of value, risk and return, should) form part of the investment decision-making process.”¹⁶⁸ The report goes on to form prescriptive guidelines and permissive guidelines. Under prescriptive guidelines, the report states that the duty of prudence requires trustees to treat their proxies as assets and vote on shareholder resolutions in an informed

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ In the 2001 edition of *Scott on Trusts*, the treatise does not mention the *de minimis* cost factor. See SCOTT ON TRUSTS, § 227.17 (4th ed. 2001).

¹⁶⁷ UNIFORM MANAGEMENT OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS ACT § 8(a)(5) (“a trustee with authority to invest and manage assets . . . may consider benefits created by an investment in addition to investment return only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits”); Freshfields Bruckhaus Deringer, *supra* note 144, at 110 (citing a Letter from the Department of Labor to William M. Tartikoff, Senior Vice President and General Counsel of Calvert Group Ltd. (May 28, 1998)). This interpretation of ERISA fiduciary duties is consistent with the Department of Labor’s statements related to Economically Targeted Investments (ETIs). See *infra* notes 226-28.

¹⁶⁸ Freshfields Bruckhaus Deringer, *supra* note 144, at 114.

manner,¹⁶⁹ and to consider the relevance of ESG considerations for investment decisions.¹⁷⁰ Under permissive guidelines, the report states that it is not a violation of their duty of loyalty to engage in shareholder activism on ESG issues with the purpose of enhancing company value, or to consider the social and environmental benefits of an investment if the expected rate of return is commensurate to similar investments.¹⁷¹ The permissiveness of such actions is consistent with the Department of Labor's statement that private pensions should engage in shareholder activism when it is expected to increase investment value.¹⁷²

3.3.2 *Conservative Decision Making*

Even if trustees are assured that LTRI would not be in violation of their duties, most pension funds are still unlikely to engage in LTRI due to the trustees' conservative investment decision making practices. Trustees are likely to follow the practices "commonly accepted throughout the investment management industry,"¹⁷³ the advice of consultants, and the actions of their peer group.¹⁷⁴ For example, in the UK, 63 percent of pension fund trustees indicated that in making investment decisions their fund "sticks as closely as possible to the accepted practice in the industry."¹⁷⁵

¹⁶⁹ See also Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2(1) (1994) (stating with respect to private pensions that "The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment").

¹⁷⁰ Freshfields Bruckhaus Deringer, *supra* note 144, at 114.

¹⁷¹ *Id.* at 115.

¹⁷² Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2(3) (1994).

An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved. *Id.*

The issues the Department of Labor lists as possible candidates for shareholder activism include "the nature of long-term business plans, the corporation's investment in training to develop its work force, other workplace practices and financial and non-financial measures of corporate performance." *Id.* This interpretive bulletin is also cited by the Myners Report in support of greater shareholder activism by pension plans in the United Kingdom. Myners, *supra* note 136, at 92-93.

¹⁷³ GORDON CLARK, PENSION FUND CAPITALISM 157 (2000)

¹⁷⁴ Myners, *supra* note 136, at 59-61.

¹⁷⁵ *Id.* at 59.

Although there is some leadership in LTRI practices,¹⁷⁶ it is far from the commonly accepted practices necessary to change trustee behavior on a large scale. To engage in sustainable investing, trustees will be forced out of their comfort zone. For example, they will need to consider managers using new strategies to incorporate non-financial data into investment analysis. These managers will not have a long track record with these strategies to demonstrate their effectiveness, which will make trustees question the appropriateness of such investments.¹⁷⁷ Likewise, trustees and investment consultants will need to develop new and perhaps untested performance measures to evaluate these managers.¹⁷⁸ This will also pull trustees back towards conventional strategies and push them away from sustainable investing.

4 Public Pension Disclosure of LTRI Investment Policy and Implementation

In light of the potential for public pensions to serve a useful role under a new governance approach to regulation and considering the currently limited involvement of these funds, public pensions in the US should be required to disclose whether or not LTRI considerations play a role in their investment policies. In addition, pension funds should provide disclosure on the actual implementation of those policies, such as their engagement with corporations, their proxy voting policies, and the basis of their selection and retention of asset managers that utilize an LTRI strategy. The most likely avenue for this reform would be through modification to the Government Accounting Standards Board (GASB) Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*. GASB statement No. 25 is the basis for the Comprehensive Annual Financial Reports (CAFR) filed by most public pensions.¹⁷⁹ Included within the CAFR is an investment section where the pension plan reports on its investment policies, asset allocations, investment activities, and fees.¹⁸⁰

Alternatively, the proposal could be implemented through amendments to the *Uniform Management of Public Employee Retirement Systems Act* (UMPERSA), which currently requires pension plans to disclose an annual report

¹⁷⁶ See *supra* notes _88-104 and accompanying text.

¹⁷⁷ See Clark, *supra* note 173, at 140 (discussing unconventional investment decisions by trustees in general).

¹⁷⁸ See *infra* notes 218-21 and accompanying text.

¹⁷⁹ Calhoun et al., *supra* note 142, at § 5.5-5.6.

¹⁸⁰ *Id.* at § 5.8.

to the public.¹⁸¹ Amendments to UMPERSA would have significantly less impact than amendment to GASB Statement No. 15, however, as it would require each state to amend their laws and UMPERSA has apparently not had a significant influence on state laws.¹⁸² As a third alternative, disclosure of LTRI investment policies and implementation actions could be encouraged as a “best practice” by influential organizations such as the Government Finance Officers Association.¹⁸³ The remainder of this section reviews the developments surrounding a similar law adopted in the UK and then the expected impact in the US.

4.1 UK Pensions of Act of 1995 Disclosure Requirements

Starting in 2000, pension funds (both public and private) in the UK are required by law to disclose in their Statement of Investment Principles (SIP) “the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments” and “their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments.”¹⁸⁴ Note that the law does not require pensions to consider social and environmental issues, but only that the pension provides disclosure on whether or not they do. Similar laws for pension funds exist in Belgium,¹⁸⁵ Germany,¹⁸⁶ and Sweden.¹⁸⁷

The SIP disclosure requirements amendment to the Pensions Act of 1995—along with the recommendations in the well-publicized Myners Report in 2001 that encouraged trustees to be more active owners¹⁸⁸—has had a significant impact on LTRI shareholder engagement in the UK. A review of actions taken by pensions during the first year of the requirement found that 59% of pensions stated that they were incorporating social and environmental issues into their investments, and 48% indicated that they directed their fund managers to take

¹⁸¹ UNIFORM MANAGEMENT OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS Act § 13. Full text of UMPERS is available at <http://www.law.upenn.edu/bll/ulc/ulc.htm#mpersa>.

¹⁸² Calhoun et al., *supra* note 142, at § 7-22 (noting partial adoptions of UMPERS in only South Carolina and Colorado).

¹⁸³ See Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 226-227 (2001) [hereinafter Romano, *Less is More*].

¹⁸⁴ The Occupational Pension Schemes Amendment Regulations 1999: Statutory Instrument 1999 No. 1849, available at www.legislation.hmso.gov.uk/si/si1999/19991849.htm.

¹⁸⁵ Freshfields Bruckhaus Deringer, *supra* note 144, at 152.

¹⁸⁶ *Id.* at 63

¹⁸⁷ *Id.* at 152.

¹⁸⁸ See Myners, *supra* note 136, at 14.

these issues into account.¹⁸⁹ Fourteen percent of the funds (mostly smaller funds) indicated that they would not take these issues into account, and one-quarter left the decision to their fund managers.¹⁹⁰ The SIP statements, however, rarely mentioned how the policy would be implemented in practice and used language that made it difficult to determine how investment practices would actually change, if at all.¹⁹¹

In the following years, the disclosure requirements continued to have a significant influence on behavior, but the extent of their actual impact on practices to-date remains somewhat unclear. For example, FairPensions, an NGO sponsored by Amnesty International, Greenpeace, and others,¹⁹² reviewed practices at the 20 largest pension funds in the UK in 2006 and found that only 12 of the 20 actually disclosed whether or not they consider ESG issues in their SIPs.¹⁹³ The study claimed that most pensions seemed to take a “box ticking” approach to ESG issues by making general statements in support of responsible investment but not doing anything to implement those statements.¹⁹⁴

Other investigations report a greater impact. Just Pensions, a program established by the UK Social Investment Forum,¹⁹⁵ surveyed 79 pensions in fall 2005.¹⁹⁶ When asked which practices the funds used “a lot” for dealing with ESG issues, amongst the large funds—those with over £ 1 billion in assets¹⁹⁷—4% used negative screening, 16% used positive screening, 58% used engagement, and 50% the exercise of voting rights.¹⁹⁸ For all pensions in the sample, almost one-half indicated that they would use engagement and voting rights at least “a little

¹⁸⁹ EUGENIE MATHIEU, RESPONSE OF UK PENSION FUNDS TO THE SRI DISCLOSURE REGULATION 33 (2000), available at www.uksif.org/Z/Z/Z/lib/2000/10/reprt-pf-discl/index.shtml

¹⁹⁰ *Id.*

¹⁹¹ *Id.* at 35.

¹⁹² FairPensions website, *About Us*, available at www.fairpensions.org.uk/about_us.

¹⁹³ FAIRPENSIONS, UK PENSION SCHEME TRANSPARENCY ON SOCIAL, ENVIRONMENTAL AND ETHICAL ISSUES i (2006), available at www.fairpensions.org.uk/news/disclosureranking.htm.

¹⁹⁴ *Id.* at iii.

¹⁹⁵ Just Pensions website, *About Just Pensions*, available at <http://www.uksif.org/J/Z/Z/jp/about/main/index.shtml>.

¹⁹⁶ CHRIS GRIBBEN & MATTHEW GITSHAM, WILL UK PENSION FUNDS BECOME MORE RESPONSIBLE?: A SURVEY OF TRUSTEES 5 (2006), available at <http://www.uksif.org/J/Z/Z/lib/2006/files/02/jp-ukpf-will06/ukpf2006-justpens.pdf>

¹⁹⁷ *Id.* at 7n.8.

¹⁹⁸ *Id.* at 11. For the smallest funds, they were more likely to use negative and positive screening and less likely to use engagement or voting rights. *Id.* Pensions for charities were the most likely to use any of these mechanisms. *Id.* 12.

more” in the next three years.¹⁹⁹ One-third of pensions indicated that ESG issues had at least “some impact” on the selection of fund managers, and over one-quarter of the sample used a formal process to incorporate ESG factors into the appointment and assessment of fund managers.²⁰⁰

Overall, the SIP disclosures requirements appear have had a significant impact in the UK. For example, based on interviews with UK fund managers, Williams and Conley find that the disclosure requirement is having a “profound effect” amongst large pension funds.²⁰¹ Others have drawn similar conclusions.²⁰² In addition, these requirements seem to have strong support amongst trustees. In fact, one-third of the sample in the Just Pensions 2005 survey “strongly agreed” and another one-third “agreed” that additional legislation is needed beyond simple disclosure of a policy and that funds should provide information on actual implementation.²⁰³ These developments have also apparently had an impact throughout the UK investment community. For example, 47% of UK investment managers expect a demand for investment products that utilize social and environmental factors in the next three years, compared to only 19% of US investment managers.²⁰⁴ There are other differences between the UK and the US, however, that likely explain a significant portion of these differences.²⁰⁵

¹⁹⁹ Id. at 12.

²⁰⁰ Id. at 15-16. None of the public pensions in this sample used those methods, though 10% used formal procedures in the selection of investment consultants. Id. at 15. The report does not provide information on the size of those public pension funds.

²⁰¹ Cynthia A. Williams and John M. Conley, *An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct*, 38 CORNELL INT'L L.J. 493, 534-35 (2005).

²⁰² See Russell Sparkes, *A Historical Perspective on the Growth of Socially Responsible Investment*, in RESPONSIBLE INVESTMENT 39, 50-51 (Rory Sullivan and Craig Mackenzie, eds., 2006) (attributing the significant growth of SRI investing in the UK to the disclosure requirement); Aris Solomon et al., *Can the UK Experience Provide Lessons for the Evolution of SRI in Japan?*, 12 CORP. GOV.: AN INTL. REV. 552, 556 (stating, in reference to the disclosure requirement, that “A seemingly minor institutional change to pension fund law has had a significant impact on pension fund trustees and on SRI in the UK.”)

²⁰³ Gribben and Gitsham, *supra* note 196, at 17. Only 3% “strongly disagreed” and an additional 8% “disagreed.” Id. In addition, two-thirds at least “agreed” that there should be regulation encouraging a long-term perspective, such as increased voting rights or lower capital gains taxes and higher dividends for long-term holders. Id. at 19-20. It should be noted that it is difficult to determine how representative their sample is of all pension funds. The survey was distributed to 1000 pensions and only 79 responded. Id. at 5.

²⁰⁴ Mercer, 2006 Fearless Forecast, *supra* note 131, at 8.

²⁰⁵ For example, institutional investments assets in mutual funds are greater in the US (which may be more short-term focused) and the UK government has shown support for CSR issues. Williams and Conley, *supra* note 201, at 535-38.

4.2 LTRI Disclosure for Public Pension Funds: A Catalyst for Change

As discussed in Part III, there does not appear to be wide-spread consideration of LTRI issues in public pension investment practices, and some actions may actual work to further the short-termism problem. This article's proposed reforms would not require that public pensions integrate such considerations into their investment policies and practices, but should ensure that the decision whether or not to do so is a fully-informed decision, rather than pre-empted by concerns over fiduciary duties or stalled due to conservative decision making. This disclosure requirement will establish the legitimacy of LTRI and allay concerns that such actions are in violation of fiduciary duties. This proposal will also raise general awareness of LTRI and allow trustees to observe and learn from the actions of others, which will reduce some of the causes of conservative decision making. Public pensions are free, or course, to state that they do not consider LTRI issues for any reason, such as cost or the belief that it is not in the beneficiaries' best interest. Overall, though, we can expect public pensions to engage in more thoughtful consideration of their policies on shareholder proposals and proxy voting, shareholder engagement, and directly through their investments.

Shareholder Proposals and Voting Policies: As shown earlier, few public pensions have well-developed policies on voting their proxies on environmental and social issues,²⁰⁶ and only a handful are active in sponsoring shareholder proposals.²⁰⁷ Although many pensions may (and should) decide to continue not to sponsor shareholder proposals due to the resources required, it is irresponsible of trustees not to have a complete proxy voting policy or to have a blanket policy of abstaining on voting on social and environmental issues. It is well established that proxies are assets of the pension plan and should be voted appropriately.²⁰⁸ There is an emerging consensus that issues of sustainability will have an impact on investment performance over the long-term²⁰⁹ and therefore prudent trustees must devote thought to their policies and provide justification for their decisions. In

²⁰⁶ See *supra* Part 3.2.1.

²⁰⁷ See *supra* notes 88-94 and accompanying text.

²⁰⁸ See Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2(1) (1994) (stating that "The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock" and that "The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment.")

²⁰⁹ See *supra* notes 9 and 36 and accompanying text.

addition, contingent on cost constraints, pensions should make their votes available to the public.²¹⁰

Shareholder Engagement. Public pensions can choose to directly engage with corporations individually or act through a coalition of investors, such as the Carbon Disclosure Project²¹¹ or the Investor Network on Climate Risk.²¹² Such coalitions operate in different ways. The Carbon Disclosure Project, for example, involves a request filed by institutional investors to corporations to provide disclosure on greenhouse gas emissions and the risks of climate change to the corporation.²¹³ This information is then available for pensions to use in any direct engagement with the corporation, for their investment managers to use in investment analysis or engagement, and for other interested stakeholders of the corporation. As a member of the Investor Network on Climate Risk, pension trustees can participate in coordinated corporate engagement with other institutional investors.²¹⁴ Overall, collaboration allows pension funds to operate more efficiently by reducing duplicate costs, learning from others' experience, and generally increasing their influence.²¹⁵ Through these coalitions investors can also engage in the public policy process, such as the efforts of some public pensions to encourage the SEC to require corporations to provide greater disclosure on climate change risks.²¹⁶ They can also engage in the policy process by monitoring the political activity of the corporations in which they invest.²¹⁷

Investment Practices. For those pension funds that decide to place an increased priority on LTRI issues, we would expect that this would have a significant impact throughout the financial industry because public pensions rely so heavily on investment consultants and external money managers. For example, if pension boards start pressing for action on LTRI practices, then investment consulting firms will start to evaluate money managers on the basis of

²¹⁰ See *infra* note 231 and accompanying text (discussing the role of disclosure to reduce the risks of politicalization of the process)

²¹¹ Carbon Disclosure Project website, available at www.cdproject.net.

²¹² See Investor Network on Climate Risk website, available at www.incr.com.

²¹³ See Carbon Disclosure Project, *About Us*, available at www.cdproject.net/aboutus.asp.

²¹⁴ Investor Network on Climate Risk, *INCR Overview*, available at <http://www.incr.com/index.php?page=2>.

²¹⁵ Hawley & Williams, *Fiduciary Capitalism*, *supra* note 22, at 173.

²¹⁶ See CERES press release, *supra* note 98

²¹⁷ See Hawley & Williams, *Fiduciary Capitalism*, *supra* note 22, at 174. In 2006, there were 29 shareholder proposals on the disclosure of political contributions and over half of those received support of 20% of greater. Institutional Shareholder Services, *Post Season Report*, *supra* note 6, at 32-34.

engagement and integration of these issues.²¹⁸ The consultants will seek investment managers that are trained on these issues and will work to develop compensation and evaluation practices that allow investment managers to undertake engagement based on long-term issues.²¹⁹ As discussed earlier, pension funds can also influence external managers' engagement practices through regular review meetings by raising these issues; to the extent these issues are not raised during review meetings, then external managers will provide little attention to them.²²⁰

Through this process, we would expect best practices to develop and to be shared related to pension funds' investment policies and implementation, as well as best practices amongst investment managers on how they demonstrate their effective consideration of LTRI issues and engagement practices to trustees and their consultants.²²¹ These developments also have the potential to influence sell-side analysts' research. This is especially important considering that new financial analysts do not believe there is a demand for consideration of these issues, and therefore do not attempt to gain additional knowledge in this area.²²² The primary

²¹⁸ Thamotheram, *supra* note 9, at 300; see also MARATHON CLUB, LONG-TERM, LONG-ONLY INVESTING: A CONSULTATION PAPER 17 (2006), available at <http://www.marathonclub.co.uk/news.htm> [hereinafter Marathon Club, Responses] (noting that the most important decision for trustees' attempting to implement a long-term investing strategy is the selection of the investment manager).

²¹⁹ See Tonello, *supra* note 14, at 44; Krehmeyer et al., *supra* note 14, at 14; Thamotheram, *supra* note 9, at 296 & 298. Compensation and evaluation practices is not as easy as simply lengthening the terms of the contract or changing from quarterly reviews to annual reviews. MARATHON CLUB, LONG TERM LONG ONLY CONSULTATION PAPER RESPONSES – A SUMMARY 1, 4-5 (2006), available online at <http://www.marathonclub.co.uk/news.htm>. Instead, it will likely require the development of new performance measures that incorporate multiple factors. *Id.* at 5. For a further discussion of what such performance metrics may include, see Marathon Club, Consultation Paper, *supra* note 218, at 19-20.

²²⁰ Thamotheram, *supra* note 9, at 296 & 298; see also Marathon Club, Consultation Paper, *supra* note 218, at 21-22 (suggesting issues to consider in manager review meetings to ensure that the manager is enacting a long-term investing strategy).

²²¹ For examples of how an investment manager may report on their engagement activities, see Insight Investment's quarterly engagement reports, available at <http://www.insightinvestment.com/Responsibility/reporting/reporting.asp>. For example, Insight Investment's quarterly report on engagement activities provides a chart listing the target company, the topic of engagement, the reason for engagement at that company, and the current status of the impact of those actions. See INSIGHT INVESTMENT, COMPANY ENGAGEMENT REPORT 1 JULY TO 30 SEPTEMBER 2006, available at <http://www.insightinvestment.com/Responsibility/reporting/reporting.asp>.

²²² Tonello, *supra* note 14, at 45; UNEP FINANCE INITIATIVE, GENERATION LOST: YOUNG FINANCIAL ANALYSTS AND ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES 4 (2005), available at http://www.unepfi.org/fileadmin/documents/ynt_summary_2005.pdf (reporting results from interviews with under-35 year-old financial analysts and finding that they were uninformed on

example in the area of analysts' research is the Enhanced Analytics Initiative.²²³ This is an initiative that seeks to improve the quality of sell-side analysts' research on LTRI issues through financial incentives. Each member of the initiative, such as a pension fund, agrees to allocate at least five percent of their brokerage commissions to analysts conducting this type of research.²²⁴ The creation of new LTRI research and the pressure for greater corporate disclosure in general will not only improve the decision-making of public pensions' asset managers, but will also further a new governance regulatory approach by creating information of use to others, including social investors, special interest groups, and government bodies.

4.3 Preventing the Politicalization of Public Pensions' Policies & Practices

The primary argument against this proposal is that public pensions—through the involvement of politicians or union representatives—will simply use LTRI as an excuse to take actions based on private political interests and without actual regard to long-term shareholder value.²²⁵ These arguments—raised most recently as an argument against granting shareholders access to the directors' ballot—echo concerns over economically-targeted investments (ETIs) in the mid-1990s. ETIs are investments by pension funds that take into account the investment's economic and social benefits to the local community, such as increased employment or the provision of affordable housing.²²⁶ Some commentators argued that ETIs opened the door to “politicizing” pension investments, as opposed to “maximizing” them.²²⁷ Although some early studies showed that ETIs had a weakly significant negative impact on pension

ESG issues and did not believe they would be rewarded for doing research incorporating those topics). Responsiveness of analysts to these issues is also furthered by the requirements of Sarbanes Oxley section 501 that attempts to improve the independence of securities analysts. See Tonello, *supra* note 14, at 38.

²²³ See *supra* note 103 and accompanying text (noting that CalSTRS has joined this initiative).

²²⁴ Tonello, *supra* note 14, at 40.

²²⁵ See Romano, *Less is More*, *supra* note 183, at 181; see generally Charles E. Rounds, Jr., *Why Social Investing Threatens Public Pension Funds, Charitable Trusts, and the Social Security Trust Fund*, in PENSION FUND POLITICS: THE DANGERS OF SOCIAL INVESTING 56 (Jon Entine, ed., 2005); Jarol B. Manheim, *The Strategic Use of Socially Responsible Investing*, in PENSION FUND POLITICS: THE DANGERS OF SOCIAL INVESTING 81 (Jon Entine, ed., 2005).

²²⁶ United States Government Accounting Office (GAO), PUBLIC PENSION PLANS: EVALUATION OF ECONOMICALLY TARGETED INVESTMENT PROGRAMS, GAO/PEMD 95-13, at 5-6 (1995); Ronald D. Watson, *Does Targeted Investing Make Sense?*, 23 FIN. MGMT 69 (Winter 1994).

²²⁷ David A. Vise, *A Billion-Dollar Battle Over Pension Plans' Purpose*, WASH. POST, December 6, 1992, at H1; see also John R. Nofsinger, *Why Targeted Investing Does Not Make Sense!*, 27 FIN. MGMT. 87, 89 (1998) (noting the agency costs resulting from the potential political benefit to trustees from the use of ETIs).

performance, these studies used data before the mid-1990s when the Department of Labor issued a statement that ETIs were appropriate if the expected rate of return was comparable to alternative investments of a similar risk.²²⁸ More recent studies—including those using data after the Department of Labor’s announcement—have not found a negative relationship between the use of ETIs and fund performance.²²⁹ Thus, this provides some evidence that encouraging the use of LTRI, with a clear, stated focus on long-term shareholder value, will not simply lead to the politicizing of investments.

In addition, the transparency required—on both policy and implementation—should also work against politicization or domination of decision-making by a special interest group. A pension’s LTRI disclosures provide an avenue for dialogue on the pension’s policies and performance from both plan members and third parties. Just as unions and special interest groups have started evaluating mutual funds and investment managers on their proxy voting records related to CEO compensation, labor issues, and the environment,²³⁰ pensions’ practices will be scrutinized by both those seeking greater consideration of sustainability issues by pensions and those believing that such issues detract from the pension’s long-term performance goals. These analyses and discussions should help inform trustees, as well as push them to justify any actions taken (or decisions not to engage in LTRI) to plan members, sponsoring government bodies, and taxpayers.²³¹

²²⁸ Pension and Welfare Benefits Administration, 59 Fed. Reg. 32,606 (June 23, 1994) (codified at 29 C.F.R. pt. 2509).

²²⁹ For a review, see Hess, *supra* note 106, at 207-208, 211-12; For empirical studies finding that ETIs have no impact on public pension’s investment performance, see *Id.* at 211-12; Alicia H. Munnell & Annika Sunden, *Investment Practices of State and Local Pension Funds: Implications for Social Security Reform*, in PENSIONS IN THE PUBLIC SECTOR 153, 161-64 (Olivia S. Mitchell & Edwin C. Husted eds., 2001); Julia L. Coronado et. al., *Public Funds and Private Capital Markets: The Investment Practices and Performance of State and Local Pension Funds*, 56 NAT’L TAX J. 579, 589-90 (2003)

²³⁰ See DOUGLAS G. COGAN, UNEXAMINED RISK: HOW MUTUAL FUNDS VOTE ON CLIMATE CHANGE RESOLUTIONS (2006), available at www.ceres.org/pub/docs/Ceres_mutual_funds_report_012606.pdf; AFL-CIO, AFL-CIO KEY VOTES SURVEY: HOW INVESTMENT MANAGERS VOTED IN THE 2006 PROXY SEASON (2006) available at http://www.aflcio.org/corporatewatch/capital/upload/2006_AFL-CIO_Key_Votes_Survey-3.pdf; AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES (AFSCME) ET AL., ENABLERS OF EXCESS: MUTUAL FUNDS AND THE OVERPAID AMERICAN CEO (2006) available at <http://www.thecorporatelibrary.com/special/afscme/EnablersofExcess.pdf>

²³¹ See Romano, Less is More, *supra* note 183, at 223 (arguing for greater transparency and a trustee-level review of empirical data related to any corporate governance activism that the public pension fund chooses to engage in) and at 226 (arguing that a formal review process of corporate governance activism may be a deterrent to politicalization of activism by the board).

To further prevent politicization—and to improve trustee decision making in general—the governance of public pensions needs greater consideration.²³² First, there should be greater disclosure of conflicts of interest policies,²³³ as political donations, for example, have the potential to inappropriately affect investment choices.²³⁴ Second, training and education of board members—especially member-elected trustees—should become a priority. One trustee of a large fund in my survey stated that “Our board members have a three year term of office and the learning curve is at least two years.”²³⁵ Surprisingly, only 14% of the trustees for large pension funds in my survey indicated that the plan had a formal, documented training program. This compared to 39% of smaller funds. Instead, the pension provided a budget for education and trustees obtained their own training on an informal basis. Common training programs attended by trustees included those offered through The Wharton School and Stanford Law School. The disclosure requirement proposed here would likely put LTRI issues on the curriculum of those programs—thus improving general knowledge of these issues—as well as spur research on sustainable development investing by the educators serving in those programs.

Finally, there should be greater consideration of the role of member-elected trustees (including those serving on an Investment Advisory Council). There is some evidence that member-elected trustees can improve fund financial performance (as long as they do not dominate the board)²³⁶ and that they may reduce political interference, such as the sponsoring government using the pension assets as a “safety-valve” against other budget short-falls.²³⁷ Additional research in this area is needed, but such trustees may serve a useful monitoring role. However, there is also the concern that member-elected trustees could lead to the domination of the board by politically-motivated special-interest groups rather than creating a balanced board. For example, the US Chamber of

²³² See S. Prakash Sethi, *Investing in Socially Responsible Companies is a Must for Public Pension Funds – Because There is no Better Alternative*, 56 J. OF BUS. ETHICS 99, 104 (2005) (arguing against fears of politicization of social investing and stating that the real issue is improving the accountability of trustees for all decisions and not just social investing decisions).

²³³ CalSTRS recently proposed a rigorous conflict of interest policy that may serve as a leadership example for others. CalSTRS website, *Press Release: California’s Teachers’ Retirement Board Sets High Ethics Bar*, Available at <http://www.calstrs.com/Newsroom/news110306.aspx>.

²³⁴ Munnell and Sunden, *supra* note 127, at 36-37; Charles E. Rounds, Jr. *supra* note 225, at 57.

²³⁵ See also Krehmeyer et al., *supra* note 14, at 17-18 (noting the lack of training for pension trustees)..

²³⁶ Hess, *supra* note 106, at 213-14.

²³⁷ *Id.* at 200-04

Commerce criticizes CalPERS for being dominated by union-elected member trustees and *ex officio* trustees that received union funding.²³⁸

The capture of pension fund LTRI practices by politicians and special interest groups is also alleviated by the involvement of external money managers for most public pensions. To the extent that these managers are rewarded and evaluated on their shareholder engagement and the creation of long-term value, they will work with corporations to develop profitable sustainable development strategies, and not simply pressure corporations to improve their environmental and social performance without regard to the economic implications of those acts for the corporation.

Capture is also alleviated if more pension funds are active this area, rather than just the current handful of active pensions.²³⁹ Greater involvement through institutional investor coalitions, the public posting of proxy voting guidelines and investment policies, and in other ways, contributes to the debate and adds new perspectives and balance. Currently, those setting the agenda for shareholder proposals, for example, are religious institutions.²⁴⁰ This does not necessarily mean that those proposals would not fit within LTRI as described in this article, but increased involvement by a diversity of pension funds will help ensure that the proposals receiving attention from corporations are consistent with LTRI.

Finally, next steps to prevent such capture, as well as further new governance regulatory goals, would be greater participation of state and federal agencies in setting the agenda for shareholder engagement. A current example involves the UK's Health and Safety Executive's (HSE) experiment with the Corporate Health and Safety Performance Index (CHaPSI).²⁴¹ CHaPSI is an attempt to develop an index to measure firms' performance and policies related to health and safety management. The HSE developed this index with the input from investors to help ensure that it is useful to them so they will be active in pressuring firms to improve their CHaPSI numbers.²⁴² Various agencies in the US

²³⁸ Thomas J. Donohue, *CalPERS Needs Reform*, June 24, 2004, available at http://www.uschamber.com/press/opeds/040624tjd_sanfran_op_ed.htm.

²³⁹ See *supra* notes 88-104 and accompanying text (describing those funds currently active in social and environmental shareholder issues).

²⁴⁰ W. Trexler Proffitt, Jr. & Andrew Spicer, *Shaping the shareholder activism agenda: institutional investors and global social issues*, 4 STRATEGIC ORG. 165(2006)

²⁴¹ For a discussion of CHaPSI as a policy tool and its relationship to SRI, see Steve Waygood et al., *Harnessing Investors to Support the Implementation of Health and Safety Public Policy*, in RESPONSIBLE INVESTMENT 322 (Rory Sullivan and Craig Mackensie, eds., 2006). For information and updates on the program, see the HSE's website on CHaPSI at <http://www.chaspi.info-exchange.com/default.asp>.

²⁴² Waygood et al., *supra* note 241, at 323-25.

could experiment with developing similar programs. Consideration of how to improve the TRI along these lines is a natural starting point.²⁴³ Public pension involvement in these programs would grant legitimacy to this part of their LTRI policy, ensures the pensions are working towards regulatory goals, and, of course, helps provide more effective and efficient regulation.

5 Conclusion

Traditional legal mechanisms are limited in their ability to regulate corporations' sustainable economic development. Under a new governance approach to regulation that seeks to harness the potential of informed and interested third-party actors to develop flexible and efficient regulation, public pensions can serve a useful role. These pensions have a natural interest in sustainable economic development, but there are hurdles in the way of their greater involvement. To motivate action, and then continually improve the quality of their involvement, public pensions should be required to disclose the extent to which they consider LTRI issues in their investment policies and practices. Public pensions are only one part of this broader, new governance regulatory approach, but they are a potentially powerful catalyst for change. Their actions can spur greater consideration of long-term responsible investor issues throughout the financial industry. In addition, their pressures for increased corporate disclosures on social and environmental issues as part of their LTRI practices will improve information-based regulatory approaches, such as the TRI and sustainability reporting.

²⁴³ See *supra* notes 64-73 and accompanying text (discussing the TRI).