Journal of Business Ethics (2011) 101:143–162
DOI 10.1007/s10551-010-0714-8 © Springer 2010

Socially Responsible Investment and Fiduciary Duty: Putting the Freshfields Report into Perspective

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ABSTRACT. A critical issue for the future growth and impact of socially responsible investment (SRI) is whether institutional investors are legally permitted to engage in it – in particular whether it is compatible with the fiduciary duties of trustees. An ambitious report from the United Nations Environment Programme's Finance Initiative (UNEP FI), commonly referred to as the 'Freshfields report', has recently given rise to considerable optimism on this issue among proponents of SRI. The present article puts the arguments of the Freshfields report into some further both empirical and critical perspective, however, and suggests that its findings do not call for very much optimism. The general argument is that while the understanding of fiduciary duty outlined by the Freshfields report seems to allow institutional investors to at least *sometimes* take *some* social or environmental considerations into account, the support it gives for SRI is notably contingent and, furthermore, it rules out exactly the kind of SRI which proponents of social responsibility and environmental sustainability should hold in highest regard – proactive cases and socially effective investment strategies. If SRI is to become an important force for corporate social responsibility through its adoption by institutional investors, then, it is suggested that legal reform is needed.

KEY WORDS: ethical investment, fiduciary duty, Freshfields report, institutional investors, legal reform, prudent investor rule, social effectiveness, socially responsible investment, United Nations Environment Programme Finance Initiative

Socially responsible investment (SRI) can be taken to refer to the practice of integrating social, ethical and/or environmental considerations – sometimes referred to as 'environmental, social and governance' (ESG) considerations – into one's financial investment process. Whereas conventional or mainstream investment focuses solely upon financial risk and return, SRI thus includes social or environmental goals or constraints *as well as* more conventional financial criteria in decisions over whether to, e.g., acquire, hold or dispose of a particular investment.[1] This practice has received increased attention over the last couple of decades – according to some recent estimates, the total amount of investments with an explicit social or environmental profile is currently as much as $2.71 trillion in the US and €2.665 trillion in Europe (Eurosif, 2008; Social Investment Forum, 2008). The factor which many commentators think will determine whether SRI can grow further than this, however, is whether it is a viable form of investment for institutional investors (see e.g. Hawley and Williams, 2002; Kiernan, 2002; Sparkes, 2002; Sparkes and Cowton, 2004). Institutional investors are organisations which invest and financially manage large pools of other people's money – for instance pension funds, banks, insurance companies and other kinds of financial trusts.

Institutional investors are really the major players in the world's financial markets: They control over 84% of total shareholdings in the UK, for instance, and over 61% in the US – where they also stand for over 80% of all share trades (Mallin, 2007; Office for National Statistics, 2007; The Conference Board, 2007). Quite obviously, if a lot of institutional investors could be persuaded to invest according to social or environmental guidelines, the SRI movement could become an important force for corporate social responsibility worldwide. A critical point of controversy in this context, however, is whether taking ESG considerations into account really is legally permitted for institutional investors. Being a

form of trusts, institutional investors by law have so-called fiduciary duties towards their beneficiaries – that is, they are generally required to manage their funds in the best interest of the underlying owners or ultimate recipients of these funds. And many institutional investors argue that there is a conflict between their duties to their beneficiaries and the idea of taking ESG considerations into account (Hess, 2007; Hesse, 2008; Juravle and Lewis, 2008; Kiernan, 2009; Lewis and Juravle, 2009). While they personally may care about many social, ethical and environmental issues, some say for example that their fiduciary duties disallow them from attending to personal biases. Others argue that their duty to beneficiaries simply is to maximise the profits on their investments, and this is then thought to rule out the integration of ESG concerns.

The traditional position among business lawyers and legal scholars has been that this view is correct (see e.g. Ali and Yano, 2004; Hutchinson and Cole, 1980; Langbein and Posner, 1980; Lanoff, 1980; Whitfield, 2005). My central focus in this article, however, is a report commissioned by the United Nations Environment Programme's Finance Initiative (UNEP FI) to the law firm Freshfields Bruckhaus Deringer in 2005, which has come to be known simply as the 'Freshfields report' and has given rise to considerable optimism among those in favour of SRI as a viable alternative for institutional investors. According to the authors of the Freshfields report, taking ESG considerations into account may not only be legally *acceptable* for institutional investors under certain circumstances, but it is actually legally *obligatory* on many occasions (Freshfields Bruckhaus Deringer, 2005). The Freshfields report has been called 'the single most effective document for promoting the integration of environmental, social and governance (ESG) issues into institutional investment' (UNEP FI, 2009, p. 13) and its conclusions are nearly universally accepted by proponents of the SRI movement (see, e.g. Aviva Investors, 2008; International Decision Strategies, 2009; Kiernan, 2009; NRTEE, 2007; UNEP FI, 2009; Viederman, 2008).

The present article aims to put the arguments of the Freshfields report into some further both empirical and critical perspective and consider whether they indeed call for considerable optimism about the prospects for SRI on the part of institutional investors. My general argument will be that while the understanding of fiduciary duty outlined by the Freshfields report seems to allow institutional investors to at least *sometimes* take *some* ESG considerations into account, the support it gives for SRI is notably contingent and, furthermore, it rules out exactly the kind of SRI which proponents of social responsibility and environmental sustainability should hold in highest regard (proactive cases and socially effective investment strategies). When put into some further perspective, then, I will suggest that the Freshfields report's findings do not call for very much optimism. And if SRI is to become an important force for corporate social responsibility through its adoption by institutional investors, I suggest that legal reform is needed. Although I cannot adequately address the issue of suitable legal reform in a article of this length, I will speculate about some possibilities open to legislators in this context towards the end of the article.

I recognise that a great deal has been written on the topic of SRI for institutional investors since the publication of the Freshfields report. Curiously, however, it seems fair to say that this literature (with the notable exception of Benjamin Richardson's work – see Richardson, 2007, 2008a, b, 2009) has moved on from the issue of whether, or to what extent, the legal framework surrounding fiduciary duties is consistent with institutional investors taking ESG considerations into account – an issue largely considered to be settled by the Freshfields report. The focus of most of the more recent literature on SRI for institutional investors has instead been on the issue of why the majority of institutional investors continue to ignore ESG considerations, despite there being no legal obstacles to doing so (see e.g. Hess, 2007; Hesse, 2008; Kiernan, 2009; Krosinsky and Robins, 2008; UNEP FI, 2009; Woods, 2009). By once again addressing the issue of legislation, however, I wish to highlight the fact that I think this issue is far from resolved. Even though some of the blame for why institutional investors are not doing enough in terms of adopting SRI practices certainly may rest on institutional investors themselves, there is also a need for legal reform and it is important to discuss the political side of SRI.

The article proceeds as follows: In the first section, I give some background to the concept of

fiduciary duty and introduce the Freshfields report's suggestions as to how SRI is compatible with the fiduciary duties of institutional investors. In the three following sections, I then go through these suggestions one by one and discuss exactly how strong support for SRI on the part of institutional investors they give, and also what kind of SRI they support. In the penultimate section, I address an issue not addressed in the Freshfields report, namely that of the social effectiveness of different SRI practices. Finally, in the last section, I give some concluding remarks on possible ways forward, i.e. possible legal reforms in the context of SRI for institutional investors.

The fiduciary duties of institutional investors

Background

'Fiduciary' comes from a Latin verb meaning 'to trust' and, hence, 'fiduciary duties' is the common term for the duties which trustees – e.g. pension funds – have towards their beneficiaries – e.g. present and future retirement pensioners. It should be noted from the start that the extent to which these duties are legally defined, how they are legally defined, and then how they are understood in practice and what specific requirements they impose on investment institutions, varies a great deal between different countries and also different types of institutions. Indeed, technically speaking, the term 'fiduciary duties' really only applies in common law jurisdictions, i.e. in countries where legal rules generally are interpreted in light of relevant court decisions (and not by reference to the principles or purposes behind their enactment) (Freshfields Bruckhaus Deringer, 2005; Richardson, 2007). To a fair degree, however, it seems that most countries, both common and civil law jurisdictions, impose a roughly similar set of core responsibilities on institutional investors, which they have exactly in virtue of being trustees of other people's money. For reasons of brevity, I will continue to refer to these as the fiduciary duties of institutional investors.

The core fiduciary duties imposed on institutional investors in most countries could be said to consist in the following two tenets (Hutchinson and Cole, 1980; Langbein and Posner, 1980; Miller and Calhoun, 2000; Pearce and Stevens, 2006; Richardson, 2007; Watt, 2006; Whitfield, 2005): (A) Trustees are to manage their funds in the interests of the ultimate beneficiaries, and not in their own self-interest. This is sometimes stated more generally as the duty to act in accordance with the purpose of the trust and, to be fair, some trusts may have terms which give trustees a somewhat different purpose (Meakin, 2005). In the standard case, however, as with e.g. pension funds and mutual funds, the purpose of the trust is typically taken to be to provide financial benefits for the beneficiaries. Furthermore, (B) trustees are to exercise due care and prudence when managing their funds. This is generally referred to as the 'prudent man rule' or 'prudent investor rule' in some jurisdictions, and could be taken to be the part of the fiduciary duties of institutional investors issuing more concrete action-guidance. The duty to exercise due care and prudence is typically taken to imply that trustees should, e.g., seek adequate information before making investment decisions, consult with expertise if they are not financial experts themselves, and carefully weigh the expected returns of particular investments against both expected risk and how they fit in with the rest of the overall portfolio (Langbein and Posner, 1980; Richardson, 2007; Scanlan, 2005; Watt, 2006).

Whether the fiduciary duties of institutional investors are compatible with purposively taking ESG concerns into account has been the subject of intense debate, really since the dawn of the SRI movement (for an early discussion of the issue, see Simon et al., 1972). Now, it may be noted that some rather high-profile institutional investors frequently are referred to as pioneers in this movement – for instance, the California Public Employees' Retirement System (CalPERS) and the New York Teachers Retirement System in the US, and the Universities Superannuation Scheme (USS) in the UK (see e.g. Richardson, 2008a; Sparkes, 2002). Hence there are some institutional investors, then, which seem to think that SRI is compatible with fiduciary duty. However this is far from the received view. A vast amount of institutional investors around the world interpret the legislation surrounding fiduciary duty as precluding them from doing anything else than seeking maximum returns on investments. In a recent survey among American

pension fund trustees, for example, as many as 45% of respondents indicated that considerations of fiduciary duty were their main reason for not engaging more actively in SRI (Hess, 2007; see also Hesse, 2008; Juravle and Lewis, 2008; Kiernan, 2009; Lewis and Juravle, 2009).

The traditional position among business lawyers and legal scholars, as noted at the outset, has tended to be that this view basically is correct (see e.g. Ali and Yano, 2004; Hutchinson and Cole, 1980; Langbein and Posner, 1980; Whitfield, 2005). After all, the two tenets above seem to combine into the idea that trustees are to act prudently in the financial interest of their beneficiaries. This is then, rather straightforwardly, thought to preclude institutional investors from taking non-financial considerations into account in their investment decisions and to sacrifice returns for social or environmental goals. According to the classic and oft-cited commentary of the Chicago law professors Langbein and Posner, e.g., '[t]he duty of prudent investing […] reinforces the duty of loyalty in forbidding the trustee to invest for any other object than the highest return consistent with the preferred level of portfolio risk' and, were fiduciaries to take ESG considerations into account, 'both the duty of loyalty and the prudent man rule would be violated' (1980, p. 98).

To once and for all establish whether the traditional position on this matter really is correct, the Asset Management Working Group of UNEP FI commissioned a full-scale investigation of the issue from the London-based law firm Freshfields Bruckhaus Deringer in 2005. UNEP FI is a collaboration between the UN's Environment Programme and a range of high-profile financial institutions with interests in SRI; for example, BNP Paribas, Calvert, Citigroup, Hermes and HSBC (for more on UNEP FI, see Kiernan, 2009). The subsequent report, which has become known simply as the 'Freshfields report', is impressively ambitious in its scope and contains reviews of both international and national jurisdictions, covering the European Union, Australia, Canada, France, Germany, Italy, Japan, Spain, the United Kingdom and the United States.[2] In commenting on these jurisdictions, the report generally confirms what I have said above – e.g. that there is a common core of responsibilities imposed on institutional investors in all of these countries (Freshfields Bruckhaus Deringer, 2005, p. 7). The striking feature of the report, however, is its contention that the traditional position on the incompatibility of these responsibilities and SRI is fundamentally mistaken. The report suggests that the fiduciary duties of institutional investors are consistent with taking ESG concerns into account in many situations and, what is more, it is sometimes obligatory to take such concerns into account.

The Freshfields report's arguments

The general argument of the Freshfields report is that profit *maximisation* never has been a part of the fiduciary duties of institutional investors in any country (pp. 8–12). In countries like the UK and US, the idea that fiduciary duty requires profit maximisation is suggested to stem from a common but superficial reading of certain central court decisions. The judge in the famous case of *Cowan v. Scargill* in the UK, for instance, ruled that powers of investment must be exercised 'so as to yield the best return for the beneficiaries' ([1984] 3 WLR 501 at 513). However, if you read the entire ruling, and also put this case into some perspective, the Freshfields report suggests that it is erroneous to infer from it that trustees have an obligation to seek profit maximisation. Whereas the purpose of the trust certainly should be respected, which most often will mean that the overriding goal should be to provide financial benefits for the beneficiaries, as long as institutional investors exercise their investment powers carefully and fairly they are not required to maximise profits with complete disregard of all other factors (pp. 88–90). And this is also how similar court decisions or codes in other jurisdictions should be understood.[3] The report thus argues that institutional investors have some discretion in deciding what it means to exercise due care and prudence, and sometimes this may include taking ESG concerns into account.

In contrast with the traditional view, the report more specifically presents three sorts of circumstances where it is argued that taking ESG concerns into account is either permissible or, in fact, obligatory for institutional investors (pp. 10–13). (1) First of all, choosing investments on the basis of their ESG

characteristics is argued to be permissible when deciding between investments with exactly similar financial characteristics. That is, if the financial prospects of investing in either company A or company B are found to be exactly on a par, the report argues that choosing company A over company B for ESG reasons is compatible with the duty of having the financial interests of the beneficiaries as one's overriding goal. (2) Secondly, taking ESG concerns into account is argued to be *obligatory* when such concerns are financially relevant – that is, when a certain company's or industry's ESG performance reasonably can be expected to have an impact on its financial performance or valuation. The report suggests that this quite generally would be the case, and so a duty to take ESG considerations into account is thought to follow directly from the duty to seek adequate information before making investment decisions noted above.

(3) Finally, choosing investments on the basis of their ESG performance is argued to be obligatory when it is reasonable to think that this actually would be supported unanimously by the beneficiaries. Whereas the *financial* interests of beneficiaries normally should be the main goal of investment decision-makers, the report notes that many courts have allowed exceptions to this rule when trustees have taken other factors into account which, although they are not in the financial interests of beneficiaries, plausibly could be said to be in their interests in a slightly broader sense. Thus, the report argues that trustees to some degree have an obligation to consider certain non-financial interests of their beneficiaries. However, only if doing so reasonably could be expected to be unanimously supported by the beneficiaries themselves.

It seems fair to say that the Freshfields report has been met with considerable enthusiasm among proponents of the SRI movement. Matthew Kiernan, for instance, suggests that the publication of the Freshfields report 'was a pivotal intellectual event' (2009, p. 159) and Jim Hawley is reported to have said that '[t]he report is extraordinarily significant for a number of reasons: first, it essentially flip-flops the conventional wisdom on fiduciary duty, completely turning it on its head, [and s]econd, the fact this report was prepared by Freshfields – the third largest law firm in the world […] – carries huge clout' (Baue, 2005). Aviva Investors calls it 'the single most comprehensive analysis of fiduciary duty and the integration of ESG issues into investment' (Aviva Investors, 2008) and according to a report prepared for the U.S. Environmental Protection Agency, 'the Freshfields report marked a turning point in the debate on fiduciary duty and ESG investments' and it 'remains the most authoritative study to this point on the legal context in which ESG investing does or does not take place in most advanced capital markets around the world' (International Decision Strategies, 2009). Finally, according to a Canadian public committee on the environment and the economy, the Freshfields report 'essentially put this question [of fiduciary duty versus SRI] to rest' (NRTEE, 2007, p. 23).[4]

In July 2009, UNEP FI published another report, officially labelled as a follow up to the Freshfields report and appropriately named 'Fiduciary II' (UNEP FI, 2009). While part of the motivation behind the commissioning of this report seems to have been to highlight legislative improvements since 2005, its authors solemnly acknowledge that 'the law regarding fiduciary duty has changed very little in the years since the Freshfields Report' (p. 47). Most of the recommendations of Fiduciary II therefore instead focus on *cultural* impediments to SRI, both among institutional investors themselves and their subcontracted asset managers and financial consultants. With regards to the legislative side, there is really no end to the praise given to the Freshfields report in Fiduciary II; it is called 'a landmark report' (p. 9) and '[t]he single most effective document for promoting the integration of environmental, social and governance (ESG) issues into institutional investment' (p. 13). Furthermore, the Freshfields report's 'clear conclusion' is claimed to be 'routinely cited by practitioners, academics and opinion formers worldwide' (p. 13) and is suggested to, together with some other 'ground-breaking reports' from UNEP FI, have 'created a near universally accepted platform in support of ESG integration on which many other initiatives were able to build' (p. 17).

I certainly agree that the Freshfields report indicates grounds for *some* optimism on the issue of SRI versus fiduciary duty. However, I will now suggest that much of the extreme praise noted above is greatly exaggerated. Even though the report

persuasively supports the contention that taking *some* ESG considerations into account *sometimes* can be compatible with fiduciary duty, a rather basic and legitimate question seems to be exactly what level of devotion to ESG issues it allows for. In the following three sections, I will go through the three central arguments of the Freshfields report and discuss this issue more carefully, and in the section following that, I will note a dimension of this issue not addressed by the authors of the Freshfields report.

ESG considerations as tie-breakers

The current legal framework surrounding fiduciary duty dictates that the overriding goal of institutional investors should be to provide financial benefits for their beneficiaries. However, according to the Freshfields report, this does not necessarily preclude taking ESG considerations into account. A first sort of circumstance in which trustees may be permitted to take such considerations into account is when purely financial considerations have been exhausted. The report says: 'There may [...] be cases where a decision-maker has exhausted the analysis of financial criteria [...] in making an investment decision and is still left with a number of alternatives, all of equal attractiveness from the point of view of the overall investment strategy being pursued. In those cases, the decision-maker would be entitled to select one alternative on the basis of its non-value-related ESG characteristics, without thereby being in breach of his or her fiduciary duties or civil law obligations' (Freshfields Bruckhaus Deringer, 2005, p. 12). According to the report, then, a first argument for the compatibility between fiduciary duty and SRI is that ESG considerations may be considered as tie-breakers between investments with similar financial characteristics.[5]

This argument may seem straightforward enough, and I believe there is at least one feature of the argument which calls for some degree of optimism. Although ESG concerns only may be considered as tie-breakers, there are no further restrictions on what ESG considerations trustees are allowed to take into account. That is, in situations where trustees conclude that the financial characteristics of two or more investments are exactly on a par, the argument suggests that they are permitted to decide which one to pursue by reference to whatever social or environmental concern they may have. This feature of the argument may be considered positive since it gives some space for trustees to consider social and environmental issues in their own right – that is, to have an independent agenda on ESG issues which is not influenced by financial or other concerns – and we will soon see that the report's other arguments actually are more restrictive on this dimension. The obvious question in relation to this first argument, however, is exactly how often trustees will be able to give effect to such an agenda – that is, how likely it is that trustees will find themselves in situations where the financial characteristics of two or more investments are exactly on a par.

It seems intuitive to think that, in a fundamental sense, no two investment opportunities can have *exactly* similar financial characteristics. After all, even two companies pursuing similar business strategies within the same industry may have managers with slightly different qualifications, or employees with slightly different home situations, for example, and may also be exposed to slightly different external opportunities or threats because of factors as simple as the weather and local politics. However, of course, investors cannot be expected to gather information on every last detail relevant to the investment opportunities they are facing, and so they typically design some more abstract measures, either statistical or qualitative, which give them an at least rough picture of the financial characteristics of these opportunities. Such measures will inevitably simplify reality considerably and so the likelihood that two investments will come out as on a par in the rough estimations of actual investors is higher. When reading the investment policies of the institutional investors which indeed take ESG considerations into account (like CalPERS and USS), one certainly gets the impression that they have given much attention to the financial characteristics of their investment opportunities – but they have still clearly managed to find room for integrating ESG considerations into their choices of what investments to hold or dispose of.[6] Hence, should we conclude from this that there is ample space for institutional investors to take ESG considerations into account as tie-breakers?

The central question in this context is how likely it is that investors will find themselves in situations

where the financial characteristics of two or more investments are equal *in the sense encoded in the law*. And while I can only speculate here, I suggest that it actually seems rather unlikely that investors with adequate skills in modern financial analysis will find themselves in such situations – or, at least, that they will do so very often. In a sense, their job is precisely to try to get as close to these investments' real or underlying characteristics as possible. In order to make sure that trustees do this job properly, appeals to the techniques of modern financial analysis are often encoded in the law. The prudent investor rule imposed on trustees in most countries, for instance, is often formulated so as to require their application of modern portfolio theory in decisions over what investments to pursue (Langbein and Posner, 1980; Pearce and Stevens, 2006; Richardson, 2008a; Thornton, 2008; Watt, 2006). And some central tenets of modern portfolio theory are, first, that investment decisions should be based on both expected return and expected risk (both systematic and non-systematic) and, second, that they not only should be based on the characteristics of individual investments in isolation, but also on how these fit in with the rest of the investor's portfolio.

Given that trustees adequately analyse their investment opportunities according to modern portfolio theory, Rosy Thornton – an expert on trust law – suggests that it would be outright 'inconceivable' that they would find themselves in a situation where the financial characteristics of two investments are exactly the same. 'Not only is it extremely improbable that the complex measures used to estimate expected return and variance will produce two identical sets of values', she suggests, 'but it must be remembered that these assets are not being considered in isolation but in relation to an existing portfolio. Therefore the trustees should be comparing not only the expected return and variance of the two assets themselves, but also the covariance between those assets and the rest of the holdings within the portfolio. When this factor is taken into account, it becomes inconceivable that there would be no legitimate investment ground upon which to distinguish between the two assets' (2008, p. 405; see also Hutchinson and Cole, 1980). These are clear words indeed and, if this interpretation of the law is correct, the Freshfields report's appeal to the possibility of integrating ESG considerations as tie-breakers indeed would seem to be seriously misleading.

Perhaps Thornton's view could be said to be too legalistic – one may, for instance, ultimately want empirical evidence on to what extent CalPERS and USS manage to live up to (at least the spirit of) modern portfolio theory and fiduciary law. And perhaps Thornton's interpretation of the law also is somewhat strict – it may be noted that some countries' legal standards explicitly give a bit further leeway in the present context: In a decision from Maryland Court of Appeals in the US, for instance, the court suggested that investors have not transgressed their duty of loyalty as long as the costs of considering the social consequences of investment decisions are *de minimis* (Freshfields Bruckhaus Deringer, 2005, p. 111) – and this obviously goes further than the tie-breaker clause. Taking these considerations into account, I suggest that it probably is exaggerated to say that it is entirely 'inconceivable' that investors will find themselves in situations where the financial characteristics of two or more investments are equal in the sense encoded in the law. Nonetheless, I contend that it at least would seem rather *unlikely* that they will find themselves in such situations – at least that they will do so very often. Even though no one is perfect, investors with adequate skills in modern financial analysis can be expected to be able to judge which of two investments suits their portfolio best in most situations. The likelihood that they will find themselves in a situation where non-financial tie-breakers can come in, then, is relatively slim.

Thornton wishes to add a further problem here. Even if some trustee, perhaps because of lack of information or just lack of financial analysis skills, indeed were to judge that two investments seemed to present the exact same financial opportunities, she suggests that the recommendations of modern portfolio theory are not exhausted. After all, the investments may still differ in terms of *hidden* (or underlying) risk and so the prudent choice may be to simply invest in both of them in order to spread this hidden risk (Thornton, 2008, pp. 405-406). I do not wish to put too much emphasis on this last point, in order to give the Freshfields report's interpretation of the law the benefit of the doubt. In conclusion, however, I take the above considerations to suggest that the report's first

argument for the compatibility between fiduciary duty and SRI leaves only limited room for institutional investors to take ESG considerations into account.

The financial relevance of ESG factors

While the authors of the Freshfields report themselves may have doubts about their first argument (they simply suggest that there 'may' be situations in which it makes SRI 'at least permissible'), they certainly put a lot more emphasis on their second argument. The report quite straightforwardly states that: 'In our view, decision-makers are *required* to have regard (at some level) to ESG considerations *in every decision they make*. This is because there is a body of credible evidence demonstrating that such considerations often have a role to play in the proper analysis of investment value' (Freshfields Bruckhaus Deringer, 2005, pp. 10–11, emphasis added). The second argument, then, is that the ESG performance of companies quite generally has an impact on the *financial* performance (or valuation) of these companies and, for this reason, a duty to take ESG considerations into account is thought to follow directly from the duty to seek adequate financial information before making investment decisions.[7] Taking ESG considerations into account is not only *permitted* for institutional investors according to this argument, but it is actually *required*.

Scrutinising the great amount of praise given to the Freshfields report more closely, it seems fair to say that it is this second argument which the majority of commentators applaud and/or support most intensively (see e.g. Aviva Investors, 2008; Kiernan, 2009; NRTEE, 2007; UNEP FI, 2009; Woods, 2009). Now curiously, the only real example of when ESG performance affects financial performance given in the Freshfields report is the case of climate change. The report says in a note: ''Climate change is an obvious example of an environmental consideration that is recognised as affecting value. Following the recent release of a report by Mercer Investment Consulting noting the financial impact that climate change has already had on companies' costs, revenues, assets and liabilities, the UK Carbon Trust expressed the view that 'Pension fund trustees have a duty to address the financial risk posed by climate change when making investment decisions''' (Freshfields Bruckhaus Deringer, 2005, p. 11, n. 11). Fiduciary II is equally unable to present further examples, besides the case of climate change, of when ESG considerations are financially relevant (UNEP FI, 2009, p. 24). However, could this kind of thinking be generalised to cover all ESG considerations?

It should be noted that the issue of the possible financial relevance of ESG considerations has been the subject of an enormous amount of studies over the last couple of decades – indeed, UNEP FI itself has published a number of studies and summaries on this issue (UNEP FI, 2004, 2006; UNEP FI and Mercer, 2007). In a recent meta-analysis of previous research in the area, probably the most ambitious one to date, Margolis et al. (2007) compared a total of 192 statements in as many as 167 previous studies on the link between what they call corporate social performance (CSP) and corporate financial performance (CFP). The result of their analysis is that the overall link seems 'positive but small' (p. 2). However, what is most interesting in the present context is the enormous spread of results discovered in the analysis. Of all 167 previous studies, 58% found no statistically significant relationship between CSP and CFP, 27% found a positive relationship and 2% a negative relationship (p. 21).

Margolis et al. suggest that the variation to some extent can be explained by differences in how CSP and CFP were defined in these studies, and perhaps also by differences in research methodology (pp. 9, 16–17). Indeed, in a more detailed analysis of the results, they found that some aspects of CSP (e.g. charitable contributions, revealed misdeeds and environmental performance) seemed more strongly correlated with CFP than others (pp. 17–21). However, they hesitate to draw any general conclusions even on these aspects. In the end, the authors suggest that '[t]he variation in results across types and measures of CSP may itself be the most important signal to emerge from the 35 years of research on the connection between CSP and CFP' (p. 24).

This meta-analysis would seem to show that there is no clear evidence for saying that ESG considerations always – or even most often – have financial relevance. Now proponents of the SRI movement may seek to challenge this result in a number of ways. They may suggest, for instance, that the

connection between CSP and CFP gets stronger over the long term – and that it is the long term which is interesting from the point of view of institutional investors. Alternatively, they may appeal to the idea of institutional investors as 'universal owners', famously put forward by Hawley and Williams (2000, 2002). According to this idea, since institutional investors typically invest in a very large sample of different companies across different industries, their returns depend more or less on how the economy as a whole fares. And while the link between CSP and CFP may be weak with regards to most individual companies because they basically can 'externalise' the costs of poor CSP, perhaps it is stronger on the portfolio level because they will have to be borne by other parts of the economy.

I am unfortunately unable to address all of the details of these suggestions here. I suggest, however, that even proponents of the SRI movement must accept that there (at least currently) is no solid empirical evidence in support of any of them. Many of the studies included in the meta-analysis above were studies exactly of the long-term correlation between CSP and CFP, it may be noted, and yet the analysis showed no stable results. Similarly, none of the summaries published by UNEP FI itself have been able to show that there always – or even most often – is a connection between CSP and CFP over the long term; not even in the case of climate change (see UNEP FI, 2004, 2006, UNEP FI and Mercer, 2007). Whether there is a connection between CSP and CFP on the portfolio level or the level of the economy as a whole – that is, whether the universal owner thesis is correct – is obviously quite difficult to test empirically. To my knowledge, however, no solid empirical evidence of such a connection has yet been presented. And perhaps there are also grounds for questioning whether institutional investors really behave as universal owners in practice (for a critique of the universal owner thesis, see Richardson, 2008a, pp. 133–137).

Taking a step back from these empirical enquiries, I suggest that there are sound theoretical reasons for thinking that the relationship between ESG factors and financial performance could be a contingent one at best. ESG considerations are a kind of *non*-financial considerations after all, and whether companies choose to engage certain social or ethical problems is supposed to be motivated, at least to some extent, by directly social or ethical reasons, quite apart from their motivation to seek maximum profits. Quite intuitively, then, the fact that empirical studies generally have yielded inconclusive results should come as no surprise. However, where does this leave the Freshfields report's second argument? I conclude that if institutional investors only are justified in taking ESG considerations into account when they are financially relevant, this could at best be a very contingent support for their adoption of SRI practices. Indeed, this support would in one regard seem even more contingent than the support for SRI given by the first argument above – where I said that, although situations in which two or more investments have exactly similar financial characteristics are unlikely to occur, there were at least no further restrictions on exactly what kind of ESG considerations trustees were thought to be allowed to consider.

There is actually a further problem with justifying SRI from an appeal to the financial relevance of ESG considerations. Arguably, not only companies but also social investors sometimes want to take social or ethical concerns into account exactly for social or ethical reasons.[8] One such situation in particular seems to be when a certain company or industry is performing extremely poorly along some ESG dimension, but there is no economic disadvantage to such behaviour in the foreseeable future. A genuinely social investor would plausibly want to avoid investing in, or perhaps attempt to reform, this company or industry – part of the reasoning behind the whole SRI movement, after all, is that SRI *as such* could be a force for penalising poor ESG performance (Domini, 2001; Freshfields Bruckhaus Deringer, 2005; Haigh and Hazelton, 2004; Hudson, 2005; Knoll, 2002; Rivoli, 2003). However, since there is no reason to think that these particular cases of such performance will have any financial relevance in the foreseeable future, such behaviour would seem to be ruled out by the present line of argument. The SRI of institutional investors could only be *re*active and never truly *pro*active, then, if they only are justified in taking ESG considerations into account when they are financially relevant.

Richardson (2008a, 2009) makes a similar observation. In his terminology, the current legislative framework surrounding fiduciary duty only supports 'business case SRI' and not 'ethical SRI' (see e.g.

2008a, pp. 212–220). And even though institutional investors to *some* degree are allowed (or even obliged) to take ESG considerations into account, then, he suggests that the focus on 'business case SRI' does not call for very much optimism. He writes:

> The notion that environmental care and business success can be compatible is, of course, not inconceivable. The danger is how the optimism behind this synergy can become a pretext for standard business practices. A huge gap between a financial materiality model of SRI and an ecologically sustainable economy persists. That model does not guarantee cessation of resource depletion and environmental damage, because current financial metrics cannot reflect all environmental values. Moreover, a potent business case continues for many environmentally tragic practices, such as the vacuuming of the oceans of marine life and the unabated oil fields exploitation despite looming climate change (2008a, p. 383).

The issue of the financial relevance of ESG concerns is an interesting one, and it will most probably continue to be the most widely researched issue in relation to SRI in academia. I have said nothing here which should be taken to mean that it is absolutely futile to continue trying to establish a (positive) link between CSP and CFP. I have suggested, however, that it seems overly optimistic to build one's case for why SRI is compatible with the fiduciary duties of institutional investors on an appeal to financial relevance alone and, therefore, also the second argument of the Freshfields report seems to leave limited room for SRI among institutional investors. Could an appeal to the non-financial interests of beneficiaries perhaps be more fruitful?

Finding a consensus among beneficiaries

According to the Freshfields report, taking ESG considerations into account is not only obligatory for institutional investors when they are relevant to the financial interests of beneficiaries, but could also be justified when certain non-financial interests are at stake. Of course, the financial interests of beneficiaries should be the main target in the typical case. 'However', the report says, "a decision-maker may integrate ESG considerations into an investment decision to give effect to the views of the beneficiaries in relation to matters beyond financial return. Courts in the UK have recognised that trusts such as charities are entitled to exclude investments that conflict with their values and that the concept of beneficiaries' 'best interests' under a general pension trust may extend beyond their financial interests to include their 'views on moral and social matters'. In a similar way, US law permits investments to be excluded where the beneficiaries so consent" (Freshfields Bruckhaus Deringer, 2005, p. 12). According to the third argument of the Freshfields report, then, as long as the beneficiaries so consent, institutional investors are perfectly allowed to take ESG considerations into account in their investment decisions.[9] Indeed, it is argued that doing so sometimes may obligatory (p. 13) – that is, *not* taking ESG considerations into account may be a breach of the fiduciary duty of trustees when this is the will of the beneficiaries.

However, exactly how should the appeal to the 'will of the beneficiaries' be spelled out? According to the report, the general rule is that taking a certain ESG concern into account only is permissible when you know that all beneficiaries consent to doing so – '[a] decision-maker who chooses to exclude an investment or category of investments on this basis will need to be able to point to a consensus amongst the beneficiaries in support of the exclusion' (p. 12). Now, it is acknowledged that determining what all beneficiaries want seldom will be practically feasible. In the absence of such knowledge, the report suggests that trustees may use certain well-established social conventions as a kind of proxies for the will of the beneficiaries. 'Whilst there is little guidance directly on point', the report says, 'it can […] be argued that even in the absence of […] express consensus, there will be a class of investments that a decision-maker is entitled to avoid on the grounds that their ESG characteristics are likely to make them so repugnant to beneficiaries that they should not be invested in, regardless of the financial return that they are expected to bring. It is not possible to define the parameters of this class, but it might include investments that are linked to clear breaches of widely recognised norms, such as conventions on the elimination of child labour' (*ibid.*).

Do these suggestions entail a stronger support for SRI for institutional investors than the previous two arguments? Unfortunately, although the report's

general line of reasoning in connection with this argument is inspiring, I do not think it does. I will start by discussing the possibility of finding a consensus among beneficiaries in general, and thereafter say something more about the appeal to social conventions.

A consensus among beneficiaries

The Freshfields report suggests that the general rule in the present context is that taking a certain ESG concern into account only is permissible when you know that all beneficiaries consent to doing so, although it concedes that it seldom may be practically feasible to identify such a consensus. Interestingly, then, while the report acknowledges certain *practical* problems in identifying a consensus among beneficiaries, it seems to assume that a consensus actually exists (or at least can exist) on at least some ESG issues. I suggest, however, that this idea has more than practical problems – indeed, I think it is extremely unlikely that there is a single ESG issue on which all beneficiaries can agree.

Although it is far from equally well-researched as the issue of the financial relevance of ESG concerns, it may be noted that a relatively popular research topic in relation to SRI has been the psychological profile of individual social investors and their views on various issues related to SRI. A couple of studies have inquired directly into what ESG issues social investors are most concerned about, for instance, and one found that sales to military purchasers, tobacco and gambling were popular issues (Anand and Cowton, 1993), whereas another found that environmental issues and labour relations were most important (Rosen et al., 1991). According to the authors of the first study, some of the variation in what ESG areas different social investors have strong feelings about could be explained further by dividing them into certain subgroups – for instance, the 'sin stock' group, the 'human rights/pacifist' group and the 'post industrial' group (Anand and Cowton, 1993). A couple of other studies have inquired into what investment strategies social investors prefer and one study found considerable support for the kind of investment strategies currently used by so-called ethical funds, although a consistent minority supported more progressive investment strategies (Lewis and Mackenzie, 2000a). Another study, however, found that social investors were genuinely conflicted when it comes to having to choose one investment strategy over another, and even gave contradictory answers to differently formulated questions about this (Sandberg and Nilsson, 2010).

A number of studies on the demo- and psychographics of social investors have shown that people exhibiting certain 'pro-social' or 'green' attitudes are more likely to invest in SRI vehicles than others, but that many actually choose SRI for the financial returns as well (Getzner and Grabner-Kräuter, 2004; Lewis and Webley, 1994; Nilsson, 2008, 2009; Rosen et al., 1991). Quite interestingly, one study showed that over 50% of social investors seem to accept that SRI comes with a cost and would not sell their SRI vehicles even if they substantially underperformed the market (Lewis and Mackenzie, 2000b; see also Beal and Goyen, 1998; Webley et al., 2001). This result has to be put in relation to some other studies, however, which did not find equally strong evidence for altruism among social investors, or actually found traces of a fairly traditional profit motive (Mackenzie and Lewis, 1999; Nilsson, 2008, 2009).

A lot of further research certainly needs to be done in this area. However, what is interesting in the present context is the incredibly diverse picture of social investors that is beginning to emerge. As far as we presently know, there is simply no such thing as what 'typical' social investors care about or want. Thus, the idea that there could be certain ESG areas where there was a consensus among social investors about what to do or think seems extremely far-fetched. Now, most of the research referred to above has focused exclusively on self-proclaimed social investors, i.e. investors who have already invested in some SRI vehicle. Getting back to our assessment of the Freshfields report, it should be noted that the idea is that taking a certain ESG concern into account only is permissible for institutional investors when all *beneficiaries* consent to doing so. However, if there is so much heterogeneity already among social investors, it seems obvious that there will be *enormous* heterogeneity in terms of what ESG issues *beneficiaries* care about – at least for the most common types of institutional investors (e.g. insurance companies and pension funds). According to the report, the beneficiaries of a pension fund could be understood as widely as all people that are either (1)

currently building up benefits in the pension scheme, (2) currently receiving a pension from the scheme or (3) may build up benefits or receive a pension in the future – and this may include widows, widowers and dependants of both current and future members (Freshfields Bruckhaus Deringer, 2005, p. 18). In the case of a public pension fund, I guess this would make more or less the entire population into beneficiaries and it just seems extremely unlikely that there is any ESG issue on which they all will agree.

Richardson (2007, 2008a) at one point curiously disputes this claim. 'A common argument against SRI policies based on members' preferences', he says, 'is that beneficiaries may hold conflicting views on ethical questions. While disagreements will most likely permeate traditional ethical or religious issues, such as alcohol or gambling, substantial agreement in other areas may readily arise. For instance, members of a pension fund probably rarely favour deliberate environmental degradation or human rights' violation' (2007, p. 166). While I think I understand where this comment is coming from, I cannot help but finding it somewhat naïve. First of all, Richardson does not present any empirical evidence for his view, and the way in which, e.g., current political and public debates go on environmental issues certainly seems to cast doubt on the idea of there being a general consensus on such issues in society (see e.g. Hoffman et al., 1990). Furthermore, even though most pension fund members may think that environmental degradation is ethically problematic to at least some extent, they will most probably disagree about precisely how unethical it is, what institutional investors should do about it more exactly, and to what extent it is adequate to sacrifice financial returns in order to avoid supporting it.

Having said this, I should contend that Richardson discusses some better examples at a different place (2008a, pp. 264–288). One is obviously more likely to find some convergence of opinion in an occupational trust of some sort, for instance, involving people working together in a common profession or locality, than in, say, a life insurance company whose beneficiaries are likely to be drawn from a wider cross-section of society. Furthermore, some institutional investors are philanthropic foundations which increasingly have a policy to eschew investments in certain activities that would be contrary to their core mission as a foundation (e.g. gross environmental or human rights abuses). The cases to which the Freshfields report refers, where courts indeed have granted exceptions based on beneficiaries' opinions, primarily seems to concern investors of this kind – and I cannot rule out that it may be possible to find a stable consensus on at least some ESG issues among the beneficiaries of at least some types of institutional investors. On the whole, however, it would still seem highly unlikely.

The appeal to social conventions

The considerations above suggest that appealing to a consensus among beneficiaries leaves very limited room for most types of institutional investors to engage in SRI. In the end, however, we have seen that the report suggests that trustees may use certain well-established social conventions as a kind of proxies for the will of the beneficiaries. I think this suggestion is very interesting, but I am not sure whether it really solves anything in the present context. Indeed, it may be noted that it gives rise to a number of problems on its own.

First of all, there is obviously a tension between this idea and the direct appeal to a consensus among beneficiaries. Even though certain social conventions, most obviously national laws and international treaties, to a large extent are the result of democratic processes, this should in no way be taken to mean that exactly everyone agrees with them. Even on the issue of child labour, one may note that some people (and, indeed, some academics) think that giving the children of destitute families jobs at least is better than letting them starve (see e.g. Satz, 2003, Sebastian, 1997). If the appeal to a consensus among beneficiaries is taken at face value, however, all it seems to take in order for a lack of consensus to persist is that one person disagrees. However, perhaps trustees are allowed to disregard certain views if they are sufficiently absurd, say, or if they are held only by a sufficiently small minority?

Even if something of this kind is allowed, I suggest, the appeal to social conventions does not extend the scope of legitimate SRI for institutional investors *so* much. As indicated earlier, the range of ESG issues which social investors generally care about is very wide – some care about armaments and

war issues, others about classical sin issues (alcohol, tobacco, gambling), others about environmental issues, and yet again others about labour relations. While there indeed are some fairly robust social conventions on some of these issues – there are, for instance, multiple international treaties on environmental protection and labour standards signed by an impressive amount of nations[10] – there simply is a vast range of important issues where there are no clear conventions or treaties at all. Now, it might of course be suggested that certain very abstract international conventions, such as the UN's Universal Declaration of Human Rights, in effect covers a vast amount of ESG issues. Alternatively, it may be suggested that institutional investors should be free to embrace a range of more indefinite social norms such as, e.g., the common idea that pornography is degrading to women. I concede that part of what is enticing about the present line of argument is its ambiguity in exactly what social norms trustees may consider. The exact phrase used in the Freshfields report, however, is 'clear breaches of widely recognised norms' (Freshfields Bruckhaus Deringer, 2005, p. 12). And as much as many people may agree with a whole range of indefinite social norms, I guess the problem with allowing institutional investors to incorporate these is exactly their indefiniteness – that is, that one can easily imagine a 'slippery slope' where fund managers simply act on the interpretation of these norms which they happen to support themselves.[11]

Just as the appeal to financial relevance, then, the appeal to social conventions can at best give rather contingent support for the inclusion of SRI by institutional investors. And these arguments actually share a further flaw. It may be noted that international treaties generally are the result of long and complicated political processes, and something similar seems to be true also of other kinds of widely recognised social conventions. That is, it takes a lot of time, awareness and discussion among the general public before anything like a social convention could be said to be in place. However, once again, then, the SRI of institutional investors could only be *re*active and never truly *pro*active – that is, institutional investors are only allowed to take certain ESG concerns into account once the desirability of this has become widely recognised in society. I take it that this conclusion should be regarded in a negative light in the present context. After all, an important driving force of the SRI movement as such is the idea that social investors actually can be a part of the creation of *new* social conventions, and in changing the way people generally tend to think (Domini, 2001; Kiernan, 2009; Sandberg, 2008; Sparkes, 2002).

Profitability versus social effectiveness

Interestingly, the authors of the Freshfields report seem to give the appeal to a consensus among beneficiaries coupled with the appeal to social conventions extremely much weight in comparison to the financial responsibilities of trustees. If beneficiaries so consent, the report says, trustees are allowed to avoid pursuing certain investments 'regardless of the financial return that they are expected to bring' (p. 12). However, as we have seen, the general rule confirmed by the report is that the fiduciary duties of trustees require that investment decisions are made with the financial interests of beneficiaries as the overriding goal. Now as a final way of putting the Freshfields report into further perspective, I think it is important to address more generally the issue of the relationship between the profitability and social effectiveness of different SRI practices. Curiously, although the Freshfields report notes that a common justification for SRI as such is the idea that '[i]nvestors have a moral responsibility to support and encourage companies to achieve higher standards of corporate responsibility according to legitimate ethical principles' (Freshfields Bruckhaus Deringer, 2005, p. 28), the report does not explicitly condone this idea. Furthermore, it never really addresses the issue of just how effective the kind of SRI policies which it allows for can be.

We may understand the social effectiveness of a certain investment practice quite broadly in the present context as the tendency it has to 'make the world a better place' in one way or the other – by, for instance, creating incentives for companies with poor ESG performance to improve, supporting or encouraging other companies to perform even better on ESG dimensions, or simply giving direct financial support to financially impoverished groups (Sandberg, 2008). There is now a growing literature on the social effectiveness both of SRI as a

whole and of the more specific investment practices typically utilised by SRI actors. Although this topic has received far less interest than the issue of the financial relevance of ESG concerns, and also less than the issue of the psychological profile of social investors, I think the tentative results of this sort of research are the most interesting and important in the present context. The results of this research namely indicate that there is a fairly general conflict between the social ('making a difference') and the financial ('making money') aspirations of the SRI movement. And this obviously poses a problem for institutional investors if they, as the Freshfields report suggests, fairly seldom are allowed to sacrifice financial returns in their attempts at promoting better ESG performance.

I have until now, following the language of the Freshfields report, spoken rather loosely of 'taking ESG considerations into account' – but it may be time to say something about what this means more precisely. On most accounts, investors in SRI typically integrate ESG considerations in their investment practices in one or more of three ways: negative screening, positive screening and shareholder activism (Aviva Investors, 2008; Domini, 2001; Oxford Business Knowledge, 2007; Social Investment Forum, 2008; Sparkes and Cowton, 2004). There are other techniques that investors can use as well, but I will focus on these three because I think they most straightforwardly embody the main ways in which ESG integration could make a difference.[12] Negative screening denotes the strategy of refraining from investing, or selling investments, in companies with poor ESG performance and this is probably the practice most commonly associated with SRI among members of the general public. Positive screening, on the other hand, denotes the strategy of seeking out and investing in companies or projects with good ESG performance, and this can be everything from large and commercial companies developing 'green' technologies to smaller and less commercial housing projects in financially impoverished neighbourhoods.[13] Finally, shareholder activism denotes the strategy of investing in companies with poor ESG performance and using one's shareholder powers to instigate reform – typically through owner–management dialogues or proxy voting.

Can institutional investors' use of any of these investment strategies reasonably be expected to be socially effective? Well, a number of commentators have been critical of the possibility of creating social change through simply buying and selling the shares of different companies at the stock market, which basically is what both negative and positive screening is about. The market for most listed companies' shares is simply sufficiently liquid to prevent the buying and selling behaviour of SRI actors from affecting share prices, and the motivational structure of non-SRI actors would typically make them counteract price changes that are not motivated from a strictly financial point of view (Haigh and Hazelton, 2004; Hudson, 2005; Knoll, 2002; Mackenzie, 1997; Munnell and Sundén, 2005; Statman, 2000; Wall, 1995). According to some commentators, however, one way in which a negative screening scheme on the part of an institutional investors perhaps could affect the share price of a given company would be if the institution sold off a very large quantity of the shares at once (Knoll, 2002; Mackenzie, 1997; Sandberg, 2008). After all, institutional investors often hold rather substantial quantities of many companies' shares and there may simply not be enough buyers on the market to balance this out – at least not in the short run. Selling off a very large quantity of shares at once, however, will obviously incur massive losses on the acting institution.

The market for the shares of certain smaller-sized companies, perhaps not even listed on the stock exchange, may sometimes be less liquid than for bigger companies. According to some commentators, then, one way in which a positive screening scheme on the part of an institutional investor could have a tangible influence on corporate finances would be for the institution to actively seek out such smaller-sized ventures (Mackenzie, 1997; Rivoli, 2003; Sandberg, 2008; Wall, 1995). For very small but highly effective social projects, it should be noted, financial support from an institutional investor could certainly make an enormous difference. For many reasons, however, investing in smaller-sized companies or projects will inevitably be much riskier, and the prospects for considerable returns may be slim (Mackenzie, 1997; Oxford Business Knowledge, 2007; Powers, 1971; Sparkes, 2002). Moreover, imposing high performance expectations on social projects may actually decrease the likelihood of their becoming socially successful, and so further financial sacrifices on the institution's part

may actually increase social effectiveness very directly.

Maybe shareholder activism is the most progressive option for institutional investors in the present context. Institutional investors would in theory be the perfect shareholder activists because they often control substantial quantities of shares in the companies they have invested in, and there is actually a growing pool of evidence showing that many activist campaigns have been quite successful – at least when they have been conducted by influential coalitions or very large financial institutions like CalPERS (see e.g. Hebb, 2008; Kanzer, 2009; Logsdon and Van Buren, 2009). Some experts also suggest that recent amendments to the legislation surrounding corporate governance in countries like the UK and the US are likely to make activism even more effective in the future. Shareholder activism can be practiced in a number of different ways, however, and at different costs to the acting institutions. And according to many commentators, simply proposing shareholder resolutions or voting on resolutions at shareholder meetings – which would be the easiest and cheapest form of activism – is not the most effective way of indeed making a difference to corporate policies. Management typically controls the majority of the votes at these meetings (because of their control over absentees' votes), and resolutions are only non-binding requests to management anyway (Logsdon and Van Buren, 2009; Sandberg, 2008; Strätling, 2003). More effective forms of activism may be continuous dialogue with management, interaction with other investors and interaction with the media, but such practices will often require more resources on the part of the acting institutions (Hebb, 2008; Logsdon and Van Buren, 2009; Sandberg, 2008; Wen, 2009). The more hard-line these activist campaigns get, furthermore, the more shareholders also open themselves up to libel charges and counteraction from the companies targeted (Sandberg, 2008).

All of the considerations above suggest a fairly general conflict between the social and financial aspirations of SRI actors. And a further consideration may be added which is relevant to all of the practices discussed. Gathering adequate information on how a large number of companies perform on various ESG issues, and also putting sufficient effort into planning one's reaction to this information, is obviously both costly and time-consuming. The larger one's team for ESG analysis and SRI strategy is, then, and also the more highly skilled it is, the greater the likelihood of social impact – yet also the greater financial cost (Knoll, 2002; Michelson et al., 2004; Richardson, 2007). This consideration alone suggests that it is quite difficult to be a socially effective SRI actor without considerable financial sacrifice. And, as I have said, this poses a problem for institutional investors if they, as the Freshfields report suggests, fairly seldom are allowed to sacrifice financial returns in their attempts at promoting better ESG performance. While they are allowed to engage in *some* SRI activity, then, it seems fair to conclude that this would probably not be of the system-changing kind.

Now to this some proponents of SRI may say that I am only focusing on the actions of individual institutional investors, taken in isolation. However, perhaps the SRI movement as a whole would be able to make a difference – without any investor having to sacrifice financial returns – as long as (or when) enough investors joined in. I admit that this certainly is possible, and recent years have indeed seen the forming of a number of coalitions between institutional investors which call for at least mild optimism in this context – for instance, the Investor Network on Climate Risk (INCR), the Institutional Investors Group on Climate Change (IIGCC) and the Investor Group on Climate Change (IGCC). However, it should be noted that these coalitions face many significant challenges on their way to success – theoretical considerations suggest that the portion of investors that would have to join in order to make a substantial and lasting difference to 'business as usual' most likely is very great, and we are certainly not there yet (Heinkel et al., 2001; Mackenzie, 1997; Munnell and Sundén, 2005). Given the current situation, then, I submit that it does not seem outrageous to say that it would be preferable if the SRI techniques of individual institutional investors had been allowed to have at least a bit more teeth as such.

Concluding discussion

The aim of the present article has been to put the arguments of the Freshfields report into some further both empirical and critical perspective. My general

argument has been that while the understanding of fiduciary duty outlined by the Freshfields report seems to allow institutional investors to at least *sometimes* take *some* ESG considerations into account, the support it gives for SRI is notably contingent and, furthermore, it rules out exactly the kind of SRI which proponents of social responsibility and environmental sustainability should hold in highest regard: proactive cases and socially effective investment strategies. When put into some further perspective, then, I have suggested that – contrary to what most proponents of the SRI movement suggest – the Freshfields report does not call for very much optimism. And if SRI is to become an important force for corporate social responsibility through its adoption by institutional investors, I believe that legal reform is needed.

Exactly what kind of legal reform would be most adequate is a complicated issue and I can only note some possibilities here. The Freshfields report ultimately holds out two legislative examples which it considers to be 'directions for the future' in the area. First, it notes that the Canadian province of Manitoba reformed its view of the fiduciary duties of trustees in 2005 to expressly allow trustees to take ESG considerations into account provided that their duties of prudence are met (Freshfields Bruckhaus Deringer, 2005, pp. 12, 53). Similar reforms have since also been introduced in Ontario, Canada and Connecticut, USA (Kiernan, 2009; Richardson, 2008a). The point of these reforms has basically been to encode in law the sort of position defended in the Freshfields report, and similar reforms could perhaps be useful for persuading institutional investors with little confidence in the Freshfields report as such to see that some ways of taking ESG considerations into account indeed are compatible with the current legislative framework surrounding fiduciary duties. However, if the Freshfields report's position has the kind of serious limitations I have been discussing here, similar reforms will obviously make quite little progress.

The other positive example held out by the Freshfields report are the guidelines issued for the French retirement reserve fund in 2003, encouraging it to work proactively with ESG issues (Freshfields Bruckhaus Deringer, 2005, pp. 12, 58-59). Similar guidelines have since also been issued for public pension funds in Sweden, Norway and New Zealand, and single-issue restrictions on what investments public pension funds are allowed to pursue have been implemented in Belgium and a number of US states (Eurosif, 2008; International Decision Strategies, 2009; Munnell, 2007; Oxford Business Knowledge, 2007; Richardson, 2008a). While this second sort of reform may seem more encouraging, it may be noted that the relevant pension funds have not been released from their more general fiduciary duties of loyalty and prudence. The guidelines for the public pension funds in Sweden, for instance, encourage them to take 'environmental and ethical considerations into account without relinquishing the overall goal of a high return on capital' (quoted in Oxford Business Knowledge, 2007, p. 21). As a result, the social effectiveness of these reforms has been questioned (see e.g. Richardson, 2009). Furthermore, no legislators have been bold enough to issue similar guidelines for other kinds of institutional investors.

Richardson (2008a, b, 2009) argues that a lot more needs to be done in terms of legal reforms to promote SRI on the part of institutional investors. His favourite suggestion is that institutions should be legally required to meet certain independently set sustainability benchmarks. He says that "[f]inancial institutions that fail to meet such standards could be subject to regulatory sanctions including future restrictions on their investment choices or financial penalties to reflect social costs. Thus, the fiduciary standard by this model would effectively emphasise the 'returns' to society as a whole" (2009, p. 566). However, this is not the only way in which legislators could help to promote SRI on the part of institutional investors, and other possibilities have been mentioned in the literature. The disclosure requirements currently being imposed on pension funds in many jurisdictions could be made more extensive, for instance, or representatives of beneficiaries could be appointed to the boards of directors of investment institutions, or tax incentives could be given for adequate consideration of ESG issues, or legislators may even consider holding investors liable for the poor ESG performance of the companies they have supported financially (for an overview of these suggestions, see Richardson, 2008a).

I unfortunately cannot elaborate adequately on any of the reforms mentioned here, but I believe they all certainly deserve further attention.[14] Even though some of the blame for why institutional

investors are not doing enough in terms of adopting SRI practices certainly may rest on institutional investors themselves, then, I have sought to emphasise that there also is a need for legal reform. And we really need to discuss the political side of SRI a lot more.

Acknowledgments

This article was much improved by helpful comments from the editor, three reviewers and two informal advisors with Journal of Business Ethics. It won a 'Highly Commended Paper' award from Sir Adrian Cadbury at the 8th International Conference on Corporate Governance, University of Birmingham in June 2010. The author gratefully acknowledges financial support from the Swedish Foundation for Strategic Environmental Research (Mistra) through the Sustainable Investment Research Platform (SIRP).

Notes

[1] This is obviously only a rough definition of the phenomenon. Further discussion of how social and environmental considerations are integrated can be found in the section on 'Profitability versus social effectiveness' section.

[2] The principal authors of the report are Paul Watchman, Jane Anstee-Wedderburn, Lucas Shipway, Daniel Kalderimis and Giedre Kaminskaite-Salters. Part of the report has also been published elsewhere (Watchman et al., 2005).

[3] It may be noted that the Freshfields report primarily is interested in how to understand fiduciary duty at the level of principle, and therefore often generalises various lines of reasoning. This is a quite philosophical way of discussing legal doctrine which not all readers may be accustomed to – indeed I have found that some legal scholars find it unsuitable, since it abstracts away from the particulars of individual jurisdictions. In order to give the report the benefit of the doubt, however, I will continue the discussion at the level of principle throughout the article.

[4] To be fair, it should be noted that a number of seemingly independent treatments of the legal ramifications of SRI for institutional investors published more or less concurrently with the Freshfields report actually reached conclusions rather similar to it (see Gay and Klaassen, 2005; Richardson, 2007; Scanlan, 2005; Sethi, 2005). To the extent that the issue now could be considered 'put to rest', then, it would seem more adequate to praise all of these authors.

[5] For similar arguments, see Hutchinson and Cole (1980), Miller and Calhoun (2000), Richardson (2007).

[6] Information about CalPERS can be found at www.calpers.ca.gov and information about USS at www.uss.co.uk.

[7] For similar arguments, see Richardson (2007, 2008a), Woods (2009).

[8] Interestingly, it remains unclear whether institutional investors are allowed to invest according to ESG concerns for manifestly ethical or environmental reasons *only*. According to some commentators, the legal ramifications surrounding fiduciary duty should not only be interpreted as restricting trustees' *practices*, but also their *motivations* (Richardson, 2007; Thornton, 2008).

[9] For similar arguments, see Langbein and Posner (1980), Miller and Calhoun (2000), Richardson (2007), Scanlan (2005), Thornton (2008).

[10] Environmental treaties can be found in the UNEP-sponsored Ecolex database (www.ecolex.org) and labour treaties in the International Labour Organization's ILOLEX database (www.ilo.org/ilolex/index.htm).

[11] Thornton (2008) notes a further problem in this context: Even in cases where there are international conventions which impose clear legal obligations on *companies*, it is not obvious why this should imply any obligations on the part of their *investors* (p. 413).

[12] Some commentators speak of 'integration', or the consideration of ESG aspects directly in one's financial assessments of risk and return, as a separate form or strategy of SRI (Aviva Investors, 2008; Eurosif, 2008; Richardson, 2008a; UNEP FI and Mercer, 2007). However, I take it that the supposed difference between screening and integration on these accounts mainly lies in the details of exactly when and how companies are included or excluded for ESG reasons. These details are less important for my present concerns and so I use the terms positive and negative screening in a broad sense here which can be taken to include integration techniques. The problems discussed below are obviously problems for integration techniques as well.

[13] It may be noted that I here – for reasons of brevity – include in positive screening so-called community investing, or economically targeted investing, which sometimes is recognised as a separate strand of SRI (Domini, 2001; Richardson, 2008a; Social Investment Forum, 2008).

[14] This is obviously not to say that they all can be expected to work perfectly – attention also needs to be given to possible negative side-effects of legislative changes.

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