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RECENT TRENDS AND REGULATORY IMPLICATIONS IN SOCIALLY RESPONSIBLE INVESTMENT FOR PENSION FUNDS

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The study was prepared by Oxford Business Knowledge. The views contained within do not necessarily represent those of the OECD or its member governments.

Recent Trends and Regulatory Implications of Socially Responsible Investment for Pension Funds[1]

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Abstract: More than €3 trillion in assets are managed by socially responsible investment (SRI) funds around the world – a significant part of those funds by private pension funds. To date, international approaches (as enshrined in self-regulation such as the United Nation's Global Compact and Principles for Responsible Investment) have urged institutional investors, like pension funds, to take a more stringent view of SRI than the approach taken by national regulatory authorities which relies largely on disclosure requirements. This paper argues that these regulations should be buttressed with guidance regarding the definition of social, environmental and other risks targeted by SRI. Pension funds should also be required to disclose in their statement of investment policy the potential implications of their SRI strategy for their diversification and performance objectives, and how they expect to implement it (screening or advocacy approach).

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Introduction

At the time of this writing, a number of recent public controversies have centred on large funds liquidating their investments in companies (or entire countries) perceived by their staff (or by the public at large) as lacking corporate social responsibility. The lack of social responsibility by some large business has militated for investment funds and assets managers to use their investment decisions as a way of encouraging companies to consider more actively issues related to society and environment. Taking investment decisions based on these considerations – often called socially responsible investment (SRI) -- has entered the policy domain in two main forms. First, several of the most visible cases of funds using social criteria have been funds directly owned and managed by the public sector. For example, Norges Bank – which managed funds on behalf of the Norwegian Government Pension Fund–Global (formerly the Norwegian Petroleum Fund) – withdrew their $416 million investment in Wal-Mart shares. The California Public Employee Retirement Scheme's (CalPERS) highly publicized withdrawal from investing in countries such as Thailand made such investment decisions political, as well as financial. Second, across the OECD, governments are adopting indirect regulatory methods – preferring to mandate disclosure of the effects of investment activity on society and environment – rather than requiring companies to invest in particular ways.

To what extent should regulations encourage private pension funds and other institutional investors to incorporate social and environmental criteria into their investment decisions? This paper argues that pension fund regulators should promote a common definition of SRI and its underlying risk factors or criteria. Such initiative could favour the application of international good practices in private pension systems and limit the potential for misinformation created by current disclosure requirements.

The paper is structured as follows. The first section introduces SRI to the reader without extensive prior knowledge of the subject. The second section presents SRI trends in several OECD countries, showing the dramatic rise in SRI assets under management. The third section explores more fully SRI issues related to private pension funds. The fourth section covers international policy action which has been encouraging the development of SRI. The fifth section considers regulatory issues in the OECD countries. The last section concludes and provides some tentative policy recommendations. While the issues of corporate social responsibility and corporate governance are both highly relevant to the SRI discussion, this policy brief only touches briefly on these themes – focusing on SRI as applied to pension fund investment.[2]

[2] The extent to which a company considers environmental and social factors in its operations is both a concern to the company itself (namely its own corporate social responsibility) and to investors in the company (those making socially responsible investment). Moreover, corporate governance practices which encourage a Board-level consideration of these issues are often subsumed into a discussion of corporate governance. To focus only on SRI issues applied to private pension funds, we omit an extensive discussion of corporate social responsibility and corporate governance – leaving the reader to consider Gordon (2001) for more on these issues.

I. Defining Socially Responsible Investment

The origins of Socially Responsible Investment (SRI) are often traced to the investors in the United States in the early 1900s who avoided -- for religious reasons -- companies which invested in the production of tobacco, alcohol, or operated gambling establishments. The recent dialogue on SRI incorporates the concerns of modern finance theory (around risk and return), arguing that "extra-financial" factors can affect (increase or lower) expected returns and portfolio risk. Historically, the factors considered by SRI investors have fallen into three main categories:

- *Social factors*: human capital (training and education, working conditions, and health), community development, labour rights (such as the right to unionisation);
- *Environmental factors*: urban and industrial pollution, global warming, depletion of some natural resources (such as oil) and restricted access to others (such as clean water), the reduction of the world's flora and fauna populations;
- *Ethical factors*: violations of human rights, use of child labour, manufacture or distribution of weapons, inhumane testing of products on animals, implicit support of oppressive political regimes, slavery, forced prostitution, as well as the traditional ethical concerns around pornography, alcohol and gambling.

Despite a broad agreement on the social, environmental and ethical factors (SEE) which may affect investment risk and return, the definition of SRI itself varies between investors in different countries. Social investment organisations from different countries typically include social and environmental criteria in their definitional of SRI (see Figure 1), but some also place emphasis on other factors. For example, the UK and US Social Investment Forums (SIFs) include community investment and other economically-targeted investments (ETI) in the definition of SRI, while other countries do not. The UK SIF's SRI definition includes ethical considerations, while the Canadian and US definitions do not.

ETI remains a controversial aspect of SRI, although some authors such as Alexander (1997) argue that it comprises one of the most vital elements of SRI. Often provided by community development institutions which rely at least partly on charitable contributions or government subsidies, these institutions seek to invest in economically disadvantaged communities and under-invested markets. Unlike more traditional investors or microfinance investors (e.g. the Grameen Bank) who invest in under-developed markets to benefit from higher marginal returns to capital or from unexploited investment opportunities, the ETI investors may accept below-market rates of return to encourage investment that can help the communities where the investor's beneficiaries are based.

Figure 1: Several Definitions of Socially Responsible Investment (SRI)[3]

Australia: the Australian Ethical Investment Association defines SRI as "the integration of personal values with investment decisions. It is an approach to investing that considers both the profit potential and the investment's impact on society and the environment."

Canadian Social Investment Organisation: The Social Investment Organization defines SRI as "the process of selecting or managing investments according to social or environmental criteria."

Sweden's Forum for Sustainable Development: SRI "is investment that in addition to financial criteria, also takes social, ecological, and ethical factors into investment decision-making processes."

UK Social Investment Forum: "Socially Responsible Investment (SRI) combines investors' financial objectives with their concerns about social, environmental and ethical (SEE) issues."

US Social Investment Forum: "Integrating personal values and societal concerns with investment decisions is called Socially Responsible Investing (SRI). SRI considers both the investor's financial needs and an investment's impact on society. With SRI, you can put your money to work to build a better tomorrow while earning competitive returns today."

European Social Investment Forum (Eurosif): "Socially Responsible Investment (SRI) combines investors' financial objectives with their concerns about social, environmental, ethical (SEE) and corporate governance issues. SRI is an evolving movement and even the terminology is still very much in the evolving phase. Some SRI investors refer only to the SEE risks while others refer to ESG issues (Environmental, Social, and Governance). Eurosif believes both are relevant to SRI. SRI is based on a growing awareness among investors, companies and governments about the impact that these risks may have on long-term issues ranging from sustainable development to long-term corporate performance."

Association for Sustainable and Responsible Investment in Asia (ASrIA): "Sustainable and Responsible Investment (SRI), also known as Socially Responsible Investment, is investment which allows investors to take into account wider concerns, such as social justice, economic development, peace or a healthy environment, as well as conventional financial considerations."

Recent work on SRI has increasingly focused on the non-ethical aspects of SRI, and has instead incorporated corporate governance criteria. The new approach to SRI among institutional investors such as pension funds is motivated by mounting evidence that social, environmental and corporate governance (ESG) factors affect a firm's long-run specific and non-diversifiable risks. For example, Orlitzky and Benjamin (2001) find, using econometric analysis, that better corporate social performance (CSP) – and particularly having a reputation for social responsibility -- results in lower firm specific financial risks. Even anecdotal evidence suggests that environmental and social risks can significantly affect returns on portfolio assets – as investors in Nike and Newmont

[3]The Australian definition is from:
http://www.eia.org.au/html/s02_article/article_view.asp?id=283&nav_cat_id=249&nav_top_id=92&view=&history=1&gback=home&dsa=694,

the Canadian definition is from http://www.socialinvestment.ca/AboutSIO.htm,

the Swedish definition is from http://www.swesif.org/eng/index.html,

the UK definition is from http://www.uksif.org/Z/Z/Z/sri/main/index.shtml,

the US definition from (from http://www.socialinvest.org/Areas/SRIGuide/,

the European definition from http://www.eurosif.org/sri and the Asian definition from www.asria.org/guide/sri.

Mining discovered in the 1990s – when consumer groups staged large-scale protests and boycotts of these companies' products.

II. Socially Responsible Investments and their Returns

In some cases, such as in Norges Bank's divesture from Wal-Mart or CalPERS' liquidation of its entire class of Thai assets, SRI may be based on the simple screening of a company's investment activities. Increasingly, however, institutional investors are interpreting SRI as promoting a mandate to actively engage with the company's board in order to change corporate policies. The engagement or shareholder advocacy approach tends to make use of ESG criteria while the more traditional screening approach is usually applied to ethical criteria.

The engagement or advocacy approach to SRI is exemplified by the case of Nike. One of the company's larger institutional investors -- the United Methodist General Board of Pensions (UMGBP) – chose to engage with the company instead of simply liquidating its positions. In 1996, the UMGBP filed a shareholder resolution to encourage the company to seek changes in the labour practices of its suppliers. In many cases, such shareholder activism has been shown to increase the financial performance of the target company.[4]

The SRI "ecosystem" of institutional investors consists of a wide range of different investing styles and philosophies. Figure 2 provides a simple representation of these strategies, dividing SRI techniques into screening and engagement applied either partially or completely to the investment portfolio.

Figure 2: Types of SRI Investment Strategies

	SRI Technique	
	Screening	**Engagement**
Partial scope (a sub-set of the entire portfolio)	Investing in an ethical SRI mutual fund	Investing in an advocacy-based SRI mutual fund
Integration (complete portfolio)	Applying screens to every investment	Engaging with each company whenever concern arises

Three types of screening are normally considered when looking at an SRI fund's investment strategy (see Appendix 1 for more). *Positive screening* involves establishing a set of ethical or/and ESG criteria – based on the evaluation of the company's or entire industry's work on such activities (e.g. reducing CO2 emissions or investing in renewable energy technologies). *Negative screening* involves applying ethical or/and ESG criteria to exclude companies through

[4] For example, Smith (1996) finds in his sample of 51 firms targeted by CalPERS over the 1987-93 period, that shareholder wealth increased for firms that adopted or settled with CalPERS and decreased for firms who resisted. Yet, the study fails to find a statistically significant change in operating performance in companies who adopted CalPERS recommendations – militating against the argument that shareholder activism automatically translated into more responsible business practices.

simple screens (e.g. investment in companies which participate in particular activities such as the manufacture of weapons, tobacco pornography or cosmetics tested on animals) and norms-based screens (e.g. companies whose operations do not comply with international labour, human rights and environmental conventions). *Passive screening* shifts the decision about screening criteria to SRI Index managers. Each SRI Index fund may use its own screens – as shown by differences in portfolio composition of the Dow Jones Sustainability Index, the Dow Jones Islamic Market Index, FTSE4 Good and KLD's Domini 400 Social Index. As shown in Figure 3, core SRI techniques in Europe mainly consisted of ethical exclusions while weapons screening appeared to be the largest screen for broad or non-core SRI screening.

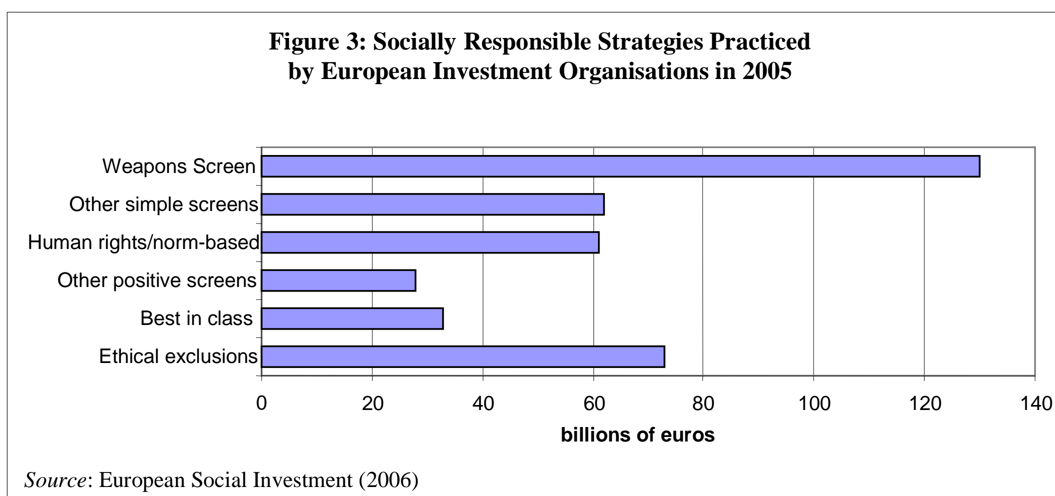


Figure 3: Socially Responsible Strategies Practiced by European Investment Organisations in 2005

Source: European Social Investment (2006)

Investment taking ethical or/and ESG criteria into account comprises a considerable proportion of portfolio investment (see Figure 4). The US-based Social Investment Forum (2003) has identified over $2 trillion in US portfolio assets as being professionally managed using one or more of the three core socially responsible investing strategies – screening, shareholder advocacy, and community investing (or roughly 10% of total assets under management). In Europe, according to the European Social Investment Forum (Eurosif, 2006) report, SRI defined in a broad sense covered €1 trillion in assets under management as of year-end 2005, of which €105 billion in assets are managed according to more traditional, core definitions of SRI which rely on ethical exclusions and positive screening techniques. Investments by institutional investors (including pension funds) comprised over 94% of SRI, while 6% was accounted for by retail investors.[5] Within Europe, the United Kingdom has one of the largest SRI markets, representing 35% of the British stock market.

SRI has been growing in popularity in the late 1990s and early 2000s (particularly in the United States). From 1999 to 2001, SRI assets grew by 36%, as compared to a 22% rise in all professionally managed assets. The greatest growth within this category occurred in screened private portfolios for individuals and institutions, which rose by 40% to $1.9 trillion. TIAA-CREF, one of the largest private pension plans in the world (US$325 billion in assets), has offered a Social Choice Account Fund since 1990, which currently manages US$6 billion in assets.

[5] The survey, however, excluded all Scandinavian countries, which have large SRI markets.

Moreover, such investment was extremely robust. During this three-year period, while the market witnessed a 94% drop in the amount of new assets invested in mutual funds of all classes, SRI fund placements only fell by 54% -- roughly half the market average (the US Social Investment Forum, 2001).

Figure 4: Total SRI Investment in OECD Countries in 2005

	Total (billions of euros)	% of total assets under professional management
Australia[6]	7.2	
Austria[7]	1	0.5%
Belgium	9.5	4%
Canada[8]	45	
Czech Republic	NA	
Denmark	NA	
Finland	NA	
France	8.2	
Germany	3	0.3%
Greece	NA	
Hungary	NA	
Iceland	NA	
Ireland	NA	
Italy	2.8	
Japan	NA	
Korea	NA	
Luxembourg	NA	
Mexico	NA	
Netherlands	41.5	4.3%
New Zealand	NA	
Norway	NA	
Poland	NA	
Portugal	NA	
Slovak Republic	NA	
Spain	1.5	
Sweden[9]	5.5	
Switzerland	7	0.3%
Turkey	NA	
United Kingdom	30.5	0.8%
United States[10]	1 786	9.4%

Other evidence suggests that a consideration of social issues extends beyond SRI mutual fund placements. According to a 2001 poll by the Opinion Research Corporation (sponsored by MMA-Praxis), about 50% of U.S. investors reported that they consider social criteria when

[6] Source: Ethical Investment Association, data for 2006.

[7] Source: Eurosif. The data provided for Belgium, France, Italy, Netherlands, Spain, Switzerland, and the United Kingdom refer to *core* SRI investments consisting mainly of ethical exclusions and various types of positive screening. *Broad* SRI investments are bigger.

[8] Source: Social Investment Organisation, data for Canada.

[9] Source: Swesif, data for Sweden for 2004.

[10] Source: Social Investment Forum.

making investment decisions. As a result, some of the largest pension funds in the United States have taken SRI initiatives in response to this demand. The California Public Employees' Retirement System (CalPERS) actively engages companies to promote socially responsible behaviour and was one of the leaders of the tobacco divestment of the late 1990s (among the numerous SRI screens applied in the United States, the most popular is to exclude tobacco stocks). Investments in companies whose policies have been affected by shareholder engagement make the impact of SRI even higher. Yet, as shown in Figure 5, such shareowner engagement fell in the U.S. by 40%.

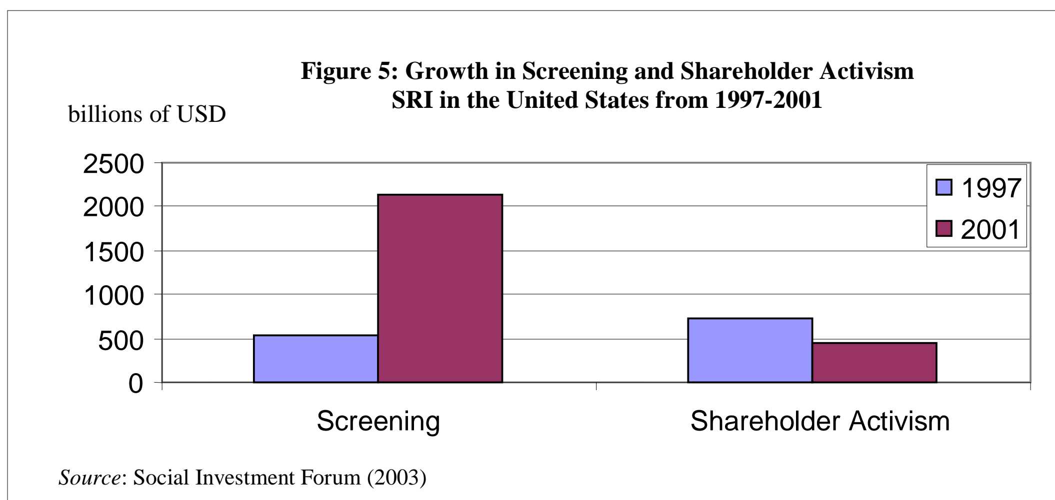


Figure 5: Growth in Screening and Shareholder Activism SRI in the United States from 1997-2001

Source: Social Investment Forum (2003)

Despite the increase in SRI activity, the evidence about its profitability is mixed. Guerard (1997), in one of the earlier studies looking at the US market, "find[s] no statistically significant differences in the mean returns of unscreened and screened equity universes for the 1987-94 period." Margolis & Walsh (2001), reviewed 80 studies on SRI performance, and found that more than half of the studies indicated a positive link between sustainable practices by companies and SRI fund performance. Orlitzky *et al.* (2002) find – looking at 52 studies of SRI rates of return in the United States -- a positive relationship between corporate responsibility and investment performance. Yet, in their study of SRI fund returns, Geczy *et al.* (2005) find that funds which are "constrained" to consider SRI issues can cost investors at least 30 basis points per month in losses as opposed to their non-constrained peers. Derwall *et al.* (2005) carried out a study on what they call the "eco-efficiency" of US companies (the ratio of economic value added to the environmental waste created) and found a higher risk-adjusted performance between 1995 and 2003 from a portfolio consisting of the most eco-efficient companies. They also address methodological concerns, showing that the performance differential cannot be explained by differences in market sensitivity, investment style, or industry-specific components.

The studies from other countries have led to similar conclusions. Schroder (2005), in his analysis of SRI funds in Germany, Switzerland and the United States, finds that SRI assets (funds and indices) have a similar performance compared to other market benchmark funds. Yet, unlike the non-SRI funds, "only a few funds and indices exhibit a relatively poor performance. Thus, an investor in SRI assets can expect a similar risk-adjusted return compared to an investment in conventional assets, although SRI is only a subset of the total investment universe." A similar

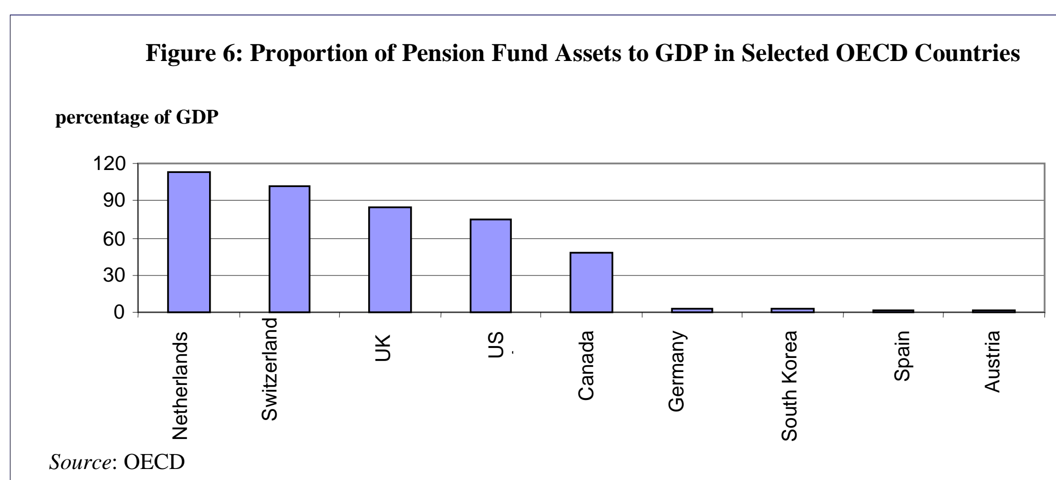
conclusion was reached by Jin *et al* (2005) who looked at a Japanese synthetic SRI portfolio from 1996 to 2006. They found that the SRI portfolio outperformed the TOPIX stock market index without much additional volatility.

One important shortcoming in many SRI performance studies is that they do not differentiate ethical and ESG factors, even though the case of a link to financial performance has been made mainly for the latter. Moreover, the definite verdict on SRI performance can only be carried out when the underlying risks and externalities materialise. Such effects may take years, even decades (in the case of environmental damage) to materialise. "Universal owners" with long-term horizons will recognise such risks and opportunities and consider their interlocking impact on their investment portfolios.[11]

III. Socially Responsible Investment by Private Pension Funds

Pension funds -- being among the most important institutional investors in the OECD – hold over $15 trillion in assets (OECD Global Pension Statistics). In countries like the Netherlands, Switzerland or the United Kingdom, pension funds are the main shareholders, holding over one fifth of stock market capitalisation as well as holding assets totalling a significant share of GDP (as shown in Figure 6, the Netherlands's pension assets total more than 100% of GDP while in Austria they comprise about 1%). Pension funds also have longer-term investment horizons and an inherent focus on providing long-term retirement income for the investor.

Figure 6: Proportion of Pension Fund Assets to GDP in Selected OECD Countries



Source: OECD

In some OECD countries, pension funds have started engaging in positive screening based on ethical or/and ESG criteria. For example, PME, one of the five biggest pension funds of the Netherlands (with invested assets of around €18bn), represents an example of a pension which

[11] The Universal Owner hypothesis states that the negative externalities that a portfolio investor avoids in one company may prop up in other investments in the portfolio, lowering overall portfolio returns. The hypothesis was first formulated by Robert Monks and Nell Minow, and has since been elaborated by James Hawley and Andrew Williams. For a review of the universal owner hypothesis and the importance of collective action, see Thamotheram and Wildsmith (2006). More information on the Universal Owner can be found at www.fidcap.org.

applies ESG principles on part of its investment strategy. In 1999, the Fund's Board decided to invest 1% of its capital in socially responsible businesses which – besides having acceptable rates of return – also scored positively on its "durability criteria." In line with the fund's long-term investment objectives, the Board gave social factors a weighting of 70% of the total portfolio (with financial criteria having 30%). Of that 70%, the following factors were given weightings: consideration of the surrounding world (10%), respect for human rights in supply chain management (10%), fair corporate governance (10%), respect for customer's rights (10%), consideration of employee interests (30%), and conservation of the natural environment (30%). Since 2003, the Spanish *Telefónica* pension fund has invested 1% of its assets in ethical, social or ecological funds; while *BS Plan Ético y Solidario* invests part of its funds in the underlying assets of the FTSE 4 Good Europe Index. The French Pension Reserve Fund has also earmarked €600 million for SRI-related investment.

In other cases, a negative screening approach has been taken. As referred to earlier, the Norwegian Government Pension Fund–Global (formerly the Norwegian Petroleum Fund) applied a selective negative screen (following the Fund's Advisory Council on Ethics suggestion to withdraw from Wal-Mart). Since 2005, based on other recommendations, weapons producers such as EADS, Lockheed Martin, Thales, BAE Systems, Boeing, Finmeccanica, and Honeywell International have been black-listed; as has Freeport (one of the largest mining companies in the world) because of its "extensive and serious damage to the environment" (See Figure 7). In September 2006, Sweden's AP2 state pension fund followed the Norwegian Pension Fund's example, withdrawing from Wal-Mart.

Figure 7: Comply or Explain: Saying *Nei* to Wal-Mart and Freeport

Many institutional investors engaging in negative screening apply also a "comply or explain" principle allowing the company to explain its practices prior to deciding on the screening. In the case of the Norwegian Ministry of Finance's order to divest from Wal-Mart and Freeport (among other companies), the Ministry has argued that it gives priority to corporate engagement. In Wal-Mart's case, the Ministry of Finance found it unlikely that exercising the Fund's ownership rights vis-à-vis Wal-Mart "would have sufficiently reduced the risk of the Fund contributing to ethically unacceptable conduct, as defined in the Ethical Guidelines."

The Ministry of Finance acted upon the advice of the Council on Ethics' recommendation of 15 November 2005, according to which "*an extensive body of material indicates that Wal-Mart consistently and systematically employs minors in contravention of international rules, that working conditions at many of its suppliers are dangerous or health-hazardous, that workers are pressured into working overtime without compensation, that the company systematically discriminates against women in pay, that all attempts to unionise by the company's employees are stopped, that employees are in a number of cases unreasonably punished and locked in, along with a number of other circumstances."* The Council's assessments encompassed Wal-Mart's business operations in the United States and Canada, and at its suppliers in Nicaragua, El Salvador, Honduras, Lesotho, Kenya, Uganda, Namibia, Malawi, Madagascar, Swaziland, Bangladesh, China and Indonesia.

The Council on Ethics summarised its recommendation as follows: *"What makes this case special is the sum total of ethical norm violations, both in the company's own business operations and in the supplier chain. It appears to be a systematic and planned practice on the part of the company to hover at, or cross, the bounds of what are accepted norms for the work environment. Many of the violations are serious, most appear to be systematic, and altogether they form a picture of a company whose overall activity displays a lack of willingness to countervail violations of norms in its business operations."*

The Council, through Norges Bank, wrote to Wal-Mart on 14 September 2005 inviting them to comment on the allegations of complicity in violations of human rights and labour rights. Wal-Mart did not respond to this letter.

The Council on Ethics recommended the exclusion of Freeport on the basis of the company's environmental damage as a result of its copper mining operations in Papua New Guinea, which was "extensive, long-term and irreversible". While the toxic disposals (riverine tailings) were not banned by the Papua New Guinea government, the Council considered that *"lenient legislation in a country does not automatically justify a heavy environmental burden if the damage is considerable."*

Freeport was invited by letter of 22 December 2005 from Norges Bank (the fund's asset manager) to comment on the Council's advice. The company replied by letter of 20 January 2006, refuting the allegations levelled at the company, but it did not provide any evidence in support of its position.

Source: Norwegian Ministry of Finance

Reflecting Japan's highly consensual industrial structure, the Japanese Pension Fund Association issued in 2003 standards on shareholder activism among private pension funds. These standards call on Pension Fund Association members to "encourage companies to fulfil their social responsibilities, including improving their relationships with customers, employees and the wider community, as well as their environmental impact."

Pension funds and other institutional investors are also increasingly coordinating their action on SRI, partly in order to discus their SRI analysis and strategies, but also to enhance their corporate engagement. These considerations explain the success of the Institutional Investors Group on Climate Change (IIGCC) in increasing companies' awareness over global warming and

related environmental risks. The IIGCC has been active lobbying for reductions in greenhouse gas emissions through the statement on global warming. Through this statement, asset managers and investment consultants commit themselves to incorporating climate change risks and opportunities in their investment analysis and selection, while pension funds agreed to consider climate change issues when appointing asset managers.

IV. The Wider Policy Environment: SRI and Corporate Social Responsibility

Four factors have been responsible for the rise of interest in socially responsible investment[12]:

- The concern over the ability of public policy (national governments and international organisations) to address issues such as environmental degradation and human rights abuses, especially in developing countries, coupled with an acknowledgement that (international) business has the responsibility and financial resources to address these issues.
- Empirical research showing that investors can increase their portfolio risk-adjusted rates of returns by considering ESG issues.
- The perception in some countries that fiduciary responsibility may and should include wider concerns than financial returns.
- Public opinion favouring SRI, largely as a result of intense advocacy by lobbying groups.

SRI is to some extent response to the broader corporate social responsibility movement that has been the focus of various international policy initiatives. The OECD Guidelines for Multinational Enterprises represent one of the first international initiatives to taking concerted effort on social responsibility in international business. According to the OECD, the Guidelines are "the foremost international corporate responsibility instrument. The Guidelines set high standards for responsible business conduct in all major areas, including: employment and industrial relations, human rights, environment, information disclosure, combating bribery, consumer interests, science and technology, competition, and taxation. They have a unique, government-backed implementation procedure. The 39 OECD and non-member governments that have adhered to the Guidelines have National Contact Points (NCP) charged with promoting observance of the Guidelines among companies operating in or from their territories. NCPs maintain a mediation facility (called "specific instances") contributing to reducing tensions and building trust between international business and host societies. Ninety-six specific instances have been considered by NCPs since the June 2000 Review. Corporate managers use the Guidelines. In the area of human rights for instance, forty-one per cent of the respondents to a 2006 survey of the Fortune Global 500 companies indicated that their companies use the Guidelines as a reference."[13]

[12] While SRI focuses on institutional investors, equivalent strategies have been applied to bank lending. The UNEP Financial Initiative has financed an excellent example of an analysis of wider environmental change on the quality of bank lending portfolios in the United States and Canada. They find that risks related to changes in input prices, output prices, policy change and physical damage are likely to increase bank lending risks to companies, particularly in the production of electricity, cement, and aluminium (while health care, paper and forest products, and automobile manufacturing have low risks). SRI-like principles for bank lending were approved recently (The Equator Principles).

[13] See www.oecd.org/daf/investment/guidelines.

The United Nation's Global Compact provides the main direction for the organisation's work on corporate social responsibility, aiming to "bring companies together with UN agencies, labour and civil society to support universal environmental and social principles."[14] Issue 5 -- dealing with financial markets – particularly pertains to pension fund managers; and has been basis of various UN campaigns. The UNEP Principles for Responsible Investment approved in 2006 represent one of the most concrete expressions of work on Issue 5. These Principles – which have roughly 120 signatories -- encourage asset owners, investment managers and professional services' providers to consider ESG issues when making investments. They also promote corporate engagement (through shareholder advocacy) instead of rigid screening (see Figure 8). [15]

In order to make assessment and comparisons of compliance with ESG concerns, a number of private companies and not-for-profit organisations offer reporting guidelines and frameworks. The Global Reporting Initiative (GRI) Framework represents an example of such an attempt to identify important ESG issues and standardize the reporting. The GRI – an organisation supported by membership contributions and grants – has collected and offers for distribution 1701 reports (as of the time of this writing) which use their reporting framework. The GRI Reporting Framework admonishes companies to engage in triple bottom line reporting by disclosing the social and environmental impacts (as well as the financial impacts) of their activity. The Enhanced Analytics Initiative addresses ESG issues as Extra-Financial Issues. Also a membership organisation, the EAI represents members who would like to see more extended reporting of extra-financial issues in financial statements and in the financial media (and pledge 5% of their brokerage commissions for funding such research).

Interest in CSR and SRI has led to the growth of a social investment research industry dedicated to the evaluation of companies' environmental and social risks. Such research aims at helping investors identify those companies with better management of and lower ESG risks. Such SRI-related research has heightened interest in techniques such as triple bottom line reporting (whereby a company will report in its annual statement its social and environmental operation results as well as its financial ones). Indeed, many EU governments have already started to require such reporting (with France currently imposing the most stringent requirements in the EU). In the UK where such reporting is still voluntary, 70 of the top 100 companies produce such reports (the UK government also considered making reporting on environmental impact obligatory for listed companies but withdrew the proposal in 2005).

These international initiatives have undoubtedly raised awareness about socially responsible behaviour, among both companies and investors. Yet, they are not without critics. First, some detractors argue that their vague language and lack of enforcement mechanisms prevent international conventions and guidelines from providing clear guidance to institutional investors. In particular, the UNEP Principles for Responsible Investment provide "possible

[14] http://www.unglobalcompact.org/AboutTheGC/index.html .

[15] Other international organisations have also promulgated recommendations in the field of social responsibility such as the International Labour Organisation's Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy or the Corporate Citizenship Principles of the World Economic Forum (through its Global Corporate Citizenship Initiative). See http://www.weforum.org/pdf/ppp_summary.pdf for a list of their recommendations.

actions" to accompany each principle), but the actions themselves can be somewhat ambiguous (see Figure 8).

Second, the Global Reporting Initiative and the Enhanced Analytics Initiative have over 100 signatories – suggesting that work is clearly being done by the industry itself. Yet, as these initiatives are either partially or wholly financed by large financial institutions, their recommendations may not incorporate a sufficient amount of concern over environment or social issues. For example, the UNEP Finance Initiative requires investment companies with global operations to pay a subscription of $15,000 per year (and the Initiative has over 150 members); the GRI and the EAI also are financed through membership contributions (EAI earned €8 million for 2005 from member contributions). Detractors note that the institutions which finance this work would not have an interest in elaborating recommendations which run counter to their financial interests. In some cases, standard-makers may have a financial interest in companies adopting their standards (for example, Enhanced Analytics Initiative has a close relationship with onValues, a private consultancy and research company). Furthermore, as a self-enforcing mechanism, in some cases, neither the members nor the secretariat which administers this type of arrangements would have strong incentives to police their own recommendations.[16]

Third, these recommendations may not be incentive-compatible. In addition to the Recommendations previously cited, the Global Framework for Climate Risk Disclosure and Carbon Disclosure Project encourage companies to release statements about the effects their operations will have on global warming and climate change. Under the current system, companies can only expect penalties for truthful disclosure of bad practice. Haigh and Hazelton (2004), in their quantitative evaluation of socially responsible investment (SRI), find that neither of the two main mechanisms of the SRI 'movement' -- shareholder advocacy and managed investments – is likely to be effective. They note that shareholder advocacy – as embodied by shareholder resolutions proposed and/or passed at corporate annual meetings -- have been largely unsuccessful in changing company behaviour because the "underlying economic opportunities remain."

[16] Another critique concerns the public goods nature of social and environmental actions. Many economists consider these to be "public goods" in which the benefit of environment protection is higher for society as a whole than for any group of individuals or companies. As a result, companies may be unwilling to bear the costs of regulation from which others benefit – resulting in insufficient regulation. In this circumstance, government regulation comprises the standard policy prescription (unless other mitigating factors result in other policies being better). A discussion of the economics of regulation extends beyond the mandate of this policy brief.

Figure 8: The Principles for Responsible Investment

1 We will incorporate ESG issues into investment analysis and decision-making processes.

- Address ESG issues in investment policy statements
- Support development of ESG-related tools, metrics, and analyses
- Assess the capabilities of internal investment managers to incorporate ESG issues
- Assess the capabilities of external investment managers to incorporate ESG issues
- Ask investment service providers (such as financial analysts, consultants, brokers, research firms, or rating companies) to integrate ESG factors into evolving research and analysis
- Encourage academic and other research on this theme
- Advocate ESG training for investment professionals

2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

- Develop and disclose an active ownership policy consistent with the Principles
- Exercise voting rights or monitor compliance with voting policy (if outsourced)
- Develop an engagement capability (either directly or through outsourcing)
- Participate in the development of policy, regulation, and standard setting (such as promoting and protecting shareholder rights)
- File shareholder resolutions consistent with long-term ESG considerations
- Engage with companies on ESG issues
- Participate in collaborative engagement initiatives
- Ask investment managers to undertake and report on ESG-related engagement

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

- Ask for standardised reporting on ESG issues (using tools such as the Global Reporting Initiative)
- Ask for ESG issues to be integrated within annual financial reports
- Ask for information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives (such as the UN Global Compact)
- Support shareholder initiatives and resolutions promoting ESG disclosure

4 We will promote acceptance and implementation of the Principles within the investment industry.

- Include Principles-related requirements in requests for proposals (RFPs)
- Align investment mandates, monitoring procedures, performance indicators and incentive structures accordingly (for example, ensure investment management processes reflect long-term time horizons when appropriate)
- Communicate ESG expectations to investment service providers
- Revisit relationships with service providers that fail to meet ESG expectations
- Support the development of tools for benchmarking ESG integration
- Support regulatory or policy developments that enable implementation of the Principles

5 We will work together to enhance our effectiveness in implementing the Principles.

- Support/participate in networks and information platforms to share tools, pool resources, and make use of investor reporting as a source of learning
- Collectively address relevant emerging issues
- Develop or support appropriate collaborative initiatives

6 We will each report on our activities and progress towards implementing the Principles.

- Disclose how ESG issues are integrated within investment practices
- Disclose active ownership activities (voting, engagement, and/or policy dialogue)
- Disclose what is required from service providers in relation to the Principles
- Communicate with beneficiaries about ESG issues and the Principles
- Report on progress and/or achievements relating to the Principles using a 'Comply or Explain' approach [17]
- Seek to determine the impact of the Principles
  Make use of reporting to raise awareness among a broader group of stakeholders

Source: www.unpri.org

[17] The Comply or Explain approach requires signatories to report on how they implement the Principles, or provide an explanation where they do not comply with them.

Thus, in addition to international conventions, other forces are influencing pension funds' adoption of SRI. First, and most importantly, many experts argue that SRI investments will have higher long-term risk adjusted returns than non-SRI investments. Some analysts argue that risk is currently improperly priced, and if ESG risks were incorporated in a conventional risk-adjusted rate of return, the rates of return currently reported on a range of investment classes would be much lower. Other analysts argue that "starving" socially risky investments (such as the manufacture of weapons or even industries likely to see increased consumer activism such as cosmetic companies which test products on animals) results in lower overall market (or systematic) risk. Still other analysts argue that 'buy and hold' (or long-term investment strategies) outperform short-term strategies. With a long-term strategy, social risks become more important because they are less likely, but potentially more harmful.

Second, pension funds in certain OECD countries have -- as enshrined in national law -- an *uberrimae duty of care* (or *utmost*, using the Anglo-Saxon standard of fiduciary responsibility) which forces them to consider wider risks. Most of the discussion referred to earlier (the Global Compact and the work of the UKSIF) stresses the fund manager's ultimate fiduciary responsibility to the investor. While the issue of returns remains important, they argue for a broader legal conception of fiduciary responsibility that includes wider investors' interests and welfare, not just financial gains.

Third, SRI has started as, and remains, a political issue. According to Haigh and Hazelton (2004), "marketing material and investment prospectuses issued by socially responsible mutual funds (SRI funds) commonly contain the claim that, by affecting corporations' access to capital funding, SRI funds can change corporate practices." A recent article about the Global Compact refers to the Compact as the portent of a "new era of shareholder activism."[18] Indeed, a Just Pensions report *Do UK Pension Funds Invest Responsibly?* (July 2002), found that "two years after the adoption of regulations mandating that UK pension funds publish a Statement of Investment Principles which takes social and environmental issues into account, they find that the majority of pension funds were exposed to criticism because they had failed to adequately translate their SIPs into action, with only a handful of larger pension funds taking the lead."[19] Organisations like the Council on Institutional Investors (CII) in the United States and the Association of British Insurers (ABI), which control $1.5 trillion and $1 trillion, respectively, have each issued statements that corporate social responsibility is a key factor of long-term financial success (SIF, 2001). As the ABI warns, "it is increasingly accepted that failure to take [social and environmental] risks into account can lead to a long-term loss not just in [a company's] reputation but also in [its] value." Such politicization has been increased the activism by large non-governmental organisations such as Amnesty International, Greenpeace and the Ethical Trading Initiative; which have been increasingly active in bringing the investment decisions of large corporations to the public's attention. Some NGOs have also started lobbying pension funds on SRI (e.g. Just Pensions in the UK).

[18] http://www.ft.com/cms/s/1a39035e-fa24-11da-b7ff-0000779e2340,dwp_uuid=1ed35160-f7c4-11da-9481-0000779e2340.html

[19] http://www.uksif.org/J/Z/Z/jp/home/main/index.shtml

V. Regulating Socially Responsible Investment by Pension Funds

Most legislation in OECD countries establishes a fiduciary relationship between investors and the manager of the investors' funds. Thus, while an investor fund's consideration of ethical or/and ESG issues may take a broader conception of the fiduciary's interest, most legislations restrict that responsibility to maximising the investment's expected risk-adjusted returns. This fiduciary duty is particularly strong in the case of pension funds, as they are also often subject to a prudent person standard and a duty of loyalty (acting in the exclusive interest of the pension fund's beneficiaries).

As a result of these fiduciary duties, pension fund regulatory authorities in most OECD countries have taken a relatively passive regulatory stance towards SRI. At present, disclosure forms the bulwark of such regulation -- requiring pension funds to inform their clients of the extent to which such factors are incorporated into a fund's investment strategy (see Figure 9). The United Kingdom was the first OECD country to require SRI disclosures -- in July 2000, the UK Pensions Act was amended to require trustees of occupational pension plans to disclose their policy on socially responsible investment as part of their Statement of Investment Principles (SIP). Courts in the United Kingdom have also dictated that the concept of beneficiaries' 'best interests' under a pension trust may extend beyond their financial interests to include their 'views on moral and social matters'. Since 2000, Austria, Belgium (2003), France, Germany, Italy, Spain (2004), and Sweden have also adopted disclosure regulations similar to the ones in place in the United Kingdom. The Belgian Federal Government is also currently discussing the possibility of introducing lower taxation on pension savings in SRI products.

In Hungary and the Netherlands, SRI regulatory initiatives are still being discussed. In Hungary, in the framework of privatisation of public propriety, several standards relating to such areas as employment obligations, protecting the environment and labour standards have been sent to investors by the Ministry of Employment, Policy and Labour and the Ministry of Economy in close co-operation with the investment community.

In the Netherlands, the 1995 Green Investment Directive promotes access to finance for environmentally sound projects. This directive provides that returns from green financial intermediaries are exempted from income taxes. A green intermediary is a financial intermediary that originates loans and investments in green projects that comply with government criteria. For asset and liability risk management reasons, green intermediaries are allowed to allocate at most 30 per cent of their assets to non-green projects, and at least 70 per cent must be invested in approved green projects. Special government agencies control and monitor green projects and decide whether a project qualifies as green.

While EU directives have not yet affected the sector, work is underway. In 2005, the Commission considered a Green Paper on the Enhancement of the EU Framework for Investment Funds which, small part, addressed the EU's position on socially responsible investment. The opinion quite significantly notes that it "seem[s] important to emphasise that with regard to the dualistic, bank- and financial market-oriented approach that characterises the "Anglo-Saxon" model (and that of the United States in particular) as compared to the "European model", current legislative trends and the direction of the Union seem to indicate a desire to continue to work towards full integration of the two approaches in our economic system" (European Commission,

2005). The EU is likely to take this position in its treatment of SRI as well. Moreover, during the negotiation of the draft European Directive on Institutions of Occupational Retirement Provision (IORPs, the EU term for occupational pension funds), the Committee on Economic and Monetary Affairs proposed the inclusion (in article 12) of fully disclose of the fund's "ethical and socially responsible investment principles" in its statement of investment principles.

Australia and the United States represent almost opposite ends of the present regulatory spectrum. In Australia, amendments to the 2001 Australian Financial Services Reform Act required that all products with an investment component – including superannuation (pension) funds and mutual funds -- include disclosure of "the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention and realisation of the investment." More recently, the Australian Securities and Investments Commission (ASIC) released Practice Statement 175, which requires that advisors providing personal financial advice (which may include advice to superannuation fund members) to enquire whether environmental, social or ethical considerations are important to their clients. On the other hand, in the United States, as a result of the U.S. Department of Labor's Pension Welfare & Benefit Administration advisory opinion from May 1998, pension fund trustees or managers may be in breach of their fiduciary responsibility if they engage in SRI which demonstrably results in lower returns than alternatives. Thus, US pension funds have been wary of negative screening – focusing on investing in high-return companies which *also* impact positively on society.

In Japan, there are no legal rules or official guidance prescribing or encouraging the integration of ethical or/and ESG issues in investment decisions by private pension funds. On the contrary, it has been suggested that since pension funds have an obligation to maximise financial benefits, taking account of such factors would conflict with fiduciary duties unless this leads to an improvement in financial returns.

In Canada, there is no legislation or government guidance regarding SRI disclosure by pension funds nor is there any a mandate to take such concerns into account. In Manitoba, one of the Canadian provinces, trustee legislation and pension legislation state that non-financial considerations are not prohibited, so long as trustees and administrators still satisfy the requisite standard of care.

Figure 9: Private Pension Fund SRI Legislation in OECD Countries

	Regulation does not specifically address SRI	Regulation requires disclosure on whether SRI is considered in investment policy	Regulation require pension funds that engage in SRI to consider performance impact
Australia		x	
Austria		x	
Belgium		x	
Canada	x		x (Manitoba)
Czech Republic	?		
Denmark	?		
Finland	?		
France		x	
Germany		x	
Greece	?		
Hungary	x		
Iceland	?		
Ireland	?		
Italy		x	
Japan	x		
Korea	x		
Luxembourg	?		
Mexico	x		
Netherlands	x		
New Zealand	x		
Norway	x		
Poland	?		
Portugal	?		
Slovak Republic	?		
Spain		x (pending)	
Sweden		x	
Switzerland	x		
Turkey	x		
United Kingdom		x	
United States			x

A more proactive form of SRI legislation has been applied to public pension funds in OECD countries, and especially to the national pension reserve funds that have been established in recent years to help finance public pension systems (see Figure 10). Some of these reserve funds are accumulating a large volume of assets and may therefore be expected to give greater impetus to the SRI industry.

Figure 10: SRI Legislation for Public Pension Funds in Selected OECD Countries

Canada: Provincial legislations that set up public pension funds, including large pension funds such as OMERS and the Ontario Teachers' Pension Plan Board, require consideration of social responsibility issues. The federal legislation that established the Canada Pension Plan Investment Board (CPPIB) also calls on the board's members to address social and environmental risks in its investment strategy.

France: The French *Fond de Réserve pour les Retraites* (FRR) must include in its investment policy how it accounts for social, environmental and ethical issues.

Japan: There is no legislation concerning SRI by the state pension reserve fund, the Government Pension Fund. The fund is currently only permitted to invest in equities via indices and is forbidden from exercising shareholder activism in companies included in its investment portfolio.

New Zealand: New Zealand Superannuation Fund: the legislation requires the fund to "avoid prejudice to New Zealand's reputation as a responsible member of the world community" and to disclose its policy regarding ethical investments. The statement of investment policy must describe policy regarding "avoiding prejudice".

Norway: the Norwegian government approved in 2004 ethical guidelines for the government pension fund which require negative screening of companies producing certain categories of weapons (such as biological weapons and cluster bombs), the exclusion of companies responsible for human rights violations, gross corruption and environmental degradation and a corporate governance policy targeting long-term financial returns, mainly on the basis of the UN Global Compact and the OECD Guidelines for Multinational Enterprises. The 2004 regulation led to the establishment of the Petroleum Fund's Advisory Council on Ethics which advises the Ministry of Finance on screening and exclusion of companies whose activities may be inconsistent with the ethical guidelines for the Fund.

Sweden: Under the Public Pension Funds act (2000:192), national pension funds (AP 1 to 5 and AP7) must draw up an annual business plan that describes how environmental and ethical considerations are considered in investment activities and the impact of such considerations on funds management. According to the law, funds may not own shares in companies that violate the funds' policies on environment and ethics. The finance department has the responsibility of controlling whether funds are applying the law. Since 2002, Sweden's AP funds "must take environmental and ethical considerations into account without relinquishing the overall goal of a high return on capital".

Source: websites of respective public pension funds.

Marginal attempts taken now to strengthen requirements that pension funds consider social issues may reduce regulators' ability to regulate the sector in the future. In their study of the UK SRI market, Friedman and Miles (2001) argue that SRI regulation would have a significant impact on the overall equity market in the UK. They argue that SRI regulation will result in a "marked increase in the size and power of the SRI sector." Such empowerment will certainly increase the political and lobbying power of the industry. Indeed, any regulation of the SRI sector is likely to affect financial markets overall. Figure 4 shows the relative size of pension funds to GDP in a number of countries. As can be seen, any regulation which will go beyond disclosure to affect the allocation of pension funds will likely have larger impacts.

Initial evidence (again from the UK) suggests that the adoption of SRI regulations, if and when it comes – comes quickly. Mathieu (2000), in her study of the top 500 pension funds in the UK, found that funds disclosed their investment principles quickly. She also found that 59% of funds, representing 78% of assets, incorporate socially responsible investment (SRI) into their investment strategies either by engagement or by specific request to the fund manager. Of these,

48% of funds, representing 69% of assets, want fund managers to consider the financial impact of ethical, social and environmental issues.

Several issues arise from the public discussion about the regulation of pension funds. *First, should disclosure requirement on SRI be extended to other OECD countries?* The concept of "universal owners" and long-term potential impact of ESG factors on portfolio performance (the so-called materiality of sustainability) appear to be sufficient reasons to make disclosure on SRI compulsory.

In some cases, ESG risks may concern countries where, because of weaker government regulation or enforcement, any impact on the financial performance of pension fund investments may not materialise in the short- to medium- term. Yet, over longer periods of time that may not be the case. Furthermore, requiring disclosure allow pension funds beneficiaries to be aware of any SRI issues with which they may agree or disagree. This is certainly better than if SRI practices take place in a hidden or obscure way.

Second, is disclosure on SRI sufficient or should pension funds be required to actively consider ESG issues? On the one hand, it could be argued that if investors are free to choose among pension funds, appropriate disclosure of SRI should be sufficient. Such freedom is present in most personal or retail-based private pension systems, including the mandatory defined contribution systems in OECD countries such as Australia, Denmark, Mexico, Hungary, Poland, the Slovak Republic and Sweden, as well as in the Turkish voluntary private pension system. In these cases, the pension fund may be viewed as a simple intermediary. The individual investor is arguably best placed to choose a social value adjusted pension fund. Disclosure of SRI policies allows investors to consider how ESG factors may affect the future evolution of their investment portfolio. This contrasts with standard measures of risk adjusted returns, such as the Sharpe ratio, which tend to be backward-looking (as they are constructed on the basis of historical market data).

On the other hand, it could be argued that a pension fund directors or trustee's fiduciary's duties should stretch onto general considerations of the investor's (or beneficiaries') well-being, and not just the purely financial ones. Such fiduciary duties may be particular relevant in occupational pension plans, where plan members normally cannot choose a pension fund other than that proposed by the plan sponsor.

Action on the environment and on reducing income disparities both constitute areas where the social gains of doing something are higher than the private gains (with the private costs as well being higher). The temptation to use SRI regulation – particularly requirements related to positive screening -- as a way of engaging certainly exists, and may be increase economic welfare without increasing government expenditure. However, the economic losses from distorting the allocation of capital may outweigh any gains from a more activist regulatory stance (which no government to date has taken in the name of SRI). For example, the Norwegian Government Pension (formerly Petroleum) Fund, in 2005, withdrew investments in Honeywell International Inc. because they produce central components for nuclear weapons. Yet, Honeywell International also has developed new products which non-ozone depleting hydro fluorocarbons (HFC) refrigerants for automotive, home, commercial and transportation uses. If the Norwegian government's decision materially impacts on Honeywell International operations, the promotion of ethical investment may come with the price of reducing environmental sustainability.

Third, should regulations provide a standard definition and classification of SRI? Regulators have fallen short of providing any guidance on the definition of SRI or the underlying risk factors, which facilitates misinformation and mis-selling. Pension funds and their managers can pretend to be active in SRI by complying with the disclosure rule and signing international agreements such as the UNEP FI Principles for Responsible Investment without actually implementing any SRI policy.

Another shortcoming of these regulations is that none of them require a clear separation of ethical considerations from ESG risks, even though, as argued above, it is mainly the latter that has a quantifiable impact on financial performance. Similarly, pension funds can pass the SRI test in some countries via community investing (ETI), although by definition such investments are expected to have a lower expected return than equally risky alternatives. Pension fund regulations therefore leave a high degree of discretion on the type and contents of the disclosures made. The regulations are also silent as to how pension fund fiduciaries should integrate ESG criteria into their investments.

Regulators can help improve transparency by including a clear definition of SRI (international organisations such as the UN or the OECD could help promote a common definition), or at least by requiring pension funds to report on which ethical or ESG criteria they include in their SRI policy and how they may be expected to affect the financial performance of the fund. Regulators should also require pension funds that engage in SRI to disclose in their statement of investment principles (SIP) the way in which they will address the different criteria and implement the SRI policy. In particular, pension fund fiduciaries that engage in SRI should be required to consider the different implications of screening vis-à-vis engagement techniques and disclose their chosen technique in the SIP.

Fourth, what is the appropriate regulatory response to ESG risks that have materialised? If harm can be shown from a private pension fund ignoring SRI considerations, what remedies can be imposed on these pension funds? A heavy-handed regulatory approach would allow for legal liability, possibly leading to sanctions and compensation to the damaged parties. A light-handed approach would be to rely on reputation effects – as funds which take excessive ESG risks would be shunned by investors, although this approach would only function in retail pension markets.

Conclusion

Roughly €3 trillion in assets are managed by socialy responsible investment (SRI) funds worldwide – a significant part of those funds by private pension funds. To date, international approaches (as enshrined in self-regulation such as the UN's Global Compact and Principles for Responsible Investment) have urged institutional investors, like pension funds, to take a more stringent view of SRI than the approach taken by national regulatory authorities. Pension fund regulators should consider the potential distortion caused by the current approach to disclosure requirements on SRI. Given the intense lobbying by environmental and other advocacy groups, there is a risk of confusion in pension funds' treatment of SRI. Pension fund regulators should therefore seek to provide guidance on the definition of the criteria underlying SRI and require pension funds to consider and disclose the factors which underlie their SRI policy, how they expect to implement it (through screening, shareholder advocacy), and what impact they expect it to have on their investment portfolio.

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Appendix 1: Screens Employed by Socially Responsible Mutual Funds

The following – taken from Geczy *et al.* (2005) – represents a taxonomy of the screens typically employed by SRI funds using 20 variables. In many cases, several of these screens are used simultaneously.

A. Negative Screens

Screens	Definitions
Alcohol	Firms that produce, market, or otherwise promote the consumption of alcoholic beverages
Tobacco	Manufacturers of tobacco products
Gambling	Casinos and suppliers of gambling equipment
Nuclear Power	Manufacturers of nuclear reactors and related equipment and companies that operate nuclear power plants
Firearms	Companies producing firearms for personal use Defence Contracting (Military) Production of weapons for domestic or Weapons foreign militaries
Irresponsible Foreign Operations	Investment in oppressive regimes such as Burma or China and mistreatment of indigenous peoples
Abortion/Birth Control	Abortion providers; drug manufacturers that manufacture and distribute abortifacients; insurance companies that pay for elective abortions (where not mandated by law); or companies that provide financial support to Planned Parenthood; Manufacturers of birth control products
Usury	Predatory lending, bonds, fixed income securities
Pornography	Pornographic magazines; production studios that produce offensive video and audio tapes; companies that are major sponsors of graphic sex and violence on television

B. Positive or Negative Screens

Screens	Definitions
Products/Services	Strong investment in R&D, quality assurance, product safety; avoidance of antitrust violations, consumer fraud, and marketing scandals.
Animal Rights	Seeks promotion of humane treatment of animals; avoids animal testing, hunting/trapping equipment, and the use of animals in end products.
Labour Relations and Workplace	Avoids worker exploitation and sweatshops; seeks strong union Conditions relationships, employee empowerment, and/or profit-sharing.
Diversity	Minorities, women, gays/lesbians, and/or disabled persons recruited and represented among senior management and the board of directors
Environment	Avoids companies that pollute, produce toxic products, and contribute to global warming; seeks proactive involvement in recycling, waste reduction, and environmental cleanup
Human Rights	Avoids companies directly or indirectly complicit in human rights violations; seeks companies promoting human rights standards

C. Positive Screens

Screens	Definitions
Renewable Energy	Power derived from sources such as hydroelectric damns, fuel cells geothermal energy, solar energy, and/or wind energy.
Community Involvement/Investment	Proactive investment in surrounding communities by sponsoring charitable donations, employee volunteerism, and/or housing and education programs
*Fund Participation	The mutual fund itself invests in Community Development Financial Institutions (CDFIs)
*Shareholder Activism	The mutual fund attempts to influence company policies and actions through direct engagement with management and/or sponsoring shareholder resolutions

*These categories apply to the investment and management policies of the socially responsible mutual fund itself, rather than to those of the companies in which in which it invests.
Source: Geczy *et al.* (2005)