

ETHICAL INVESTMENT IN SUPERANNUATION FUNDS; CAN IT OCCUR WITHOUT BREACHING TRADITIONAL TRUST PRINCIPLES?

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Ethical investing in commercial activities is a topic which has received considerable attention of late. This has occurred in the areas of company law at all levels, with the concerns of consumers in relation to the production of products, and also in trust law, in particular superannuation trusts. Superannuation Trusts are of particular significance as they have become significant institutional investors in a number of substantial commercial activities. Ethical investment which requires the trustees to take account of issues other than financial when investing is seen to run counter to traditional trust law principles. Relevant issues relating to ethical investing include: human rights and labour concerns, environmental and moral issues such as investing in the alcohol and tobacco industries. This paper focusing upon superannuation law in the Australian and New Zealand jurisdictions considers the investment obligations of trustees in superannuation trusts. Such obligations closely resemble what may be referred to as traditional or core obligations of trustees. It acknowledges that difficulties arise when attempting to include ethical considerations in investment decisions with trust property. Having acknowledged this, the paper in upholding the place of ethical investing in the current environment proceeds to outline a means by which ethical investing can be adopted without compromising the position of trustees in any manner and which still focuses upon the best financial interests of the beneficiaries.

I. TRUST LAW

It is commonly stated that the trustee is the legal owner of the trust property while the beneficiary is the equitable owner. This arrangement establishes the basis of a fiduciary relationship between the trustee and the beneficiary. Fiduciaries are required to act in the best interests of their beneficiaries.¹ They must not allow personal interest and duty to conflict.² Self interest must be set aside for the interests of the beneficiaries. The basis of this relationship is that the fiduciary by virtue (in the present case the trustee) of being given the discretionary power to manage property on behalf of the beneficiary, is in a position of power.³ The power comes about by virtue of the discretion held by a trustee to manage the property of behalf of the beneficiary. The trustee may through investment and other decisions manage the property in a manner which either advances

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1 Rt Hon Justice E Thomas, 'The Conscience of the Law', (2000) 8 *Waikato Law Review*, 9.

2 *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134n (HL).

3 Rt Hon Justice E Thomas, 'The Conscience of the Law', (2000) 8 *Waikato Law Review*, 9.

the interests of the beneficiary or undermines them. Equity requires that trustees act in a manner which advances their interests.⁴

A beneficiary is a volunteer to a trust. This means that a beneficiary has provided no consideration for the trust entitlement.⁵ The equitable maxim that equity will not assist a volunteer is well established and acknowledged.⁶ However once a trust is established,⁷ it is also acknowledged that a beneficiary has a proprietary interest in the trust property and can as such enforce that interest against the trustee.⁸ As Lord Millet noted in *Armitage v Nurse*⁹ the fact that there is an irreducible core of obligations owed by the trustees to the beneficiaries makes it central to trust law that such obligations are enforceable.¹⁰ This right of enforcement has received statutory codification in different jurisdictions.¹¹ However there are differing degrees of interest that a beneficiary holds in a trust. These range from a beneficiary with a fixed interest in a trust to a beneficiary of a discretionary trust where trustees are given the discretion to select beneficiaries from selected groups of people.¹² The beneficiary with a fixed interest has a propriety interest in the trust which can be enforced.¹³ The discretionary beneficiary does not enjoy a propriety interest and the only power of enforcement is to ensure that trustees exercise their discretion fairly, or reasonably or properly.¹⁴ The extent of the beneficial interest and the associated right of enforcement is significant when one comes to consider superannuation trusts. While in general trusts the beneficiary is a volunteer to the trust, this technically is not the situation with beneficiaries of contributory superannuation scheme. As noted by Warner J in *Mettroy Pension Trustees v Evans*¹⁵ beneficiaries under a pension scheme where contributions are made are not volunteers. The contributions are totally derived from their work as an employee.¹⁶ Warner J proceeds to note:

The rights of beneficiaries of a pension scheme have contractual and commercial origins. They have been derived from contracts of employment of the members. The benefits under the scheme have been earned by the service of the members under those contracts.¹⁷

The acknowledgement of a contractual relationship within the pension/superannuation trust relationship coming about through the regular financial contribution on the part of the beneficiary is significant and could be said to give a superannuation trust a special status. Here it is important to note an observation of Richardson J from the New Zealand jurisdiction in *Re UEB Industries Ltd Pension Plan*:

4 *Mabo v Queensland (No 2)* (1992) 175 CLR 1 (HCA) 203.

5 This represents one of the key differences between a contractual relationship and a trust relationship. In contract law consideration is perhaps the most essential ingredient of a contractual relationship.

6 As stated in *Pennington v Waine* [2002] 4 ALL ER 215, 227.

7 It often becomes the role of the court to determine whether or not a trust relationship exists.

8 *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] 2 All ER 961, 988.

9 *Armitage v Nurse* [1997] 2 All ER 705.

10 Ibid.

11 For example in New Zealand Trustees Act 1956 s 66 allows any person with a beneficial interest in the property who is aggrieved by an act or omission of the trustee to apply to the court to review the act or omission.

12 Perhaps the most famous example of this is *McPhail v Doulton (In re Baden's Deed Trusts)* [1971] AC 424.

13 Andrew Butler *Equity and Trusts in New Zealand*, (2003), 56.

14 *Gartside v IRC* [1968] 1 All ER 121, 134.

15 *Mettroy Pension Trustees v Evans* [1990] 1 WLR 1587, 1610.

16 David Hayton *Pension Trusts and Traditional Trusts; Drastically Different Species of Trust* [2005] 69 Conv, 229, 230.

17 *Mettroy Pension Trustees v Evans* [1990] 1 WLR 1587, 1610.

Pension plans are different in nature from traditional trusts. There is an interrelationship of contract law and trust law in any pension scheme.... In commercial terms a pension plan of this kind is fundamentally a contract entered into by an employer to fund the payment of defined benefits to members of the plan and their dependants.¹⁸

The existence of a trust gives rise to a fiduciary obligation of the part of the trustee to act in the best interest of the beneficiaries. A contract gives rise to rights and obligations as defined by the terms and conditions of the contract. In a superannuation fund a beneficiary provides consideration through his/her contribution to the scheme through part of his/her wages.¹⁹ The deferment of wages through the contribution to the scheme could also be said to be another manner in which the beneficiary is providing consideration.²⁰ The provision of consideration establishes on the part of the beneficiary a legitimate expectation that contractual rights will be fulfilled. A fiduciary obligation coupled with a contractual obligation on the part of the trustees establishes, it is submitted, significant rights and expectations on the part of the beneficiaries, rights which exceed those of other beneficiaries of a traditional trust. This point is emphasized as it has important relevance in terms of the investing powers and obligations on the part of the trustees. The requirement to invest in the best interests of the beneficiaries is clearly of significant relevance when issues of ethical investment are raised with regards to the investment of superannuation funds.

II. TRUST LAW AND INVESTMENT

The investment obligations on the part of the trustees was considered in some depth in the now seminal case of *Cowan and Others v Scargill and Others*.²¹ This case concerned the investment of trust funds of the Mineworkers' Pension Scheme. The funds totalled some £300 million, with some £200 million available for investment every year.²² The Committee of Management which had wide powers of investment had ten trustees. Five were appointed by the Board and five were appointed by the National Union of Mineworkers. The trustees adopted a formal investment plan which included investments in oil, overseas investment, and the acquisition of land overseas. Such plans were strongly objected to by the Union representatives on the basis that they were in direct conflict with Union policy.²³ It was concluded by the Judge, Sir Robert Megarry that the Union trustees were mainly, if not solely activated by a desire to pursue union policy.²⁴ The opposition and censuring of the proposed investment strategy resulted in deadlocked board. As there was no casting vote, the matter came before the courts.²⁵ The non union trustees were concerned that such censuring meant that they were unable to diversify the fund so as to maximize the return for beneficiaries by investing domestically and abroad.²⁶

18 *Re UEB Industries Ltd Pension Plan* [1992] 1 NZLR 294, 298.

19 *Imperial Group Pension v Imperial Tobacco* [1991] 2 All ER 597.

20 This is sometimes referred to as executory consideration. This is where a person makes a payment for a benefit that can be expected to be received in the future.

21 *Cowan and Others v Scargill and Others* [1985] 1 Ch 270.

22 *Ibid.*

23 *Ibid* 279.

24 *Ibid* 294.

25 Justice Margaret Stone, 'The Superannuation Trustee: are Fiduciary Obligations and Standards Appropriate?' (2007) 1, *Journal of Equity*, 167.

26 *Ibid* 286.

In considering the situation Sir Robert Megarry reemphasized some of the basic principles of trust law. That is that the paramount duty of the trustees is to represent and promote the best interests of the beneficiaries.²⁷ Such a requirement is only qualified by a requirement to comply with the laws of the jurisdiction.²⁸ The beneficiaries' best interests usually means their best financial interests.²⁹ This requires an investment strategy which considers the risk of particular investments against the acquisition of income and capital appreciation of the assets of the trust.³⁰ This requires the trustees to put aside their own personal interests and views including strongly held social or political views.³¹ This would include during the apartheid era an opposition to apartheid; opposition to the manufacturing of armaments and to the production of tobacco and alcohol.³² Therefore, when exercising their powers and duties as trustees, if such investments would yield returns and long term capital appreciation to an extent that was greater than other investments, then there was an obligation to undertake such investments. In this manner we are seeing the fiduciary obligation being imposed in a slightly different way. The obligation not to allow duty to conflict with interest usually refers to the self interests of a fiduciary seeking to advance his/her own financial or business interests. However self interest in this context refers to a fiduciary's moral, social and political views. Such views must not conflict with the obligation to act in the best interests of the beneficiaries of the trust. This establishes an interesting new dimension to the fiduciary obligation reflecting the flexibility and adaptability of its application.

As noted in advancing their position, the Union trustees were focused upon advancing and implementing union policy rather than promoting the best interests of the beneficiaries. Sir Robert did acknowledge that if all of the beneficiaries of a superannuation trust held strong views about alcohol, armaments or certain types of entertainment, then it would not be in their best interests to invest in enterprises involved in such activities. He proceeded to observe however, that such situations where there would be consensus *ad idem* amongst all of the beneficiaries on ethical or moral issues would be very rare.³³ He also acknowledged that a strong case could be mounted to argue that the outflow of significant funds from the country through overseas investment is detrimental to the domestic economy.³⁴ However for such a position to be justified careful articulation and linkage to the pension scheme in particular was required. How would the clear selection of domestic rather than foreign investment benefit the local economy and in turn the beneficiaries of the trust? It was noted that although the scheme was large it had not been shown how such investment restrictions could influence the national economy in a positive manner.³⁵ Further the restriction was excluding a very significant area of potential investments and was not conducive to the requirement to diversify investments.³⁶

As noted the focus of the beneficiaries was to promote the Union policy. Sir Robert Megarry having considered Arthur Scargill's submissions concluded that there was no explanation as to

27 *Ibid* 287.

28 *Ibid*.

29 *Ibid*.

30 *Ibid*.

31 *Ibid*.

32 *Ibid*.

33 *Ibid* 288.

34 *Ibid* 295.

35 *Ibid* 296.

36 *Ibid* diversification of investment is a central priority for a trustee when investing in trust property.

how or why it was in the best interests of the beneficiaries to put union policy into force through imposing the investment prohibitions.³⁷

While Sir Robert Megarry is clear in his views about the focus of investment in the beneficiaries financial interests, the decision does contain an acknowledgement of the possibility of the promotion of arguments that:

- investing in a country with repressive policies might in fact be investing in a fragile economy and therefore not in the long term best interests of the beneficiaries; and
- that overseas investment might not be beneficial to the national economy which the pension scheme operates under.³⁸

However for such argument to be upheld, clear and careful articulation would be required to highlight how such investment decisions would provide specific benefits to the superannuation scheme under consideration. Such articulation effectively linking benefits to a specific scheme through a particular 'ethical investment strategy' is clearly difficult given the size of an economy such as the United Kingdom.

This raises the question: is it possible to apply principles of ethical investment to superannuation trusts in the absence of specific statutory codification requiring that such investment be undertaken? This will be the focus of the next part of the paper. It is firstly necessary to consider the investment obligations in more detail. Then the principles of ethical investment will then be discussed and critiqued. This will lead to the development of an argument that there can be some form of marriage between commercial prudent investment on the part of the trustees while at the same time complying with stated ethical standards. Such a marriage must be carefully articulated.

III. INVESTMENT STRATEGIES

As noted, trustees are required to adopt an investment strategy which is in the best interests of the beneficiaries. The best interests, unless a trust deed would suggest otherwise, means the best financial interests of the beneficiaries or members of a superannuation or pension scheme. Such obligations have been codified into different pieces of legislation. In Australia, section 52 the Superannuation Industry (Supervision) Act 1993³⁹ sets out covenants which are to be included in the governing rules of Superannuation entities. The two which are of particular relevance to investment are:

(2)(b) which sets out the requirement to exercise the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property for another for whom the person felt morally bound to provide;⁴⁰

(2)(f) this sets out the requirement to formulate and give effect to an investment strategy having regard to the circumstances of the entity as a whole. Regard needs to be given to;

- the risks relating to certain investments;
- the composition of the entity's investments as a whole taking into account the adequacy of diversification;

37 Ibid.

38 Ibid 295.

39 This is the legislation which provides the legislative regime to regulate superannuation schemes.

40 Superannuation Industry (Supervision) Act 1993 (Cth) s 52(2)(b).

- the liquidity of the entity's investments.⁴¹ In terms of the investment strategy, provision is made for a specified beneficiary(s) to give direction to the trustees with regards to particular assets of the fund.⁴²

Further section 62(1)(a)(i) of the same legislation requires that a superannuation fund must be maintained solely for one or more of the following purposes... *the provision of benefits for each member of the fund on or after the members retirement*. This is a particularly practical and focused purpose. In promoting this purpose the trustees are focusing upon the best financial interests of the beneficiaries which in the context of superannuation law is the provision of a adequate income for the beneficiaries upon retirement. Consequently it has been argued by Sir Robert Meggery in *Cowan* that taking account of moral factors other than maximization of return and capital appreciation is not acting in the beneficiaries best interests.⁴³ This is a view which found support some ten years later from Lord Nicholls of Birkenhead.⁴⁴

The consideration of risk, expected return and the required diversification to manage this which is central to an investment strategy has been codified in section 52 of the Superannuation Industry (Supervision) Act. In taking account of this trustees are required to adopt the position of the ordinary prudent person. It needs to be noted that the phase that has been adopted is 'prudent person' and not 'prudent business person'.⁴⁵ As Lord Nicholls notes the ordinary prudent person is a creation of equity and has his/her counterpart with the reasonable person in common law.⁴⁶ While Lord Nicholls might argue the ordinary prudent person threshold only requires the adoption of minimal standards and allows for certain errors,⁴⁷ such comments need to be considered in the context of the other Covenant obligations set out in section 52 of the Superannuation Industry (Supervision) Act 1993. These include the minimal standards with regards to an investment strategy,⁴⁸ to act honestly,⁴⁹ in the best interests of the beneficiaries,⁵⁰ and to allow a beneficiary access to any prescribed information or any prescribed documents.⁵¹ The different obligations taken together create significant legal expectations on the part of trustees including in particular the adoption of appropriate and effective investment strategies.

It seems to be accepted today that the appropriate means of giving effect to the prudent investor rule is through what is known as modern portfolio theory.⁵² This theory enables trustees to determine both expected returns of an asset together with the volatility of or risk attached to that

41 Superannuation Industry (Supervision) Act 1993 (Cth) s 52(2)(f).

42 Superannuation Industry (Supervision) Act 1993 (Cth) s 52(4).

43 *Cowan and Others v Scargill and Others* [1985] 1 Ch 270, 287.

44 Lord Nicholls of Birkenhead, 'Trustees and Their Broader Community: Where Duty, Morality and Ethics Converge', *The Australian Law Journal*, Vol 70, March 1996, 205, 211.

45 Such a phase has been adopted in other jurisdictions. See for example New Zealand Trustee Act 1956 s 13(D).

46 Lord Nicholls of Birkenhead, 'Trustees and Their Broader Community: Where Morality and Ethics Converge', *Australian Law Journal*, March 1996 Vol 8 205, 210.

47 *Ibid.*

48 Superannuation Industry (Supervision) Act 1993 (Cth) s 52(1)(f).

49 *Ibid* s 52(1)(a).

50 *Ibid* s 52(2)(c).

51 *Ibid* s 52(2)(h).

52 Paul U Ali and Gold M *An Appraisal of Socially Responsible Investment for Trustees and Other Investment Fiduciaries*, (Research Paper, Centre for Corporate Law and Securities Regulation) June 2002.

particular asset.⁵³ This is done by considering the different possible outcomes for an investment and the degree of variation of such outcomes.⁵⁴ Trustees when investing, invest in a number of different activities. The combination of these different investments is known as an investment portfolio.⁵⁵ A balanced and well considered portfolio allows for a balance of the minimization of risk while at the same time achieving the maximization of return. A spread of assets allows for the minimization of risk.⁵⁶ As Lord Nicholls notes, risk is managed across a balanced portfolio, incorporating a prudent mixture of low and higher risk assets.⁵⁷ In this regard the degree of risk of the combined assets when considering the investment portfolio as a whole should be less than the degree of risk of individual investments.⁵⁸ In other words the investment in stable low risk activities should effectively counter balance any investment risk in higher risk or volatile activities.

If the duty of investment in this regard is to realise the beneficiaries' financial interests through providing an adequate retirement income, then careful considerations of variance of risk or return when considered in the light of the totality of investments does not leave a great deal of room for account to be given to ethical considerations. Further as noted by Lord Nicholls:

If the trust was created to confer financial benefits on individuals, a decision not to maximize those financial benefits but to promote moral objectives on which widely differing views are held is, by definition, not to advance the purposes of the trust and, hence is not in the best interests of the beneficiaries under that trust.⁵⁹

The learned Judge proceeds to note that if moral objectives become a material consideration in investment strategies, this amounts to a significant shift from benefiting the named beneficiaries of the trust specifically to the benefiting of the community as a whole to which the beneficiary belongs.⁶⁰ This, as Sir Robert Megarry would agree is not ad idem with the purposes of traditional trust law. Adopting the approach of Sir Robert Megarry in *Cowan* the only way that such an approach could be in accord with traditional trust law would be for trustees to show that the benefits conveyed to the community through the ethical investments could be translated into positive investment outcomes for the beneficiaries.⁶¹ However it would appear that from a completely economic perspective any restriction of investment based on ethical or other grounds will have some detrimental impact upon investment returns through limitation of investment choice.⁶² While this

53 Rosy Thornton, 'Ethical Investments: A Case of Disjointed Thinking', *Cambridge Law Journal* 67 (2) July 2008, 396, 399.

54 Ibid.

55 Ibid 400.

56 Ibid.

57 Lord Nicholls of Birkenhead, 'Trustees and Their Broader Community: Where Morality and Ethics Converge', (1995) 9(3) *Trust Law International*, 71, 76.

58 Rosy Thornton, 'Ethical Investment: a Case of Disjointed Thinking', *Cambridge Law Journal*, 67(2) July 2008, 396, 400. As Thornton notes: 'Some combinations of assets will be more effective than others in reducing the overall risk of the portfolio. For example if two assets are likely to perform well under opposite market conditions or at different times, then dividing the fund between these two should substantially reduce the degree of risk.'

59 Lord Nicholls of Birkenhead, 'Trustees and Their Broader Community: Where Duty, Morality and Ethics Converge', *The Australian Law Journal*, March 1996 Vol 70 205, 211.

60 Ibid.

61 *Cowan and Others v Scargill and Others* [1985] 1 Ch 270, 295-296.

62 Rosy Thornton, 'Ethical Investments: a Case of Disjointed Thinking', *Cambridge Law Journal*, 67 (2) July 2008, 396, 409.

position is certainly not adopted by all commentators⁶³ in the field, trustees are prima facie placing themselves in a very vulnerable position if they are to take account of ethical decisions without being given some mandate to do so by for example the trust deed.

The issue becomes therefore: how does one take account of ethical considerations in superannuation trust investment in a manner which does not compromise the financial interests of the beneficiaries and increase the risk of legal liability upon the trustees?

IV. THE BASIS FOR ETHICAL INVESTMENT AND THE UNDERLYING REASONING FOR SUPERANNUATION FUNDS TO TAKE ACCOUNT OF SUCH CONSIDERATIONS

According to Donnan J ethical investing from its broadest perspective is the commitment to an alignment of a person's personal values and social concerns with investment practices.⁶⁴ Rosy Thornton differentiates between a socially dictated policy and a socially sensitive policy in terms of investment.⁶⁵ A socially dictated policy is one which uses predetermined ethical considerations to limit or determine the selection of investment assets, *such considerations taking precedence over commercial factors*.⁶⁶ A socially sensitive policy allows ethical considerations to come into play when choosing between investments which appear equivalently attractive according to normal financial criteria.⁶⁷ It would appear that the socially dictated policy would offend against the requirement of the trustees to act in the beneficiaries financial interests. The socially sensitive strategy however seems to be somewhat limited in its effectiveness in promoting ethical investment. Under this strategy should an investment in an entity involved in armaments production provide a more attractive rate of return, then the investment in the armaments supportive enterprise would prevail. Donnan's approach of aligning personal values and social concerns with investment practices, while allowing for a certain amount of flexibility, aligns itself most closely with the socially dictated policy approach. The Donnan approach could still lead to potential conflict between the traditional obligations of a trustee and the requirement to invest ethically. Given this clear potential for conflict, if the requirement to ethically invest is to be justified, solid arguments need to be advanced to support such justification. Two such arguments are now advanced.

A. *The Growing Focus on Environmental and Social Issues*

It can be said that there is an increasing consciousness of and concern over environmental, social and human rights issues when considering corporate behaviour.⁶⁸ This concern is reflected in a number of ways. It is useful, indeed important to offer two examples.

63 For example M Scott Donald and Nicholas Taylor, 'Does "Sustainable" Investing Compromise the Obligations Owed by Superannuation Trustees?' (2008) 36 *ABLR* 47, 53. They argue that empirical evidence suggests that shares in companies pursuing sustainable business practices are unlikely to generate returns statistically different from any other shares when account is taken of different operational risks, different industries, capital structure and so on.

64 Donnan J 'Regulating Ethical Investment: Disclosure Under the Financial Services Reform Act' (2002) 13 *JBFLP* 155, 156.

65 Rosy Thornton, 'Ethical Investments: a Case of Disjointed Thinking', *Cambridge Law Journal*, 67(2) July 2008, 396, 401.

66 Emphasis added by author.

67 Rosy Thornton, 'Ethical Investments: a Case of Disjointed Thinking', *Cambridge Law Journal*, 67 (2) July 2008, 396, 402.

68 Paul U Ali 'Ethical Finance: Can Ethical Objectives be Achieved Through Financial Investments?' (2008) 26 *C&SLJ*, 127.

The first is the fact that there has over recent years been a shift in the position of the consuming community towards expecting company's to adopt ethical standards in decision making with regards to the appropriate priorities set by the company boards in their decision making. This is evidenced through a number of studies. For example a 1995 study carried out on behalf of a Canadian Labour Union indicated that over 92 per cent of Canadians would choose to buy products made ethically if given the choice between 'ethical' and regular products. 89 per cent said that they would pay more for clothing produced under ethical conditions and over two thirds would be more likely to shop in a store selling ethical products.⁶⁹ The importance of ethical standards through promoting sustainability has also been acknowledged by some of the larger transnational companies. For example Shell in its 2002 report on Sustainable Development emphasized the importance of adopting the 'good neighbourhood principle' with those communities with which it operates.⁷⁰ The adoption of acceptable environmental standards in its activities is now an important part of Shell's overall programme.⁷¹

The second can be evidenced in the requirement to act socially responsibly now being codified into legislation. This is seen in the recently enacted Companies Act 2006 in the United Kingdom. Section 173 of the legislation which is contained in the part of directors' obligations focuses upon the success of the company. When promoting the best interests of the company, directors are required to take account of amongst other things; the interests of the company's employees; the need to foster the company's business relationships with suppliers, customers and others; the impact of a company's operations on the community and the environment; the desirability of the company maintaining a reputation for high standards of business conduct.⁷² The requirement to take account of such factors is mandatory.⁷³ A company's success therefore is determined not just by having regard to its financial accounts and shareholder dividends but also to the relationship that it develops with its stakeholders. The explanatory notes accompanying the legislation sees this provision as giving effect to what is known as enlightened shareholder theory.⁷⁴ Enlightened shareholder theory recognizes that acting in a manner which is socially responsible can have long term benefits for a company.⁷⁵ It recognizes that shareholder and stakeholder interests are not mutually exclusive and can be 'relational and interdependent'.⁷⁶

69 Ibid 25.

70 Shell Oil Report 2002, *People Planet and Profits*. Here it is interesting to note that Shell adopted such a position in response to the negative international publicity that it received as a result of its joint venture with the Nigerian Government. Protests against environmental degradation as a result of oil extraction were responded to aggressively by the Nigerian Government. This aggressive response included human rights abuses. The fact that Shell was part of a joint venture linked indirectly if not directly to such abuses.

71 Ibid.

72 United Kingdom Companies Act 2006 s 173 (1).

73 As evidenced in the wording of the section 'have regard to'.

74 Available at <<http://www.apsi.gov.uk/acts/acts/2006/ukpga20060046>> accessed 28 June 2009.

75 Horrigan, 'Directors' Duties: Anglo-Australian Reform of Corporate Social Responsibility', (2005/2006) 87 *Reform* 17, 20.

76 Ibid.

These developments are significant.⁷⁷ Traditionally, companies and other corporate or commercial entities have as a practice attempted to externalize the negative aspects of their activities.⁷⁸ In this context there is a term known as externalities. An externality is where a person/company/entity imposes costs/damage on another person or third party through its actions without compensating them for such loss or damage.⁷⁹ Therefore the negative action and its detrimental impact is displaced onto the community or society at large. An example of this can be seen in a decision by a company to close an operation or plant which it has operated in a particular community for a number of years. Such a local operation may have contributed to the overall success of the company. Closure for the local community will mean job losses and closure of various businesses due to the overall local economic downturn. This is what is meant by displacing the consequences of a negative action on the community at large. The recent developments requiring companies to see themselves within the social matrix in which they operate has seen a growing expectation on the part of companies to internalize these externalities.⁸⁰ Sometimes this occurs through regulation for example with regards to environmental practices. At other times it comes about through social pressure with the community at large making it clear that they expect the adoption by commercial activities of ethical practices.⁸¹ In this regard there are varying degrees of pressure or enforcement to internalize negative impacts of the commercial activity. Such developments, it can be appreciated are significant. This leads to the second issue with regards to the possibility of ethical investment being incorporated into investment strategies of superannuation trusts. That is the influence that the superannuation trusts can exhibit as institutional investors.

B. The Impact of the Superannuation Trust as an Institutional Investor

The significance that superannuation trusts as institutional investors can have on the corporate governance and commercial direction is seen in the extent of their investor power. When commenting on the United Kingdom experience it was noted that superannuation funds, insurance companies and other large institutions own one half or more of the shares of all listed companies in the United Kingdom, the United States and Japan.⁸² In Australia as of March 2007, the superannuation fund industry held approximately A\$425.6 billion in the Australian equity market (approximately 28 per cent of the local market).⁸³ Ali notes that superannuation funds reunite ownership and control in commercial activities. These funds pool the collective wealth of Australians

77 In acknowledging the significance of such developments it also needs to be noted that while the UK legislation makes it mandatory for account to be taken of the interests of named stakeholders, the named stakeholders are not provided through the legislation any means of enforcing such a requirement.

78 Thomas Clark *International Corporate Governance, a Comparative Approach*, (2007) 68.

79 Paul U Ali 'Ethical Finance: Can Ethical Objectives be Achieved Through Financial Investments?' (2008) 26 *C&SLJ* 127, 132.

80 *Ibid* 133.

81 There are various studies to support this. For example in 1995 a study carried out on behalf of a Canadian Union indicated that over 92% of Canadians would choose to buy products made ethically if given the choice between 'ethical' and 'regular' products. (Christopher L Avery, Business and Human Rights in a Time of Change, *Amnesty International UK*, 24).

82 Lord Nicholls of Birkenhead, 'Trustees and their Broader Community: Where Duty, Morality and Ethics Converge'. *The Australian Law Journal* Vol 70 March (1996) 205, 206.

83 Australian Bureau of Statistics. *Managed Funds* (Cat No 5655) (1st March 2007), 1.

and then invest on their behalf through acquiring equity in Australian Corporations.⁸⁴ This in turn provides them with significant shareholder power meaning that they can have considerable influence over the corporate behaviour hence the linkage of ownership and control.⁸⁵ In this way they can promote social and environment objectives.⁸⁶

It is suggested that there are two ways that superannuation schemes as institutional investors can promote ethical behavior through ethical investments. The first is through investing in targeted companies. This can be done to either encourage or acknowledge ethical practices. The second is through constricting finance or deliberately choosing not to invest in particular enterprises.⁸⁷ Given the amount of finance that the Australian Superannuation fund has to invest, a clear decision to selectively avoid investing in companies whose practices contravene acceptable environmental or socially acceptable standards is going to exclude such excluded companies from a significant pool of finance.

The targeted financing of companies means that the institutional shareholders acquire a significant shareholding in the company and can influence corporate behavior through voting and other rights of a shareholder. This is sometimes known as 'shareholder engagement'.⁸⁸ Engagement goes further than voting and involves active dialogue with the company about the adoption of appropriate ethical standards and practices. The ability to undertake such engagement arises directly out of being a shareholder. However for this to be effective there would need to be a clearly stated objective for the superannuation funds to use their voting power to promote ethical practices. At the moment many funds are investing funds of a very large number of people for whom there is a considerable variance of political, social and moral views.⁸⁹ To achieve ethical investment guidelines which would be in accord with such divergent views would be very difficult if not impossible.

Therefore, while there are solid reasons for justifying ethical investment, the possible and sometimes clear conflict between ethical investment and traditional investment obligations remains. There is a need to either reconcile or manage this conflict. One method which is suggested by Rosy Thornton which makes a good deal of sense is to include the provision for ethical investment in the trust instrument.⁹⁰ This prima facie would enable the trustees to implement an ethical policy without legal or practical difficulty.⁹¹ There is however one qualification to this. That is that the terms are defined with sufficient clarity.⁹² The guidelines would need to be articulated in a manner which enabled the trustees to feel comfortable when making their investment choices. The difficulty however with private schemes at least is to ensure that beneficiaries support such guidelines which as just noted is very difficult. This leads Rosy Thornton to raise the question

84 Paul U Ali 'Ethical Finance: Can Ethical Objectives be Achieved Through Financial Investments?' (2008) 26 *C&SLJ* 127, 130.

85 *Ibid.*

86 *Ibid.*

87 *Ibid* 133.

88 Rosy Thornton, 'Ethical Investments: a Case of Disjointed Thinking', *Cambridge Law Journal*, 67 (2) July 2008, 396, 402.

89 This was a point noted in *Cowan and Others v Scargill and Others* [1985] 1 Ch 270, 288.

90 Rosy Thornton, 'Ethical Investments: a Case of Disjointed Thinking', *Cambridge Law Journal*, 67(2) July 2008, 296, 421.

91 *Ibid.*

92 *Ibid.*

about the appropriateness of superannuation trusts through ethical investment being used as vehicles to promote environmentally and socially responsible behavior.⁹³ This is a relevant question and it highlights the challenges of incorporating ethic principles into investment decisions regarding superannuation trusts. While noting these challenges, it is the position of this paper that given the investment influence of superannuation funds and the fact that society generally seems to be requiring commercial entities to adopt ethical practices and internalize externalities, it is appropriate for superannuation schemes to be involved in and promoting the use of ethical investment. The challenge is how to reconcile the different concerns and priorities. The New Zealand Government controlled superannuation fund to ensure provision of a base provision of superannuation payments for all of the population over 65, provides, it is submitted an example and model of how this can be achieved.

V. NEW ZEALAND SUPERANNUATION FUND

As a part of its commitment to the concept of a welfare state, New Zealand provides a flat rate of universal superannuation to people who are over 65.⁹⁴ Given the ageing population, it was decided to establish a government operated superannuation fund which had sufficient resources to meet the present and future costs of New Zealand superannuation.⁹⁵ This came about as the result of a reasonable amount of political consensus between the major parties.⁹⁶ The body responsible for managing the fund is a Crown Entity which is a corporate body with perpetual succession⁹⁷ known as the Guardians. This body is responsible for the investing of the fund and they are required to invest the Fund on a prudent, commercial basis and are required to administer the Fund in a manner which is consistent with:

- Best practice portfolio management; and
- Maximizing return without undue risk to the Fund as a whole; and
- Avoiding prejudice to New Zealand's reputation as a responsible member of the world community.⁹⁸

Section 61 requires that there be a statement of investment policies, standards, and procedures. These standards, policies and procedures are required to cover amongst other things:

- ethical investment, including policies, standards, or procedures for avoiding prejudice to New Zealand's reputation as a responsible member of the world community;⁹⁹
- the retention, exercise, or delegation of voting rights acquired through investments;¹⁰⁰ and
- the balance between risk and return in the overall Fund portfolio.¹⁰¹

What is significant in these provisions is that the commitment to ethical investment arises out of the need to uphold New Zealand's reputation as a responsible citizen. The requirements of

93 Ibid 422.

94 Currently the rate for a person living alone is \$347.77 per week. (Taken from the first Schedule of the New Zealand Superannuation Act 2001).

95 New Zealand Superannuation Act 2001.

96 The political co operation and consensus was seen in 1994 when it was necessary to gradually increase the eligibility age for superannuation from 60-65. It was cost which necessitated such a move.

97 New Zealand Superannuation Act 2001 s 48.

98 Ibid s 58.

99 Ibid s 61(d).

100 Ibid s 61(i).

101 Ibid s 61(e).

responsible citizenship are articulated in different documents such as the codified international instruments drafted and enacted by the United Nations General Assembly.¹⁰² Importance is given to voting rights to ensure that the Guardians can have maximum influence on the bodies in which it invests.¹⁰³ The requirement to find an appropriate balance between risk and return in the overall fund portfolio shows the commitment to standard practices of investment.¹⁰⁴ What the legislation through its developed policies attempts to do here is to balance the requirement for prudent best practice investment with the need for ethical investment. In terms of ethical investment, the Guardians are guided by the United Nations Principles for Responsible Investment which they are signatories to and the United Nations Global Compact.¹⁰⁵ The principles for responsible investment place emphasis on the long term interests of beneficiaries. They acknowledge that environmental, social and corporate governance issues can affect the performance of investment portfolios.¹⁰⁶ They also acknowledge that the adoption of such principles better aligns the companies to the broader objectives of society.¹⁰⁷ The United Nations Global Compact which again the New Zealand Superannuation Fund has committed itself to encourages listed companies around the world to adopt international standards on human rights, working conditions, the environment and anti corruption.¹⁰⁸ The Guardians give effect to ethical investment through voting, engagement and divestment.¹⁰⁹

The effect of the voting rights within the context of ethical investment has already been canvassed. Institutional investors with significant shareholding can have a definite impact on the direction of the company in terms of affirmatively advocating socially responsible and policies through appropriate exercise of their voting rights. The impact can be even greater when a number of institutional investors reach an agreement to support the same policies in terms of responsible/ethical investment. This is especially the case where the institutional investors combined shareholding exceeds 50 per cent of the total share holding making the group majority shareholders thereby being able to determine policy. To ensure consistency in its voting behavior, the New Zealand Superannuation Fund has developed and committed itself to a set of voting guidelines.¹¹⁰ These guidelines emphasise the importance of good and transparent corporate governance and provide guidance on such matters as the appointment and removal of directors and the determination of appropriate remuneration.¹¹¹ The importance of transparency is contained in all of the guidelines. These guidelines acknowledge that the adoption of good corporate governance practic-

102 Such instruments have established and articulated reasonably clear international human rights standards.

103 NZ Superannuation Fund: Responsible Investment in Practise Reports available at <<http://www.nzsuperfund.co.nz/Index.asp>> accessed 28 June 2009.

104 Other traditional trust investment practices are included in s 61, New Zealand Superannuation Act 2001.

105 Available at <<http://www.nzsuperfund.co.nz/index.asp>> accessed 28 June 2009.

106 Available at <<http://www.unpri.org>> The New Zealand Superannuation fund is not the fund who is a signatory to these Principles. Other New Zealand investors which are signatories include; Accident Compensation Corporation, New Zealand Fire Service Superannuation Scheme; Canterbury Community Trust; Trust Waikato; DNZ Property Group Limited and Trust Waikato.

107 Ibid.

108 Available at <<http://www.nzsuperfund.co.nz/index.asp>> Responsible Investment Updates. Accessed 28 June 2009.

109 NZ Superannuation Fund: Responsible Investment in Practice Reports available at <<http://www.nzsuperfund.co.nz/Index.asp>> accessed 28 June 2009.

110 ISSNZ 2006 Guidelines pdf. Available at <<http://www.nzsuperfund.co.nz/index.asp>> Responsible Investment - Responsible Investment Reports. Accessed 28 June 2009.

111 Ibid.

es goes hand in hand with a commitment to upholding core standards of human rights and labour conditions as well as being responsible in terms of environmental standards.

Engagement focuses upon investor dialogue with the Company board and executive management to encourage ongoing evaluation of their policies and practices so as to determine whether their operations may directly or indirectly support human rights abuses or poor environment practices. This is a practice which the New Zealand Superannuation Fund Guardians are very much committed to.¹¹² The aim of such engagement is to encourage companies operating in situations where human rights violations are a clear possibility if not a reality, to adopt strong human rights policies.¹¹³ Recent engagement has occurred through concern over human rights and environmental practices in the global steel industry. For example concern was expressed from different sectors over some of the practices of Freeport McMoran Copper and Gold (Freeport). This led to the request by the Guardians for further information with regards to their human rights and environment practices. There has also been communication with other shareholders about these issues.¹¹⁴ In this way engagement is not just occurring with the Board but also the other shareholders. This clearly strengthens the impact of engagement. One clear focus with regards to engagement on human rights issues is the adoption of acceptable labour standards. An example of such a concern arose in 2006 with regards to the labour conditions experienced by Brazilian charcoal producers. Charcoal is a product which is an element of the steel production chain.¹¹⁵ Concern was expressed that the steel industry and large steel users, such as car manufacturers, were potentially identified with these practices through using materials which had been produced in circumstances where inappropriate labour standards were being practiced.¹¹⁶ This led the Guardians and other concerned investors to meet with companies whose reputation, and potentially that of their brands, could be negatively affected due to sourcing from the Brazilian pig-iron industry.¹¹⁷ The response was varied with some companies being prepared to give appropriate consideration to the dilemmas while other companies were not.¹¹⁸ Such an example is significant as it reflects concern being shown about indirect as well as direct association with human rights violations.

The engagement process encourages companies to take such issues concerning human rights and environmental standards seriously and to consider how they can be appropriately addressed. The fact that engagement occurs not just with the Company Board but also with other shareholders is significant and strengthens the effectiveness of engagement. This is especially the case when other shareholders have also committed themselves to the United Nations Principles for Responsible Develop and the United Nations Global Compact. This means that the concerned shareholders have a common focus.

Divestment has occurred in a number of situations. For example, in 2006 the Guardians approved divestment of Singapore Technologies Engineering Ltd, Aliant Techsystems Inc, General Dynamic Corp, and Textron Systems Corp from the Funds portfolios due to the involvement of

112 Ibid.

113 Ibid.

114 NZ Superannuation Fund: Responsible Investment in Practice Reports. Available at <<http://www.nzsuperfund.co.nz/index.asp>> accessed 28 June 2009.

115 Available at <<http://www.nzsuperfund.co.nz/index.asp>> Investment Strategy/Responsible Investment/ Responsible Investment in Practise Reports accessed 28 June 2009.

116 Ibid.

117 Ibid.

118 Ibid.

these companies in personal mines.¹¹⁹ They also excluded Maruha Group Inc due to its involvement in the processing of whale meat.¹²⁰ The fund managers have also been directed to exclude the securities of eleven companies involved in the manufacture of cluster munitions from the fund.¹²¹ Further recent divestment has also occurred with companies involved in the tobacco industry.¹²² Engagement was considered but was not considered to be an effective approach in such circumstances.¹²³ This being said the UN Principles for Responsible Investment favour the process of engagement if at all possible as this promotes change in a co operative and positive manner.¹²⁴ Because the New Zealand Superannuation fund's single investment in a particular company would not be of a magnitude so as to impact on the company through divestment, it could be suggested that divestment essentially occurs where the guardians consider that certain practices such as the manufacturing of cluster bombs are so contrary to international law that complete distancing is required by New Zealand. Divestment achieves the appropriate distancing. It also amounts to a clear statement about New Zealand's position on particular issues. Such examples could be said to be indicative of the fund adopting a socially dictated policy of investment. The foundation for this socially dictated policy lies in the legislation.¹²⁵

The Guardians are clearly using the mechanisms identified earlier in the paper to promote ethical investing. However, the New Zealand Superannuation Fund is a fully government operated fund established by statute to administer and manage a fund to ensure the provision of superannuation payments to all members of the population who have reached 65 years. Given these circumstances it is understandable that the Government wishes to maintain its reputation as a responsible member of the world community. This is a very different situation from a large private superannuation fund, responsible for investing employee and employer contributions for a large number of members with differing political, social and moral views. The members invest in order to obtain a guaranteed income during retirement. Trustees entrusted with the investment of these funds are required under traditional trust law to act in the beneficiaries best financial interests.

Perhaps a means of dealing with this clear conflict can be found in a former superannuation scheme which was introduced into New Zealand in 1973 but being repealed in 1976 was very short lived. This scheme was contained in the New Zealand Superannuation Corporation Act 1973. This scheme required compulsory contribution by the employees and self employed people.¹²⁶ The contributions were placed into the New Zealand Superannuation Fund¹²⁷ and managed by a Board who were Government appointed.¹²⁸ Certain senior Government officials were also a part of this Board, which was responsible for the investment of the funds.¹²⁹ Contribution to superannuation was compulsory. However, it was possible for people to gain approval to invest in

119 Ibid.

120 Ibid.

121 NZ Superannuation Fund: Responsible Investment Updates available at <<http://www.nzsuperfund.co.nz/index.asp>> accessed 28 June 2009.

122 Ibid.

123 Ibid.

124 Ibid.

125 New Zealand Superannuation Act 2001 s 61(d).

126 S 35 New Zealand Superannuation Corporation Act 1973.

127 Ibid s 20.

128 Ibid s 21.

129 Ibid s 27.

alternative schemes which were approved by the Government.¹³⁰ It needs to be emphasized that such schemes required statutory approval. Such a statutory scheme, it could be argued provides a justifiable basis to require superannuation schemes to adopt ethical investing practices when investing the funds. A government established scheme would expect investment practices to be adopted which were in accord with the country being a responsible global citizen. Approved alternative schemes would be expected to adopt the same standards. Such standards would be codified in respective legislation. The justification for this is:

- i. The size of the superannuation investments which gives them a significant influence in the global economy. Such influence can be either positive or negative in terms of human rights or environmental matters;
- ii. The fact that basic standards of human rights and environmental protection have been well articulated and justified, the implementation of such practices should be encouraged in every possible manner.¹³¹ States wishing to be good corporate citizens should be particular in ensuring that no direct or indirect actions coming from within its jurisdiction support human rights breaches or inappropriate environmental practices;
- iii. Corporate bodies should be encouraged to internalize their externalities.

A government operated contributory superannuation scheme requiring other approved private schemes to adopt the same standards of ethical investing would ensure consistency thereby providing equity among all members of all schemes. On this basis it would be a logical step to require private superannuation schemes governed and regulated by legislation such as the Australian Superannuation Industry (Supervision) Act 1993 to contain the same requirements for ethical investment. Such a requirement could be incorporated into the covenants in section 52 of the legislation which have been discussed earlier in the paper. Other amendments would also be required with regards to reporting requirements, monitoring and supervision. In this manner it is the government who is the embodiment of the people which establishes the parameters for ethical investment. Such parameters would be based upon the United Nations Principles for Responsible Development and other relevant international documents which jurisdictions such as Australia and New Zealand have committed themselves to. This addresses the issue relating to diverging views of beneficiaries on social and political matters in different private funds. The restrictive parameters that a State adopts, is to uphold its international reputation and to contribute to the advancement of internationally accepted standards. The adoption of such an approach would require further regulation on the part of the Australian and New Zealand legislatures.

VI. CONCLUSION

Superannuation schemes exist to ensure adequate retirement income to those who contribute to such schemes. The trustees of such schemes must manage the fund in the best interests of the beneficiaries. This means their financial interests which in turn justifies a narrow investment focus using traditional investment strategies. However given the magnitude that superannuation investments have achieved over recent years, considerable influence can be exerted by these schemes on the commercial entities that they chose to invest in. Given such influence and the growing commitment to responsible investment practices, it is only appropriate that ethical investment

¹³⁰ *Ibid* s 75.

¹³¹ Louis Henkin, 'International Law: Politics, Values and Functions', contained in: 216 *Collected Courses of The Hague Academy of International Law*, 13 (Vol IV) (1989) 251.

practices are adopted to ensure that the funds contribute to the advancement of universal human rights and labour practices standards and the exercising of responsible practices in environmental matters. To avoid placing trustees in an unfair conflict situation between traditional and ethical investment obligations, it is important to incorporate the requirement of responsible ethical investment through legislation and regulation. Such regulation must also still require a well managed investment portfolio which spreads risk as the New Zealand Superannuation Act 2001 does. The trustees and Guardians must still act in the best interests of the beneficiaries and this means their financial interests. However they are restricted in their investment decisions and practices through the appropriate legislation requiring the adoption of ethical practice which they must comply with. As Sir Robert Megarry noted in *Cowan*, trustees must act in the best interests of beneficiaries but in a manner which does not break the law.¹³²

132 *Cowan and Others v Scargill and Others* [1985] 1 Ch 270, 287.