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Can Socially Responsible Investment Provide a Means of Environmental Regulation?

Benjamin J. Richardson
Osgoode Hall Law School of York University

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CAN SOCIALLY RESPONSIBLE INVESTMENT PROVIDE A MEANS OF ENVIRONMENTAL REGULATION?

BENJAMIN J RICHARDSON*

The seemingly rapid growth of the market for socially responsible investment ('SRI') in Australia and other jurisdictions promises to make financing decisions more accountable to social and environmental criteria. Indeed, the ability of financiers to withhold funds and thereby hinder development, such as the decision of the Australia and New Zealand Banking Group Ltd in 2008 to shun financing a Tasmanian pulp mill planned by Gunns Ltd, raises hopes that financial institutions could act as surrogate environmental regulators. The long-standing SRI movement arose partly as an answer to the lacunae or weaknesses of official regulation, providing a means by which ethical investors could challenge corporations partaking in socially egregious or environmentally irresponsible practices condoned by authorities. Yet, these aspirations appear to have been too ambitious. Lacking sufficient market leverage, and reliant on relatively tame voluntary codes of conduct, paradoxically the success of the SRI movement increasingly relies on the state itself. SRI depends on weightier public policy reforms in such areas as economic incentives and fiduciary duties, although considerable uncertainty persists concerning which policy reforms could most effectively advance SRI. Concomitantly, reformers must justify why investment institutions should be held legally accountable to a higher standard than those firms they finance. Unless these barriers to SRI and its regulation are resolved, it is doubtful whether SRI in Australia or elsewhere can contribute significantly to environmental governance.

I THE ISSUES

Can socially responsible investment ('SRI') provide a means of environmental regulation, disciplining companies to adhere to higher environmental standards as a condition of financing? It has become important to answer this question given the seemingly rapid growth of the SRI market in Australia and other countries in recent years, coupled with faith among some commentators and investors in SRI's capacity to promote sustainable development. A related pressing question is what should be the relationship between the SRI market and regulation, including environmental law? If a company is acting in accordance with basic

* Professor of Law, Osgoode Hall Law School, Toronto. I am grateful for the helpful comments provided by the anonymous reviewers on an earlier draft of this article.

environmental legislation, should the legal system concern itself with investors wishing to raise the environmental bar?

The financial sector, comprising institutional investors such as superannuation plans, as well as retail investors who buy into mutual funds, and the banking sector, has not traditionally been seen as relevant to environmental policy. Today, the financial sector is attracting growing interest from environmental organisations and policymakers in Australia, who are taking a broader and more sophisticated view of the economic forces that shape environmental pressures.[1] On the one hand, financial institutions may be viewed as the unseen polluters, contributing to environmental problems that they fund and profit from, yet are rarely held directly accountable for. Instead, such problems are habitually attributed to the operations of front-line companies. On the other hand, the SRI movement promises to catalyse the financial sector into an instrument of progressive social and environmental change. Recent developments in Australia have drawn attention to these dyadic roles of financial institutions.

One such development was the controversy over whether the Australia and New Zealand Banking Group Ltd ('ANZ') would fund Gunns Ltd's ('Gunns') new pulp mill in Tasmania. It is worth commenting on this interesting episode. In May 2008, the ANZ decided not to support the A$1.4 billion pulp mill proposed by Gunns, the forestry behemoth.[2] Although the ANZ publicly declined to elaborate on its reasons for shunning the project,[3] it appears that it was partly concerned about the environmental sequelae of the project, or at least the negative publicity from conservation groups campaigning against the controversial pulp mill.[4] Other financial institutions in Australia such as Perpetual Investments had also incurred criticisms for having ties to Gunns.[5] Earlier, the ANZ had commissioned a technical review of the project, which examined the mill's environmental standards. As a signatory to the Equator Principles,[6] an international voluntary code of conduct for socially responsible financing, the ANZ had also promised to observe high standards of environmental due diligence. Yet, curiously, although

1 See PricewaterhouseCoopers International Ltd, *The Role of Australia's Financial Sector in Sustainability: A Report Prepared for Environment Australia* (2001); Donald Ross and Dorothy Wood, 'Do Environmental and Social Controls Matter to Australian Capital Investment Decision-making?' (2008) 17 *Business Strategy and the Environment* 294; Nina Lansbury, *Socially Responsible Climate Change? Fossil Fuel Investments of the Socially Responsible Investment Industry in Australia* (2002) Mineral Policy Institute <http://users.nlc.net.au/mpi/rr/docs/sri_climate_change.pdf> at 15 October 2009.

2 Marian Wilkinson and Ben Cubby, 'ANZ Exit from Pulp Mill Project Confirmed', *The Age* (Melbourne), 28 May 2008, 3.

3 Fairfax Digital, 'ANZ Quiet on Gunns Funding', *Sydney Morning Herald* (Online), 22 May 2008 <http://business.smh.com.au/business/anz-quiet-on-gunns-funding-20080522-2h52.html> at 15 October 2009.

4 Australian Broadcasting Corporation ('ABC'), 'Lobby Group Ups Pressure on ANZ', *ABC News* (Online), 7 April 2008 <http://www.abc.net.au/news/stories/2008/04/07/2209539.htm> at 15 October 2009.

5 ABC, 'Perpetual Investments Chief Sprayed over Gunns Stake', *ABC News* (Online), 30 October 2007 <http://www.abc.net.au/news/stories/2007/10/30/2076107.htm> at 15 October 2009.

6 See Equator Principles Financial Institutions ('EPFI'), *The 'Equator Principles': A Financial Industry Benchmark for Determining, Assessing and Managing Social and Environmental Risk in Project Financing* (2006) <http://www.equator-principles.com/documents/Equator_Principles.pdf> at 15 October 2009.

ANZ declined to finance the pulp mill, government authorities had endorsed it so long as Gunns complied with relevant environmental and other regulatory standards.[7]

This article is not an in-depth investigation of the financing of the Tasmanian pulp mill, although more will be said about it later. Rather, it concentrates on the issues of broader significance posed by this episode, particularly whether banks and other financial institutions could and should play a greater role in safeguarding the environment and promoting clean development. As mechanisms of corporate financing, banks and other financial institutions may be strategically placed to influence development choices and economic trends.[8] As shareholders, financiers also acquire a voice within corporate governance to leverage change. Yet, corporate financing has been viewed in the investment community largely as a passive relationship in which financial institutions do not need to consider the environmental consequences of projects or companies they support. The only significant exception is where their own financial interests are jeopardised. They could be threatened if a borrower sinks into insolvency under the weight of hefty pollution fines, or if a company's share price dives because of a sullied environmental reputation.[9] Otherwise, it would appear to be wishful thinking to hope that financiers could reliably act as surrogate regulators, using their market leverage to improve the environmental quality of economic development. Financiers could price themselves out of the market as clients look elsewhere for funding from less scrupulous sources.

Financiers' freedom of action in these respects is also constrained by investment laws.[10] Superannuation funds, investment companies and other types of financiers owe fiduciary duties to their investors, which tend to preclude their putting the public interest before the financial interests of their beneficiary investors. Although there is no Australian case law on the issue,[11] some British court rulings

7 On 4 October 2007 the Hon Malcolm Turnbull, Minister for the Environment and Water Resources, approved the pulp mill under the *Environment Protection and Biodiversity Conservation Act 1999* (Cth), subject to Gunns satisfying 48 conditions: Commonwealth of Australia, *Approval Decision – Gunns Pulp Mill (EPBC 2007/3385)* (2007) Department of the Environment, Water, Heritage and the Arts <http://www.environment.gov.au/epbc/notices/assessments/2007/3385/pubs/approval-decision.pdf> at 17 October 2009. The Tasmanian Government issued its own special permits for the pulp mill: Australian Government, *Environment Protection and Biodiversity Conservation Act 1999 (EPBC Act): Fact Sheet* (2008) [2] <http://www.environment.gov.au/epbc/publications/pubs/epbc-act-fact-sheet.pdf> at 15 October 2009.

8 Julie Froud, Adam Leaver and Karel Williams, 'New Actors in a Financialised Economy and the Remaking of Capitalism' (2007) 12 *New Political Economy* 339.

9 See Jacqueline Lipton, 'Project Financing and the Environment: Lender Liability for Environmental Damage in Australia' (1996) 11 *Journal of International Banking Law* 7.

10 See generally Benjamin J Richardson, *Socially Responsible Investment Law: Regulating the Unseen Polluters* (2008).

11 Academic commentators believe that Australian courts would follow English law on this point: see Andrew Leigh, '"Caveat Investor": The Ethical Investment of Superannuation in Australia' (1997) 25 *Australian Business Law Review* 341, 347-8; Paul Ali and Martin Gold, *An Appraisal of Socially Responsible Investments and Implications for Trustees and Other Investment Fiduciaries* (2002) [15] <http://cclsr.law.unimelb.edu.au/research-papers/Monograph%20Series/SRI%20final%20report.pdf> at 15 October 2009.

such as in *Cowan v Scargill*,[12] and other cases,[13] suggest investment institutions would be liable to their beneficiaries if they recklessly sacrifice financial returns at the altar of ethical causes.[14] While the directors of a bank do not owe similar fiduciary duties to the bank's depositors, they are legally accountable to the bank and its shareholders to act financially prudently.[15] Other legal obstacles to environmentally-enlightened financing include the difficulties the system of corporate governance poses to altruistic, Ralph Nader-style shareholder activism from within.[16] Superannuants are often in no better position to influence the investment policy of their pension fund, being largely relegated into a passive role by fiduciary law principles that assume only trustees can speak on their behalf.[17] Also, international and domestic financial regulation contains virtually no rules to address the environmental pressures that arise from financial markets, as the regulatory system attributes the environmental costs of damaging activities to the front-line companies, for regulation at an operational level through separate environmental laws.[18]

Despite such obstacles, in recent decades a movement for SRI has swept international financial markets including Australia, raising the spectre of a more enlightened approach to financing not predicated on maximising financial returns.[19] Its proponents include pension plans promoting sustainable, long-term investment, mutual funds selling SRI portfolios to the general public, and banks requiring their borrowers to minimise the environmental degradation of financed projects.[20] SRI came to prominence in the 1980s during the campaign led by religious investors to divest from South Africa then under the apartheid regime. After a lull during the 1990s, SRI has taken off again. The most recent survey, published in November 2008 for the Responsible Investment Association Australasia, valued Australian SRI portfolios at approximately A$15.7 billion, representing 1.9 percent of all managed investment portfolios in the country.[21] By comparison, in 2000 these SRI portfolios were only worth a paltry A$325

12 [1985] 1 Ch 270.

13 *Martin v City of Edinburgh District Council* [1988] SLT 329; *Harries v Church Commissioners for England* [1992] 1 WLR 1241.

14 See Rosy Thornton, 'Ethical Investments: A Case of Disjointed Thinking' (2008) 67 *Cambridge Law Journal* 396.

15 John Glover, 'Banks and Fiduciary Relationships' (1995) 7 *Bond Law Review* 50.

16 Ruth Aguilera et al, 'Corporate Governance and Social Responsibility: A Comparative Analysis of the UK and the US' (2006) 14 *Corporate Governance: An International Review* 147.

17 Gregory Alexander, 'Pensions and Passivity' (1993) 56 *Law and Contemporary Problems* 111. Note, however, that Australia's *Superannuation Industry (Supervision) Act 1993* (Cth) does mandate some limited member representation on trustee boards of funds.

18 On financial markets regulation, see Peter Spencer, *The Structure and Regulation of Financial Markets* (2002); John Braithwaite and Peter Drahos, *Global Business Regulation* (2000).

19 Russell Sparkes, *Socially Responsible Investment: A Global Revolution* (2002).

20 See Marcel Jeucken, *Sustainable Finance and Banking: The Financial Sector and the Future of the Planet* (2001); Sonia Labatt and Rodney White, *Environmental Finance: A Guide to Environmental Risk Assessment and Financial Products* (2002).

21 Corporate Monitor, *Responsible Investment 2008: A Benchmark Report on Australia and New Zealand by the Responsible Investment Association Australasia* (2008) 15.

million.[22] Public opinion surveys in Australia also suggest rising popular sentiment in favour of more ethical investment choices.[23]

Concomitantly, a plethora of international SRI codes of conduct has been drafted, often advanced by the investment community itself. These include the Equator Principles, the United Nations Principles for Responsible Investment ('UNPRI'),[24] and the United Nations Environment Program's Finance Initiative ('UNEP FI').[25] Many Australian financiers have signed up to these codes of conduct.[26] This ensemble of quasi, 'soft' regulation is furnishing both normative standards and procedures for more transparent and accountable financial decisions.[27] A venerable feature of these mechanisms is that they can apply to multi-jurisdictional contexts and target financial institutions operating in global markets.[28]

This article thus seeks to resolve debates about SRI's capacity to provide a means of environmental regulation, and the rationale for such an approach, with particular reference to SRI in Australia. The first half of the article examines the capacity of SRI to leverage change in corporate environmental behaviour, and argues that on several grounds its capacity to act as a means of governance is presently rather limited. Most of the remaining part of the article explores the relationship between SRI and law, and it advances an argument that investors should be held legally accountable for environmental problems associated with corporate financing. The concluding section sketches some ideas for legal reform of the SRI market, highlighting the importance of institutional investors' fiduciary duties. Throughout the discussion, theoretical and empirical perspectives from a range of disciplines apart from law are canvassed. The SRI market and its governance cannot be meaningfully analysed from the narrow lens of legal doctrine alone.

22 Ibid 16.

23 See, eg, Mark Watmore and Leanne Bradley, *The Rothschild Report: Ethical Investing, A Study into Current Perceptions* (2001). Some more recent surveys in other jurisdictions point to growing interest in SRI: F&C Asset Management, *Research Commissioned by F&C Asset Management into the Ethical Investment Concerns of the UK Public* (2006); CNW Group, 'Canadians Weigh Social and Environmental Factors in Investment Decisions, Investors Group Research Finds', *Canada Newswire*, 6 November 2007 <http://www.cnw.ca/en/releases/archive/November2007/05/c3691.html> at 15 October 2009.

24 See Principles of Responsible Investment ('PRI') Secretariat, *Principles of Responsible Investment* (2009) PRI <http://www.unpri.org/principles/> at 15 October 2009.

25 See United Nations Environment Programme Finance Initiative ('UNEP FI'), *UNEP Finance Initiative* (2009) UNEP FI <http://www.unepfi.org> at 15 October 2009.

26 Corporate Monitor, above n 21, 20-1.

27 See Kate Miles, 'Targeting Financiers: Can Voluntary Codes of Conduct for the Investment and Financing Sectors Achieve Environmental and Sustainability Objectives?' in Nathalie Chalifour et al (eds), *Critical Issues in Environmental Taxation: International and Comparative Perspectives Volume V* (2008) 947; Oren Perez, 'The New Universe of Green Finance: From Self-regulation to Multi-polar Governance' in Olaf Dilling, Martin Herberg and Gerd Winter (eds), *Responsible Business: Self-governance and Law in Transnational Economic Transactions* (2008) 151.

28 Robert Falkner, 'Private Environmental Governance and International Relations: Exploring the Links' (2003) 3 *Global Environmental Politics* 72.

II SRI AS A MEANS OF GOVERNANCE?

A *Introduction*

The recent ascendancy of SRI has occurred largely without official imprimatur, yet, as will be argued, its future growth and effectiveness is likely to depend on regulatory intervention from the state. The argument in this section of the paper focuses on three critical problems with the SRI market, which cast serious doubts on its ability to provide an effective means of controlling the social and environmental behaviour of financial markets. First, for various reasons, the SRI movement has increasingly shunned ethical arguments in favour of a business case for responsible financing. It promises to make investors prosperous, rather than merely virtuous. By making social and environmental activism conditional on furthering the 'bottom line', SRI has blunted its critical strength because, inter alia, there often remains a countervailing business case for financing socially irresponsible activities. Second, as corporate finance theory predicts, the SRI market generally lacks the ability to influence the cost of capital of firms, and thereby give green companies a tangible market advantage over polluting rivals. Even the shift to business case motivations has failed to transform significantly SRI's stunted leverage. Third, the efforts of the SRI movement to develop its own codes of conduct, such as the Equator Principles or the UNPRI, have resulted in relatively facile standards that fall well short of moving the financial community beyond business-as-usual.

B *SRI's Morph from the Ethical to the Business Case*

SRI's philosophical motivations have altered dramatically in the last decade without commensurately enhancing its capacity to leverage improved corporate behaviour. Having evolved from its traditions of religious-based, limited-issue activism, which began with the Quakers in the 18th century, the modern era of SRI arose in the late 1960s in the wake of opposition to corporate ties to the Vietnam War[29] and South Africa's apartheid regime.[30] SRI now spans a broad constellation of financial actors campaigning on a potpourri of social and environmental causes.[31] It champions issues as diverse as animal welfare, aboriginal rights and mitigating climate change. While there is no authoritative agreement in the market on what qualifies as 'SRI', it has become widely recognised as primarily a means to further environmentally sustainable development, or 'sustainability', as the concept is often known.[32] Yet, as with the contested sustainability discourse, the

29 Michele Micheletti, *Political Virtue and Shopping: Individuals, Consumerism, and Collective Action* (2003) 104-5.

30 Malek Lashgari and David Gant, 'Social Investing: The Sullivan Principles' (1989) 47 *Review of Social Economy* 74.

31 Russell Sparkes, 'A Historical Perspective on the Growth of Socially Responsible Investment' in Rodney Sullivan and Craig Mackenzie (eds), *Responsible Investment* (2006) 39.

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

motivations to incorporate environmental considerations in investment decisions are diverse. The dominant motivation in SRI has become a business case, on the assumption that SRI can give investors a financial advantage. This stance has come at the expense of a greatly diminished, ethically-based boutique sector.

Let us look at the latter style of SRI first, as historically SRI was typically understood nobly as ‘ethical investment’. While ethical approaches to investment were mainly based on deontological ethics (focusing on the rightness or wrongness of an act), presently they are commonly associated with teleological ethics (focusing on the *consequences* of a particular action).[33] An example of the former approach is investors not wishing to profit from ‘sinful’ activities, such as gambling or pornography. Conversely, the latter style of ethical investment is promoted to leverage change in the environmental or social behaviour of companies. It does not ignore the ‘bottom line’, yet expects consideration of ethical issues for their own sake, and not only for financial benefit. It presumes that an individual or organisation remains moral when faced with any decision, including a financial one.[34]

Ethical investment is commonly associated with religious institutions.[35] They exploited their financial resources to campaign against the former apartheid regime in South Africa. This divestment campaign was motivated not by a desire to reap a financial advantage, but because morally it was perceived as the just course of action. Today, some faith-based investors continue to champion the moral high-ground, such as the United States-based Interfaith Center for Corporate Responsibility’s campaigns on climate change and environmental justice.[36] Outside of the religious sector, ethically-motivated investors are sometimes found among community-based credit unions (for example, Canada’s Vancouver City Savings Credit Union), in the banking sector (for example, the Cooperative Bank, in the United Kingdom)[37] and some investment companies that screen rigorously on ethical criteria (for example, the Australian Ethical Investment Ltd).[38]

Ethical considerations evidently do not weigh greatly on the SRI calculations of institutional investors. Institutions that invest on behalf of thousands of investors would likely dismiss calls that they should choose investments on ethical grounds, contending that, as their fund members likely hold diverse ethical views on social and environmental issues, it would be impossible to achieve a

33 Neil Carter and Megan Huby, ‘Ecological Citizenship and Ethical Investment’ (2005) 14 *Environmental Politics* 255; Paul Dembinski et al, ‘The Ethical Foundations of Responsible Investment’ (2003) 48 *Journal of Business Ethics* 203.

34 Wesley Cragg, ‘Business Ethics and Stakeholder Theory’ (2002) 12 *Business Ethics Quarterly* 113.

35 Paola Triolo, Martin Palmer and Steve Waygood, *A Capital Solution: Faith, Finance and Concern for a Living Planet* (2000) 26-53.

36 See Interfaith Center on Corporate Responsibility, *Working Groups: Global Warming: Goals & Objectives* (2004) <http://www.iccr.org/issues/globalwarm/goalsobjectives.php> at 15 October 2009.

37 See The Co-operative Bank, *The Co-operative Bank* (2009) <http://www.co-operativebank.co.uk> at 15 October 2009; UmweltBank, *UmweltBank* (2009) <http://www.umweltbank.de> at 15 October 2009.

38 See Australian Ethical Investment Ltd, *Rigorous Ethical Screening* (2009) <http://www.australianethical.com.au/our-approach> at 15 October 2009.

consensus of values to guide financial decision-making.[39] This stance seemingly relegates ethics to a subjective, personal taste, compared with the supposed hard objectivity of financial returns. Alternatively, the maximisation of financial returns is considered by investment institutions as a clear and easily measurable benchmark to which they should be held accountable.[40] The dominant style of contemporary SRI is thus driven by a business case, which scrutinises the social, environmental and corporate governance issues not because they are viewed as intrinsically significant, but primarily because they can affect the financial condition of companies. In business parlance, such factors garner attention when considered to be financially 'material', involving additional financial risks or investment opportunities.[41]

Evidence of this changing SRI discourse is readily found. Symbolically, in 2007 Australia's peak SRI industry association changed its name from the 'Ethical Investment Association' to the 'Responsible Investment Association Australasia'.[42] The connotation is that 'responsible investment' is a more neutral term without the political and moral connotations of 'ethical' investment. The influential UNEP FI, which is an industry partnership coordinated by the United Nations to promote SRI, downplays ethical arguments. In its report, *Show Me the Money*, UNEP FI explains that '[t]he first – and arguably for investors the most important – reason to integrate [SRI] issues is, simply, to make more money'.[43] Another UNEP FI report cautions investment analysts to '[c]ommunicate on issue-specific, proven, quantifiable, material links to business value; [and to] avoid moral arguments'.[44] In contrast to the assertive divestment campaigns and confrontational shareholder activism of earlier forms of SRI, business case SRI is typically implemented through light-touch screens filtering only the most pernicious companies from an investment portfolio, polite engagement with corporate management, and more sophisticated financial evaluations of the risks and profitable opportunities inhering in corporate social and environmental behaviour. Aggressive shareholder advocacy and strict ethical screens are tactics rarely found among mainstream 'responsible' investors.

At first glance, then, by seeking to conceptualise environmental and social issues in the market's own logic, business case SRI promisingly provides a solution to the movement's historical marginalisation. Thus, environmental issues such as biodiversity conservation and climate change may come to resonate with greater

39 Interview with staff, Responsible Investment Association Australasia, 11 December 2005.

40 See Luc Renneboog, Jenke Ter Horst and Chendi Zhang, 'Socially Responsible Investments: Institutional Aspects, Performance, and Investor Behavior' (2008) 32 *Journal of Banking and Finance* 1723.

41 UNEP FI, *The Materiality of Social, Environmental and Corporate Governance Issues in Equity Pricing* (2004).

42 See Responsible Investment Association Australasia ('RIAA'), *About RIAA* (2009) <http://www.responsibleinvestment.org/html/s02_article/article_view.asp?id=462&nav_cat_id=233&nav_top_id=89> at 15 October 2009.

43 UNEP FI, *Show Me the Money: Linking Environmental, Social and Governance Issues to Company Value*, Report (2006) 4.

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

significance in investment decision-making as issues with material financial consequences.

However, for several reasons, the business case is not a complete answer to the barriers to SRI; indeed, if there was a clear business case for investing responsibly, why would we ever need corrective environmental regulation, let alone a movement for SRI? A primary blind spot with business case SRI is that, unless social and environmental issues are perceived to have tangible financial implications, investors may ignore them. Often they are perceived as too nebulous for workable financial quantification.[45] Values such as biodiversity or climate integrity cannot be captured by conventional financial accounting systems unless they give rise to specific expenses, income or financial risks attributable to an individual organisation.[46] Sometimes 'reputational risks' associated with unethical practices may be of sufficient consequence to financiers to motivate action.[47] Yet, reputational risk to financiers is not an echo for all underlying societal concerns, as sometimes the most disadvantaged groups and victims of environmental hardship lack the means to publicise their plight. The second ingrained problem is that often there remains a countervailing business case for environmental pillage. For example, despite the SRI industry's rhetoric about climate change risks, the fossil fuel industry has hardly changed. The continuing investment in Canada's oil sands is one controversial example.[48] The profit to be made by exploiting Australia's old-growth forests is another.[49] Without an additional layer of ethical responsibility, financiers may lack the incentive to take actions beyond those prescribed by an orthodox business case. The third limitation is that, while the SRI community increasingly argues that there is a 'long-term' business case for investing responsibly on such issues as climate change, the problem is that market pressures to act for the short-term readily trump any perceived long-term costs and benefits that are discounted considerably. For example, the incentive system for fund managers greatly hinders their willingness to move their focus beyond short-term performance and market valuations.[50]

Beyond the perverse incentives individual financiers face to investing responsibly, collective action problems also hinder SRI. The financial market overall contains no mechanism to scale the economy within ecosystem-based limits, such as by

45 Susan McGeachie, Michael Kiernan and Eric Kirzner, *Finance and the Environment in North America: The State of Play of the Integration of Environmental Issues into Financial Research: Executive Summary* (2005) 57.

46 Susannah Goodman and Tim Little, *The Gap in GAAP: An Examination of Environmental Accounting Loopholes* (2003).

47 Somewhere between 50-70 percent of large companies' economic value is reportedly intangible, tied up in their brand name and goodwill: Noel Purcell, 'The Other ROI – The Responsibility of Investment' (Speech delivered at the UNEP FI Global Roundtable, Melbourne, 24-25 October 2007).

48 Kirk Makin, 'High-stakes Battle Looms over Oil-sands Pollution', *The Globe Mail* (Canada), 15 August 2007, A1.

49 Robert Gale, 'Old Growth Logging: Does It Matter if Environmental Protection Costs Jobs? (2005) 1 *International Journal of Environment, Workplace and Employment* 203.

50 Carmen Juravle and Alan Lewis, 'Identifying Impediments to SI in Europe: A Review of the Practitioner and Academic Literature' (2008) 17 *Business Ethics: A European Review* 285, 290.

restraining pollution within the assimilative capacity of the environment.[51] In the absence of regulatory restraints, such as a legislative cap on an economy's carbon emissions, environmentally-conscious investment institutions face steep hurdles to working collectively to moderate economic growth imperatives. Further, because such institutions commonly act through intermediaries such as fund managers, who are hired on limited-term contracts with frequent performance evaluations, even the most enlightened fund geared to sustainable, long-term investment can readily succumb to myopic financing practices.[52]

Given these and other limitations, as the following section will show, neither business nor ethical compulsions have so far proved adequate to allow SRI to dominate the market.

C *SRI's Muted Market Leverage*

Despite some contrary rhetorical claims in the academic and popular press,[53] SRI remains largely a boutique, niche sector. Precisely quantifying the SRI market is not easy, because existing surveys use inconsistent methodologies, indicative of the underlying lack of an objective basis to defining SRI. Research in North America and Western Europe by the leading SRI industry groups suggests that SRI probably accounts for below 10 percent of the investment markets in these regions.[54] Much research appears to exaggerate the extent of SRI; for instance, the US surveys treat as 'SRI' any fund that ethically screens merely against one activity, such as tobacco stocks, while counting its *entire* investment portfolio, which otherwise resembles any regular fund.[55] International research on the banking sector also indicates cause for concern, with one 2006 study concluding that 'with few exceptions bank policies are lagging significantly behind relevant international standards and best practices'.[56]

Likewise, while the SRI market in Australia has apparently blossomed in recent years, it remains small in absolute terms. According to the most recent survey, as previously noted, the 'core' assets of retail and institutional SRI as at 30 June 2008 amounted to only about A$15.7 billion.[57] Taking into account the additional value of financiers' corporate engagement to promote social and environmental issues,

51 Herman Daly, 'Allocation, Distribution and Scale: Towards an Economics That Is Efficient, Just and Sustainable' (1992) 6 *Ecological Economics* 185.

52 See Robert Shiller, *Irrational Exuberance* (2nd ed, 2005).

53 See, eg, Patricia Aburdene, *Megatrends 2010: The Rise of Conscious Capitalism* (2005) 140; Tavia Grant, 'Social Investment Assets Soar', *The Globe and Mail* (Canada), 22 March 2007, B17.

54 Social Investment Forum ('SIF'), *2007 Report on Socially Responsible Investing Trends in the United States* (2008); Eurosif, *Socially Responsible Investment among European Institutional Investors* (2006).

55 SIF, *2005 Report on Socially Responsible Investing Trends in the United States: A 10-year Review* (2006) 9.

56 Worldwide Fund for Nature and BankTrack, *Shaping the Future of Sustainable Finance: Moving from Paper Promises to Performance* (2006) 4. See also International Finance Corporation, *Banking on Sustainability: Financing Environmental and Social Opportunities in Emerging Markets* (2007).

57 Corporate Monitor, above n 21, 4-5. See also the earlier study (a survey of SRI funds in Australia): Total Environment Centre, *Socially Responsible Investment: Assessing the Non-financial Performance of Companies* (2002).

and improved financial analysis of social and environmental considerations, the 'broad' SRI market in Australia was estimated by that survey to be about A$58 billion.[58] By market share, these figures amount to somewhere between 2 and 5 percent of the Australian financial economy.[59]

Such a market, even if doubled or tripled to allow generously for any miscalculations, is vastly insufficient to enable SRI to influence significantly the behaviour of companies. Yet, proponents of SRI contend that it financially rewards ethical firms by additional investment, while punishing unethical firms through divestment and thereby higher costs of raising capital.[60] Presumably, affected firms would then be motivated to reform their policies, making them more attractive to SRI-driven financiers. These effects are also related to social investors' desire, as discussed shortly, to benefit financially from their 'ethical' investments.[61]

Modern corporate finance theory doubts that SRI can change corporate conduct while benefiting investors financially.[62] Modern portfolio theory holds that a diversified investment universe is more likely to produce optimal, risk-adjusted returns than a narrowly constructed portfolio.[63] Exclusionary ethical screens that reduce the investment universe should increase risks and thereby ultimately hurt returns.[64] Even if markets in the real world do not necessarily behave as theory predicts, as some commentators plausibly contend,[65] SRI may not necessarily enjoy an advantage because an inefficient market may under- or over-rate both ethical and unethical businesses equally.[66] While much empirical research suggests that risk-adjusted returns for SRI portfolios do not generally under-perform the market,[67] there may be a simple explanation. As Haigh and Hazelton explain: 'The reason for correlations between the performance of conventional and SRI funds may be that the portfolios of SRI funds are not markedly different to those of conventional mutual funds'.[68] In other words, SRI is likely to be too inclusive, screening out a lone tobacco producer, but otherwise investing as usual.

58 Corporate Monitor, above n 21, 4-5.

59 Ibid.

60 Harrison Hong and Marcin Kacperczyk, 'The Price of Sin: The Effects of Social Norms on Markets' (Working Paper, Princeton University and University of British Columbia, 2006); Russell Sparkes and Christopher Cowton, 'The Maturing of Socially Responsible Investment: A Review of the Developing Link with Corporate Social Responsibility' (2004) 52 *Journal of Business Ethics* 45.

61 Peter Camejo (ed), *The SRI Advantage: Why Socially Responsible Investing Has Outperformed Financially* (2002).

62 John Langbein and Richard Posner, 'Social Investing and the Law of Trusts' (1980) 79 *Michigan Law Review* 72; Michael Knoll, 'Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment' (2002) 57 *Business Lawyer* 681.

63 Harry Markowitz, 'Portfolio Selection' (1952) 7 *Journal of Finance* 77. Returns, for instance, include dividends paid by firms as well as appreciation of the firms' stock prices.

64 Andrew Rudd, 'Social Responsibility and Portfolio Performance' (1981) 23 *California Management Review* 55.

65 See, eg, Ray Ball, 'The Theory of Stock Market Efficiency: Accomplishments and Limitations' (1995) 30 *Journal of Applied Corporate Finance* 4.

66 Knoll, above n 62, 706.

67 UNEP FI and Mercer Consulting, *Demystifying Responsible Investment Performance: A Review of Key Academic and Broker Research on ESG Factors* (2007).

68 Matthew Haigh and James Hazelton, 'Financial Markets: A Tool for Social Responsibility?' (2004) 52 *Journal of Business Ethics* 59, 65.

A second fundamental problem with SRI is its present limited ability to influence the cost of capital. Finance theory implies that social investors are price takers, not price makers. Certainly, corporations' need to raise funds is a crucial variable, as 'SRI is more likely to be relevant whenever companies are heavily dependent on the stock market as a financing instrument'.[69] Corporate financing data suggest that most companies, especially well-established firms, are able to self-finance their operations and some growth through operational revenue rather than by borrowing or issuing bonds or new stock.[70] However, even mature companies are not entirely insulated from the demands of investors.[71] They have reasons to be mindful of their stock price even when not issuing new stock to raise capital. For instance, a declining stock price can affect a firm's market capitalisation and thus stock market listing. Also, corporate managements' remuneration is often tied to stock options, giving management incentives to adopt measures to keep stock prices high.

Conventional finance theory suggests that investors can trade any quantity of a firm's shares without affecting its price.[72] Supposedly this is because in an efficient equity market, where demand for a company's stock is almost perfectly elastic,[73] the price of a stock simply reflects the expected future cash flows, and all informed investors value the company's stock at the same price.[74] As shareholder divestment by SRI funds does not change the expected cash flow from the firm's activities, its stock prices therefore should not yield.[75] Only if potential traders believe the sale or purchase of stock reflects a downward or upward view of the company's underlying financial prospects would the stock price vary significantly. Business case SRI that educates the market to the financial consequences of firms' environmental behaviour may have such an effect. It is when SRI views unethical behaviour differently from the market as a whole that it may not influence economic fundamentals, and thus corporate behaviour.

Other theoretical research that takes a more granular perspective of capital markets, and does not assume that markets always behave according to textbook theory, predicts that SRI can alter the cost of capital when the stock is risky, unique, or is

69 Andrea Beltratti, 'Socially Responsible Investment in General Equilibrium' (Working Paper No 93, Bocconi University, 2003) 21.

70 Jenny Corbett and Tim Jenkinson, 'The Financing of Industry, 1970-1989: An International Comparison' (1996) 10 *Journal of the Japanese and International Economies* 71. Cf Andreas Hackethal and Reinhard Schmidt, 'Financing Patterns: Measurement Concepts and Empirical Results' (Working Paper No 125, University of Frankfurt, 2003).

71 Michael Jensen and Kevin Murphy, 'CEO Incentives – It's Not How Much You Pay, but How' (1990) 68 *Harvard Business Review* 138.

72 Jean Tirole, *The Theory of Corporate Finance* (2005) 90-5 passim.

73 Claudio Loderer, John Cooney and Leonard van Drunen, 'The Price Elasticity of Demand for Common Stock' (1991) 46 *Journal of Finance* 621. In contrast, for an asset that is relatively unique and has few close substitutes, the demand curve should be steep and less elastic.

74 Glen Arnold, *The Handbook of Corporate Finance: A Business Companion to Financial Markets, Decisions and Techniques* (2005) 314, 330.

75 Wallace Davidson, Dan Worell and Abuzar El-Jelly, 'Influencing Managers to Change Unpopular Corporate Behavior through Boycotts and Divestitures' (1995) 34 *Business and Society* 171.

traded in small, restrictive markets.[76] Heinkel, Kraus and Zechner have developed a theoretical model of corporate environmental responsibility, which predicts that SRI investors will need to hold at least 20 percent of the market in order to lower the cost of capital sufficiently to induce a business to invest in environmental improvements.[77] Other researchers suggest a much higher market share, although even 20 percent greatly exceeds the size of the SRI market presently.[78]

The foregoing discussion, relating to equity investors, is not necessarily applicable to debt financing such as the situation involving the ANZ and Gunns. Banks can exert relatively more influence over borrowers, especially small enterprises that have fewer financing options, as well as firms seeking large project financing loans.[79] Gunns, for example, sought nearly A$1.5 billion for its Tasmanian pulp mill, more than the market capitalisation value of the forestry company.[80] Self-interested risk mitigation principally motivates lenders to follow environmental due diligence in scrutinising prospective borrowers. Lenders may adjust the cost of a loan to reflect any residual environmental risks, requiring the borrower to adopt specific environmental safeguards, or demanding more valuable security relative to the value of the loan.[81] But in a competitive credit market, lenders also have incentives not to raise the bar too high for risk of losing clients to less scrupulous lenders.

Hard evidence regarding the impact of SRI in the equity and debt financing markets generally does not support the claim that SRI leverages change. The most comprehensive studied action is the South African boycott, and much research suggests that the divestment campaign has had limited effect on the economic performance of targeted companies.[82] The significant divestment from the tobacco industry in the wake of a spate of litigation against tobacco firms also appears to have had a muted effect on their stock prices.[83] Other research that has investigated changes to the cost of capital in light of new market information about firms' environmental behaviour, such as news of an environmental scandal, pollution fines or, conversely, commendations for environmental achievements,

76 Pietra Rivoli, 'Making a Difference or Making a Statement? Finance Research and Socially Responsible Investment' (2003) 13 *Business Ethics Quarterly* 271.

77 Robert Heinkel, Alan Kraus and Josef Zechner, 'The Effect of Green Investment on Corporate Behavior' (2001) 36 *Journal of Financial and Quantitative Analysis* 431.

78 James Angel and Pietra Rivoli, 'Does Ethical Investing Impose a Cost upon the Firm? A Theoretical Perspective' (1997) 6 *Journal of Investing* 57.

79 Jeucken, above n 20; Paul Thompson, 'Bank Lending and the Environment: Policies and Opportunities' (1998) 16 *International Journal of Bank Marketing* 243.

80 Its market capitalisation was A$1.2 billion in September 2007: John Durie, 'Gunns in a Bet-the-Company Project', *The Australian* (Sydney), 18 September 2007, 40.

81 Ibid.

82 Siew Teoh, Ivo Welch and Paul Wazzan, 'The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott' (1999) 72 *Journal of Business* 35. Cf Raman Kumar, William Lamb and Richard Wokutch, 'The End of South African Sanctions, Institutional Ownership, and the Stock Price Performance of Boycotted Firms' (2002) 41 *Business and Society* 133.

83 Tom Burroughes, 'Ethical Investors Losing out as Tobacco Stocks Burn up Britain's Equity Markets', *The Business* (United Kingdom), 24 February 2007.

suggests such factors could affect stock prices or the cost of borrowing.[84] However, the market impact tends to be short-lived.[85]

Research on shareholder advocacy, a seminal means of SRI, provides another way to map the impact of SRI. Social investors sometimes choose to influence laggards by dialogue and exerting pressure from within, rather than by divestment. Institutional investors are widely known as passive investors, lacking knowledge and incentives to monitor companies because of the costs involved and difficulties of coordinating action.[86] Where they do engage with companies out of social or environmental concerns, as some commentators believe they increasingly do,[87] their impact appears episodic and fleeting. Shareholder advocacy is predominantly a North American tradition, and is not widely practised among Australian social investors. The 2008 survey of the Australian SRI market noted forlornly that 'for the last 3 years, and again in 2008, there have been no specific shareholder resolutions that related to an issue of environmental or social responsibility'.[88]

Shareholder activism initiated by environmental groups in Australia arose in the late 1990s.[89] One early example occurred in September 1999 when the Wilderness Society Inc ('WSI') sought to hinder Wesfarmers' logging of old-growth forests in Western Australia. Purchasing a small batch of shares in the company, the WSI then led a coalition of disaffected shareholders in petitioning the board of Wesfarmers to hold an extraordinary general meeting to consider a shareholder resolution. Yet, as has typically happened to such SRI-driven resolutions in Australia, 98 percent of the Wesfarmers shareholders voted against the WSI's proposal that asked the company to conduct more rigorous environmental assessments of its logging operations.[90] Nonetheless, the WSI has continued to harness shareholder pressure as one of its campaign tactics, including as a means of challenging Gunns's proposed pulp mill in Tasmania. Attempting to influence the ANZ Bank when it was contemplating finance for the project, the

84 Nathan Lorraine, David Collison and David Power, 'An Analysis of the Stock Market Impact of Environmental Performance Information' (2004) 28 *Accounting Forum* 7; Susmita Dasgupta, Benoît Laplante and Nlandu Mamingi, 'Capital Market Responses to Environmental Performance in Developing Countries' (Working Paper No 1909, World Bank, 1998); James Hamilton, 'Pollution as News: Media and Stock Market Reactions to the Toxics Release Inventory Data' (1995) 28 *Journal of Environmental Economics and Management* 98.

85 Denis Cormier, Michel Magnan and Bernard Morard, 'The Impact of Corporate Pollution on Market Valuation: Some Empirical Evidence' (1993) 8 *Ecological Economics* 135; Mark White, 'Investor Response to the Exxon Valdez Oil Spill' (Working Paper, University of Virginia, 1995).

86 John Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1995) 168-9.

87 Stephen Davis, Jon Lukomnik and David Pitt-Watson, *The New Capitalists: How Citizen Investors Are Reshaping the Corporate Agenda* (2006) 15-16.

88 Corporate Monitor, above n 21, 23.

89 See Shelley Bielefeld et al, 'Directors' Duties to the Company and Minority Shareholder Environmental Activism' (2004) 23 *Company and Securities Law Journal* 28.

90 Kirsten Anderson and Ian Ramsay, 'From the Picketline to the Boardroom: Union Shareholder Activism in Australia' (Research Report, Centre for Corporate Law and Securities Regulation, University of Melbourne, 2005) 9-10.

WSI issued an 'Open Letter to ANZ Shareholders' calling for an extraordinary general meeting to discuss actions to address the environmental issues at stake.[91]

Although SRI-inspired shareholder resolutions rarely garner more than 10 percent of votes cast,[92] sometimes defeated shareholder resolutions may induce management to work cooperatively, as they may interpret even modest dissenting votes as reflective of broader unease about company policies and decisions. Apart from formal resolutions, investors may favour informal corporate engagement to influence management, although its extent and impact by its very nature is much harder to gauge.

Overall, SRI is yet to transform financial markets and the companies they finance. Certainly, more capital now flows into self-proclaimed SRI funds than has occurred historically. Some investors are becoming more active shareholders, and markets increasingly heed corporate environmental performance when it is perceived as financially salient. SRI has generally not yet had the strength of a surrogate regulator, able to impose on companies a separate market licence to operate. Indeed, business case-driven SRI appears to rely on the underlying system of environmental regulation to alter the financial advantages between polluters and socially responsible firms.

Because the SRI market is likely to be much smaller than industry surveys suggest, its capacity to engineer change by raising the cost of finance for polluters or pressuring for change through shareholder activism, has been limited. Regulatory and public policy changes are therefore probably essential to improve the quality and extent of SRI. However, the SRI movement itself has not greatly clamoured for such reforms, preferring instead to draft its own codes of conduct for financiers to adopt voluntarily. The following discussion will concentrate on one of these codes, the Equator Principles.

D *Market-based SRI Standards and Codes*

1 *Overview*

Contemporary SRI is more than just a label to describe certain financial transactions that are socially or environmentally sensitive. The SRI sector has also fashioned its own codes of conduct and standards to help coordinate, standardise and facilitate responsible financing. These voluntary mechanisms developed by market and civil society institutions, which have proliferated greatly since 2000, are attracting considerable interest in the financial community.[93]

This web of SRI governance spans a diversity of methods, structures and objectives, which we can broadly categorise into four types, although any

91 Wilderness Society Inc, 'Open Letter to ANZ Shareholders: Gunns' Proposed Pulp Mill' <http://tasmaniantimes.com/images/uploads/Open_letter_to_ANZ_shareholders.pdf> at 15 October 2009.

92 Corporate Monitor, above n 21, 23.

93 Perez, above n 27; Benjamin J Richardson, 'Financing Sustainability: The New Transnational Governance of Socially Responsible Investment' (2006) 17 *Yearbook of International Environmental Law* 73.

individual mechanism may contain elements of each type. First, there are normative frameworks that enunciate substantive principles and guidance on desirable performance. They include the Collevecchio Declaration on Financial Institutions[94] and the UNPRI.[95] Process standards enabling the assessment, verification and communication of performance constitute another form of governance. These include the Equator Principles[96] and the Global Reporting Initiative.[97] They do not dictate social and environmental outcomes, but rather establish processes, such as environmental reporting standards, that may be conducive to improving performance. Third, management systems, such as the International Organization for Standardization's ISO 14001 regime,[98] provide frameworks for organisations to manage routinely their environmental and social impacts. For example, a management system could create a process for an organisation to improve an aspect of its operations, such as its energy consumption, and thereby to reduce its environmental footprint. The fourth and final key modality of governance is comparative evaluation mechanisms, whereby external entities evaluate and rank corporate sustainability performance for the SRI industry. These rating mechanisms include SRI stock market indexes such as the Dow Jones Sustainability Indexes[99] and the London Stock Exchange's FTSE4Good Index Series.[100]

The main advantages of the new SRI codes would appear to be their ability to create a framework for coordinated action on common concerns, to provide a forum for exchange of information and best practices, and to build a network for peer pressure to minimise unscrupulous and unethical financing. These effects are quite possible given that some of the codes have been well subscribed to: the UNPRI, for example, boasted at least 360 signatories managing approximately US$14 trillion as of mid-2008.[101] Sixty-five of the UNPRI signatories at this date were Australian financial institutions.[102] The most successful voluntary codes have been those that set standards for corporate social and environmental disclosures, which help social investors to differentiate companies' sustainability performance. One such code is the Carbon Disclosure Project ('CDP'), a mechanism that coordinates requests from institutional investors for information

94 See BankTrack, *Collevecchio Declaration: The Role and Responsibility of Financial Institutions* (2003) <http://www.banktrack.org/download/collevecchio_declaration_with_signatories/030401_collevecchio_declaration_with_signatories.pdf> at 15 October 2009.

95 See PRI Secretariat, above n 24.

96 See EPFI, above n 6.

97 See Global Reporting Initiative ('GRI'), *What Is GRI?* (2009) <http://www.globalreporting.org/AboutGRI/WhatIsGRI> at 15 October 2009.

98 International Organization for Standardization, *ISO 14001:2004* (2009) <http://www.iso.org/iso/iso_catalogue/catalogue_ics/catalogue_detail_ics.htm?csnumber=31807> at 17 October 2009. See also Frank Montabon et al, 'ISO 14000: Assessing Its Perceived Impact on Corporate Performance' (2000) 36(2) *Journal of Supply Chain Management* 4.

99 See SAM Indexes GmbH, *Dow Jones Sustainability Indexes* (2006) <http://www.sustainability-index.com> at 15 October 2009.

100 See FTSE, *FTSE4Good Index Series* (2009) FTSE <http://www.ftse.com/Indices/FTSE4Good_Index_Series/index.jsp> at 15 October 2009.

101 UNEP FI and UN Global Compact, *PRI: Report on Progress 2008* (2008) 2.

102 Corporate Monitor, above n 21, 20.

on companies' climate change-related activities such as their greenhouse gas emissions.[103] By mid-2009, over 5000 corporations worldwide have been asked to report to the CDP, on behalf of nearly 400 investment institutions.[104]

Many commentators and policymakers remain sceptical of corporate intentions, and doubt that voluntary mechanisms can provide a credible means of environmental or social regulation.[105] An extensive literature has theorised the drift to corporate self-regulation and the motivations behind the proliferation of various corporate codes of conduct, which does not need to be duplicated here.[106] Many of these SRI codes appear too ambiguous and open-ended in their expectations. They lack substantive standards on social justice or ecological integrity. The most demanding SRI standards are contained in the Collevecchio Declaration on Financial Institutions, drafted by civil society institutions, which has been largely ignored by mainstream investment institutions.

They favour more discretionary and procedure-based standards, dealing with disclosure, reporting, and auditing of investment activities. While these transparency measures have some beneficial effects, they appear unlikely to induce major changes in investors' underlying goals. Information on pollution or human rights violations must compete for attention in a crowded field with often seemingly more pressing and tangible concerns. Voluntary mechanisms also typically lack credible sanctions or enforcement codes, whereby compliance has come to depend on peer pressure, the discipline of the market or sustained pressure from NGOs (non-governmental organisations). The corporate stone-walling of the more stringent draft United Nations *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights*[107] poignantly illustrates the attitudes of some businesses to regulatory standards with teeth.[108]

2 *The Equator Principles*

The Equator Principles ('Principles') will be examined here to illustrate the nature and implementation of one of these SRI codes. Furthermore, as the ANZ Bank is a signatory to the Principles it is worth considering how they are applied in

103 See Carbon Disclosure Project ('CDP'), *Carbon Disclosure Project: Home* (2009) CDP <http://www.cdproject.net> at 15 October 2009.

104 CDP, *How to Disclose* (2009) CDP <http://www.cdproject.net/faqs.asp> at 15 October 2009.

105 See, eg, Ian Maitland, 'The Limits of Business Self-regulation' (1995) 27 *California Management Review* 132.

106 See, eg, Stepan Wood, 'Voluntary Environmental Codes and Sustainability' in Benjamin J Richardson and Stepan Wood (eds), *Environmental Law for Sustainability* (2006) 229; Robert Gibson (ed), *Voluntary Initiatives: The New Politics of Corporate Greening* (1999); Jeremy Moon, 'The Firm as Citizen? Social Responsibility of Business in Australia' (1995) 30 *Australian Journal of Political Science* 1.

107 United Nations Sub-commission on the Promotion and Protection of Human Rights, *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights*, UN ESCOR, 55th sess, Annex, UN Doc E/CN 4/2003/12 (2003) ('*Norms*').

108 David Kinley, Justine Nolan and Natalie Zerial, 'The Politics of Corporate Social Responsibility: Reflections on the United Nations Human Rights Norms for Corporations' (2007) 25 *Company and Securities Law Journal* 30.

relation to a specific environmental controversy. The Principles provide lenders with a framework to manage the social and environmental impacts associated with projects, such as dams, factories and mines, which the lenders finance.[109] Formulated mainly by the banking industry under the auspices of the World Bank's International Finance Corporation ('IFC'), the Principles target private, commercial lending, especially in developing countries and emerging economies where competent environmental regulation may be lacking. Motivated to evade both public criticism of their support of controversial projects and the loss of business to less scrupulous lenders, a cohort of banks has sought to level the playing field for responsible project financing by drafting the Principles.[110] The credibility of the Principles is boosted by involving the IFC, the World Bank's private-sector lending arm.

The Principles are not entirely self-contained standards, but incorporate references to the IFC's Safeguard Policies for Social and Environmental Impact Assessment ('SEIA'), forestry, dam safety, indigenous peoples and other topics. The Principles were released in June 2003[111] and revised in July 2006.[112] All signatories pledge to provide loans only to borrowers who conform to the Principles. The Principles apply to projects with a total capital cost of at least US$10 million (US$50 million before the 2006 revisions).[113] They require lenders to rate projects that they plan to finance based on the magnitude of potential impacts and risks in accordance with the screening criteria of the IFC.[114] These criteria categorise projects as A, B, or C (high, medium, and low respectively), depending on their potential environmental and social impacts. A or B project borrowers must undertake a SEIA based on IFC standards to address the issues identified in the screening process. Project-financing banks must also prepare an Action Plan based on the conclusions of the SEIA.[115] For category C projects, no further assessment is required beyond the initial screening.

Lenders of category A and B projects must also ensure that the borrower has consulted with affected local communities 'in a structured and culturally appropriate manner'.[116] This requirement falls short of the 'prior informed consent' standard demanded by indigenous peoples and other vulnerable communities, as reflected in some international legal instruments.[117] However, the Principles apply higher transparency and accountability standards than some other SRI

109 Timothy O'Riordan, 'Converting the Equator Principles to Equator Stewardship' (2005) 47(4) *Environment* 1.

110 Natasha Affolder, 'Cachet Not Cash: Another Sort of World Bank Group Borrowing' (2006) 14 *Michigan State Journal of International Law* 141, 156.

111 See EPFI, above n 6.

112 See Elisa Morgera, 'Significant Trends in Corporate Environmental Accountability: The New Performance Standards of the International Finance Corporation' (2007) 18 *Colorado Journal of International Environmental Law and Policy* 151.

113 EPFI, above n 6, 4.

114 Ibid 2 [1].

115 Ibid 3 [4].

116 Ibid [5].

117 Claire Charters, 'Indigenous Peoples and International Law and Policy' (2007) 18 *Public Law Review* 22.

codes such as the UNPRI. For example, proponents must make the SEIA report and Action Plan available in a local language for public comment, and these documents are subject to independent expert review.[118] Project financing must also include a 'grievance mechanism' to hear complaints 'by individuals or groups from among project-affected communities'.[119] Finally, prior to drawing on the loan, the borrower must covenant with the lender to implement an environmental management plan and to provide ongoing monitoring of any impacts.[120]

Given the banking sector's hand in the design of the Principles, its embracement of them is unsurprising. As of April 2009, nearly 70 banks and related financial institutions, accounting for over 85 percent of the global project financing market, have signed the Principles.[121] The signatories include three Australian banks – Westpac, the National Australia Bank and ANZ. However, the Commonwealth Bank of Australia ('CBA'), the largest bank in Australia, has not signed the Principles yet.[122] A study by the British law firm, Freshfields Bruckhaus Deringer, concluded that the Principles 'impact on the financial market generally and their success in redefining banking considerations has been far greater than anyone could have predicted'.[123] Through common standards and procedures for earlier and more granular risk assessment, the Principles have helped signatory banks to minimise the reputational risks associated with development projects that pose significant social and environmental disruption. Subscription to the Principles offers public relations benefits to deflect NGOs' incessant scrutiny of lenders.[124]

The 2006 revisions to the Principles have improved their accountability, transparency, and enforceability, although weaknesses remain.[125] A lender's categorisation of a project or the scope of an SEIA or management plan cannot readily be challenged. The categorisation of a project is crucial, for it influences the types of environmental standards and procedures that would subsequently apply. Further, while affected groups may publicly comment on a SEIA or a proposed management plan, they cannot legally challenge its adequacy. Moreover, the very

118 EPFI, above n 6, 4 [7].

119 Ibid 4 [6].

120 Ibid [8].

121 EPFI, *Institutions Which Have Adopted the Equator Principles* (2009) <http://www.equator-principles.com> at 15 October 2009.

122 Ibid. The Commonwealth Bank of Australia ('CBA') has an environmental policy, but it is much less comprehensive than the Equator Principles on environmental impact assessment and community consultation: see CBA, *Commonwealth Bank of Australia Environmental Policy* (2001) <http://www.commbank.com.au/about-us/download-printed-forms/EnvironmentalPolicy_0808.pdf> at 15 October 2009. The CBA website also details measures it purports to take to promote sustainability: CBA, *Sustainability* (2009) <http://www.commbank.com.au/about-us/our-company/sustainability/default.aspx> at 15 October 2009.

123 Freshfields Bruckhaus Deringer LLP, *Banking on Responsibility* (2005) <http://www.freshfields.com/publications/pdfs/practices/12057.pdf> at 15 October 2009.

124 See Donald Schepers**,** 'The Impact of NGO Network Conflict on the Corporate Social Responsibility Strategies of Multinational Corporations' (2006) 45 *Business & Society* 282.

125 Bill Baue, *Revised Equator Principles Fall Short of International Best Practice for Project Finance* (2006) Social Funds <http://www.socialfunds.com/news/article.cgi/article2055.html> at 15 October 2009; Andreas Missbach, 'The Equator Principles: Drawing the Line for Socially Responsible Banks? An Interim Review from an NGO Perspective' (2004) 47 *Development* 78.

formulation of the Principles tends to be vague, making it hard to hold financiers to account on other standards.

Implementation of the Principles has received mixed reviews. BankTrack, an umbrella organisation of NGOs pooling their advocacy on financial issues, has found various lapses.[126] Conversely, a report by Freshfields Bruckhaus Deringer suggests, more optimistically, that the Principles have led some Equator banks 'into more structured dialogue with stakeholders and NGOs about social and environmental aspects of their lending'.[127] Several international project financing deals have tested the credibility of the Principles. These include the Baku-Tbilisi-Ceyhan pipeline project, to bring Caspian Sea oil to Western Europe,[128] the Sakhalin II oil and gas project in Eastern Russia,[129] and the Uruguayan pulp mills bordering Uruguay and Argentina.[130] The latter project, financed by Calyon and other lenders, has been particularly controversial, leading to litigation between these states in the International Court of Justice.[131]

3 *Financing the Gunns Pulp Mill and the Equator Principles*

The financing of Gunns's forestry project in northern Tasmania has also put the spotlight on the Equator Principles in an Australian context. According to Gunns, the A$1.4 billion project represents 'the largest-ever investment by the private sector in Tasmania and the largest-ever investment within the forestry sector in Australia'.[132] Gunns also describes it as the 'world's greenest pulp mill', utilising international best practice environmental technologies and procedures.[133] Various environmental organisations and community groups dispute these assertions, fearful in particular of intensification of clear-cutting of Tasmania's old-growth forests and dioxin emissions from the mill itself.[134] Nonetheless, the prospect of increased investment, jobs and other economic benefits has contributed to both the Tasmanian and Commonwealth governments approving the project in 2007.[135] Suits brought by the WSI and Investors for the Future of Tasmania against

126 Michelle Chan-Fishel, *Unproven Principles: The Equator Principles at Year Two* (2005).

127 Freshfields Bruckhaus Deringer LLP, above n 123, 10.

128 Johan Frijns, *Equator Principles; Principles, Profit or Just PR?* (2004) BankTrack <http://www.bankTrack.org/show/news/equator_principles_principles_profits_or_just_pr> at 15 October 2009.

129 Mike Bradshaw, 'The "Greening" of Global Project Financing: The Case of the Sakhalin-II Offshore Oil and Gas Project' (2007) 51 *Canadian Geographer* 255.

130 Machted Spek, *Financing Pulp Mills: An Appraisal of Risk Assessment and Safeguard Procedures* (2006) 57.

131 *Pulp Mills on the River Uruguay (Argentina v Uruguay) (Provisional Measures)* [2006] ICJ Rep 135.

132 Gunns Ltd, *Bell Bay Pulp Mill: Frequently Asked Questions* (2005) <http://www.gunnspulpmill.com.au/faqs.php> at 15 October 2009.

133 Gunns Ltd, *Bell Bay Pulp Mill* (2005) <http://www.gunnspulpmill.com.au> at 15 October 2009.

134 See, eg, BankTrack, *Gunns Pulp Mill Proposal – Tasmania* (2008) <http://www.banktrack.org/show/dodgydeals/gunns_pulp_mill_proposal_tasmania> at 15 October 2009; Tasmanians Against the Pulp Mill Inc, 'Reports and Submissions on the Proposed Pulp Mill', <http://tapvision.info/node/31> at 15 October 2009; Richard Flanagan, 'Out of Control: The Tragedy of Tasmania's Forests' (2007) 23 *The Monthly* 20.

135 ABC News, *Govt Gives Green Light to Pulp Mill* (2007) <http://www.abc.net.au/news/stories/2007/10/04/2050653.htm> at 15 October 2009. The approval is subject to Gunns Ltd meeting various environmental and other conditions.

the federal government, claiming that successive Ministers acted unlawfully according to the principles of judicial review by allowing the environmental assessment of the pulp mill to be fast-tracked, have been dismissed by the Federal Court.[136]

Apart from the official imprimatur given to the project, the ANZ's decision to shun Gunns's project was all the more surprising given that it had been a long-standing financial backer of the company. ANZ was expected to be the lead financier in a lending syndicate for the pulp mill. However, after conducting its own independent review of the proposal and following public outcry against the project, ANZ chose to discontinue its involvement with Gunns. ANZ issued a curt public statement, explaining that '[d]ue to client confidentiality, we are not in a position to comment further on this decision'.[137]

The bank's desire to avoid tainting its reputation by association with an environmentally controversial project almost certainly contributed to its stance. BankTrack had earlier written to ANZ regarding what it saw as the failure of the environmental assessment procedure to fulfill standards required by the Principles.[138] In regard to the Principles, which the ANZ had adopted in December 2006, it declared:

> By adopting the Equator Principles, ANZ has voluntarily committed to fund only new projects that can be developed and operated according to sound social and environmental standards. The Principles are now considered global best practice for ensuring applicable project finance proposals meet these standards.[139]

The ANZ has several other policies relevant to corporate social responsibility, including an Environment Charter[140] and a Forest Policy.[141] The latter includes a promise to 'require an environmental and social impact assessment' of forestry proposals, but ANZ states that it may finance projects that bring environmental harm if 'the socio-economic benefits can been [sic] demonstrated'.[142]

The lack of disclosure by the ANZ regarding how it has evaluated the Gunns project does not meet the Principles it pledges to follow. The ANZ explains in its official policy that:

136 *Wilderness Society Inc v Turnbull* (2007) 66 FCR 154; *The Investors for the Future of Tasmania Inc v Minister for Environment and Water Resources* (2007) 98 ALD 659; *Lawyers for Forests Inc v Minister for the Environment, Heritage and the Arts* [2009] FCA 330 (Unreported, Tracey J, 9 April 2009).

137 ANZ, *ANZ and Gunns Limited's Proposed Bell Bay Pulp Mill* (2008) <http://www.anz.com/aus/About-ANZ/Corporate-Responsibility/pdf/ANZGunns.pdf> at 15 October 2009.

138 BankTrack, above n 134.

139 ANZ, *Equator Principles* (2009) ANZ <http://www.anz.com/aus/values/environment/Equator.asp> at 15 October 2009.

140 ANZ, *ANZ Environment Charter* (2005) <http://www.anz.com/aus/about/Environment/pdf/Environment8pp_52394.pdf> at 15 October 2009.

141 ANZ, *ANZ Social and Environmental Management Policy and Guideline for Forests* (2008) <http://www.anz.com/resources/b/5/b5666e004f22083d912fb36edaf3a73e/Forests-Biodiversity.pdf?CACHEID=6be2d2804f1d3ef4a5a6b558b54e5b8d> at 15 October 2009.

142 Ibid 3.

> We will report on the progress of our implementation of the Equator Principles, including numbers of transactions screened and how these transactions were categorised according to social and environmental impact, through our annual and interim Corporate Responsibility Reports and regular stakeholder communications.[143]

Neither the ANZ's Corporate Responsibility Interim Report, released in mid-2008,[144] nor its most recent reports on its implementation of the Principles, sheds any light on how it has evaluated the Gunns project.[145] Information is provided only in aggregate, summary form, which hardly allows for public scrutiny of the rigour of the bank's assessments. That said, as the ANZ is declining rather than supporting the pulp mill, in this instance the lack of disclosure is not detrimental from an environmental perspective.

While the ANZ's action alone did not halt the pulp mill, it certainly caused some inconvenience and cost to Gunns; the latter had to search for new financial backers,[146] which became much more difficult in the worsening global financial recession of 2008. To make the costs of managing the project more manageable, in 2009 Gunns was seeking a joint venture with another company.[147] The availability of less scrupulous sources of finance or support (albeit perhaps on inferior terms) for environmentally problematic projects therefore could undermine the ability of ethical financiers to promote SRI.

The activities of Chinese banks in project financing in other contexts, for example, are already rousing environmental concern.[148] The seriousness of this situation is reflected in the former President of the World Bank, Paul Wolfowitz, publicly criticising Chinese banks for not following the World Bank's example in adhering to environmental and human rights standards when lending to infrastructure projects in Africa.[149] A global financial market that allows firms to raise funds offshore has important implications for governing the SRI market.

143 ANZ, *Equator Principles*, above n 139.

144 ANZ, *Corporate Responsibility Interim Report* (2008) <http://www.anz.com/aus/About-ANZ/Corporate-Responsibility/pdf/ForestsBiodiversity.pdf> at 15 October 2009.

145 ANZ, *Equator Principles Half Year Report – March 2008* (2008) <http://www.anz.com/about-us/corporate-responsibility/customers/responsible-business-lending/equator-principles/historical-results/> at 15 October 2009; ANZ, *Equator Principles Full Year Report – December 2006 – September 2007* (2007) <http://www.anz.com/about-us/corporate-responsibility/customers/responsible-business-lending/equator-principles/historical-results/> at 15 October 2009.

146 Nick Clark, 'Gunns Reloads in Cash Hunt', *The Mercury* (Hobart), 30 May 2008.

147 Matthew Denholm, 'Gunns Close to Deal with Tassie Pulp Mill Partner', *The Australian* (Sydney), 16 April 2009, <http://www.theaustralian.news.com.au/story/0,25197,25340259-5006788,00.html> at 16 October 2009.

148 Michelle Chan-Fishel, *Time to Go Green: Environmental Responsibility in the Chinese Banking Sector* (2007).

149 Editorial, 'Mr Wolfowitz and the Bank', *New York Times* (New York), 2 January 2007, <http://www.nytimes.com/2007/01/02/opinion/02tue1.html> at 16 October 2009.

E *SRI Regulation*

1 *Holding Financial Institutions to Account*

Given the limitations of the SRI market and its own codes of conduct, public regulation will surely be necessary if the financial sector is to become an agent for sustainable development. Once presented as an alternative to governmental regulation, the SRI movement is already starting to concede the necessity of state intervention, such as reforms to corporate governance to facilitate shareholder activism, and corporate environmental reporting to enable investors to differentiate firms more readily on environmental performance.[150] The financial sector's dependence on public policymaking is most acutely evident in the area of climate finance, which requires carbon taxes and cap-and-trade schemes imposed by governments to help price the cost of greenhouse gas emissions.[151]

Before examining how states are regulating the financial sector to promote SRI, it is necessary to explain why the financial sector should be accountable for the social and environmental problems associated with companies and projects it funds. The following argument has two inter-related components. First, it addresses the question of why financial institutions should be required by policymakers to be mindful of the environmental impacts of activities they finance. Second, it considers why financiers should sometimes be held accountable to a higher standard than the firms they fund. Why, for instance, should we expect the ANZ to forego financing a pulp mill that would comply with official regulation?

Admittedly, if we had 'perfect' environmental regulation of the front-line companies, such as Gunns, there would presumably be no need to worry about the decisions of their financiers because all environmental costs and benefits would be accounted for. The cost of capital would fully reflect environmental performance, with polluters incurring higher operational costs, and therefore competitive disadvantages in raising finance. In such a scenario, SRI would revert to its traditional role of deontological ethical investment, whereby individuals could choose to shun investment in activities they found personally morally objectionable, such as alcohol or gambling.

Such perfect regulation at the corporate operational level is rare. Some four decades of environmental law-making in the modern era has mitigated but has hardly ended humankind's unsustainable path.[152] Even countries with relatively advanced environmental law systems are challenged by the growing volume of cross-border investments in jurisdictions with much less rigorous legal standards.

150 Richardson, *Socially Responsible Investment Law: Regulating the Unseen Polluters*, above n 10, 303-75.

151 See Sonia Labatt and Rodney White, *Carbon Finance: The Financial Implications of Climate Change* (2007); Benjamin J Richardson, 'Climate Finance and Its Governance: Moving to a Low Carbon Economy through Socially Responsible Financing?' (2009) 58 *International and Comparative Law Quarterly* 597.

152 Millennium Environmental Assessment, *Living beyond Our Means: Natural Assets and Human Well-being (Statement from the Board)* (2005) <http://www.wri.org/publication/millennium-ecosystem-assessment-living-beyond-our-means-natural-assets-and-human-we> at 15 October 2009.

In the context of global finance, where investors in one jurisdiction can profit from economic activities in another, it is imperative to have environmental law standards that target 'wholesale' decisions concerning future development, and thus environmental pressures, that arise. Those decisions are made in the financial sector. Bringing financial institutions to account could relieve pressure on conventional environmental laws by decreasing initiation of polluting developments. Ideally, such developments would never receive finance, or would have to be redesigned to meet sustainable development benchmarks in order to secure affordable finance.

A second reason to target financiers directly is because their strategic economic position can be exploited to enable obstacles to market regulation identified by systems theory to be reduced. Systems theory challenges the teleological interpretation of modern regulation, questioning claims that we can solve society's complex and numerous environmental dilemmas through planned social intervention.[153] Modern society is described as polycentric and acephalous: an assemblage of autonomous systems that have evolved in response to diverse functional needs. The systems include: the law, the market, the political system, and so on. There are no universal norms or supreme institutions that control the relationship between these systems. The various social systems are conceived as 'autopoietic' by Luhmann – each has developed its own operational codes, protocols, and other means of communication, and therefore can respond only to problems defined by its own terms.[154] Thus, the legal subsystem communicates through rights, duties, and rules, whereas the lingua franca of the market is based on the norms of money, exchange, competition, and profitability. Consequently, a regulatory prescription to the corporate sector to protect biological diversity, for instance, will presumably be interpreted and evaluated primarily from a cost-benefit perspective congruent with market imperatives. This conception of social systems has led 'reflexive law' theorists such as Teubner to argue for a less ambitious role for the legal system, which jettisons complex command-and-control regulation from the 'outside' in favour of market-compatible policy instruments and mechanisms to encourage business self-regulation from 'within'.[155]

The financial sector, while part of the market system, also occupies a strategic boundary position between different systems. For example, lenders are crucial for implementing governments' monetary policy on interest rates, and authorities' money laundering controls work more effectively when banks are obliged to report suspicious transactions.[156] Financiers can also be vehicles for 'legal'

153 See Niklas Luhmann, *Ecological Communication* (John Bednarz trans, 1989 ed) [trans of *Ökologische Kommunikation: Kann die moderne Gesellschaft sich auf ökologische Gefährdungen einstellen?*]; Niklas Luhmann, *The Differentiation of Society* (1984).

154 Niklas Luhmann, *Social Systems* (John Bednarz Jr and Dirk Baecker trans, 1995 ed) 13, 147 [trans of *Soziale Systeme*]; Gunther Teubner, *Law as an Autopoietic System* (Anne Bankowska and Ruth Adler trans, 1993 ed) [trans of *Recht als Autopoietisches System*].

155 Gunther Teubner, 'The Invisible Cupola: From Causal to Collective Attribution in Ecological Liability' (1994) 16 *Cardozo Law Review* 429.

156 Alastair Brown, 'Money Laundering: A European and UK Perspective' (1997) 12 *Journal of International Banking Law* 307.

communication, transmitting information about correct corporate environmental behaviour, such as where a lender's own financial interests are at stake due to a borrower's risk of incurring liability for pollution costs. Jessop suggests that organisations straddling the boundaries of different social systems are potentially well placed to 'enhance mutual understanding' and 'play a role in linking sub-systems'.[157] By holding strategic, intermediate positions between the state and corporate sector, financial organisations could be harnessed as a means of environmental regulation, such as through requirements to promote SRI.[158] Thus, to the extent that direct environmental regulation of the market is hindered, policymakers might be able to exploit the financial institutions that increasingly dominate the economy.

A third reason to target the financial sector, and even hold it accountable to higher standards than that applicable to the companies it funds, is the generally greater economic and environmental significance of financial institutions. The 2008 sub-prime mortgage lending crisis in the US illustrates painfully how failings in one financial sector can ripple through the international economy producing much more devastating impacts.[159] Thus, apart from any environmental effects attributable to the financial economy, many commentators have long argued on traditional economic policy grounds that banks and other financiers should be controlled and monitored by regulators more closely.[160] The financial sector contains propagation mechanisms that can amplify initial, small shocks throughout the economy; insolvency of a bank usually has far greater ramifications for the economy than the collapse of a non-financial company.[161]

A related fourth argument builds on the so-called 'universal owner thesis' advanced by Hawley and Williams. They herald institutional investors, such as large pension funds, as a new force for corporate responsibility.[162] Hawley and Williams contend that these universal owners, investing broadly across the economy, are self-interested in the health and long-term sustainability of the entire economy. This is because, as economy-wide investors, they 'have no interest in abetting behavior by any one company that yields a short-term boost while threatening harm to the economic system as a whole'.[163] Acting as a universal investor implies that what is an 'externality' at the level of an individual company can result in a costly 'internality' for an investor's global portfolio. In practice, however, there is much evidence that institutional investors do not invest responsibly; reliant on fund managers hired on limited-term contracts,

157 Bob Jessop, *State Theory: Putting the Capitalist State in Its Place* (1990) 329.

158 Benjamin J Richardson, *Environmental Regulation through Financial Organisations* (2002).

159 R Christopher Whalen, 'The Subprime Crisis: Cause, Effect and Consequences' (Policy Brief No 2008-PB-04, Networks Financial Institute, 2008); George Soros, *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What It Means* (2008).

160 Dirk Heremans, *Corporate Governance Issues for Banks. A Financial Stability Perspective* (2006); Jonathan Macey and Maureen O'Hara, 'The Corporate Governance of Banks' (2003) 9(1) *Economic Policy Review* 91.

161 Some non-financial corporations of course are extremely economically significant, and their collapse would produce wide-ranging economic effects. The motor vehicle industry is an example.

162 James Hawley and Andrew Williams, *The Rise of Fiduciary Capitalism* (2000).

163 Davis, Lukomnik and Pitt-Watson, above n 87, 18.

their investment strategies are often short-term and speculative.[164] As they commonly hold assets on behalf of millions of investors, such as pension plan members, whose investment portfolios are closely tied to the overall health of the economy, these universal investors should be required to take a long-term, holistic perspective of their investments including taking account of any social or ecological impacts that could hurt financial returns.

Finally, and perhaps ultimately, the most basic reason for targeting financiers is simply that, in deriving profits from funding companies engaged in environmentally degrading and socially harmful activities, they can also be considered accountable. These unseen polluters should be unveiled for their contribution to unsustainable development. Capital financing is instrumental to development choices; those who enable, and benefit from, those choices through financial investment must also share in the responsibility. Financial institutions have evolved to mobilise capital and to facilitate financial returns for investors. Anyone who has ever inquired at a bank about a personal loan, credit card or mortgage, will understand that financial institutions do not want their capital idly sitting around. To quote a well-known aphorism: 'money does not grow on trees'. Rather, money has to be actively managed and reinvested to generate profit. This pervasive drive to put capital to use, to make more capital, invariably creates a process that fuels widespread social and environmental changes. It also creates a reason to hold financiers legally accountable.

2 *SRI Regulatory Reforms for Sustainability*

Legal reforms to promote SRI in Australia and other countries have quickened since 2000, although generally they have mostly just tinkered with the operation of financial markets. The measures range from regulating substantive investment criteria to, more commonly, regulating procedures that shape investment decision-making processes. Several interwoven factors have influenced these regulatory trends and preferences. Many Western countries including Australia are experiencing a realignment of the roles of the state and the market. The regulatory *state* has tended to morph towards a system of regulatory *governance* that concedes greater responsibilities and roles for market actors and, to a lesser extent, civil society institutions.[165] Legal commentators have conceptualised some of these changes in terms of 'mutual regulation',[166] 'responsive regulation',[167] 'smart regulation',[168] and 'post-regulatory governance'.[169] Paradoxically, however,

164 Craig Mackenzie, 'The Scope for Investor Action on Corporate Social and Environmental Impacts' in Sullivan and Mackenzie (eds), above n 31, 20, 32-3, 37.

165 See generally Julia Black, 'Critical Reflections on Regulation' (2002) 27 *Australian Journal of Legal Philosophy* 1.

166 See Peter Simmons and Brian Wynne, *State, Market and Mutual Regulation? Socioeconomic Dimensions of the Environmental Regulation of Business* (1994).

167 Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992).

168 Neil Gunningham and Peter Grabosky, *Smart Regulation: Designing Environmental Policy* (1998).

169 Colin Scott, 'Regulation in the Age of Governance: The Rise of the Post Regulatory State', in Jacint Jordana and David Levi-Faur (eds), *The Politics of Regulation: Institutions and Regulatory Reforms for the Age of Governance* (2004) 145.

there has also been some countervailing expansion of states' legal capacity to correct market abuses and unresolved impacts.[170] The recent turmoil in global financial markets, which has exposed the hazards of some of these regulatory shifts, has generated further debate about the possible need to return to more stringent forms of command regulation of this sector.[171]

So far, SRI policy reforms have emphasised market-based and informational tools that alter the procedures and processes of SRI decision-making. These standards do not require additional policy consensus concerning definitions of 'ethical' or 'socially responsible'. Instead, they shape the way investments are selected and implemented, providing for greater transparency and accountability. By attempting to modify how financiers view the environmental and social repercussions of their actions, process standards may stimulate changes in social values that contribute to sustainability.[172] Reflexive law theorists contend that encouraging companies to reflect and learn about their social impacts may sometimes exert greater long-term influence than regulating firms through coercion or rewards.[173]

Among these policy instruments are requirements for investment institutions to disclose their policies for SRI and for exercising their shareholder proxy votes. The most prominent transparency reforms have been introduced in the United Kingdom, several other European states and Australia, obliging occupational pension funds to disclose their SRI policies, if any.[174] In 2001, the Commonwealth legislated for superannuation funds, mutual funds, and investment life insurance providers to disclose publicly their SRI policies (but the regulation does not *oblige* these funds to practise SRI).[175] Also, an amendment to federal superannuation legislation in 2005[176] has given fund contributors the right to choose where their monies are invested, thereby enabling socially conscious investors to switch to one of the burgeoning green and ethical funds. Another reform, adopted in Canada and the US, requires mutual funds to disclose their shareholding proxy voting policies and voting records.[177] Its purpose is to discourage fund managers from passively colluding with corporate management, and through a more active

170 John Cioffi, 'Corporate Governance Reform, Regulatory Politics, and the Foundations of Finance Capitalism in the United States and Germany' (2006) 7 *German Law Journal* 533.

171 See, eg, International Monetary Fund, *Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management* (2009).

172 David Case, 'Changing Corporate Behavior through Environmental Management Systems' (2006) 31 *William and Mary Environmental Law and Policy Review* 7.

173 See Gunther Teubner, Lindsay Farmer and Declan Murphy (eds), *Environmental Law and Ecological Responsibility: The Concept and Practice of Ecological Self-regulation* (1994).

174 See, eg, *Occupational Pension Schemes (Investment) Regulations 2005* (UK) cl 2(3)(b)(vi)-(3)(c); *Corporations Act 2001* (Cth) s 1013D(1)(l); France's *Projet de Loi sur L'Épargne Salariale* n° 2001-152 (19 February 2001) arts 21, 23.

175 *Financial Services Reform Act 2001* (Cth), as incorporated into the *Corporations Act 2001* (Cth) s 1013D(1). The regulation however does not require these funds to have an SRI policy, only to disclose any policy adopted.

176 *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2005* (Cth).

177 Securities Exchange Commission, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies* (2003); Canadian Securities Administrators, *National Instrument 81-106 Investment Fund Continuous Disclosure and Companion Policy 81-106CP* (2005).

proxy process to improve the quality of corporate governance. Research on implementation of some of these standards reveals shortcomings.[178] Mandated disclosures often entail vague, boilerplate statements that do not illuminate the methodology behind SRI decisions or their implementation.[179] Process standards have rarely extended to democratising investment policymaking, which remains dominated by fund managers, investment analysts and other experts.[180] Modern corporate and investment regulation has long been premised on investors playing the role of 'passive capital' which 'declines participation in, or is excluded from, management of the business'.[181]

Mandatory SRI standards are rare. Some governments have banned specific undesirable investments, as an adjunct to primary controls. Belgium, for example, prohibits investments in companies that produce or distribute cluster bombs.[182] Another example is the bans instituted by some US states on pension fund investments in Sudan, presently associated with extensive human rights atrocities.[183] Obligations to actively promote SRI appear confined to public pension funds, with reforms adopted in France, New Zealand, Norway and Sweden. New Zealand's *Superannuation and Retirement Income Act 2001* requires the guardians of the national superannuation fund to invest in such a way as to avoid 'prejudice to New Zealand's reputation as a responsible member of the world community',[184] and to publish a statement of investment standards and procedures that 'must cover … ethical investment, including policies, standards, or procedures for avoiding prejudice to New Zealand's reputation as a responsible member of the world community'.[185] The open-ended, discretionary nature of this standard however has contributed to its perfunctory implementation.[186] The Swedish and Norwegian funds, on the other hand, are each guided by an ethics council, which uses internationally recognised standards for human rights and sustainable development as their benchmarks.[187]

Economic incentives to alter the cost-benefit calculations of financiers in favour of sustainable development choices have also been introduced in some jurisdictions.

178 Chris Gribben and Adam Faruk, *Will UK Pension Funds Become More Responsible? A Survey of Trustees – 2004* (2004); Fair Pensions, *UK Pension Scheme Transparency on Social, Environmental and Ethical Issues* (2006).

179 Michael Schwartz, 'The "Ethics" of Ethical Investing' (2003) 43 *Journal of Business Ethics* 195, 199-200.

180 John Brogle, *The Battle for the Soul of Capitalism* (2005) 178-9; Alexander, above n 17.

181 Robert Flannigan, 'The Political Imposture of Passive Capital' (2009) 9 *Journal of Corporate Law Studies* 139, 140.

182 Netwerk Vlaanderen VZW, 'Belgium Bans Investments in Cluster Munitions' (Press release, 2 March 2007) <http://www.netwerkvlaanderen.be/en/index.php?option=com_frontpage&Itemid=87&limit=6&limitstart=18> at 15 October 2009.

183 Lucien Dhooge, 'Condemning Khartoum: The Illinois Divestment Act and Foreign Relations' (2006) 43 *American Business Law Journal* 245.

184 *Superannuation and Retirement Income Act 2001* (Cth) s 58(2)(c).

185 *Superannuation and Retirement Income Act 2001* (Cth) s 61(d).

186 Russel Norman, *Betting the Bank on the Bomb* (2007).

187 See generally UNEP FI and UK Social Investment Forum, *Responsible Investment in Focus: How Leading Public Pension Funds Are Meeting the Challenge* (2007) 7.

The leading example is the Netherlands' Green Project Directive,[188] which – several studies suggest – has massively augmented the Dutch SRI market.[189] The scheme provides taxation deductions for investments in environmentally approved projects, such as wind farms and organic farms. Conversely, economic incentives can work to discourage the financing of environmentally unsound projects. Imposing liability on lenders for pollution problems connected to their borrowers has been upheld by courts in the US under the 'Superfund' legislation; its drastic effects in dampening bank lending to the chemical industry contributed to modification of the scheme in 1996 to limit lenders' liability.[190]

Overall, however, these first generation SRI governance reforms have yet to engineer systemic changes to global financial markets to ensure that environmentally sustainable development is prioritised. Isolated success stories mask a more prevalent business-as-usual. Most SRI regulation was designed to avoid imposing burdensome regulatory costs on financial markets. Indeed, the financial industry has actively sought to thwart radical reforms. For instance, in 1996 the US banking industry successfully lobbied Congress to amend the 'Superfund' legislation to obtain a safe harbour from lender liability suits for cleanup costs of contaminated lands.[191] Also, the mutual fund industry in North America fiercely resisted regulations to make them disclose how they vote as shareholders.[192] In the United Kingdom and Australia, the pension fund sectors initially opposed or doubted proposed legislation to make them disclose publicly their policies on ethical investment.[193] These vignettes generally reveal what really motivates many financial institutions – an unencumbered market to be able to achieve the highest returns for their investors. More fundamental potential reforms, such as to the underlying fiduciary duties of investment institutions, remain unaddressed.[194] The tension between encouraging financiers to be mindful of the public interest while requiring them to promote the private economic interests of their beneficiaries has not been satisfactorily addressed.

188 The scheme was revamped and extended in 2002 and 2005: Netherlands Government, *Regeling Groenprojecten Buitenland 2002*, *Staatscourant*, 2 January 2002, n° 1, 31; Netherlands Government, *Regeling Groenprojecten 2005*, *Staatscourant*, 11 July 2005, n° 131, 13.

189 Vereniging van Beleggers voor Duurzame Ontwikkeling, *Socially Responsible Savings and Investments in the Netherlands: Developments in Volume and Growth of Socially-responsible Savings and Investments in Retail Funds* (2005) 11; SenterNovem, *Sustainable Profit: An Overview of the Environmental Benefits Generated by the Green Funds Scheme* (2002) [6] <http://www.senternovem.nl/mmfiles/sustainable_profit_tcm24-196677.pdf> at 15 October 2009.

190 Michael Greenberg and David Shaw, 'To Lend or Not to Lend – That Should Not Be the Question: The Uncertainties of Lender Liability under CERCLA' (1992) 41 *Duke Law Journal* 1211; on the 1996 statutory amendments, see Olaf de Senerpont Domis, 'New Law Finally Limits Environmental Liability' (1996) 161(189) *American Banker* 3.

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

192 Davis, Lukomnik and Pitt-Watson, above n 87, 73.

193 D Smith, 'Pension Funds to Adopt Ethical Investment Policy', *The Times*, 25 June 2000, B2; Association of Superannuation Funds of Australia ('ASFA'), *Development of ASFA Policy on 'Ethical Investment'* (2000) <http://www.superannuationnews.com/articles/news-2000-10-31_005.htm> at 15 October 2009.

194 See Benjamin J Richardson, 'Putting Ethics into Environmental Law: Fiduciary Duties for Ethical Investment' (2008) 46 *Osgoode Hall Law Journal* 243.

The dominant response of the SRI movement to this tension has been to recast SRI into a business case, whereby social and environmental issues are defined not as ethical imperatives, but rather as financial risks and opportunities that prudent fiduciaries should observe. Of course, that environmental care and business success can be compatible is not an objectionable proposition, in principle. Financiers should benefit from companies that reduce their ecological footprint. However, the exuberance behind this synergy has become for some financiers an excuse to just tinker with unsustainable modes of development. Fundamentally, business case SRI is patently no assurance to safeguarding the planet, given that the market cannot valuate many social and environmental qualities, but discounts the future and the countervailing short-term business case to profit from unsustainable practices.[195]

III CONCLUSIONS: FUTURE REFORMS

For the foreseeable future, however we may interpret the ANZ's seemingly benevolent stance to protect Tasmania's forests from a giant pulp mill, any claims that an SRI revolution in Australia or elsewhere is underway are unsubstantiated.[196] It is probably an aberration. The institutional and economic barriers to the SRI market remain entrenched and the core legal standards to which financiers are held to account remain unaltered. So, what could policymakers do to make SRI more widespread in Australian or international financial markets? While the answer requires another article of much longer length, some basic strategies can be outlined briefly.

First, the fiduciary duties of institutional investors should be reformed to ensure that the public costs of private investment are accounted for. Fiduciary duties, which govern how financial decision-makers manage the assets of beneficiary investors, hardly license ethical investment for sustainable development. The core duties of loyalty and prudence understandably encourage investment policies that prioritise the maximisation of financial returns for beneficiaries to the exclusion of collateral impacts and the interests of other stakeholders.[197] The World Economic Forum has thus recommended that authorities '[m]odify pension fiduciary rules which discourage or prohibit explicit trustee consideration of social and environmental aspects of corporate performance'.[198] A study on capital markets undertaken by Stratos Inc for Canada's National Round Table on the Environment and the Economy concluded: 'current interpretations of the fiduciary duties of pension fund managers might unnecessarily constrain their ability to address

195 For these and other problems with markets, see John McMurtry, *The Cancer Stage of Capitalism* (1998); Herman Daly, *Beyond Growth: The Economics of Sustainable Development* (1996); AnnMari Jansson et al (eds), *Investing in Natural Capital: The Ecological Economics Approach to Sustainability* (1994).

196 See Oliver Wagg, *Project Finance – Equator Principles Case Study: ANZ Shot in Foot by Blasting Gunns* (2008) Ethical Corporation <http://www.ethicalcorp.com/content.asp?ContentID=5997&rss=ec-main.xml> at 15 October 2009.

197 Thornton, above n 14.

198 World Economic Forum, *Mainstreaming Responsible Investment* (2005) 10.

the full range of relevant corporate responsibility considerations related to prospective investments'.[199] Conversely, reports commissioned by UNEP FI in 2005 and 2009 have suggested that SRI is not precluded or overly hampered by fiduciary duties.[200] However, these studies defined SRI in terms of the prevailing business case approach, which understandably can be reconciled with fiduciary duties given that it considers social and environmental issues only to the extent that they are financially 'material'.

Knowing that fiduciary duties hinder SRI is relatively straightforward – the most difficult task is to redefine intelligently fiduciary standards in a way that can promote sustainable development while holding financial decision-makers measurably accountable. Fiduciary duties for sustainable investment may be redefined along a spectrum of ever-increasing exactitude. At the most liberal end of the spectrum, fiduciary duties could merely explicitly authorise fiduciaries to consider those social and environmental factors which they view as financially material. Arguably, this business case approach is already allowable – indeed essential if environmental risks jeopardise short-term returns. Some jurisdictions have already tinkered with reforms in this direction. For instance, Connecticut legislation provides that controllers of the Connecticut Retirement Plans and Trust Funds *may* consider the environmental and social implications of investments, but it does not stipulate on what grounds they should do so.[201] The Canadian province of Manitoba provides a further example. In 1995, Manitoba's *Trustee Act* was amended to permit trustees to consider non-financial criteria in their investment policies, so long as 'the trustee exercises the judgment and care that a person of prudence, discretion and intelligence would exercise in administering the property of others'.[202] The limitation of a discretionary fiduciary standard is that it does not *oblige* consideration of social or environmental impacts. Nor does it allow affected third parties to enforce their interests. There is a difference between taking the interests of various parties into account and *owing a duty* to those parties.

The preference among law-makers and market actors to frame fiduciary responsibility concerning environmental issues purely in terms of financial 'risks' can be seen in relation to the broader trend of risk-based regulation that has emerged in many countries in recent years.[203] Such regulatory approaches incorporate cost-benefit analysis and other techniques that seek to make decisions

199 Stratos Inc, *Corporate Disclosure and Capital Markets: Demand and Supply of Financially Relevant Corporate Responsibility Information* (2004) [12] <http://www.stratos-sts.com/publications/Corporate-disclosure-eng.pdf> at 16 October 2009.

200 Freshfields Bruckhaus Deringer LLP, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (2005) UNEP FI <http://www.unepfi.org/fileadmin/documents/freshfield_legal_resp/20051123.pdf> at 15 October 2009; Asset Management Working Group of the UNEP FI, *Fiduciary Responsibility: Legal and Practical Aspects of Integrating Environmental, Social and Governance Issues into Institutional Investment*, Report (2009) UNEP FI <http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf> at 16 October 2009.

201 Connecticut Retirement Plans and Trust Funds, CONN GEN STAT para 3-13d(a) (2002).

202 *The Trustee Amendment Act*, SM 1995, c 14, s 79.1.

203 Julia Black, 'The Emergence of Risk Based Regulation and the New Public Management in the UK' [2005] *Public Law* 512.

more 'objective' and defensible, to reduce uncertainties, and to contribute to efficient and effective use of regulatory resources.[204] In the financial sector, risk management is the primary lens through which regulators seek to supervise investment and other financial decisions.[205] By framing 'risk' in ways that expose or obscure certain issues, impacts and interests, the architects of such risk-based governance regimes seek to contrive limits to their own responsibility and therefore their own accountability. Consequently, risk-based regulation serves 'to define what are acceptable "failures" and what are not, and thus to define the parameters of blame'.[206] For SRI, a system of fiduciary finance in which responsibility is conceived narrowly in terms of financial risks is no assurance of sustainable development. It would serve to limit drastically the public accountability of investment institutions given that so much environmental harm or benefit is not captured by such economic metrics. Hopefully, the spate of worldwide scandals in the financial sector in 2008 and 2009 that has shorn risk-based regulation in this sector of some of its allure[207] may open possibilities for other approaches to governing investment decision-making.

Among alternative approaches, fiduciaries could be obliged by legislation to act for sustainable development or a similar general performance standard. The difficulty would be to design a performance standard with sufficient clarity to make fiduciaries accountable. Vaguely worded stipulations for financial institutions to 'promote sustainability' would surely not suffice. They would be vulnerable to being usurped by discretionary interpretations to which financiers could not be held accountable. One solution could be to utilise the considerable advances in designing sustainable performance indicators in other fields.[208] One such indicator is the carbon footprint of an investment portfolio – one of the most potent indicators of environmental performance.[209] The SRI industry already makes extensive use of sustainability performance standards in evaluating and comparing potential investments – the challenge would be to extend such standards to the financial industry itself.[210] Under a reformed standard, fiduciary investors could remain legally accountable to only their fund members or shareholders, but they could only maximise financial returns so long as they respect sustainability

204 See Michelle Everson and Ellen Vos (eds), *Uncertain Risks Regulated* (2009); Henry Rothstein et al, 'The Risks of Risk-based Regulation: Insights from the Environmental Policy Domain' (2006) 32 *Environment International* 1056.

205 Marieke de Goede, 'Repoliticising Financial Risk' (2004) 33 *Economy and Society* 197, 213.

206 Julia Black, 'Managing Regulatory Risks and Defining the Parameters of Blame: The Case of the Australian Prudential Regulation Authority' (2006) 28 *Law and Policy* 1.

207 See Joanna Gray, 'Is It Time to Highlight the Limits of Risk-based Financial Regulation?' (2009) 4 *Capital Markets Law Journal* 50.

208 Justin Keeble, Sophie Topiol and Simon Berkeley, 'Using Indicators to Measure Sustainability Performance at a Corporate and Project Level' (2003) 44 *Journal of Business Ethics* 149; Oliver Schmid-Schönbein and Arthur Braunschweig, *EPI-Finance 2000: Environmental Performance Indicators for the Financial Industry*, Report (2000) <http://www.iwoe.unisg.ch/org/iwo/web.nsf/SysWebRessources/EPI_finance_English.pdf/$FILE/EPI_finance_English.pdf> at 15 October 2009.

209 Trucost, *Carbon Counts 2007: The Carbon Footprint Ranking of UK Investment* (2007).

210 See Henry Schäfer et al, *Who Is Who in Corporate Social Responsibility Rating? A Survey of Internationally Established Rating Systems That Measure Corporate Responsibility* (2006); Stephen Fowler and Chris Hope, 'A Critical Review of Sustainable Business Indices and Their Impact' (2007) 76 *Journal of Business Ethics* 243.

criteria. Yet, because what is 'sustainable' is often a very context-specific judgment, with reference to a certain time and place, this approach is not without limitations for some environmental criteria. A less prescriptive approach would be to expect financiers to adhere to a general 'reasonableness' standard, which could be embellished with prophylactic rules such as a requirement to conduct an environmental impact study or consult with affected third parties if local environmental laws are inadequate to ensure sustainable development.

Apart from fiduciary duties, reform is needed to address the global scale of financial markets. Parallel sustainability standards must be etched into the international legal rules governing cross-border finance. The existing range of voluntary international standards such as the UNPRI or Equator Principles fall short of meeting the exacting standards required. International financial market regulation also currently ignores the social and environmental dimensions of capital markets – indeed, the recent global financial woes illustrate the lack of effective international regulation on even some of the most elementary financial management issues.[211]

New international rules would presumably have several advantages. For one, they would minimise a race to the bottom, as level standards would dissuade capital from fleeing to the most regulatorily benign markets.[212] Further, some institutional investors in global markets may even welcome some standardisation of SRI norms, as having to contend with different rules in different markets increases compliance costs. Of course, the corporate hostility to the proposed United Nations *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights* also illustrates the likely political obstacles to such reforms.[213] On the other hand, the current global financial crisis provides a rare opportunity to forge a new Bretton Woods-type scale of reforms that could include standards conducive to SRI, such as mandatory disclosures of social and environmental risks, reforms to financial accounting to incorporate social accounting metrics, and even standards for democratising investment fund governance to widen the range of stakeholder voices in investment decisions. Regulatory theorists such as Julia Black have nonetheless cautioned that transnational governance regimes face acute challenges in achieving adequate accountability and legitimacy to enable them to govern effectively.[214] These problems tend to be greatest for non-state transnational governance mechanisms such as the Equator Principles, for which '[t]here is no one organization which is responsible for issuing the principles, interpreting or revising them'.[215] Rather, the Equator banks are effectively policing themselves, which threatens the credibility and integrity of the Principles. Mechanisms that

211 See generally Kern Alexander, Rahul Dhumale and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (2006).

212 Daniel Esty and Damien Geradin, 'Environmental Protection and International Competitiveness' (1998) 32(3) *Journal of World Trade* 5.

213 *Norms*, above n 107.

214 Julia Black, 'Constructing and Contesting Legitimacy and Accountability of Polycentric Regulatory Regimes' (2008) 2 *Regulation and Governance* 137.

215 Ibid 142.

can enable other actors to coordinate public consultation and reporting, and to ensure redress, are thus among the strategies that can boost the accountability and thus legitimacy of international reforms to promote SRI.

These and other conceivable reforms may seem far-fetched, but with a looming planetary environmental crisis, more radical and bitter alternatives may one day be contemplated if we do not bring the financial sector into the environmental debate now. These are not challenges unique to Australia or any other country, although in each jurisdiction there will be context-specific legal and policy challenges to governing SRI. Until then, SRI will likely remain a small, niche sector of the financial economy, unable to greatly influence the environmental practices of companies.