VIRGINIA LAW & BUSINESS REVIEW

VOLUME 2 | FALL 2007 | NUMBER 2

# PUBLIC PENSIONS AND THE PROMISE OF SHAREHOLDER ACTIVISM FOR THE NEXT FRONTIER OF CORPORATE GOVERNANCE: SUSTAINABLE ECONOMIC DEVELOPMENT

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## INTRODUCTION

THE *Wall Street Journal* recently reported that 2006 saw the concept of shareholder democracy return "with a vengeance."[1] The most talked about development was the push to allow shareholders to directly nominate candidates for their board of directors.[2] Increased shareholder power was also seen in the reinvigoration and success of shareholder proposals since the corporate scandals of Enron, WorldCom, and others in 2001–2002.[3] For example, proposals on board declassification have received such strong support from shareholders[4] that the CEO of proxy advisory firm Institutional Shareholder Services ("ISS") now advises corporations not even to attempt to fight these proposals.[5]

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1. Henry G. Manne, *The "Corporate Democracy" Oxymoron*, WALL ST. J., Jan. 2, 2007, at A23.
2. In 2006, the Second Circuit Court of Appeals ruled that American International Group must include in its proxy materials a shareholder proposal sponsored by the pension plan of American Federation of State, County, and Municipal Employees that, if supported by a majority of shareholder votes, would allow shareholders to directly nominate candidates for the board of directors in some circumstances. AFSCME v. AIG, 462 F.3d 121, 130–31 (2d Cir. 2006). In 2003, the SEC sought public comment on proposed changes to the proxy rules related to shareholder-nominated directors. This proposal became the subject of significant debate in the academic legal community. *See generally* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003); Martin Lipton & Steven A. Rosenblum, *Election Contests In the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67 (2003). As of this writing, the SEC has not announced its final position with respect to *AFSCME v. AIG*.
3. Martin Lipton, *Some Thoughts for Boards of Directors in 2006*, 14 CORP. GOVERNANCE ADVISOR 1, 7–8 (2006).
4. Proposals on board declassification have averaged over sixty percent of the vote in 2004 to 2006. Joan Warner, *Get Ready for a Red-Hot Season*, DIRECTORSHIP, Dec. 2006–Jan. 2007, at 1, 26–27.
5. *Id.* at 26. Likewise, the last two years have seen a dramatic increase in the number of proposals filed on majority elections for directors and the number of votes they have received. INST'L S'HOLDER SERVS., 2006 POST SEASON REPORT: SPOTLIGHT ON EXECUTIVE PAY AND BOARD ACCOUNTABILITY 3–4 (2006), *available at* http://www.issproxy.com/pdf/2006PostSeasonReportFINAL.pdf. Although only a small minority of corporations currently uses majority voting, some expect it to become the norm within a few years. Warner, *supra* note 4, at 26.

Not only are shareholders' uses of their powers generally expanding, but their concept of what constitutes a legitimate corporate governance issue is also expanding. Although still subject to much debate and controversy, corporate governance no longer includes only the traditional issues of CEO compensation, board structure, and anti-takeover devices, but also encompasses so-called non-financial criteria,[6] or in other words, sustainability.[7] Thus, for many investors, governance issues are transforming into "environmental, social, and governance" ("ESG") issues. The basis of the ESG movement is less about the *values* investing commonly associated with the socially responsible investing ("SRI") funds, and more about long-term *value* investing focused on reduced risk and improved shareholder value.[8]

Just as 2006 may be seen as a breakout year for corporate governance activism, it was also the breakout year for ESG issues. Shareholders sponsoring proposals on social and environmental issues enjoyed their most

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6. INST'L S'HOLDER SERVS., 2006 GLOBAL INSTITUTIONAL INVESTOR STUDY: CORPORATE GOVERNANCE: FROM COMPLIANCE OBLIGATION TO BUSINESS IMPERATIVE 58–59 (2006), *available at* http://www.issproxy.com/pdf/2006GlobalInvestorStudy.pdf.
7. *See* Stuart L. Hart & Mark B. Milstein, *Creating Sustainable Value*, 17 ACAD. MGMT. EXECUTIVE 56, 56 (2003) ("A sustainable enterprise is one that contributes to sustainable development by delivering simultaneously economic, social, and environmental benefits.").
8. *See* THE GLOBAL COMPACT, WHO CARES WINS: CONNECTING FINANCIAL MARKETS TO A CHANGING WORLD (2004), *available at* http://www.unglobalcompact.org/Issues/financial_markets/who_cares_who_wins.pdf (stating that corporations with better performance on ESG issues can "increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets, while at the same time contributing to the sustainable development of the societies in which they operate. Moreover, these issues can have a strong impact on reputation and brands, an increasingly important part of company value."); ONVALUES INVESTMENT STRATEGIES AND RESEARCH LTD., CONFERENCE REPORT: INVESTING FOR LONG-TERM VALUE: INTEGRATING ENVIRONMENTAL., SOCIAL AND GOVERNANCE VALUE DRIVERS IN ASSET MANAGEMENT AND FINANCIAL RESEARCH 2 (2005), *available at* http://www.unglobalcompact.org/Issues/financial_markets/zurich_rep.pdf (reporting the outcomes from a conference attended by members of various major financial institutions and finding that "[t]here was a remarkable degree of agreement among participants that ESG factors play an important role in the context of longer-term investment strategies and that the financial industry must improve their consideration in research and investment processes."); Raj Thamotheram, *A Critical Perspective on Activism: Views From a Pension Professional*, *in* RESPONSIBLE INVESTMENT 295, 299 (Rory Sullivan & Craig Mackenzie, eds., 2006) (indicating that, with respect to risk, many of the "really big discontinuous shifts in share price" are due to issues related to a firm's social performance). *See generally* Hart & Milstein, *supra* note 7 (providing a framework for understanding the tensions between short-term results and long-term growth and how managers must stop viewing sustainability as a "one-dimensional nuisance" but as a "multidimensional opportunity").

successful year to date.[9] This success coincided with increased visibility to some shareholders of the importance of non-financial matters. For example, in April 2006, United Nations Secretary-General Kofi Annan unveiled his organization's *Principles for Responsible Investment* by ringing the opening bell at the New York Stock Exchange.[10] These principles require investors to consider ESG issues in their investment analysis and decision making, to be active owners by voting on proposals and engaging with corporations, and to press for consideration of ESG issues throughout the financial industry.[11] The increased profile of climate change issues has also increased its importance to other investors.[12]

Also in 2006, both the Conference Board and the Business Roundtable's Institute for Corporate Ethics issued reports detailing the harms of the stock market's short-term focus and urging that action be taken to refocus corporations on the long term.[13] Business Roundtable Director Dean Krehmeyer and colleagues define "short-termism" as an "excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation."[14] Although commentators have discussed the problem of short-termism since the early 1980s, the issue is receiving priority again due to the scandals of 2001–2002, which showcase its harmful effects and, more importantly for purposes of this Article, the greater recognition given to the potential positive impact of ESG factors on long-term performance.[15] In other words, sustainable

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

10. U.N. News Centre, Opening N.Y. Stock Exchange, Annan Sounds Bell for Responsible Investment (Apr. 27, 2006), http://www.un.org/apps/news/story.asp?NewsID=18272&Cr=Global&Cr1=Compact.

11. U.N. Principles for Responsible Investment, http://www.unpri.org/principles (last visited Oct. 15, 2007).

12. Charles J. Bennett, *Risk and Opportunity in the Gathering Climate Change Storm*, at 2 (Conference Board, Executive Action Series No. 228, 2007) (noting the increased "frequency, pace, and profile" of climate change-related actions from the media, the scientific community, governments, financial institutions, and corporations).

13. MATTEO TONELLO, CONFERENCE BOARD, REVISITING STOCK MARKET SHORT-TERMISM (2006); CFA CTR. FOR FIN. MKT. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORP. ETHICS, BREAKING THE SHORT-TERM CYCLE: DISCUSSION AND RECOMMENDATIONS ON HOW CORPORATE LEADERS, ASSET MANAGERS, INVESTORS, AND ANALYSTS CAN REFOCUS ON LONG-TERM VALUE (2006), *available at* http://www.darden.edu/corporate-ethics/pdf/Short-termism_Report.pdf.

14. CFA CTR. FOR FIN. MKT. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORP. ETHICS, *supra* note 13, at 3.

15. TONELLO, *supra* note 13, at 5, 9.

economic development is receiving greater recognition as an issue in long-term shareholder value.[16] These issues come together under the term "long-term responsible investing" ("LTRI").[17]

Public pension funds are heavily involved in all of these developments. Collectively, state and local government pension funds control approximately ten percent of the U.S. equity market.[18] Many legal scholars envisioned a positive role for these institutional investors as monitors of corporate management, and encouraged reforms to strengthen their "shareholder voice."[19] Public pensions were seen as uniquely suited for this task due to their lack of a commercial relationship with corporate management that could create a conflict of interest,[20] and later for their long-term, economy-wide interests.[21] Some commentators cited public pensions for the recent success of social and environmental proposals.[22] Others, however, have been leery of

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16. Dow Jones Sustainability Indexes, Sustainability Investment, http://www.sustainability-indexes.com/07_htmle/sustainability/sustinvestment.html (last visited Oct. 15, 2007) ("[T]he concept of corporate sustainability is attractive to investors because it aims to increase long-term shareholder value.").
17. *See* Thamotheram, *supra* note 8, at 296 (utilizing the term "LTRI"); Danyelle Guyatt, *Meeting Objectives and Resisting Conventions: A Focus on Institutional Investors and Long-Term Responsible Investing*, 5 CORP. GOV.: INT'L J. OF BUS. & SOCIETY 139, 139, 147 n.1 (2005) (adopting the term "LTRI"). There are a variety of terms denoting the use of environmental and social factors in investment decision making, e.g., socially responsible investing, ethical investing, non-financial investment criteria, enterprise risk considerations, and social, environmental, and ethics ("SEE") factors. CHARLES J. BENNETT ET AL., CONFERENCE BOARD, EXPANDING THE INVESTMENT FRONTIER: FACTORING ENVIRONMENTAL, SOCIAL AND GOVERNANCE CRITERIA INTO INVESTMENT ANALYSIS (2005). The term "LTRI" seems to best capture the investment interests of public pension funds. Alternatively, the term "sustainable development investing" ("SDI") serves this purpose.
18. CONFERENCE BOARD, 2005 INSTITUTIONAL INVESTMENT REPORT: U.S. AND INTERNATIONAL TRENDS 27 (2005). In 2003, public pension funds controlled $2.2 trillion in assets, including $1.3 trillion in equity. *Id.* at 9, 15.
19. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 813, 886 (1992). The debate over the role of institutional investors in corporate governance developed significant attention in the early 1990s when these institutions started gaining a significant hold over the U.S. equity market. Collectively, institutional investors (including mutual funds, insurance companies, private pensions, and foundations) owned forty-one percent of the U.S. equity market in 1990. CONFERENCE BOARD, *supra* note 18, at 29. By 2003, institutions owned fifty-nine percent of the total market and sixty-one percent of the largest one thousand U.S. corporations. *Id.* at 29, 34.
20. John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1367–68 (1991).
21. JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC 3, 98 (2001).
22. Burr, *supra* note 9, at 8.

granting these institutional investors additional power. These critics argue that public pension funds will use any increased powers to take actions based on the private interests of politicians or special interest groups instead of using that power to serve the best interests of the corporation and other shareholders.[23] Likewise, Vice Chancellor Leo Strine, Jr. of the Delaware Court of Chancery argues that individual investors are lamenting that corporations are becoming "a therapy couch for politically motivated institutional investors to vent their causes of the moment."[24]

This Article will bring together these developments in shareholder activism and the next frontier of corporate governance[25]—i.e., the environmental and social aspects of the expanded definition of corporate governance—to explore the role of public pensions under a "new governance" regulatory approach focused on sustainable economic development. As recognized over thirty years ago by Christopher Stone,[26] traditional legal mechanisms have significant limits in regulating corporate behavior related to environmental and social performance.[27] In response, there is a movement toward utilizing more decentralized regulatory mechanisms that are part of a new governance approach.[28] These changes are most pronounced in environmental regulation, where regulators recognize the limits of command-and-control regulation and seek to utilize flexible, innovative approaches.[29] In this Article, I will argue that public pension funds—even with the criticisms leveled at them mentioned briefly earlier—have the potential to serve a valuable role in this new regulatory approach.

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23. *See, e.g.*, Lipton & Rosenblum, *supra* note 2, at 78–79; Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 800–03 (1993); *see also infra* note 224 and accompanying text.
24. Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuck's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1766 (2006). Commentators often combine union and public pensions together when raising these criticisms. In this Article, however, I focus only on public pensions. With respect to the shareholder activism of union pension funds, see generally Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998) and Randall S. Thomas & Kenneth J. Martin, *Should Labor Be Allowed to Make Shareholder Proposals?*, 73 WASH. L. REV. 41 (1998).
25. INST'L S'HOLDER SERVS., *supra* note 6, at 58 (asking if corporate social responsibility is the "next frontier" of corporate governance for investors).
26. CHRISTOPHER D. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR (1975).
27. *See infra* notes 47–50 and accompanying text.
28. *See infra* notes 51–61 and accompanying text.
29. Bradley C. Karkkainen, *Default Rules in Private and Public Law: Extending Default Rules Beyond Purely Economic Relationships: Information-Forcing Environmental Regulation*, 33 FLA. ST. U. L. REV. 861, 861–63 (2006).

This Article will proceed by describing new governance regulation, including why such an approach is necessary for sustainable economic development issues, and then discussing a role for public pensions under such an approach. The next Part will look at what public pensions are currently doing in the area of LTRI. I find that although some funds are making progress, overall their actions are limited and may actually be contributing to the short-termism problem. The following Part will propose that public pensions should be required to disclose how, if at all, they incorporate LTRI issues into their investment policy and how that policy is implemented. This proposal is based on a U.K. law that went into effect in 2000. This part will also consider the response of U.K. pensions to that requirement and discusses the expected benefits of such a law in the United States. In addition, I will discuss what other pension fund governance reforms may be necessary to ensure the success of the law.

## I. NEW GOVERNANCE REGULATION AND LONG-TERM RESPONSIBLE INVESTMENT

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

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

> important constituencies such as employees and communities.[30]

With respect to the failure of focusing on long-term value, Matteo Tonello states that an "excessive focus on quarterly results, scarce attention to value-creation strategies, and failure to probe deeply enough into long-term performance are believed to be leading to a kind of 'short-termism' which damages market credibility and depresses today's economic development."[31] A clear example of this problem comes from a recent survey of over three hundred public corporation financial executives that found that eighty percent of these respondents would decrease discretionary spending in such areas as research and development and plant maintenance in order to meet quarterly earnings targets.[32] The researchers also found that managers would often reject positive net present value projects if it meant missing their earnings targets for the current quarter.[33]

This short-termism not only leads to scandals such as Enron,[34] but also causes unsustainable economic development.[35] Sustainable development is

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30. Strine, *supra* note 24, at 1769. Strine goes on to state that "[e]xisting American corporate law bears out the popularity of these traditionalist views. Most U.S. states permit corporate directors to consider the interests of constituencies other than stockholders. Even Delaware law has long made clear that directors have wide leeway to pursue the course of action they believe in good faith to be in the long-term best interests of stockholders, even if that means forsaking other tactics that might increase stock value in the short term." *Id.* (footnotes omitted). While commenting that it is uncontroversial to state that regulatory policy should ensure a focus on the long term, SEC Chairman William H. Donaldson stated "I realize that speaking out on the need for a longer-term approach to investment analysis is akin to speaking out in favor of baseball, hot dogs, and apple pie—it's something (almost) everyone supports, in an abstract way." William H. Donaldson, Speech by SEC Chairman: 2005 CFA Institute Annual Conference (May 8, 2005) (transcript available at http://www.sec.gov/news/speech/spch050805whd.htm).
31. TONELLO, *supra* note 13, at 5.
32. John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 32–35 (2005). These researchers believe that these percentages are likely lower than actual practice, as respondents may be unwilling to admit such actions even in a survey. *Id.* at 36. Interviews conducted by the researchers confirmed these findings, with one manager admitting that their firm would needlessly terminate company-trained employees to meet earnings targets. *Id.* at 68–69.
33. *Id.* at 37–39.
34. *See generally* Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189 (2003).
35. For example, although there may be general support among investment professionals for the belief that proactive management of social and environmental risks has a material impact on long-term market value, there is not support for the belief that management of such risks will have a material impact on short-term market value. Rory Sullivan et al., *Does a Focus on Social, Ethical and Environmental Issues Enhance Investment Performance?*, *in*

commonly defined as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs."[36] Rather than seeking to halt development, sustainable development recognizes that economic growth is necessary to meet the needs and aspirations of both present and future generations.[37] Principles of equity and environmental protection, however, must guide that development.[38]

Some corporations are attempting to put these principles of economic prosperity, environmental integrity, and social equity into action through value creation, environmental management, and corporate social responsibility.[39] External pressures, such as the short-term pressures from investors and analysts, may impede these corporations' efforts to implement those principles. Some investors, however, do not see environmental management and corporate social responsibility as being in conflict with long-term value creation, but as necessary components of it.[40] This belief is bolstered by research showing that there is a positive relationship between corporate social performance ("CSP") and corporate financial performance ("CFP").[41] Investing on such a belief is distinct from an investment approach

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RESPONSIBLE INVESTMENT 56, 58 (Rory Sullivan & Craig Mackenzie eds., 2006). Thus, excessive focus on the short term causes limited consideration of these issues.

36. WORLD COMM'N ON ENV'T & DEV., OUR COMMON FUTURE 43 (1987). For a review of how academics and practitioners have attempted to define the term "sustainable development" and a discussion of the values and principles behind the term, see generally Robert W. Kates et al., *What Is Sustainable Development?*, 47 ENVIRONMENT, Apr. 2005, at 8.

37. WORLD COMM'N ON ENV'T & DEV., *supra* note 36, at 40; *see also* Robert C. Paehlke, *Sustainability*, *in* ENVIRONMENTAL GOVERNANCE RECONSIDERED 35, 60 (Robert F. Durant et al., eds., 2004) (stating—in reference to constraints on economic growth from a sustainability perspective—that "*limit* and *restraint* may be the wrong terms here: it is better perhaps to speak of a growing need for energy-, materials-, and land-use efficiency. In the long term, sustainability is preferable not only socially and environmentally, but economically as well.").

38. WORLD COMM'N ON ENV'T & DEV., *supra* note 36, at 40; Kates et al., *supra* note 36, at 11.

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

40. *See supra* note 8 and accompanying text.

41. *See* José Allouche & Patrice Laroche, *A Meta-Analytical Examination of the Link Between Corporate Social and Financial Performance*, 57 REVUE FRANÇAISE DE GESTION DES RESSOURCES HUMAINES 18, 33 (2005) (stating that their meta-analysis results "show conclusively that CSP has a positive impact on corporate financial performance"); Marc Orlitzky et al., *Corporate Social and Financial Performance: A Meta-Analysis*, 24 ORG. STUDIES 403, 427 (2003) (presenting results of a meta-analysis of 52 studies and finding that corporate social performance and corporate financial performance have a bi-directional, positive relationship); Joshua D. Margolis & James P. Walsh, *Misery Loves Companies: Rethinking Social Initiatives by Business*, 48 ADMIN. SCI. Q. 268, 274 (2003) (reviewing over 100 studies on the CSP–CFP link and finding that almost half show a positive relationship

that incorporates ESG issues into investment decision making based on moral judgment of a corporation's actions.[42] Indeed, there is uncertainty in what to name this movement of incorporating extra-financial factors into investment analysis, which I refer to here as LTRI.[43] It is clear that "ethical investing"[44] and even the term "socially responsible investing" bring up negative connotations. As an example, the executive director of one large public pension fund informed me that the term SRI "terrifies" the fund's trustees, but the trustees are apparently comfortable with many of the ideas behind SRI, as they approve initiatives on sustainability and governance that avoid the use of that term.[45] What "terrifies" those trustees seems to horrify those that critique this movement.

Many argue that corporate management should follow only the basic mandates of the law and should not cede to the demands of investor groups that pressure companies to exceed legal requirements, as that would be engaging in inappropriate political action.[46] This argument, however, inappropriately assumes two things. First, it assumes that the investors applying the pressure are acting from self-interested political beliefs rather than a belief that higher social and environmental performance will improve long-run performance. Second, it assumes that the law is an effective and efficient regulator of corporate behavior related to sustainable development. In this Article, I focus on the latter false assumption as motivation for my proposal, but the implementation of that proposal draws on the first.

Traditional legal mechanisms[47] have significant limits when attempting to regulate issues relating to a firm's environmental and social performance. Although traditional regulation has clearly improved corporate behavior, it

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when CSP is an independent variable, only a handful show a negative relationship, and the remainder have either no significant results or mixed results).

42. *See infra* note 86 and accompanying text (distinguishing long-term investing and universal ownership from some forms of socially responsible investing).

43. *See supra* note 17 and accompanying text.

44. In general, there seems to be a trend away from using the word "ethical," as was used in the acronym "SEE" (social, ethical, and environmental). *See* Jill Francis Solomon & Aris Solomon, *Private Social, Ethical, and Environmental Disclosure*, 19 ACCT. AUDITING & ACCOUNTABILITY J. 564, 583 (2006) (providing quotations from investment professionals that "ethical" is inappropriate terminology in investing because we can all disagree on what is ethical, e.g., "Well you see you are OK if you stay with a phrase like 'socially responsible' and never introduce the word 'ethics'!").

45. In response to a pension fund survey described *infra* Part II.B.

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

47. Traditional legal mechanisms refer to command-and-control regulation or "first-generation" regulation. *See* Karkkainen, *supra* note 29, at 861–62.

has reached its limit in many ways.[48] These failings have been well documented, and include inefficiency, over-regulation, normative legitimacy, delay in responding to new harms or changing societal expectations, enforcement issues, and focusing on compliance with minimum standards rather than encouraging corporations to seek higher standards that are within their capabilities and resource constraints.[49] Overall, traditional regulation simply encourages compliance with set standards of acceptable behavior, which has a tendency to push corporations to "leav[e] rationality, innovativeness, and societal interests behind."[50]

Due to these limitations, regulators have sought out new regulatory approaches to complement traditional legal approaches. This movement away from command-and-control regulation and towards a "second-generation" approach has been gaining significant momentum in environmental regulation,[51] as well as in such areas as occupational health and safety,[52] food safety,[53] and employment discrimination.[54] In general, this second-generation

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

49. An early, and well-known, critique of the limits of traditional legal mechanisms is found in Stone, *supra* note 26, at 93–110. *See* David Hess, *Corporate Social Responsibility and the Law*, in CORPORATE SOCIAL RESPONSIBILITY 154, 158–63 (José Allouche ed., 2006) (reviewing critiques of traditional legal mechanisms); CHRISTINE PARKER, THE OPEN CORPORATION: EFFECTIVE SELF-REGULATION AND DEMOCRACY 8–12 (2002) (critiquing command-and-control mechanisms); *see also* Daniel J. Fiorino, *Toward a New System of Environmental Regulation: The Case for an Industry Sector Approach*, 26 ENVTL. L. 457, 460–66 (1996) (arguing that environmental regulation suffers from "three major structural defects: fragmentation by medium, statutory overregulation, and agency confrontation"); Karkkainen, *supra* note 29, at 862 (arguing that environmental regulation is "often costly to implement, inflexible, insensitive to local variations in the economic costs and environmental benefits associated with achieving a specified level of environmental performance, and, in some circumstances . . . may stifle innovation").

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

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

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

53. Cary Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals*, 37 L. & SOC'Y REV. 691, 696–98 (2003).

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

approach may be referred to as "new governance" regulation.[55] As the name suggests, when applied to corporations, new governance regulation focuses less on directly regulating corporate behavior—such as through traditional command-and-control models—and more on influencing the governance of corporations. Although new governance scholarship is not based in a single socio-legal theory, Professor Orly Lobel has identified several commonalities in implementation. First, this approach is participatory in that there is a role for all sectors of society (state, market, and civil) at all stages of regulation, from the development of standards to enforcement.[56] Multiple actors are encouraged to work together to identify common values and goals, and to seek consensus rather than focus on "a winner-takes-all approach."[57] Following from this participatory approach, new governance regulation is decentralized, which promotes experimentation and utilization of local knowledge.[58] This decentralization also permits meaningful deliberation between the interested actors[59] and encourages a system that is continually updated based on new knowledge.[60] Finally, these regulatory initiatives may cut across multiple policy domains.[61]

One general method of new governance directed towards investors (and others) for the purpose of improving corporate sustainability is the practice of disclosing information related to a firm's performance on environmental and social issues.[62] One such example is the Toxics Release Inventory ("TRI") of the Emergency Planning and Community Right-to-Know Act.[63] The TRI requires companies in certain industries to publicly disclose their plants' emissions of listed pollutants.[64] A second example is sustainability reporting.

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55. *See* Bradley C. Karkkainen, *Reply: "New Governance" in Legal Thought and in the World: Some Splitting as Antidote to Overzealous Lumping*, 89 MINN. L. REV. 471, 471–72 (2004); *see generally* Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004) (providing an overview and synthesis of the work in this area).
56. Lobel, *supra* note 55, at 371–76.
57. *Id.* at 376–79. Negotiated rulemaking is an example of an attempt to achieve collaboration. *Id.* at 377.
58. *Id.* at 381–383.
59. *Id.* at 384.
60. *Id.* at 395–400.
61. *Id.* at 385–87.
62. *See, e.g.*, Archon Fung, *Deliberative Democracy and International Labor Standards*, 16 GOVERNANCE 51 (2003); David Hess, *Social Reporting: A Reflexive Law Approach to Corporate Social Responsiveness*, 25 J. CORP. L. 41 (1999); Eric W. Orts, *Reflexive Environmental Law*, 89 NW. U. L. REV. 1227 (1995); *see also* Lobel, *supra* note 55, at 371–76.
63. Emergency Planning and Community Right-to-Know Act of 1986, §§ 301–30, 42 U.S.C. §§ 11001–50 (1994).
64. *Id.* § 313, 42 U.S.C. § 11023 (1994).

These sustainability reports, published annually by corporations and made available to the public, disclose information on a firm's overall economic, environmental, and social performance. In contrast to the TRI, sustainability reporting is voluntary in the United States,[65] and the information reported is not standardized and often qualitative.[66] The primary attempt to develop standards for these reports is the Global Reporting Initiative ("GRI"),[67] whose standards are used by over one thousand organizations worldwide.[68]

For both the TRI and sustainability reporting, a key goal of the regulation is to make information available to other actors for their use in the marketplace or the political arena.[69] For example, there is evidence that corporations that are comparatively high polluters, based on their disclosed TRI data, suffer significant stock market declines.[70] Investors, when given this new information on a firm's environmental performance, react negatively, based on the belief that TRI data indicates operational inefficiencies, poor management, or that disclosure itself will negatively impact the corporation's reputation or lead to tighter environmental regulation.[71] For other actors, such as local interest groups, the TRI data is just one more piece of information to use in their interactions with corporations regarding the corporation's complex "license to operate."[72]

Overall, through mandatory disclosure of information related to a firm's environmental performance, the TRI seeks to achieve new governance goals

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65. France is the first country to require corporations to issue a comprehensive social report. For a critique of the French law, see Lucien J. Dhooge, *Beyond Voluntarism: Social Disclosure and France's Nouvelles Régulations Économiques*, 21 ARIZ. J. INT'L & COMP. L. 441 (2004).
66. For a critique of social reporting in the United States, see David Hess & Thomas W. Dunfee, *The Kasky-Nike Threat to Corporate Social Reporting: Implementing a Standard of Optimal Truthful Disclosure as a Solution*, 17 BUS. ETHICS Q. 5 (2007).
67. Global Reporting Initiative, http://www.globalreporting.org (last visited Oct. 15, 2007).
68. Press Release, Global Reporting Initiative, G3 Sustainability Reporting Guidelines Launched (Oct. 5, 2006), http://www.globalreporting.org/NewsEventsPress/PressResources/PressReleasesG3Release.htm.
69. *See* Mark Stephan, *Environmental Information Disclosure Programs: They Work, But Why?*, 83 SOC. SCI. Q. 190 (2002).
70. *See* Swaminathan G. Badrinath & Paul J. Bolster, *The Role of Market Forces in EPA Enforcement Activity*, 10 J. REG. ECON. 165 (1996); James Hamilton, *Pollution as News: Media and Stock Market Reactions to the Toxics Release Inventory Data*, 28 J. ENVTL. ECON. & MGMT. 98 (1995); Madhu Khanna et al., *Toxic Release Information: A Policy Tool for Environmental Protection*, 36 J. ENVTL. ECON. & MGMT. 243 (1998); Shameek Konar & Mark A. Cohen. *Information as Regulation: The Effect of Community Right to Know Laws on Toxic Emissions*, 32 J. ENVTL. ECON. & MGMT. 109 (1997).
71. Bradley C. Karkkainen, *Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?*, 89 GEO. L. J. 257, 329–30 (2001).
72. Neil Gunningham et al., *Social License and Environmental Protection: Why Businesses Go Beyond Compliance*, 29 LAW & SOC. INQUIRY 307, 328–29 (2004).

by empowering the corporation's stakeholders (e.g., community members, consumers, and investors) to pressure and work with corporations in an attempt to find solutions based on each corporation's specific situation and current knowledge. Under this system, the government's role is limited to developing and enforcing disclosure requirements, without directly regulating the environmental performance of corporations.

These information-based regulations do have significant limitations. Commentators have labeled the TRI as "moderately effective"[73] because TRI data fail to capture a firm's total, current environmental performance, including the nature of the environmental and health hazards caused by the listed pollutants.[74] Beyond anecdotal evidence, sustainability reporting has yet to have any demonstrated impact on corporate social performance, in part because it is a voluntary program without standardized indicators for reporting.[75] Overall, these deficiencies have made sustainability reports of limited use to investors.[76]

Both of these programs—and new governance approaches in general[77]—rely on the involvement of third parties for their success. Potential third parties include non-governmental organizations such as public interest groups, financial institutions like banks and insurance companies, consumers, commercial partners, consultants, and institutional investors.[78] As Professor Neil Gunningham and colleagues warn, however, drawing in third parties to assist as surrogate regulators "is a process with many pitfalls and, unless skillfully done, can result in negative rather than positive effects."[79] In this Article, I limit my focus to the potential role of the institutional investor category of public pension funds in improving the environmental and social performance of corporations in a manner that is more effective, efficient, legitimate, and flexible than the alternative method of continually expanding traditional regulatory methods. Pension funds fit into the new governance

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

74. For a review of criticisms of the TRI, see Karkkainen, *supra* note 71 and Alexander Volokh, *The Pitfalls of the Environmental Right-to-Know*, 2002 UTAH L. REV. 805.

75. For a review of the accounting literature analyzing sustainability reporting, see Hess & Dunfee, *supra* note 66, at 7–10.

76. *See* Solomon & Solomon, *supra* note 44, at 573–75.

77. *See supra* notes 56–57 and accompanying text (discussing the participatory and collaborative nature of new governance approaches).

78. *See* Neil Gunningham et al., *Harnessing Third Parties as Surrogate Regulators: Achieving Environmental Outcomes by Alternative Means*, 8 BUS. STRATEGY & ENV'T 211, 212–19 (1999) (discussing the potential role for each of these groups).

79. *Id.* at 212.

model by directly impacting corporations through their investment decisions and engagement. In addition, to the extent that these actions improve corporate disclosure, they advance the general effectiveness of disclosure-based policies, such as voluntary sustainability reporting.

### A. Why Harness Public Pension Funds as Surrogate Regulators?[80]

Public pension funds are a key institutional investor category in discussions related to LTRI issues for several reasons. First, they lack a conflict of interest with corporations that other institutional investors such as managers of corporate pension funds may have.[81] This independence makes public pension funds more likely to challenge management on controversial issues. Second, these pension funds are investing to provide retirement benefits for current and future government employees. Thus, they have a strong interest in the long-term return on their investments. Third, due to the increasing size of many funds (as of September 2005, there were over fifty public pensions holding more than $10 billion in assets[82]) and the fact that their holdings often span the entire market spectrum, some refer to large public pensions as "universal owners"—meaning that the economy-wide issues of the nation and the portfolio-wide issues of the pension fund are essentially the same.[83] Thus, whereas managers may not support spending on workforce education or environmental protection due to the limited direct benefits to their companies, some public pensions will directly capture those benefits to the economy from the increased positive externalities of education and the reduced negative externalities from environmental protection.[84]

Although the long-term investing and universal ownership aspects of public pensions have placed them in alignment with socially responsible investors in some situations, there are significant differences. First, not all universal owner concerns overlap with long-term investing concerns. For example, although the economy-wide concerns of a universal owner would be appropriate for a fund with indexed investments representing a large share of

80. The title of this Section is based on Gunningham et al., *supra* note 78.
81. Coffee, *supra* note 20, at 1367–68.
82. Based on data from *Pensions & Investments* online newspaper (on file with author).
83. James P. Hawley & Andrew T. Williams, *The Emergence of Universal Owners: Some Implications of Institutional Equity Ownership*, CHALLENGE, July–Aug. 2000, at 43, 45, 54. In addition, the use of an indexing strategy, or large ownership positions that prevent selling a company's shares without a negative impact, push firms to exercise voice rather than use an exit strategy. *Id.* at 45–47.
84. *Id.* at 47–49.

the market, those concerns are not necessarily appropriate for a long-term investor without such holdings.[85] Second, the concerns of long-term investors and universal owners do not overlap with those of social investors who make decisions based on the perceived morality of firms' practices or products.[86]

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

## II. PUBLIC PENSION FUNDS AND LTRI: AN EVALUATION OF CURRENT PRACTICES

Public pensions impact LTRI issues in several different ways. First, several public pension funds are currently active in filing shareholder proposals on social and environmental issues (including negotiations with corporations that cause the filer to withdraw the proposal). The most active

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85. HERMES INV. MGMT., HERMES' RESPONSE TO THE MARATHON CLUB'S DISCUSSION PAPER "LONG-TERM, LONG-ONLY INVESTING," http://www.hermes.co.uk/pdf/corporate_governance/commentary/commentary_06/Marathon_LTLO_Hermes_response_300606.pdf.

86. *See, e.g.*, Christian Brothers Investment Services, SRI Policy Development, http://www.cbisonline.com/page.asp?id=160 (last visited Oct. 9, 2007); Christian Brothers Investment Services, Company Overview, http://www.cbisonline.com/page.asp?id=20 (last visited Oct. 9, 2007). Christian Brothers Investment Services controls over $4 billion in investments for Catholic institutions and invests based on the guidelines established by the United States Conference for Catholic Bishops, which require the "refusal to invest in companies whose products and/or policies are counter to the values of Catholic moral teaching or statements adopted by the Conference of bishops," including "companies that manufacture contraceptives or derive a significant portion of its revenues from the sale of contraceptives, even if they do not manufacture them." U.S. Conference of Catholic Bishops, Principles for USCCB Investments (Nov. 12, 2003), http://www.usccb.org/finance/srig.shtml; U.S. Conference for Catholic Bishops, USCCB Investment Policies, Policy C.I.B. (Nov. 12, 2003), http://www.usccb.org/finance/srig.shtml.

are the five New York City retirement funds that act collectively through the City Comptroller, who votes proxies on behalf of the funds and directs their shareholder initiatives.[87] In 2005 and 2006, the New York City funds filed social and environmental proposals with over seventy corporations.[88] These proposals addressed such issues as the MacBride Principles,[89] sexual orientation anti-bias policies, sustainability reports, and international labor standards.[90] Other pension funds were significantly less active. The Minnesota State Board of Investments filed proposals on drug re-importing with three different pharmaceutical companies in both 2005 and 2006.[91] The New York State Comptroller, on behalf of the state common retirement fund, co-sponsored five proposals in 2006 on topics such as greenhouse gas emission and employment discrimination.[92] In addition, the Connecticut Retirement Plans and Trust Fund has filed proposals related to disclosure of climate change risk and international labor.[93]

Second, pension funds are active through collaborative shareholder groups, pushing for changes at corporations without filing shareholder proposals and lobbying for regulatory changes. Several public pension funds—CalPERS, CalSTRS, Connecticut Retirement, New York City Employees, New York City Teachers, and New York State Common Retirement Fund—belong to the Carbon Disclosure Project,[94] an

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87. *See* New York City Office of the Comptroller, Bureau of Asset Management, http://www.comptroller.nyc.gov/bureaus/bam (last visited Oct. 15, 2007).

88. N.Y. CITY COMPTROLLER BUREAU OF ASSET MGMT., 2005 PROXY INITIATIVES OF THE NEW YORK CITY PENSION FUNDS 1 (2005), *available at* http://www.comptroller.nyc.gov/bureaus/bam/corp_gover_pdf/2005-shareholder-report.pdf [hereinafter N.Y. PENSION FUNDS]; N.Y. CITY COMPTROLLER BUREAU OF ASSET MGMT., NEW YORK CITY PENSION FUNDS' 2006 SHAREHOLDER PROPOSALS 2–3, *available at* http://www.comptroller.nyc.gov/bureaus/bam/corp_gover_pdf/2006-shareholder-report.pdf.

89. *See infra* note 122 and accompanying text.

90. N.Y. PENSION FUNDS, *supra* note 88, at 3–5.

91. *See Checklist of 2005 Shareholder Proposals*, CORP. SOC. ISSUES REP. (Inst'l S'holder Servs., Wash., D.C.) June–July 2005, at 17–24; *Checklist of 2006 Shareholder Proposals*, CORP. SOC. ISSUES REP., (Inst'l S'holder Servs., Wash., D.C.) June–July 2006, at 19–24. Under current SEC rulings, those companies may now properly exclude those proposals from the proxy materials. *SEC Staff Issue First Decisions of 2007 Proxy Season*, CORPORATE SOCIAL ISSUES REPORTER, (Inst'l S'holder Servs., Wash., D.C.) Feb. 2007, at 12–13.

92. N.Y. STATE AND LOCAL RET. SYS., COMPREHENSIVE ANNUAL FINANCIAL REPORT 68 (2006), *available at* http://www.osc.state.ny.us/retire/word_and_pdf_documents/publications/cafr/cafr_06.pdf.

93. Press Release, Ceres, Investors Win Agreement from Ford Motor Co. to Prepare Climate Risk Report (Mar. 31, 2005), http://www.ceres.org/news/news_item.php?nid=93; Dan Haar, *State Treasurer Is Reform Activist*, HARTFORD COURANT, Jan. 24, 2005, at A1.

94. Carbon Disclosure Project, CDP5 Signatory Investors (2007), http://www.cdproject.net/

international group of institutional investors that makes an annual request for greenhouse gas emissions disclosure from the largest corporations worldwide.[95] Other pensions are involved in more focused projects, such as the Ohio Public Employees Retirement System's involvement in a project on the long-term profitability of the pharmaceutical industry.[96] State treasurers or comptrollers from nine different states including California, Connecticut, and New York signed a letter through Ceres demanding that the SEC do more with respect to corporate disclosures related to climate change.[97] The same pension members of the Carbon Disclosure Project (with the exception of CalSTRS and the addition of the Illinois State Board of Investment) are signatories to the United Nation's Principles of Responsible Investment.[98] Additionally, seven state treasurers, CalPERS, CalSTRS, and the Illinois State Board of Investment have signed an "investor action plan" on climate change supported by the Investor Network on Climate Risk.[99]

Third, some pension funds are directly involved in social and environmental causes through their investments. CalPERS has an environmental investments initiative which includes various projects on screening firms for environmental performance and investing in environmentally friendly technologies.[100] In addition, CalPERS restricts or prohibits investment in countries with poor records on issues such as financial transparency, political stability, and labor practices.[101] CalSTRS

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cdp5signatories.asp. In addition to these pension funds, the state treasurers of California, Maine, Maryland, Oregon, North Carolina, and Vermont are also members. *Id.*

95. Carbon Disclosure Project, About Us, http://www.cdproject.net/aboutus.asp (last visited Oct. 15, 2007).

96. Pharma Futures, About Pharma Futures II, http://www.pharmafutures.org/beta/about/ (last visited Oct. 15, 2007). The pharmaceutical industry's long-term profitability is stated as being important to "[p]ension funds who have a long-term sector exposure and particularly those whose the [sic] end customer is the member for whom they seek both solid investment returns and better healthcare value." Pharma Futures, Objectives, http://www.pharmafutures.org/beta/about/objectives.asp (last visited Oct. 15, 2007). *See also* Sophia Tickell, *Pharma Futures: Investor Analysis of the Future of the Pharmaceutical Sector*, *in* RESPONSIBLE INVESTMENT 273 (Rory Sullivan & Craig Mackenzie, eds., 2006).

97. Press Release, Ceres, Investors Call on SEC to Require Corporate Disclosure on Financial Risks of Climate Change (June 14, 2006), http://www.ceres.org/news/news_item.php?nid=197. Additional signatories included SRI funds, churches, and union pension funds. *Id.*

98. U.N. Principles for Responsible Investment, Signatories to the Principles for Responsible Investment, http://www.unpri.org/signatories/ (last visited Oct. 15, 2007).

99. Investor Network on Climate Risk, 10-Point Investor Action Plan (Apr. 11, 2007), http://www.incr.com/index.php?page=20.

100. CalPERS, Environmental Investments Initiative (Mar. 24, 2006), http://www.calpers.ca.gov/index.jsp?bc=/investments/environ-invest/home.xml.

101. CalPERS Investment Committee, Permissible Equity Market Investment Analysis Update, Agenda Item 7B (Feb. 20, 2007), *available at* http://www.calpers.ca.gov/eip-docs/about/

recently joined the Enhanced Analytics Initiative, which seeks to improve analyst research on LTRI issues.[102] Many other pensions have negative screens on their investments, but, as discussed further below, these appear to focus on a limited number of issues and do little to further the regulatory goal of improving sustainable economic development at all corporations.[103]

Overall, there seem to be only a limited number of pension funds actively involved in LTRI issues. In addition, these and other funds that purport to be working towards sustainable development may be taking other actions in their investment practices that actually work against it.[104] The following sections discuss the LTRI activities of pension funds beyond the New York, California, and Connecticut funds described above, and also discuss those pension fund activities that may actually work against LTRI.

### A. An Overview of Public Pensions

To understand how public pensions function, it is useful to conduct a brief review of their governance and investment decision-making process. Public pensions are governed by a board of trustees. Board members typically fall into one of three categories, based on how they were selected to serve on the board: trustees elected by plan members, ex officio trustees (e.g., state treasurer or city comptroller), and trustees appointed by a government official or committee. The average board would consist of thirty-six percent elected trustees, fifteen percent ex officio trustees, and forty-four percent appointed trustees.[105] However, there is wide variation in practice. For example, twenty-eight percent of public pension boards in one study did not have any member-elected trustees, while thirty-two percent had a majority of elected trustees.[106] CalPERS, for example, has six elected trustees, four ex officio trustees, and three appointed trustees.[107] The CalPERS board has responsibility for the fund's investments, but that is not the case for all

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board-cal-agenda/agendas/invest/200702/item07b-00.pdf. CalPERS has three emerging market investment managers. Between April 1, 2002 and December 31, 2006, two of the three managers had lower returns on the CalPERS' restricted portfolio than those managers did for other clients without such restrictions. *Id.* at 2–3.

102. *See infra* notes 222–23 and accompanying text (providing a brief description of the Enhanced Analytics Initiative).

103. *See infra* notes 120–27.

104. *See infra* Part II.B.3.

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

106. *Id.* at 221.

107. *Id.* at 195.

pension plans. The Florida Retirement System, for example, has its assets managed by the State Board of Administration ("SBA"). The SBA's board consists of the governor, the attorney general, and the state chief financial officer.[108] Likewise, in Connecticut, the various public retirement plans have their assets invested by Connecticut Retirement Plans and Trust Funds, which has the state treasurer as the sole trustee.[109] In both Florida and Connecticut there is an Investment Advisory Council that may comment on investment policy or selection of investment services providers.[110]

The board of the pension plan or its investment board determines the investment policy (e.g., acceptable levels of risk) and the allocation of the plan's assets. Typically, the executive director or chief investment officer, as well as an investment consultant, will assist the board in these decisions. After these decisions are made, the pension fund will hire (and then continually monitor) a combination of internal pension fund staff members and external investment managers to make the actual investments.

### B. LTRI and the Majority of Public Pension Funds

To better understand what public pensions are doing with respect to LTRI, I conducted a survey of public pension trustees in the fall of 2006. A total of sixty-four trustees responded to the survey, representing fifty-eight different pension systems from twenty-two different states. These fifty-eight pension funds controlled over $560 billion in assets. They ranged in size from those controlling approximately $20 million to several controlling over $20 billion (the average fund controlled $9.6 billion and the median fund controlled approximately $1.5 billion). In the discussion below, reference to "large" funds means those funds with over $1 billion in assets, and "small" funds are those with under $1 billion. The use of external money managers

108. Florida's chief financial officer is an elected position that takes on the roles of the state treasurer and state comptroller. Florida Department of Financial Services, Chief Financial Officer of the State of Florida, http://www.fldfs.com/Treasurer/Bio/CFO_FLDFS.asp (last visited Oct. 15, 2007).

109. DENISE NAPPIER, STATE OF CONN. TREASURER'S OFFICE, INVESTMENT POLICY STATEMENT FOR THE STATE OF CONNECTICUT RETIREMENT PLANS & TRUST FUNDS 4–5 (2002), *available at* http://www.state.ct.us/ott/pensiondocs/ips.pdf.

110. In Connecticut, the investment advisory board has two ex officio members, five appointed members, and five union elected members. STATE OF CONN. INV. ADVISORY COUNCIL, CONNECTICUT RETIREMENT PLANS AND TRUST FUNDS, *available at* http://www.state.ct.us/ott/iacbrochure.pdf (last visited Oct. 15, 2007). In Florida, the Investment Advisory Council is appointed by the board. SBA Florida, Investment Advisory Council, http://www.sbafla.com/about_iac.aspx (last visited Oct. 15, 2007).

was common, as sixty-seven percent of the funds had one hundred percent of their assets managed externally, and seventy-nine percent had over eighty percent of their assets managed externally. Other information reported below is based on my review of the 2005–2006 Comprehensive Annual Financial Reports ("CAFR")[111] and websites of the thirty-three public pension funds controlling over $20 billion in assets in September 2005.

### *1. Proxy Voting*

To be considered a responsible investor, at a minimum, a pension fund must vote its proxies on social and environmental shareholder proposals in an informed manner. The first step in this process is the development of proxy voting guidelines for use by internal and external money managers. In practice, the development of guidelines by pension plans, or at least the awareness of these policies by trustees,[112] is limited. Only twenty-nine percent of respondents indicated that they were aware that their fund had a policy on corporate governance issues (thirty-nine percent of large funds; twenty percent of small funds), ten percent on environmental issues (fourteen percent of large; seven percent of small funds), and seventeen percent on other social issues (twenty-nine percent of large; seven percent of small funds). When asked if they provided external managers with clear guidance on how to vote proxies, fifty-three percent of respondents answered affirmatively, thirty-five percent answered negatively, and the remaining twelve percent of funds did not know. Some funds abstain from getting involved in proxy voting at all. For example, one respondent indicated that his board has "external managers vote the proxies as they see fit," and another stated that "we always vote with management." These results are consistent with a recent survey finding that seventy-three percent of Canadian investment managers "exercised discretion over eighty-five percent or more of pension plan client proxies."[113]

Many commentators point to the influence of Institutional Shareholder Services and other proxy advisory firms in determining the success of a

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111. *See infra* pp. 178–79 and accompanying text (providing a description of CAFRs).

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

113. CANADIAN S'HOLDER ASS'N FOR RESEARCH AND EDUC., 2006 KEY PROXY VOTE SURVEY 10, 48 (2007), *available at* http://www.share.ca/files/Proxy_Survey_2006_FINAL.pdf.

shareholder proposal.[114] Some criticize this influence because ISS is an organization without accountability to the pension beneficiaries.[115] In this sample, twenty-six percent (thirty-three percent of large funds) indicated they relied on external advice or guidelines for voting proxies.[116] Approximately half of those indicating that they use an external advisor indicated that they relied, at least in part, on guidelines from ISS.

A review of the largest pension funds' publicly available information provides additional insight. Although many pensions do not provide any information on their proxy voting guidelines online (approximately half of the websites I reviewed), others not only post guidelines that cover social issues in some detail, but also have their actual votes at each corporation available to the public online (e.g., CalPERS, CalSTRS, Ohio Public Employees, and Wisconsin Investment Board). Some pension funds have detailed voting policies on corporate governance issues, but are virtually silent with respect to social issues. Others, such as the Colorado Employees Retirement System, have a detailed policy on corporate governance issues, but have a blanket policy of abstaining on all social issues.[117]

Overall, there is a wide range of practices in the voting of proxies. Based on my survey results and review of proxy voting guidelines, however, it seems

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114. HAWLEY & WILLIAMS, *supra* note 21, at 31.
115. *Id.*
116. Nine percent of respondents indicated that they did not know.
117. COLO. PUB. EMPS.' RET. ASS'N, COLORADO PERA PROXY VOTING POLICY 7 (2006), *available at* http://www.copera.org/pdf/Policy/proxy_voting.pdf ("PERA will *Abstain* on all social issues, and will only vote on financial issues."). In relation to the discussion in Part II with respect to sustainability reporting, it is interesting to note that several of these funds' proxy guidelines support proposals requiring corporations to provide disclosure on environmental issues. *See, e.g.*, OHIO PUB. EMPS. RET. SYS., CORPORATE GOVERNANCE POLICY STATEMENT AND GUIDELINES 14 (2004), *available at* http://www.opers.org/about OPERS/Governance/CompleteGovernancePolicy_091704.pdf ("OPERS supports proposals asking for environmental reporting, provided the proposals do not require the disclosure of proprietary information or cause an undue financial burden on the company."); STATE OF WIS. INV. BOARD, DOMESTIC PROXY VOTING GUIDELINES 23 (2006), *available at* http://www.swib.state.wi.us/proxyvotes.pdf (stating that "SWIB will support increased reporting if: (1) a company's product or service has the potential to affect the environment adversely; (2) the company has been the subject of adverse publicity or litigation because of its environmental policies; and (3) the company has failed to provide adequate information, as determined by SWIB staff, about its environmental practices to shareholders."). Others have policies against additional environmental reporting. *See* OHIO STATE TEACHERS RET. SYS., STOCK PROXY VOTING POLICY 6 (2006), *available at* http://www.strsoh.org/pdfs/ProxyVotingPolicy.pdf ("STRS Ohio will vote against resolutions requiring a report on environmental issues provided the company complies with all laws regarding environmental reporting.").

that most pensions do not take an active role in voting on shareholder proposals on social and environmental issues.

### *2. Socially Responsible Investing*

The survey also asked pension trustees about socially responsible investment practices. This, however, was probably a poor choice of wording given its potentially negative connotation.[118] Technically, SRI is a widely used practice, as twenty-eight percent of pensions indicated having some type of investment restriction (i.e., negative screen). The most common restrictions were those on investments in "terrorist" nations,[119] Sudan,[120] tobacco,[121] and the MacBride Principles (on ending religious discrimination in Northern Ireland).[122] These restrictions are typically a result of state legislative action. For example, Florida state law contains requirements based on the MacBride Principles and prohibits investment in companies that do business with Cuba.[123] Others are more specific, such as a police and firefighter pension fund stating that it would not invest in companies that promote violence against police in music or video games. When asked specifically, ten percent

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118. *See supra* note 44 and accompanying text; INST'L S'HOLDER SERVS., *supra* note 5, at 58.
119. As an example from a pension fund that was not included in the survey, see VT. PENSION INV. COMM., VPIC POLICY ON INVESTMENTS IN TERRORIST OR GENOCIDE LINKED COUNTRIES (2006), http://www.vermonttreasurer.gov/documents/retireVPIC/policy/3-006_TerroristGenocidePolicy.pdf (adopting an investment policy that seeks "to avoid investments in companies operating in a country engaged in the sponsorship of terrorism or genocide as identified by the U.S. State Department").
120. *See* Lucien J. Dhooge, *Condemning Khartoum: The Illinois Divestment Act and Foreign Relations*, 43 AM. BUS. L. J. 245, 274–75 (2006) (citing states that have laws that either require or permit public pensions and state investment boards to divest from companies doing business in Sudan).
121. *See* Elizabeth Wine, *CalPERS to Sell Tobacco Holdings*, FIN. TIMES, Oct. 19, 2000, at 27 (reporting that CalPERS' board voted to divest its $525 million holdings in tobacco investments); MINN. STATE BOARD OF INV., 2005 ANNUAL REPORT 49 (2006), *available at* http://www.sbi.state.mn.us/2005%20Annual%20Report.pdf (stating that in 1998, the investment board voted to divest holdings in any company that obtains more than fifteen percent of its revenue from consumer tobacco products).
122. For a discussion of the history of the MacBride Principles and their adoption by public pension funds, see Christopher McCrudden, *Human Rights Codes for Transnational Corporations: What Can the Sullivan and MacBride Principles Tell Us?*, 19 OXFORD J. LEGAL STUD. 167, 178–98 (1999).
123. FLA. STAT. § 121.153 (2007) ("[T]he Board of Administration shall invest the assets of the System Trust Fund in such a manner that the investments in institutions doing business in or with Northern Ireland shall reflect the advances made by such institutions in eliminating discrimination . . . ."); FLA. STAT. § 215.471 (2007) (prohibiting investments in companies doing business in or with Cuba).

of funds indicated that they had a policy on SRI. For at least two of those respondents, however, that policy was a prohibition against SRI.

Overall, pension funds are not active in social investing. Although reports on social investing by the Social Investing Forum, for example, claim that public pensions are actively involved in SRI,[124] such involvement does not appear to be widespread or beyond negative screening restrictions imposed by state law on a limited set of issues. In fact, some argue that use of social investing in general—which the Social Investment Forum places at almost one out of every ten dollars under professional management[125]—is significantly overstated.[126] In addition, it is important to note that these negative screening practices, which are the basis of most existing SRI practices, do little to promote sustainable economic development amongst a large number of corporations.

### *3. Impact on Asset Managers*

Through their asset managers, public pensions may be furthering the problem of short-termism. Currently, the United States lags behind the rest of the world in incorporating extra-financial information into investment decisions.[127] A recent survey of investment managers—including managers for some of the largest U.S. pension funds—found that only eleven percent of respondents believed that mainstream practice would include the integration of social and environmental factors into corporate performance indicators within the next five years.[128] By contrast, the affirmative response rate for European respondents was around sixty percent.[129] A follow-up survey also found the percentage of U.S. investment managers lower than the global average in believing that climate change, environmental management, human rights, and sustainability are currently material or will be material

124. *See* SOC. INV. FORUM, 2005 REPORT ON SOCIALLY RESPONSIBLE INVESTING TRENDS IN THE UNITED STATES 12–13 (2006), *available at* http://www.socialinvest.org/areas/research/trends/sri_trends_report_2005.pdf.

125. *Id.* at iv.

126. *See* Alicia H. Munnell & Annika Sunden, *Social Investing: Pension Plans Should Just Say "No," in* PENSION FUND POLITICS: THE DANGERS OF SOCIALLY INVESTING 13, 14–19 (Jon Entine ed., 2005).

127. Thamotheram, *supra* note 8, at 296.

128. MERCER INV. CONSULTING, 2005 FEARLESS FORECAST: A CONSENSUS FORECAST OF U.S. AND GLOBAL CAPITAL MARKETS AND INDUSTRY TRENDS 5 (2005), *available at* http://www.mercer.com/attachment.dyn?idContent=1155130&idFile=172829.

129. Thamotheram, *supra* note 8, at 296.

within the next five years.[130] Going forward, only one-third of U.S. investment managers expect to see an increase in client demand for the integration of ESG issues into investment practices in the next three years, and only one-fifth expect to see clients demand new products based on ESG analysis.[131]

Public pension funds seem to be doing little to change investment managers' expectations. Pension funds influence external investment managers' engagement with companies on ESG issues through the selection of managers, their initial contract, their compensation structure, and through regular review meetings.[132] The message currently sent by public pension funds through these four channels is that managers will be rewarded for meeting specific benchmarks or for beating their competition.[133] Krehmeyer and colleagues note as a problem pension funds' evaluation of their asset managers on a quarterly basis, which perpetuates the short-termism cycle.[134] In my survey, seventy percent of the funds review external managers' performance every quarter (nineteen percent do annual reviews). Quarterly review, of course, does not mean that a manager is at risk of being fired for one or two quarters of poor performance—but being evaluated and possibly compensated based on quarterly performance may encourage managers to focus only on short-term investment performance with an eye toward the relevant benchmark.[135] In addition, such a process makes it highly unlikely

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130. MERCER INV. CONSULTING, 2006 FEARLESS FORECAST: WHAT DO INVESTMENT MANAGERS THINK ABOUT RESPONSIBLE INVESTMENT? 5–6 (2006), *available at* http://www.mercer.com/attachment.dyn?idContent=1212100&idFile=177709.

131. *Id.* at 7–8.

132. Thamotheram, *supra* note 8, at 296, 298.

133. *See id.* at 307.

134. CFA CTR. FOR FIN. MKT. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORP. ETHICS, *supra* note 14, at 14.

135. *See* PAUL MYNERS, INSTITUTIONAL INVESTMENT IN THE UNITED KINGDOM: A REVIEW 10 (2001), *available at* http://www.hm-treasury.gov.uk/media/1/6/31.pdf. An ethnographic study of private and public pension funds finds evidence of the challenge of thinking long-term with respect to asset managers (both internal and external) when trustees are barraged with short-term information. WILLIAM M. O'BARR & JOHN M. CONLEY, FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING 168–72 (1992). For example, one interviewee described the process of reviewing asset managers' monthly performance reports, stating that their pension fund "[doesn't] try to fire managers over short periods of time." *Id.* at 169. The authors noted the use of the word "try" and wondered how often the interviewee's pension fund was successful in resisting a focus on the short term. *Id.* Overall, O'Barr and Conley conclude that "to focus seriously on the long term is an act of intellectual originality that goes against the cultural grain." *Id.* at 168.

that managers will focus on the long term,[136] which is necessary for adopting new investment approaches based on environmental and social issues.[137] Without a clear message from pension trustees that consideration of LTRI issues is not simply a fad and that money managers will not be punished for a short-term performance shortfall due to the integration of LTRI information into their investment decisions, investment managers will not devote significant resources to these practices.[138]

### C. Pension Fund Trustees and LTRI: The Hurdles

The survey also asked the trustees to indicate which factors influenced their fund's decision not to engage in SRI. The most common response was that the trustees believed it was not appropriate for them to make investment decisions for the fund based on ethical issues (forty-five percent selected this factor). This reflects the association of SRI with ethical investors and not with the ESG, LTRI, or extra-financial criteria investment movement.[139] It also reflects the concern of trustees that considering such factors may constitute a breach of their fiduciary duty—in fact, two trustees provided a write-in response specifically indicating this concern.

As for additional factors influencing the decision not to engage in SRI, trustees indicated that they believed SRI would reduce returns (thirty-six percent), that they were not under pressure from the plan membership to develop SRI policies (thirty-three percent), that they lacked knowledge (twenty-two percent), or that it was viewed as too expensive (fifteen percent).[140] Only two trustees indicated that they did not have an SRI policy because they thought the plan membership would be against it. Among the open-ended responses provided by the trustees, one mentioned "fear of change" by the board. Although only one trustee mentioned this fear, it is reflected more broadly in trustees' beliefs about the impact of social investing on returns and their general knowledge of these practices. Such concerns are addressed in the Subsection below on conservative decision making by trustees.

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136. CFA CTR. FOR FIN. MKT. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORP. ETHICS, *supra* note 14, at 9.

137. *See infra* notes 218–219 and accompanying text.

138. Guyatt, *supra* note 17, at 143–45.

139. *See supra* notes 44, 86 and accompanying text.

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

### *1. Breach of Fiduciary Duties*

Trustees may decline to incorporate sustainability factors into their investment practices due to a belief that it would be a breach of their fiduciary duties to do so. The state laws establishing each pension fund typically also list the fiduciary duties of the trustees, which can be categorized as the duties of loyalty and prudence. These duties also exist as common-law duties, as set forth in the *Restatement (Third) of Trusts*. With respect to the duty of prudence, state statutes establish either a prudent person standard (requiring trustees to consider each investment in isolation) or a prudent investor standard (requiring trustees to consider each investment as part of an investment portfolio).[141] The trend is toward adopting the prudent investor standard,[142] with forty-three states having adopted some variation of the Uniform Prudent Investor Act ("UPIA").[143] Included within the duty of prudence is the duty of care, which requires trustees to "to exercise reasonable effort and diligence in making and monitoring investments for the trust."[144] The duty of loyalty requires that the trustees "administer the trust solely in the interests of the beneficiaries."[145]

Some state statutes modify, or seek to clarify, the content of these duties through additional provisions. For example, in Nebraska, the law establishing the duties of the Investment Council states that "[n]o assets of the retirement systems . . . shall be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives."[146] By contrast, Connecticut state law provides that the state treasurer "may

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141. CAROL V. CALHOUN ET AL., GOVERNMENTAL PLANS ANSWER BOOK §§ 7.10–7.13 (2d ed. 2007). Some states combine the two standards. *Id.*

142. *Id.* at § 7.13.

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

144. RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. d (1992).

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

146. NEB. REV. STAT. § 72-1239.01(3) (2003); *see also* KAN. STAT. ANN. § 74-4921(3) (1993) ("No moneys in the fund shall be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives."). Calhoun et al. argue that the Kansas statute is unclear on whether it prohibits consideration of social issues in all instances, or only when it is expected to have a negative impact on the investment's return. CALHOUN ET AL., *supra* note 141, at § 7–31.

consider[] the social, economic and environmental implications of investments of trust funds in particular securities . . . ."[147]

The *Restatement (Third) of Trusts* discusses social investing in its commentaries, but it does not provide a clear statement on whether it is consistent with trustees' fiduciary duties.[148] These comments, however, rely primarily on academic articles discussing trustees' fiduciary duties in the context of social investing based on negative screens, with most of these articles relating to institutional investors divesting from corporations conducting business in apartheid South Africa in the 1980s.[149] As discussed above, social investing may either be based on ethical values or intended as a strategy to increase value through decreased risk and higher return.[150] Although social investing based on ethical values and the use of negative screening is likely not a violation of fiduciary duties,[151] an investment strategy based on utilizing environmental and social factors to increase value is clearly not a violation of a trustee's fiduciary duties.[152] In fact, a recent survey of the law by the law firm Freshfields Bruckhaus Deringer suggests that it would be a violation of fiduciary duties *not* to consider environmental and social issues in certain situations.[153]

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147. CONN. GEN. STAT. § 3-13d (2002).

148. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. c (1992).

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

150. *See supra* note 8 and accompanying text.

151. *See infra* notes 154–59 and accompanying text.

152. FRESHFIELDS BRUCKHAUS DERINGER, *supra* note 143, at 102–16 (reviewing the consideration of ESG issues in investment decision making under ERISA, the *Restatement (Third) of Trusts*, and the UPIA); CALHOUN ET AL., *supra* note 141, at § 7-31 ("No one questions the right of a pension fund to avoid investment in tobacco stocks based on the trustees' reasonable belief that the risks associated with tobacco stocks, in relationship to their returns, make them a poor investment.").

153. FRESHFIELDS BRUCKHAUS DERINGER, *supra* note 143, at 11–14. The U.N. Environment Programme Finance Initiative's Asset Management Working Group commissioned the Freshfields report. *Id.* at 6. This report reviews fiduciary duty requirements in nine different countries. *Id.* The objective of the study was to answer the following question: "Is the integration of environmental, social and governance issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) voluntarily permitted, legally required or hampered by law and regulation; primarily as regards public and private pension funds, secondarily as regards insurance company reserves and mutual funds?" *Id.*

Social investing may violate the duty of loyalty if investment returns are sacrificed for the primary purpose of providing benefits (social or financial) to a third party,[154] or if the trustees are using the plan's assets to further their own political agenda.[155] Both statements, however, need further explanation. First, the duty of loyalty is not violated when the purpose of social investing is long-term value creation consistent with the duty of prudence, as is the case with LTRI.[156] In this situation, the benefits accruing to the third parties are not the primary purpose of the investment decision, but rather a result of the recognition that the proper management of such social and environmental matters may decrease risk and increase value for the corporation (and the pension fund's investment portfolio). Second, it is permissible to consider collateral social benefits when the costs are minimal. In one of the few cases considering social investing by public pension funds, *Board of Trustees of the Employees' Retirement System of Baltimore v. Mayor of Baltimore*,[157] the court held that a city ordinance preventing city pension funds from investing in companies doing business with apartheid South Africa would not cause the trustees to violate their fiduciary duty of loyalty. This ruling was based, in part, on the finding that the costs of such a strategy were de minimis.[158] Third, distinct from their personal social and political beliefs, trustees may act upon "fundamental and generally accepted ethical principles" without violating the duty of loyalty or the duty of prudence.[159]

In *Employees' Retirement System of Baltimore*, the court also found that the city ordinance did not alter the trustees' duty of prudence.[160] In making this ruling the court relied on the treatise *Scott on Trusts*.[161] The court cited *Scott* for the proposition that it is reasonable for a trustee to believe that a more

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

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

156. *See infra* note 162 and accompanying text.

157. Bd. of Trs. of Emps.' Ret. Sys. of Balt. v. Mayor and City Council of Balt., 562 A.2d 720 (Md. 1989), *cert. denied sub nom.* Lubman v. Mayor and City Council of Balt., 493 U.S. 1093 (1990).

158. *Id.* at 738.

159. SCOTT ON TRUSTS § 227.17 (4th ed. 1988). Scott goes on to state that trustees "may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility." *Id.*

160. Bd. of Trs. of Emps.' Ret. Sys. of Balt., 562 A.2d at 735–38.

161. *Id.* at 736–7.

socially responsible corporation will perform better over the long run.[162] In addition, the court also cited *Scott* for the idea that, regardless of the impact of social performance on financial performance, "the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of funds in a manner detrimental to society."[163] This holding was qualified, however, in that the trustee's decision must also involve only de minimis costs,[164] which is not a factor mentioned in *Scott*.[165]

These statements are also consistent with the Uniform Management of Public Employee Retirement Systems Act ("UMPERSA") and private pension trustees' fiduciary duties under the Employee Retirement Income Security Act of 1974 ("ERISA"). Both UMPERSA and the Department of Labor state that the consideration of collateral benefits through socially responsible investing is consistent with a trustee's fiduciary duties if the investment has an expected rate of return commensurate with alternative investments of similar risk.[166]

Overall, it is clear that the practice of responsible long-term investing with a goal of sustainable economic development is consistent with a trustee's fiduciary duties. Freshfields Bruckhaus Deringer summarizes its review of U.S. law by stating that "there appears to be a consensus that, so long as ESG considerations are assessed within the context of a prudent investment plan, ESG considerations can (and, where they affect estimates of value, risk and return, should) form part of the investment decision-making process."[167] The report goes on to form both prescriptive and permissive guidelines. Under the prescriptive guidelines, the report states that the duty of prudence requires trustees to treat their proxies as assets and vote on shareholder resolutions in

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162. *Id.* at 737.
163. *Id.*
164. *Id.*
165. In the 1988 edition of *Scott on Trusts*, the treatise does not mention the de minimis cost factor. *See* SCOTT ON TRUSTS § 227.17 (4th ed. 2001).
166. UNIF. MGMT. OF PUB. EMPLOYEE RET. SYS. ACT § 8(a)(5) (1997) ("[A] trustee with authority to invest and manage assets . . . may consider benefits created by an investment in addition to investment return only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits."), *available at* http://www.nasra.org/resources/umpersa.pdf; FRESHFIELDS BRUCKHAUS DERINGER, *supra* note 143, at 110 (citing a letter from the Department of Labor to William M. Tartikoff, senior vice president and general counsel of Calvert Group Ltd. (May 28, 1998)). This interpretation of ERISA fiduciary duties is consistent with the Department of Labor's statements related to Economically Targeted Investments ("ETIs"). *See infra* notes 225–27.
167. FRESHFIELDS BRUCKHAUS DERINGER, *supra* note 143, at 114.

an informed manner[168] and to weigh the relevance of ESG considerations in making investment decisions.[169] Under permissive guidelines, the report states, it is consistent with the duty of loyalty both to engage in shareholder activism on ESG issues with the purpose of enhancing company value and to consider the social and environmental benefits of an investment when the expected rate of return is commensurate with that of similar investments.[170] The permissiveness of such actions is consistent with the Department of Labor's statement that private pensions should engage in shareholder activism when it is expected to increase investment value.[171]

### *2. Conservative Decision Making*

Even if trustees are assured that LTRI would not be in violation of their duties, most pension funds are still unlikely to engage in LTRI due to the trustees' conservative investment decision-making practices. Trustees are likely to follow the practices "commonly accepted throughout the investment management industry,"[172] the advice of consultants, and the actions of their peer group.[173] For example, in the United Kingdom., sixty-three percent of

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168. *See also* Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2(1) (1994) ("The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment.").
169. FRESHFIELDS BRUCKHAUS DERINGER, *supra* note 143, at 114.
170. *Id.* at 115.
171. Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2(3) (1994).

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

*Id.* The issues the Department of Labor lists as possible candidates for shareholder activism include "the nature of long-term business plans, the corporation's investment in training to develop its work force, other workplace practices and financial and non-financial measures of corporate performance." *Id.* This interpretive bulletin is also cited by the Myners Report in support of greater shareholder activism by pension plans in the United Kingdom. MYNERS, *supra* note 135, at 92–93.

172. GORDON CLARK, PENSION FUND CAPITALISM 157 (2000).
173. MYNERS, *supra* note 135, at 59–61.

pension fund trustees indicated that in making investment decisions, their fund "sticks as closely as possible to the accepted practice in the industry."[174]

Although there is some leadership in advancing LTRI practices,[175] the positive trend has not yet proven sufficient to change trustee behavior on a large scale. To engage in sustainable investing, trustees will be forced out of their comfort zone. For example, they will need to consider managers' use of new strategies to incorporate non-financial data into investment analysis. These managers will not have a long enough track record with these strategies to demonstrate their effectiveness, which will make trustees question the appropriateness of such investments.[176] Likewise, trustees and investment consultants will need to develop new, and perhaps untested, performance measures to evaluate these managers.[177] This new evaluation method will also pull trustees back towards conventional strategies and away from sustainable investing.

## III. PUBLIC PENSION DISCLOSURE OF LTRI INVESTMENT POLICY AND IMPLEMENTATION

In light of the potential for public pension funds to serve a useful role in a new governance approach to regulation, and considering the limited involvement of these funds, public pensions in the United States should be required to disclose whether LTRI considerations play a role in their investment policies. In addition, pension funds should provide disclosure on the actual implementation of those policies, such as their engagement with corporations, their proxy voting policies, and the basis for their selection and retention of asset managers who utilize an LTRI strategy. The most likely avenue for this reform would be through modification to the Government Accounting Standards Board ("GASB") Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*. GASB Statement No. 25 provides the basis for the Comprehensive Annual Financial Reports filed by most public pensions.[178] Included within the CAFR is an investment section, in which the pension plan reports on its investment policies, asset allocations, investment activities, and fees.[179]

Alternatively, the proposal could be implemented through amendments to the Uniform Management of Public Employee Retirement Systems Act,

174. *Id.* at 59.
175. *See supra* notes 87–103 and accompanying text.
176. *See* CLARK, *supra* note 172, at 140 (discussing unconventional investment decisions by trustees).
177. *See infra* notes 217–20 and accompanying text.
178. CALHOUN ET AL., *supra* note 142, at §§ 5-5–5-6.
179. *Id.* at § 5–8.

which currently requires pension plans to issue an annual report to the public.[180] Amending UMPERSA would have significantly less impact than amending GASB Statement No. 25, however, as it would require each state to amend its laws, and UMPERSA has not had a significant influence on state laws.[181] As a third alternative, disclosure of LTRI investment policies and implementation actions could be encouraged as a best practice by influential organizations such as the Government Finance Officers Association.[182] The remainder of this Part reviews the developments surrounding a similar law adopted in the United Kingdom and the expected impact of such a law in the United States.

### A. U.K. Pensions Act of 1995 Disclosure Requirements

As of the year 2000, public and private pension funds in the United Kingdom are required by law to disclose in their statement of investment principles ("SIP") "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realization of investments" and "their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments."[183] Note that the law does not require pensions to consider social and environmental issues, but only that pensions disclose whether or not they do. Similar laws exist in Belgium,[184] Germany,[185] and Sweden.[186]

The SIP disclosure requirements amendment to the Pensions Act of 1995, along with the recommendations in the well-publicized Myners Report of 2001 that encouraged trustees to be more active owners,[187] has had a significant impact on LTRI shareholder engagement in the United Kingdom. A review of pension funds' actions during the first year of the requirement found that fifty-nine percent of pensions stated that they were incorporating social and environmental issues into their investments, and forty-eight percent

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180. UNIF. MGMT. OF PUB. EMP. RET. SYS. ACT § 13 (1997), *available at* http://www.law.upenn.edu/bll/ulc/mopepf/retirsy2.pdf.

181. CALHOUN ET AL., *supra* note 141, at §§ 7–22 (noting partial adoptions of UMPERSA in only South Carolina and Colorado).

182. *See* Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 226–27 (2001).

183. The Occupational Pension Schemes Amendment Regulations, 1999, S.I. 1999/1849, art. 2 ¶ 4 (U.K.), *available at* http://www.legislation.hmso.gov.uk/si/si1999/19991849.htm.

184. FRESHFIELDS BRUCKHAUS DERINGER, *supra* note 143, at 152.

185. *Id.* at 63.

186. *Id.* at 152.

187. *See* MYNERS, *supra* note 135, at 14.

indicated that they directed their fund managers to take these issues into account.[188] Fourteen percent of the funds (mostly smaller ones) indicated that they would not take these issues into account, and twenty-seven percent left the decision to their fund managers.[189] The SIP statements, however, rarely mentioned how the policy would be implemented in practice and used language that made it difficult to determine how investment practices would actually change, if at all.[190]

In the following years, the disclosure requirements continued to have a significant influence on behavior, but the extent of their actual impact on practices to date remains somewhat unclear. For example, FairPensions, an NGO sponsored by Amnesty International, Greenpeace, and others,[191] reviewed practices at the twenty largest pension funds in the United Kingdom in 2006 and found that only twelve of the twenty actually disclosed whether they consider ESG issues in their SIPs.[192] The study claimed that most pensions seemed to take a "box ticking" approach to ESG issues by making general statements in support of responsible investment, but not doing anything to implement those statements.[193]

Other investigations have reported a greater impact. Just Pensions, a program established by the United Kingdom Social Investment Forum,[194] surveyed seventy-nine pensions in fall 2005.[195] When asked which practices the funds used "a lot" in dealing with ESG issues, four percent of the large funds (those with over £1 billion in assets)[196] used negative screening, sixteen percent used positive screening, fifty-eight percent used engagement, and fifty percent used the exercise of voting rights.[197] For all pensions in the sample, almost one-half indicated that they would use engagement and voting rights at

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188. EUGENIE MATHIEU, RESPONSE OF U.K. PENSION FUNDS TO THE SRI DISCLOSURE REGULATION 33 (2000), *available at* http://www.uksif.org/cmsfiles/uksif/ukpfsurv.pdf.
189. *Id.*
190. *Id.* at 35.
191. FairPensions, About Us, http://www.fairpensions.org.uk/about_us (last visited Oct. 15, 2007).
192. FAIRPENSIONS, U.K. PENSION SCHEME TRANSPARENCY ON SOCIAL, ENVIRONMENTAL AND ETHICAL ISSUES (2006), *available at* http://www.fairpensions.org.uk/pdf/Pension%20Scheme%20Transparency%20Report%20Nov2006.pdf.
193. *Id.* at iii.
194. Just Pensions, About Just Pensions, http://www.uksif.org/pension-funds/just-pensions/About-JP (last visited Oct. 15, 2007).
195. CHRIS GRIBBEN & MATTHEW GITSHAM, JUST PENSIONS, WILL U.K. PENSION FUNDS BECOME MORE RESPONSIBLE? A SURVEY OF TRUSTEES 5 (2006), *available at* http://www.uksif.org/cmsfiles/jp/ukpf2006-justpens.pdf.
196. *Id.* at 7 n.8.
197. *Id.* at 11. The smallest funds were more likely to use negative and positive screening and less likely to use engagement or voting rights. *Id.* Pensions for charities were the most likely to use any of these mechanisms. *Id.* at 12.

least "a little more" in the next three years.[198] One-third of pensions indicated that ESG issues had at least "some impact" on the selection of fund managers, and over one-quarter of the sample used a formal process to incorporate ESG factors into the appointment and assessment of managers.[199]

Overall, the SIP disclosure requirements appear have had a significant impact in the United Kingdom. For example, based on interviews with U.K. fund managers, Professors Cynthia Williams and John Conley found that the disclosure requirement is having a "profound effect" amongst large pension funds.[200] Others have drawn similar conclusions.[201] In addition, these requirements seem to have strong support amongst trustees. In fact, one-third of the sample in the Just Pensions 2005 survey "strongly agreed" and another one-third "agreed" that additional legislation is needed beyond simple disclosure of a policy and that funds should provide information on actual implementation.[202] These developments have also apparently had an impact throughout the U.K. investment community. For example, forty-seven percent of U.K. investment managers expect a demand for specialized investment products that utilize social and environmental factors in the next three years, compared to only nineteen percent of U.S. investment managers.[203] There are other differences between the United Kingdom and the United States that likely explain many of these discrepancies.[204]

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198. *Id.*

199. *Id.* at 15–16. None of the public pensions in this sample used those methods, though ten percent used formal procedures in the selection of investment consultants. *Id.* at 15. The report does not provide information on the size of those public pension funds.

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

201. *See* Russell Sparkes, *A Historical Perspective on the Growth of Socially Responsible Investment*, in RESPONSIBLE INVESTMENT 39, 50–51 (Rory Sullivan and Craig Mackenzie, eds., 2006) (attributing the significant growth of SRI investing in the U.K. to the disclosure requirement); Aris Solomon et al., *Can the U.K. Experience Provide Lessons for the Evolution of SRI in Japan?*, 12 CORP. GOVERNANCE: AN INT'L REV. 552, 556 ("A seemingly minor institutional change to pension fund law has had a significant impact on pension fund trustees and on SRI in the U.K.").

202. GRIBBEN & GITSHAM, *supra* note 195, at 17. Only three percent "strongly disagreed" and an additional eight percent "disagreed." *Id.* In addition, two-thirds at least "agreed" that there should be regulation encouraging a long-term perspective, such as increased voting rights or lower capital gains taxes and higher dividends for long-term holders. *Id.* at 19–20. It is difficult to know how representative the study's sample was; the survey was distributed to about one thousand trustees, and trustees from seventy-nine pensions responded. *Id.* at 5.

203. MERCER INV. CONSULTING, *supra* note 130, at 8.

204. For example, institutional investments assets in mutual funds are greater in the United States (which may be more short-term focused) and the U.K. government has shown support for CSR issues. Williams & Conley, *supra* note 200, at 535–38.

### B. LTRI Disclosure for Public Pension Funds: A Catalyst for Change

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

*Shareholder Proposals and Voting Policies.* As illustrated earlier, few public pensions have well-developed policies for voting their proxies on environmental and social issues,[205] and only a handful are active in sponsoring shareholder proposals.[206] Although many pensions may, and should, decide to continue not to sponsor shareholder proposals due to the resources this would require, it is irresponsible of trustees not to have a complete proxy voting policy or to have a blanket policy of abstaining from voting on social and environmental issues. It is well established that proxies are assets of the pension plan and should be voted appropriately.[207] There is an emerging consensus that issues of sustainability will have an impact on investment performance over the long term[208] and therefore, prudent trustees must devote thought to their policies and provide justification for their decisions.

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205. *See supra* Part II.B.1.
206. *See supra* notes 87–93 and accompanying text.
207. *See* Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, 29 C.F.R. § 2509.94-2(1) (2006) ("The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock . . . . The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment.").
208. *See supra* notes 8, 35 and accompanying text.

In addition, contingent on cost constraints, pensions should make their votes available to the public.[209]

*Shareholder Engagement.* Public pensions can choose to engage directly with corporations or act through a coalition of investors, such as the Carbon Disclosure Project[210] or the Investor Network on Climate Risk.[211] Such coalitions operate in different ways. The Carbon Disclosure Project, for example, involves institutional investors filing a request that corporations provide disclosure on greenhouse gas emissions and the risks of climate change to the corporation.[212] This information is then available for pensions to use in any direct engagement with the corporation, for their investment managers to use in investment analysis or engagement, and for other interested stakeholders of the corporation. As a member of the Investor Network on Climate Risk, a pension trustee can participate in coordinated corporate engagement with other institutional investors.[213] Overall, collaboration allows pension funds to operate more efficiently by reducing duplicate costs, learning from others' experience, and generally increasing their influence.[214] Through these coalitions, investors can also engage in the public policy process, such as the efforts of some public pensions encouraging the SEC to require corporations to provide greater disclosure on climate change risks.[215] Investors can also engage in the policy process by monitoring the political activity of the corporations in which they invest.[216]

*Investment Practices.* Because public pensions rely so heavily on investment consultants and external money managers, one would expect pension funds that emphasize LTRI issues to have a significant impact throughout the financial industry. For example, if pension boards start pressing for action on LTRI practices, then investment consulting firms will start to evaluate money

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209. *See infra* note 230 and accompanying text (discussing the role of disclosure to reduce the risks of politicization of the process).
210. Carbon Disclosure Project, *supra* note 95.
211. *See* Investor Network on Climate Risk, About INCR, http://www.incr.com/netcommunity/page.aspx?pid=261&srcid=198 (last visited Oct. 15, 2007).
212. Carbon Disclosure Project, *supra* note 95.
213. Investor Network on Climate Risk, INCR Overview, http://www.incr.com/index.php?page=2 (last visited Apr. 14, 2007).
214. HAWLEY & WILLIAMS, *supra* note 21, at 173.
215. *See* Press Release, Ceres, *supra* note 97.
216. *See* HAWLEY & WILLIAMS, FIDUCIARY CAPITALISM, *supra* note 21, at 174. In 2006, there were twenty-nine shareholder proposals on the disclosure of political contributions and over half of those received twenty percent or greater of shareholder votes. INST'L S'HOLDER SERVS., POST SEASON REPORT, *supra* note 5, at 32–34.

managers on the basis of their engagement and integration of these issues.[217] The consultants will seek investment managers who are trained on these issues and will work to develop compensation and evaluation practices that allow investment managers to undertake engagement based on long-term issues.[218] As discussed earlier, pension funds can also influence external managers' engagement practices by raising these issues through regular review meetings; to the extent these issues are not raised, external managers will pay little attention to them.[219]

This process is expected to develop and disseminate best practices relating to pension funds' investment policies and implementation, as well as best practices among investment managers for demonstrating their effective consideration of LTRI issues and engagement practices to trustees and their consultants.[220] These developments also have the potential to influence sell-side analysts' research. Influencing sell-side analysts is especially important, as new financial analysts do not believe there is a demand for consideration of these issues and therefore do not attempt to increase their knowledge in this area.[221] The primary example in the area of analysts' research is the Enhanced

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217. Thamotheram, *supra* note 8, at 300; *see also* MARATHON CLUB, LONG-TERM, LONG-ONLY INVESTING: A CONSULTATION PAPER (2006), *available at* http://www.marathonclub.co.uk/Docs/Guidance%20Note%20-%20FINAL%20DRAFT%206a%20March%2006.pdf (noting that the most important decision for trustees attempting to implement a long-term investing strategy is the selection of the investment manager).

218. *See* TONELLO, *supra* note 13, at 44; CFA CTR. FOR FIN. MKT. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORP. ETHICS, *supra* note 13, at 14; Thamotheram, *supra* note 8, at 296, 298. Changing compensation and evaluation practices is not as easy as simply lengthening the terms of the contract or changing from quarterly reviews to annual reviews. MARATHON CLUB, LONG TERM LONG ONLY CONSULTATION PAPER RESPONSES—A SUMMARY 1, 4–5 (2006), *available at* http://www.marathonclub.co.uk/Docs/consultation_response_summary.pdf. Instead, it will likely require the development of new performance measures that incorporate multiple factors. *Id.* at 5. For discussion of what such performance metrics may include, see MARATHON CLUB, *supra* note 217, at 19–20.

219. Thamotheram, *supra* note 8, at 296, 298; *see also* MARATHON CLUB, *supra* note 217, at 21–22 (suggesting issues to consider in manager review meetings to ensure that the manager is enacting a long-term investing strategy).

220. For examples of how investment managers may report on their engagement activities, see Insight Investment's quarterly engagement reports. Insight Investment, Engagement and Voting, http://www.insightinvestment.com/Responsibility/reporting/reporting.asp (last visited Oct. 15, 2007). Insight Investment's quarterly report on engagement activities provides a chart listing the target company, the topic of engagement, the reason for engagement at that company, and the current status of the impact of those actions. *See* INSIGHT INVESTMENT, COMPANY ENGAGEMENT REPORT 1 (2006), *available at* http://www.insightinvestment.com/documents%5Cresponsibility%5CEngagement_and_Voting%5CQ3_06_Engagement_Report.pdf.

221. TONELLO, *supra* note 13, at 45; UNEP FINANCE INITIATIVE, GENERATION LOST: YOUNG FINANCIAL ANALYSTS AND ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES 4 (2005),

Analytics Initiative.[222] This initiative seeks to improve the quality of sell-side analysts' research on LTRI issues through financial incentives. Each member of the initiative, such as a pension fund, agrees to allocate at least five percent of their brokerage commissions to analysts conducting this type of research.[223] The creation of new LTRI research and the pressure for greater corporate disclosure in general will not only improve the decision making of public pensions' asset managers, but will also further a new governance regulatory approach by creating information that is of use to others, such as social investors, special interest groups, and governmental bodies.

### C. Preventing the Politicization of Public Pension Policies and Practices

The primary argument against this Article's proposal is that public pensions—through the involvement of politicians or union representatives—will simply use LTRI as an excuse to take actions based on private political interests, without actual regard to long-term shareholder value.[224] This argument, raised most recently against granting shareholders access to the directors' ballot, echoes concerns over economically targeted investments ("ETIs") in the mid-1990s. ETIs are pension fund investments that take into account the investment's economic and social benefits to the local community, such as increased employment or the provision of affordable housing.[225] At the time, some commentators argued that ETIs opened the door to "politicizing" pension investments, as opposed to "maximizing"

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*available at* http://www.unepfi.org/fileadmin/documents/ymt_summary_2005.pdf (reporting results from interviews with financial analysts under thirty-five years of age and finding that they were uninformed on ESG issues and did not believe they would be rewarded for researching those topics). Analysts' responsiveness to these issues is also furthered by the requirements of Section 501 of the Sarbanes-Oxley Act, which attempts to increase the independence of securities analysts. *See* TONELLO, *supra* note 13, at 38.

222. *See supra* note 102 and accompanying text (noting that CalSTRS has joined this initiative).

223. TONELLO, *supra* note 13, at 40.

224. *See* Romano, *supra* note 182, at 181; *see generally* Charles E. Rounds, Jr., *Why Social Investing Threatens Public Pension Funds, Charitable Trusts, and the Social Security Trust Fund*, *in* PENSION FUND POLITICS: THE DANGERS OF SOCIALLY RESPONSIBLE INVESTING 56 (Jon Entine ed., 2005); Jarol B. Manheim, *The Strategic Use of Socially Responsible Investing*, *in* PENSION FUND POLITICS: THE DANGERS OF SOCIALLY RESPONSIBLE INVESTING 81 (Jon Entine ed., 2005).

225. GAO, PUBLIC PENSION PLANS: EVALUATION OF ECONOMICALLY TARGETED INVESTMENT PROGRAMS, GAO/PEMD-95-13, at 5–6 (1995), *available at* http://archive.gao.gov/t2pbat1/154006.pdf; Ronald D. Watson, *Does Targeted Investing Make Sense?*, 23 FIN. MGMT. 69 (Winter 1994).

them.[226] Although some early studies showed that ETIs had a negative impact on pension performance, these studies used data from before the mid-1990s, when the Department of Labor issued a statement that ETIs were appropriate if the expected rate of return was comparable to that of alternative investments of a similar risk.[227] More recent studies, including those using data after the Department of Labor's announcement, have not found a negative relationship between the use of ETIs and fund performance.[228] Thus, these studies provide some evidence that encouraging the use of LTRI, with a clear, stated focus on long-term shareholder value, will not necessarily lead to the politicizing of investments.

In addition, the transparency required in both policy and implementation should also work against politicization or domination of decision making by a special interest group. A pension fund's LTRI disclosures provide an avenue for dialogue on the pension's policies and performance with both plan members and third parties. Just as unions and special interest groups have started evaluating mutual funds and investment managers on their proxy voting records related to CEO compensation, labor issues, and the environment,[229] pension funds' practices will be scrutinized by both those seeking greater consideration of sustainability issues and those believing that such issues detract from long-term performance goals. These analyses and discussions should help to inform trustees, and push them to justify to plan

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

227. Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2(1) (1994).

228. For a review, see Hess, *supra* note 105, at 207–208, 211–12. For empirical studies finding that ETIs have no impact on public pensions' investment performance, see *id.* at 211–12. *See also* Alicia H. Munnell & Annika Sunden, *Investment Practices of State and Local Pension Funds: Implications for Social Security Reform*, *in* PENSIONS IN THE PUBLIC SECTOR 153, 161–64 (Olivia S. Mitchell & Edwin C. Hustead eds., 2001); Julia L. Coronado et. al., *Public Funds and Private Capital Markets: The Investment Practices and Performance of State and Local Pension Funds*, 56 NAT'L TAX J. 579, 589–90 (2003).

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

members, sponsoring government bodies, and taxpayers any action or lack thereof they choose to make.[230]

In order to further prevent politicization and to improve trustee decision making in general, the governance of public pensions must be given greater consideration.[231] First, there should be greater disclosure of conflict of interest policies,[232] as political donations, for example, have the potential to inappropriately affect investment choices.[233] Second, training and education of board members—especially member-elected trustees—should become a priority. One trustee of a large fund in my survey stated that their board members "have a three-year term of office and the learning curve is at least two years."[234] Surprisingly, only fourteen percent of the trustees of large pension funds in my survey indicated that their fund had a formal, documented training program, compared to thirty-nine percent of smaller funds. Instead, most large funds provided a budget for education whereby trustees obtained their own training on an informal basis. Training programs commonly attended by trustees included those offered through the Wharton School and Stanford Law School. The disclosure requirement proposed here would likely put LTRI issues on the curriculum of those programs, thus improving general knowledge of these issues, as well as spurring research on sustainable development investing by the educators serving in those programs.

Finally, there should be greater consideration of the role of member-elected trustees (including those serving on an investment advisory council). There is some evidence that member-elected trustees can improve fund financial performance as long as they do not dominate the board,[235] and that

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230. *See* Romano, *supra* note 182, at 223 (arguing for greater transparency and a trustee-level review of empirical data related to any corporate governance activism that the public pension fund chooses to engage in); *id.* at 226 (arguing that a formal review process of corporate governance activism may be a deterrent to politicization of activism by the board).

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

232. CalSTRS recently proposed a rigorous conflict of interest policy that may serve as a leadership example for others. Press Release, CalSTRS, California's Teachers' Retirement Board Sets High Ethics Bar (Nov. 3, 2006), *available at* http://www.calstrs.com/Newsroom/news110306.aspx.

233. Munnell & Sunden, *supra* note 126, at 36–37; Rounds, *supra* note 224, at 57.

234. *See also* CFA CTR. FOR FIN. MKT. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORP. ETHICS., *supra* note 13, at 17–18 (noting the lack of training for pension trustees).

235. Hess, *supra* note 105, at 213–14.

they may reduce political interference, such as when a sponsoring government uses pension assets as a "safety-valve" against other budget shortfalls.[236] Additional research in this area is needed, but such trustees may serve a useful monitoring role. However, there is also the concern that member-elected trustees could lead to the domination of the board by politically motivated special interest groups rather than creating a balanced board. For example, the U.S. Chamber of Commerce criticizes CalPERS for being dominated by union-elected member trustees and ex officio trustees that received union funding.[237]

Public pension funds' use of external money managers alleviates the danger that politicians and special interest groups will "capture" pension fund LTRI practices. To the extent that external money managers are rewarded and evaluated based on their shareholder engagement and creation of long-term value, they will work with corporations to develop profitable sustainable development strategies and not simply pressure corporations to improve their environmental and social performance without regard to the economic implications of those acts for the corporation.

The threat of capture can also be alleviated if more pension funds become active in this area, rather than just the current handful of active pensions.[238] Greater fund involvement, such as through institutional investor coalitions or the public posting of proxy voting guidelines and investment policies, contributes to the debate and adds new perspectives and balance. For example, religious institutions are currently setting the agenda for shareholder proposals.[239] This does not necessarily mean that those proposals would not fit within LTRI as described in this Article, but increased involvement by a diversity of pension funds will help ensure that the proposals receiving attention from corporations are consistent with LTRI.

Finally, the next step to prevent special interest group capture, as well as to further new governance regulatory goals, would be greater participation among state and federal agencies in setting the agenda for shareholder engagement. A current example involves the U.K. Health and Safety Executive's ("HSE") experiment with the Corporate Health and Safety

236. *Id.* at 200–04.

237. Thomas J. Donohue, *CalPERS Needs Reform*, S.F. EXAM'R, June 24, 2004, *available at* http://www.uschamber.com/press/opeds/040624tjd_sanfran_op_ed.htm.

238. *See supra* notes 87–103 and accompanying text (describing those funds currently active in social and environmental shareholder issues).

239. W. Trexler Proffitt, Jr. & Andrew Spicer, *Shaping the Shareholder Activism Agenda: Institutional Investors and Global Social Issues*, 4 STRATEGIC ORG. 165 (2006).

Performance Index ("CHaPSI").[240] CHaPSI represents an attempt to measure firms' performance and policies related to health and safety management. The HSE developed this index with input from investors, who will in turn be active in pressuring firms to improve their CHaPSI numbers.[241] Various agencies in the United States could experiment with similar programs, and considering how to improve the TRI along these lines would be a natural starting point.[242] Public pension involvement in these programs would grant legitimacy to this part of their LTRI policy, ensure the pensions are working towards regulatory goals, and, of course, help provide more effective and efficient regulation.

## CONCLUSION

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

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

241. Waygood et al., *supra* note 240, at 323–25.

242. *See supra* notes 63–72 and accompanying text (discussing the TRI).