IN THE WAKE OF THE FINANCIAL CRISIS: RETHINKING RESPONSIBLE INVESTMENT†

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Rethinking "Responsible Investment" in the wake of the financial crisis is a daunting theme, and one best accomplished with some humility. Responsible Investment is a beguilingly simple but elusive notion. As we survey the damage wrought by the crisis and attempt to build some safety and soundness into the financial system, how could the notion of Responsible Investment not be viewed as a useful approach in the capital markets? Responsible Investment is, by definition, a valuable notion. Responsibility is quintessential for fiduciaries—those investing on behalf of others. The question then is perhaps not whether Responsible Investment might be a good idea, but what is holding it back? What would cause Responsible Investment to lose its rather platitudinous moniker—responsible—and simply become "investment"? If markets are efficient, because information is sufficient and investors are rational,[1] then Responsible Investment would be nothing worthy of comment. Irresponsible investment would represent the occasional excess, indiscretion, or folly.

The current situation, however, appears more complex and the problems more intractable. We have a tragedy of the commons.[2] No single actor has the power, or perhaps even the motive, to solve

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1. *See* MELVIN ARON EISENBERG & JAMES D. COX, CORPORATIONS & OTHER BUSINESS ORGANIZATIONS 56–61 (10th ed. 2011) (discussing generally the concept of market efficiency, hypothesis and qualifications).

2. *See* Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243, 1243–48 (1968) (describing the theory of the Tragedy of the Commons).

systemic problems in the capital markets, but each individual player suffers from those systemic failures. The proposition is that the concept of Responsible Investment can provide some guidance on how to navigate this complex terrain. Individual actors following the precepts of Responsible Investment may bring order to some of the chaos and undesirable outcomes of modern capital market volatility, short-term focus, and inability to price vitally important externalities, such as environmental damage.

A wide variety of definitions exist as to what Responsible Investment might be—all variations on a theme, including sustainable or ethical investing, active ownership, or related to the environmental, social and governance themes ("ESG"). All of these approaches attempt to do something beguilingly simple: ensure an optimal outcome for those benefitting from and affected by the investment process. The alphabet soup of shorthand in this arena (ESG, Responsible Investment ["RI"], Socially Responsible Investment ["SRI"] and more) reflects the proposition that current arrangements do not lead to optimal outcomes. Capital markets may be more efficient, in the short-term or for certain players, but more is needed to ensure that investment meets its best purpose; that is, capital must be allocated to where there is productive potential and monitoring that allocation to ensure that it is effectively deployed.

The invention of the corporate form and the systems of finance to support its growth have evolved, like most else in human history, as ways to meet human needs and wants. The system has been prone to crisis and overhauls at regular intervals from the start.[3] The reaction to such collapse and disaster has, at times, been extreme. The Bubble Act of 1720,[4] for example, banned incorporation for over a century in reaction to the South Sea Crisis.[5] The Joint Stock Company was pieced together over several decades after ill-tempered debates and disagreements in the British Parliament occurred over what was necessary for capital accumulation and what safeguards were sufficient to protect the public from the risks posed

3. *See generally* Paul W. MacAvoy & Ira M. Millstein, *The Current Crisis*, *in* THE RECURRENT CRISIS IN CORPORATE GOVERNANCE 7 (Paul W. MacAvoy & Ira M. Millstein eds., 2003); JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA (2003) (providing an overview of the rise of business from 3000 BC to the multinational state corporations in 2002).

4. 6 Geo., c. 18 (1720).

5. *See* MICKLETHWAIT, *supra* note 3, at 31–33.

by the corporation and the potential for wild excess.[6]

When I first studied economics in the late 1970s it was considered the study of large and complex—but essentially mechanistic—processes. Students were taught econometrics as though there were simple levers and pulleys to explain money supply and inflation. The task of the government was to ensure those cogs and pulleys were at the proper settings. The task of corporate management was to behave rationally in response to those mechanisms, which would, in turn, determine costs and profit. The investor simply needed to understand basic concepts that could probably be worked out with the stub of a pencil on the back of an envelope: the discounted rate of return relative to the alternative opportunities and the investor's needs (cash versus capital over the period and knowledge of the investor's particular appetite for risk). This was all very pleasing to a young student because world problems, against a backdrop of post-War growth, could be solved with simple arithmetic.

My economics tutor at St Hilda's College, Oxford was a gentle, but formidable woman who, at six feet tall, towered over her students, and strode around the college in tweeds and men's shoes. She had advised the National Government in the United Kingdom during the War and the Labour government in the aftermath. We were enthralled by our Don, who had not only grappled academically with the subject of economics, but had also been in public service during a time of great crisis. She understood all too well the limits of her subject. How could those equations describing the workings of the economy—employment, inflation, taxes, the very well-being of nation—ever be relied upon? Many years after her service to the government, classical economics was straining to explain events: industrial conflict, political strife, social protest against foreign wars, and calls for reordering labour markets in favour of equality. Little of this was captured in those previous equations. My tutor had a helpful explanation for those equations that would not balance: the factor "X" should be inserted. But what did X represent? "Think of X as accounting for human nature," she said. In other words, our economic calculations would explain events if we could just control for human nature.

Controlling for human nature in economics has since become a respectable subject for inquiry. Concern with human happiness, social welfare, and even "sustainability" has been a fundamental

6. *See generally id.*, at 32, 39–43 (discussing generally the effects of the Bubble Act on the Joint Stock Company).

concern since commerce and its companion, financing for that commerce, began—this was also true with codes of conduct and decent business behaviour. These principles were not the sole province of religion. Take for example one of the earliest surviving examples, the Hammurabi scripts from Mesopotamia.[7] This Code set the price and quality of goods, and specified punishments for spoiling property.[8]

The current round of debate on standards in commerce, finance, trade, and the regulation thereof has long roots to the origins of the corporation and trade. It is easy to be seduced with the suggestion of progress—but we are still wrestling with how to meet human needs and wants, and to harness the animal spirit of the market to achieve that cause.

The scale of the financial crisis has illustrated that investors are no longer simply challenged on long-standing issues of concern, such as the despoiling of the environment, degrading of resources, the fair treatment of labour, customers, or even corruption of government.[9] Investors are also being challenged on their ability to discharge responsibility for routine matters including: managing risk, overseeing conflicts of interest, and being competent or even efficient in allocating assets to match liabilities.

To compound the problem, the basic architecture of the financial system is creaking. Markets are global, complex, and, too often, opaque. The governance systems for regulating the markets are based on nineteenth century designs. The truth is that those concerned with Responsible Investment will not make progress unless these wider issues related to the soundness of the capital markets are addressed.

The task for the Responsible Investment movement, therefore, is to engage with the mainstream. Some key areas where collaboration of thinking between the Responsible Investment followers and the mainstream is required include: the regulatory framework, accounting and auditing procedures, pension deficits, retirement security across the population, asset allocation against a backdrop of

7. *See generally The Code of Hammurabi*, THE AVALON PROJECT (2008), http://avalon.law.yale.edu/ancient/hamframe.asp.

8. *See, e.g., id.* at para. 108 (describing an especially harsh punishment for watering beer—merchants were to be drowned in their own swill).

9. *See generally* Suzanne A. Spears, *The Quest for Policy Space in a New Generation of International Investment Agreements*, 13 J. Int'l Econ. L. 1037, 1037 (2010) (discussing the position of international investors and balancing the protection of society and the environment).

lower growth and higher volatility, fees, incentives, and governance across the chain of intermediaries.

Take, for example, the shifting landscape of pension funds, an area where the situation continues to be uncertain and can be treacherous. Underfunding presents a major challenge. Pension deficits have ballooned. The pressure to get investment right is intense because it is the main source of funding for these benefits plans. This fragility was met—and magnified—by the assault of the financial crisis. The difficult question of investment strategy rests against this backdrop of pension deficits, in a market environment where lower growth and higher volatility is the norm. If one refuses to grapple with the consequences of inaction, the calls for pension funds to address the critical issues in Responsible Investment will be overcome by more pressing concerns because, in the hierarchy of needs, survival comes first. And the effects on these primary savings vehicles will set the scene for what can be expected of pension funds as shareholders.

Another shift in the pension landscape also affects the world of Responsible Investment—the shift in pension vehicles from single employer defined benefit schemes to private individual holdings. This has not only increased risk for individuals and driven up the costs of administration,[10] thereby eating heavily into returns, but has also fragmented and intermediated the ownership base of market capitalism.

This fragmentation has been exacerbated by intermediation in the investment chain. The distance between ultimate owners and companies appears insurmountable when ownership and control are not only separated but also made tenuous through complex instruments and holding vehicles that lack clear disclosure.

Some argue that the notion of ownership is simply misplaced. I disagree. We may consider the legal and technical niceties to exclude the owners of shares from being conflated as ownership of companies, but whilst equity providers have the right to hire and fire the board, can wind up the enterprise, vote on its fate, and are entitled to the residual returns, we have a close approximation. There is also the delicate question of the alternative. If not shareowners, then who? Government does not shine in the role. Employees have a legitimate place in many governance systems, but

10. *See* David Pitt-Watson, *Tomorrow's Investor: Building the Consensus for a People's Pension in Britain*, RSA PROJECTS 19 (Dec. 2010), http://www.thersa.org/__data/assets/pdf_file/0009/366948/RSA-TI-report-ensions.pdf.

they are rare in the U.S. and U.K. markets. Management? Banks? We need to work with the imperfect realities in which ownership is no longer a proxy for control.

Responsible Investment rests on the simple premise that owners of capital have an alignment of interest with wider society. In turn, they have been granted rights and powers in many markets that enable them to hold companies to account. This should not be overstated. Diversified portfolios often result in small holdings, and fragmented power. Exercising influence requires collaboration, which is time-consuming and difficult, even if ultimately fruitful.

Many markets do not allow investors to exercise basic rights. Rather than engage in pure democratic processes, director elections are often met with tenacity. In the U.S., companies have been under sustained pressure to allow a "no" vote on the election of directors, but those directors continue to hold their posts on their respective corporate boards.[11]

Also, in many markets, the pattern of ownership militates against the simple oversight model envisaged by Responsible Investment. Most European and Asian markets have concentrated ownership: families, the state, and corporate cross holdings.[12] This means that controlling shareholders call the shots. Minority shareholders have become more active in markets as diverse as Brazil, Korea, Italy, and even Russia but they still have their work cut out for them.

Note that shareholders will have different goals and time frames. Conflicts of interest prevent some from acting; short-term investment goals make it rational to ignore anything beyond trading information for others. The "rethink" needs to start with realism. We should conduct triage on Responsible Investment: there are

11. *See Facts at a Glance: Corporate Governance*, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM 3–4 (Oct. 2011), http://www.calpers.ca.gov/eip-docs/about/facts/corpgov.pdf (describing shareowner proxy access as a "top CalPERS governance priority" because without such access "the director election process simply becomes a ratification of corporate management's slate of nominees"). "CalPERS believes proxy access is a fundamental shareowner right that allows investors reasonable access to place nominees on corporate proxy ballots with all nominees being subsequently subject to a vote of the majority of shareowners." *Id. See also Enhanced Investor Protection After the Financial Crisis: Hearing Before the S. Comm. On Banking, Housing & Urban Affairs*, 112th Cong. 7–8 (2011) (statement of Anne Simpson in Dodd-Frank provisions relating to shareowners' right to vote in director elections).

12. *See, e.g.*, Stijn Claessens & Joseph P. H. Fan, *Corporate Governance in Asia: A Survey*, 3 INT'L R. OF FIN. 71, 74 (2002).

owners, traders, and raiders. Understanding which group the investor falls into, or moves between, will explain their appetite for Responsible Investment. It will also position them for a different role in the capital markets.

This is not a counsel of despair—quite the reverse. By being honest and realistic about what drives the investment agenda, we can make sure we become more effective in proposals for reform, be that through practice or regulation.

CalPERS is engaged in its own overhaul of Responsible Investment, through a project to integrate environmental, social and governance issues into our investment strategy across our asset classes.[13] This is no small undertaking. CalPERS approaches this work through a familiar framework. One dimension is Responsible Investment work designed to protect our beta[14] returns. This is the bulk of our fund's risk and return, which reflects our exposure to global economic growth, and gives us an interest in systemic risk and market integrity. We have an active programme of engagement with legislators, regulators and leaders in the development of market best practice. We call this workstream our focus on Financial Market Reform.[15]

This is complemented by the alpha[16] contribution to our governance agenda. This is where we pursue company-specific engagements in order to tackle particular risks or underperformance. An example is the Focus List Program, in which CalPERS identifies companies with significant governance weakness and financial underperformance. Over a significant period of time, ten years, there is evidence that this active ownership strategy has added value for the fund.[17]

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13. *See* Anne Simpson, *Responsible Investment's Next Decade: Developing CalPERS Total Fund Process for ESG Integration*, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM 3 (Aug. 15, 2011), http://www.calpers.ca.gov/eip-docs/investments/video-center/view-video/mercer-report-next-decade.pdf.

14. "Beta" reflects the extent to which an investment reflects the risk of larger market fluctuations. An investment with a positive beta generally follows market gains and losses, while investments with a negative beta tend to move in opposition to the market. Beta is also sometimes referred to as market risk and non-diversifiable risk, given its reference to the market.

15. *See Facts at a Glance*, *supra* note 11, at 4–5 (discussing CalPERS Financial Market Reform).

16. "Alpha" reflects the rate of return on an investment once market risk has been accounted for, showing the excess return on an investment over and against the risk assumed.

17. *See Facts at a Glance*, *supra* note 11, at 3 (discussing the Wilshire Con-

We are now planning a "total fund" process to ensure that our strategy is effective across all of our asset classes. The proposition is that if ESG strategies can contribute to risk management and enhancement of returns, we should consider this in order to improve our decision making whenever, and however, we allocate capital. The trick is to ensure that our strategies in certain asset classes (public vs. private) or capital forms (debt vs. equity) have been well considered and are complementary across the portfolio.

Throughout this process, collaboration with other asset owners is vital. CalPERS formed a Peer Exchange that includes some of the world's largest asset owners so that we can learn how to improve our practice, and also coordinate where there exists a common interest. Although CalPERS may be the largest public fund in the United States, with the considerable heft of a $220 billion portfolio, we still need to collaborate.

There is also a special character to working for an investment office with fiduciary duties to the 1.6 million beneficiaries who will rely upon the fund for their retirement. The investment office is located at the local Sacramento branch of the CalPERS benefits office. This is a wholly good thing. There is no sense in being removed from those you are working for. It is also a reminder of the need to balance investment objectives. CalPERS is not just a long-term investor, it verges on permanence. But along the way, the fund has to pay out billions in cash each year by way of benefits. That gives us a keen interest in the short term, as well as a fiduciary duty to consider the long-term. By virtue of size, we are a universal owner, and have an interest in the financial system, as market-wide returns are the fund's main source of financing for benefit payments. This sets the stage for our review of our own strategy for Responsible Investment. Put simply, our objective is to make Responsible Investment our investment strategy. We are at the beginning of this process and there is much to do. The wake of the financial crisis brings a new imperative to Responsible Investment, but one which drives us toward integration with wider financial and market reform. The watchword is sustainability: over time and across asset classes. Sustainability inherently captures the financial duties of a fiduciary. In its simplest form, sustainability means the ability to continue. Responsible investors need to integrate their financial with their ESG objectives. Both are needed for sustainability.

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sulting study to the CalPERS Board).