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An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct

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Introduction

Scholars of corporate governance commonly divide the world into two spheres: the Anglo-American "outsider" system and the continental European and Japanese "insider" system, each with a characteristic set of structural elements, ownership patterns, and strengths and weaknesses.[1] In addition to having distinct corporate governance structures, inhabitants of these two spheres make different assumptions about corporate goals. In general, the Anglo-American approach is understood to valorize "shareholder value,"[2] while the European approach includes a broader social class of "stakeholders"—employees, creditors, suppliers, communities, and even the environment—within the ambit of managerial concern.[3]

During the last decade, a variety of academic disciplines, including law, finance, and sociology, have paid sustained attention to the potential convergence of these two systems of corporate governance.[4] American law professors who study convergence have primarily examined whether European companies are moving toward the Anglo-American pattern[5]—either because of cross-border mergers and acquisitions[6] resulting from American

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1. For some starting points in the extensive literature, see generally Ruth V. Aguilera & Gregory Jackson, *The Cross-National Diversity of Corporate Governance: Dimensions and Determinants*, 28 ACAD. OF MGMT. REV. 447 (2003), which proposes a theory that explains the differences between the Continental European stakeholder model and the British and American shareholder model, and Rafael LaPorta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999), which presents empirical evidence illustrating the different corporate ownership patterns in various countries.

2. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 794 (2002) (asserting that "most modern academic commentary on corporate law . . . rests . . . on the principle of shareholder primacy").

3. *See* Aguilera & Jackson, *supra* note 1, at 459-61.

4. For an overview of the convergence discussion in multiple disciplines, see generally Steen Thomsen, *Convergence of Corporate Governance During the Stock Market Bubble: Towards Anglo-American or European Standards?*, *in* CORPORATE GOVERNANCE AND FIRM ORGANIZATION 297-317 (Anna Grandori ed., 2004).

5. For overviews of the discussion among law professors, see generally John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 646-47 (1999), which characterizes the debate as one between neoclassical economists and another group of scholars emphasizing the importance of political forces and path dependency, and Sanford M. Jacoby, *Corporate Governance in Comparative Perspective: Prospects for Convergence*, 22 COMP. LABOR L. & POL'Y J. 5 (2000), which summarizes legal, political, and social forces driving convergence as well as factors such as path dependence and micro- and macroeconomic forces that limit convergence. For a more critical view of convergence, see Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 COMP. LABOR L. & POL'Y J. 97, 123-26 (2000), which focuses on the allocation of power between shareholders and labor. And for an optimistic pre-Enron account of the coming predominance of the American shareholder-centric view of the firm, see Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439, 449-58 (2001).

6. *See generally* Jeffrey N. Gordon, *Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany*, 5 COLUM. J. EUR. L. 219 (1999) (examining whether cross-border mergers, such as the one between Chrysler and Daimler-Benz, are likely to lead to convergence).

institutional capital investing abroad,[7] or as a consequence of global competition,[8] each of which favors a focus on shareholder value. Contrary views suggest that corporate governance systems will not converge to any great extent because of politics, path dependence, and history.[9] The American literature has paid far less attention to the opposite phenomenon: the factors that may encourage British and even American companies to engage in some degree of stakeholder thinking. This Article analyzes recent legal developments that are promoting precisely this convergence.

Recent convergence on stakeholder thinking has been paralleled by the emergence of the global corporate social responsibility ("CSR") movement. We argue that there is a causal relationship between these parallel developments and, specifically, that the CSR movement has been a major factor in moving corporate governance theory in the stakeholder direction by demanding that companies go beyond the creation of short-term shareholder wealth in pursuit of broader objectives such as sustainable growth, equitable employment practices, and long-term social and environmental well-being. The CSR movement has pursued these objectives both directly, by pressing for substantive changes in corporate behavior, and indirectly, by promoting expanded disclosure of corporate social and environmental information, in the expectation that shareholders will eventually force the desired substantive changes.[10] In many countries, most notably the United States, CSR advocates have had the daunting task of persuading the corporate and legal communities to move from a narrow focus on shareholders' immediate financial returns to a broader measure of corporate well-being, what could be called "stakeholder value."[11]

Notwithstanding the difficulty of that task, we argue, the historically unified Anglo-American front may be breaking down as a result of CSR

7. *See* Jacoby, *supra* note 5, at 14-18 (arguing that, while U.S. investment abroad may facilitate a convergence on the U.S. "equity culture," such an outcome is unlikely given differences in culture, history, and the role of labor).

8. *See* Hansmann & Kraakman, *supra* note 5, at 449-52 (arguing that shareholder-centered corporate governance systems have a competitive advantage in global product and financial markets).

9. *See generally* Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Governance and Ownership*, 52 STAN. L. REV. 127 (1999) (focusing on path dependence); Jacoby, *supra* note 5 (concluding that the Anglo-American system of corporate governance and the Continental European style will remain distinct); Curtis J. Milhaupt, *Property Rights in Firms*, 84 VA. L. REV. 1145, 1158-65 (1998) (arguing that differences in corporate governance systems stem from differences in property rights systems reinforced by inefficiencies in the market for political control).

10. For further discussion of the global CSR movement, see generally RUTH V. AGUILERA ET AL., PUTTING THE S BACK IN CORPORATE SOCIAL RESPONSIBILITY: A MULTI-LEVEL THEORY OF SOCIAL CHANGE IN ORGANIZATIONS (Univ. of Ill. Ctr. for Int'l Bus. Educ. & Research, Working Paper No. 04-0107, 2004), *available at* http://www.ilir.uiuc.edu/lubotsky/AguileraRuppWilliamsGanapathiJuly04final.pdf. For background on expanded social and environmental disclosure, see generally Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1273-99 (1999).

11. *See* Douglas M. Branson, *Corporate Governance "Reform" and the New Corporate Social Responsibility*, 62 U. PITT. L. REV. 605, 611-15 (2001).

advocates' actions and governments' and companies' reactions.[12] While American corporate governance remains firmly focused on shareholder value, the United Kingdom ("UK") appears to be setting out on a "third way" that merges elements of the shareholder and stakeholder approaches. On a number of governance issues, including takeovers and the role of labor, the United Kingdom continues to resist European influences.[13] In the realm of corporate social responsibility, however, Britain has very recently emerged as a leader. Its "third way" explicitly advocates a shift in focus to long-term, "enlightened shareholder value" and requires that companies recognize and report on their effects on extended stakeholder constituencies, such as employees, suppliers, communities, and the environment. This Article describes and analyzes these new developments and argues that they have major implications for the general theory of the corporation.

The initial lens through which we examine pressures for pro-stakeholder convergence is the identification and disclosure of corporate information concerning social and environmental risks. When American lawyers think of the identification of risk, they naturally think first of financial accounting and the disclosure of financial risks and uncertainties. Events in the United States in the last few years, in which the accuracy of the financial statements of mainstream companies such as Enron, WorldCom, Global Crossing, Qwest, Xerox, Sunbeam, Waste Management, and Cendant has been challenged,[14] have focused public and legislative attention on the quality of companies' financial disclosure. Clearly, this

12. Some would argue that there never has been a "historically unified Anglo-American front." Professor Cheffins has examined the history of British share ownership patterns and has shown that widely dispersed share ownership developed later in Britain than in the United States, and for different reasons. *See* Brian R. Cheffins, *History and the Global Corporate Governance Revolution: The UK Perspective*, Bus. Hist. Oct., 2001, at 87-88 (arguing that "the three factors that have been identified as important" in describing the necessary preconditions to the development of widely dispersed share ownership—"company law, financial services regulation and political ideology—are not decisive variables" in describing the history of British share ownership). Professors Armour, Deakin, and Konzelmann have also suggested recently that there is not a unified "Anglo-American" concept of "shareholder wealth maximizing," and that any consensus between the two countries about the social value of maximizing shareholder wealth is fragile. *See* John Armour et al., *Shareholder Primacy and the Trajectory of UK Corporate Governance*, 41 Brit. J. of Indus. Rel. 531, 531-32 (2003). (Our analysis of corporate governance in the UK was motivated in part by the excellent work of Professors Armour, Deakin, and Konzelmann. In particular, their discussion of the changing behavior of institutional investors in the UK caused us to wonder why such a change was occurring in the UK and not in the United States.) Yet, there clearly are important similarities between the two systems, and a widely used intellectual construct, "Anglo-American corporate governance." It is to this intellectual construct that this Article is addressed.

13. *See* Armour et al., *supra* note 12, at 534-36 (discussing takeover law in the UK); Catherine Barnard et al., *"Fog in the Channel, Continent Isolated": Britain as a Model for EU Social and Economic Policy?*, 34 Indus. Rel. J. 461, 463-69 (2003) (discussing resistance in the UK to the EU's working time labor directives).

14. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 308-30 (2004).

focus is appropriate, since accurate financial information is critical to investors' confidence and to the proper functioning of the capital markets.

There is, however, another risk-related trend in world markets that has been little noted in the American corporate law literature: the increasing number of global firms that have started to report publicly about the social and environmental risks they face.[15] In recent years, many of the world's largest companies have started to produce social, environmental, or sustainability reports (which integrate social, environmental, and financial information) in addition to their financial reports. In 2002, 45% of the Global *Fortune* Top 250 companies ("GFT250") produced a separate social, environmental, or sustainability report, compared to 35% in 1999, and compared to 13% of the Global 100 in 1993.[16] In 2002, 29% of these reports were independently verified, most often by accounting firms, up from 19% in 1999.[17] These statistics reflect trends that began in the early 1990s: the percentage of the top 100 companies in each of nineteen countries that have produced social reports grew from 13% in 1993 to 23% in 2002.[18] And these percentages may be deceptively low, given much higher reporting rates in some of the largest countries. Thus, in Japan, 72% of the top 100 companies publish separate social reports; in the UK, 49% do; as do 36% in the United States, and between 25% and 35% in Northern Europe.[19]

Much of this disclosure is based on companies' voluntary decisions to engage in expanded triple-bottom-line (financial, social, and environmental) reporting. In some countries, however, there are newly promulgated legal mandates that require the disclosure of much more information about social and environmental risks. We focus on developments in the European Union ("EU"), France, and the UK as illustrative of the types of rules being promulgated and contrast those with the more limited requirements for social and environmental disclosure in the United States. We suggest

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15. The term "social risk," as used in this Article, includes risks arising from companies' labor relationships and practices and risks arising from companies' relationships with their communities and political environments in which they operate around the world.

16. KPMG International Survey of Corporate Sustainability Reporting 2002, at 9 (2002), *available at* http://www.wimm.nl/publicaties/KPMG2002.pdf. The KPMG Sustainability Group began publishing international surveys describing the increase in sustainability reporting in 1993. However, the reporting rates of 1993 cannot be directly compared to those of 2002 because various parameters changed over the years. *See id.* at 27 app. A.

17. *Id.* at 18.

18. *Id.* at 12.

19. *Id.* at 14. There is a wide range of specificity in these reports, as well as a wide range of subjects covered. We evaluate the meaning of such reports in a companion empirical project briefly described in Cynthia A. Williams & John M. Conley, *An Emerging Third Way: The Erosion of the Anglo-American Shareholder Value Theory,* NEW ACAD. REV., Autumn 2004, 96. Here, we simply point to them as an indication that the largest companies worldwide are recognizing a value in reporting on their social and environmental relationships, and we assert that these expanded communications are one impact of the CSR movement.

that this contrast illuminates the comparative conceptions of corporate governance at the center of this discussion.

As we discuss in Part I, current developments in the UK present an especially revealing instance of the shareholder-stakeholder conflict. In some important respects, British corporate law values and corporate governance structures continue to be aligned with their American counterparts. The United States and the UK today share a pattern of widely dispersed share ownership, in contrast to Europe and Japan, where more companies are family-owned, otherwise have a dominant shareholder, or exhibit patterns of concentrated bank share-ownership or cross-shareholding between bank and industry.[20] Both countries have well-developed securities markets, and both depend upon similar mechanisms to promote managerial accountability, including financial transparency, stock market valuations, and the market for corporate control.[21] Moreover, the United States and the UK both exhibit a form of shareholder capitalism, under which the purpose of the corporation is to maximize shareholder wealth, in contrast to the European stakeholder view, according to which managers need to balance the interests of multiple constituencies when making decisions.[22]

This dichotomy has been evident in the EU's decades-long effort to harmonize the national corporate laws of its Member States.[23] In the negotiations over a proposed Thirteenth Directive dealing with hostile takeovers, for example, the British government has advocated a position that would facilitate such takeovers as a form of market discipline over ineffi-

20. *See* LaPorta et al., *supra* note 1, 491-511.

21. Like others, we are dubious that the market for corporate control is simply a mechanism to promote managerial accountability, *see, e.g.*, John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 274-75 (2000) (arguing that by promoting managerial continuity, the poison pill does not in fact harm shareholders and implying that increasing liquidity in the market for corporate governance does not necessarily promote managerial accountability and shareholder interests), since 98% of mergers or acquisitions in the United States are "friendly" transactions, meaning that both companies' boards of directors agree to the merger. MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS AND FREEZEOUTS § 1.01 (2004). Moreover the majority of merged companies underperform in the market with respect to their industry benchmark, *see* James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 BUFF. L. REV. 249, 257 (2001), while top managers will have received generous "golden handshakes" if they do not continue with the merged company, and multimillion dollar bonuses for completing a merger—in many cases, even if they do stay on. *See* Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 144-47 (2001). Thus, a majority of mergers and acquisitions could represent a failure of managerial accountability and a huge transfer of wealth from a company and its shareholders to its managers, directors, investment bankers, and lawyers. By this view, the market for corporate control functions very badly if it is meant to promote managerial accountability. For a review of the empirical evidence on the efficiency of the corporate control market, see Barnard et al., *supra* note 13, at 469-71.

22. *See* sources cited *supra* note 1; *see also* Brian R. Cheffins, *The Metamorphosis of "Germany, Inc.": The Case of Executive Pay*, 49 AM. J. COMP. L. 497, 498-501 (2001) (providing an overview of the shareholder-stakeholder divide).

23. *See infra* notes 61-86 and accompanying text.

cient companies.[24] Strong resistance has come from stakeholder countries such as Germany, where employee representatives on supervisory boards have an equal say with shareholders in responding to takeover bids and shareholding is concentrated in large financial institutions.[25]

In other respects, though, shareholder capitalism in the UK is beginning to diverge from its American counterpart and develop its third way: a long-term enlightened shareholder value perspective with strong elements of European stakeholder thinking. This divergence is occurring because a number of institutions shaping corporate governance in the UK are requiring or encouraging broader thinking about stakeholder interests.[26] Such institutional pressures either do not exist at the moment in the United States or are present in much weaker form. These institutions include the EU; the UK government; institutional investors, particularly pension funds and insurance companies that are starting to attend to long-term risks such as climate change; and nongovernmental organizations ("NGOs").

In our analysis of these differing institutional pressures, we focus particularly on differences in the composition of the institutional investor community and the actions it takes. Both countries' markets have a high level of institutional investment—over half of total share ownership in each case—but the composition of this ownership differs. In the UK, the institutional investor segment is dominated by pension funds and insurance companies, which necessarily have a long-term perspective on investment risk.[27] In the United States, by contrast, mutual funds, which are likely to have a shorter-term perspective, are far more prevalent.[28] Perhaps reflective of the long-term obligations of pension funds and insurance companies, a substantial percentage of institutional investment financial managers in the UK are affiliated with socially responsible investment networks ("SRI") or informal SRI collaborations.[29] Institutional investor industry groups have promulgated standards calling on portfolio companies to disclose information about their social and environmental risks and about their management systems on an annual basis and have suggested that a company's approach to social responsibility is among the corporate governance concerns that will determine investor engagement and action.[30] And institutional investors have established visible coalitions among themselves and with government and NGOs to address long-term problems such as climate change, HIV and AIDS, and government corrup-

24. *See* Barnard et al., *supra* note 13, at 469-73.

25. *See id.* at 473.

26. For an analysis of these institutional pressures, see Ian Jones & Michael Pollitt, *Understanding How Issues in Corporate Governance Develop,* 12 CORP. GOV. 162 (2004).

27. *See infra* notes 237-242 and accompanying text.

28. *See infra* note 243 and accompanying text.

29. For instance, eleven of the twenty leading fund managers for the UK pension industry are members or affiliates of the UK Social Investment Forum, a socially responsible investment fund trade group. *See infra* note 246 and accompanying text.

30. *See infra* text accompanying notes 265-269. These groups include the Association of British Insurers ("ABI") and the Institutional Shareholders' Committee. *See infra* notes 266-274 and accompanying text.

tion in emerging economies.[31] Through these and other actions described below, institutional investors in the UK have acted, and reacted, to bring stakeholder concerns and issues of social responsibility into the financial mainstream in a way that has not happened in the United States.

Stakeholder influence in the UK can also be seen rather dramatically in the process, still ongoing, of promulgating a new code concerning the disclosure of environmental and social risks. On May 5, 2004, after an extensive public consultation process, the British government introduced draft regulations that will require 1290 British-based companies listed on the London Stock Exchange ("LSE"), the New York Stock Exchange ("NYSE"), or NASDAQ to publish an annual Operating and Financial Review and Directors Report ("OFR").[32] The OFR, among other things, will require companies to identify material social and environmental risks and to disclose information about those risks. This regulation is the culmination of a decade-long process of prestigious commissions examining corporate governance in the UK.[33] This process, in conjunction with changing norms among British institutional investors, has also operated to give greater prominence to corporate social and environmental issues.

In light of these developments in the UK, we suggest in Part II that the conventional thinking about the dichotomy between the Anglo-American shareholder model of the corporation and the European stakeholder model needs to be refined in at least two ways. First, a British corporate governance system that embodies a concept of enlightened shareholder value may be emerging to occupy a unique third position between the American shareholder wealth-maximizing position and the continental stakeholder model. As we interpret these developments, the UK's goal appears to be to maintain its corporations' financial accountability to a constituency of dispersed, independent shareholders while simultaneously using market forces to nudge companies in the direction of greater social responsibility. Because of London's role as an important venue for cross-border securities trades and fund management,[34] the norms of corporate disclosure set by London's institutional investors and fund managers can be expected to influence actions beyond Britain.[35] In fact, the social and environmental

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31. *See infra* notes 281-287 and accompanying text.

32. The Draft Companies Act 1985 (Operating and Financial Review and Directors' Report) Regulations 2005. *See infra* notes 132-168 and accompanying text.

33. This process is analyzed in Jones & Pollitt, *supra* note 26, at 163.

34. *See* Gordon L. Clark, *London in the European Financial Services Industry: Locational Advantage and Product Complementarities*, 2 J.ECON. GEOGRAPHY 433, 433-34 (2002) (asserting that "[e]ven if Wall Street is much larger in terms of traded volume, listed securities and total assets, London dominates cross-border transactions and is the favoured location of many foreign banks and market intermediaries."). We thank Professor Clark for bringing this point to our attention and emphasizing its significance.

35. Such an influence would be consistent with the UK's historical role as a progenitor of corporate governance reform. *See* Brian R. Cheffins, *Corporate Governance Reform: Britain as an Exporter*, 8 HUME PAPERS ON PUB. POL'Y 10, 10-11 (2000). Professor Cheffins asserts that the UK has a "distinguished pedigree as an exporter of legal concepts and innovations," which he illustrates with several examples from UK company law. *Id.* Though the UK has gradually been losing influence in this regard, it is

transparency newly required by the OFR may become the global gold standard of corporate governance. England may thus recapture some of the influence of her lost mercantile empire by becoming the world's de facto corporate governance regulator.[36] Second, even in the United States, where market pressures have advanced the concept of shareholder primacy to a greater extent than in other countries, stakeholders' interests are starting to be articulated with more vigor and efficacy within the corporation. Here too, the global CSR movement is blurring the edges of the traditional shareholder-stakeholder distinction.

Despite these trends that we regard as generally positive, two caveats are in order. First, at several points in the Article we inject a cautionary note based on early results from a companion empirical project.[37] In order to examine the practical effects of the legal developments we discuss here, we have begun to interview people in corporations, NGOs, socially responsible investing funds, "mainstream" investment funds, and public relations firms, both in the United States and in the UK; have attended major CSR gatherings (both real and online) as ethnographic observers; and have undertaken linguistic analyses of a number of published CSR reports. Multinational corporations have begun to engage in new forms of communications, including stakeholder dialogues and wide-ranging social and environmental reports. While these communications are a reaction to heightened legal requirements and social expectations, the companies themselves have a major role in controlling the discussion and debate and thereby shaping the same social expectations to which they are ostensibly responding. It is thus unclear whether these communication strategies will lead to substantive changes in corporate behavior or will simply provide "safe" (from the companies' point of view) venues for the disaffected to let off steam. This pragmatic question, which is central to our empirical research, must be answered before the ultimate impact of the legal developments we discuss in this Article can fully be evaluated.

Second, the "corporate governance complex" in every country today includes managerial and shareholder as well as stakeholder influences. Notwithstanding the developments we have just reviewed, there are clearly shareholder value pressures at work in the UK, and we do not mean to suggest otherwise. The mergers and acquisitions culture, the financial

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seeking to recapture its former position through its ongoing Company Law Reform process.

36. We recognize that the disclosure standards and particularly the accounting standards of the United States typically have been regarded as the most stringent in the world. *See* John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1788-90 (2002). Moreover, enforcement concerning disclosure in the United States is more vigorous, given the resources of both the government and private plaintiffs. *See id.* at 1793-97. With respect to social and environmental disclosure, we assert that the London standard is surely going to become the better standard, at least unless the United States starts to require more information about long-term social and environmental risks.

37. These preliminary findings, as well as our empirical methods, are discussed in Williams & Conley, *supra* note 19.

press, financial globalization, and managerial self-interest are powerful incentives for companies to focus on short-term stock valuations.[38] The pro-stakeholder influences of the CSR movement are still minority cross-currents in the United States, and probably remain such even in the UK. They may ultimately prove to be weak, ephemeral, and therefore ineffective at fundamentally changing the views of company directors and managers about what their job is and whose interests they ought to consider. Nonetheless, we argue, the relatively stronger pro-stakeholder influences in the UK are already leading to a subtle shift in the conceptualization of the corporate purpose from maximizing shareholder wealth in the short term, as in the United States, to the creation of a broader-based and longer-term "enlightened shareholder value."

The structure of this Article is straightforward. Part I analyzes recent legal developments in several countries that are simultaneously reflecting and promoting convergence on the stakeholder model. We review recent enactments in the EU and several of its member countries, the ongoing CSR and corporate governance reform process in the UK, and some little-discussed but potentially significant provisions in the United States. Part II develops the implications of these developments, particularly those in the UK, for corporate governance theory. The Article concludes with some thoughts about the future influence of the CSR movement both here and abroad.

I. Mandated Disclosure of Social and Environmental Risks

The last few years have seen concentrated attention on questions of corporate governance, much of it focused on financial issues. Comparative corporate law writers have reveled in the fascinating nuances of different countries' corporate governance systems and debated possibilities of convergence.[39] European and Japanese companies and their home countries

38. *See* Don Young & Pat Scott, Having Their Cake . . . How the City and Big Bosses Are Consuming UK Business 35-46 (2004) (discussing the pressures from the financial press, investment bankers, and the mergers and acquisitions culture to emphasize shareholder value); Armour et al., *supra* note 12, at 534-36 (asserting that the UK regulations governing mergers and acquisitions have the effect of encouraging directors to focus on short-term shareholder wealth); Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 Tul. L. Rev. 1363, 1377-84 (2002) (arguing that managers justify decisions by referring to their duty to increase "shareholder value" when, in fact, the decisions primarily advance the managers' own interests). We recognize that on the most robust view of the efficient capital market hypothesis ("E.C.M.H"), there should not be a difference between the long-term value of a company (and thus managing for the long term) and a company's current stock value. *See* Lynn Stout, *The Mechanics of Market Inefficiency: An Introduction to the New Finance*, 28 J. Corp. L. 635, 637. Yet, some of the assumptions underlying the E.C.M.H. may be overly optimistic, particularly those regarding the ability of the market to accurately value long-term risks and investments. *See id.* Explicitly adopting a policy framework to encourage managing for the long term, as the UK has, may, in fact, lead to different management decisions. *Cf. id.* at 636-39 (discussing factors that encourage managers in the United States to focus on short-term profits).

39. *See generally* Coffee, *supra* note 5 (discussing convergence in securities regulation).

have come under increasing pressure to adopt the American idea of shareholder value as the definitive measure of a well-functioning company,[40] and the EU has continued to examine issues of corporate governance and corporate law.[41] This attention has only intensified in the post-Enron era. That event has inspired a debate in the United States about how mechanisms of management accountability can be improved, and a corresponding discussion in Europe about the extent to which European companies are vulnerable to Enron-style governance meltdowns.[42]

During the same period, however, a number of countries in the EU and the EU itself have issued recommendations or passed laws to require companies to identify and disclose social and environmental risks. These developments, we argue, are an aspect of a fundamental debate over which model of the corporation should prevail—the shareholder model or the stakeholder model. We do not claim that there is a one-to-one correspondence between a requirement of broader nonfinancial disclosure and a stakeholder model of the corporation because much of the expanded disclosure has as its goal better informing investors.[43] We do contend, however, that these new disclosure policies have important implications for corporate governance theory and the convergence debate. This Part describes these international developments, and their implications are developed in Part III.

A. The European Union

Legal developments at the EU level have come against the background of steps by individual Member States in the direction of mandated social and environmental reporting. For example, France,[44] Belgium,[45] Ger-

40. *See* Hansmann & Kraakman, *supra* note 5, at 439 (arguing that there is an emerging consensus that corporate law should principally strive to increase shareholder value); O'Connor, *supra* note 5, at 123-26 (examining the influence of institutional investors on corporate governance standards). *See generally* Coffee, *supra* note 5 (discussing corporate migration and cross-listing as factors facilitating convergence of disclosure standards).

41. Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union—A Plan To Move Forward, COM(2003)284 final; OECD Principles of Corporate Governance, 2004, *available at* http://www.oecd.org/dataoecd/32/18/31557724.pdf.

42. For an overview, see Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement*, 78 IND. L. J. 723, 735-44, 773-77 (2003) and Luca Enriques, *Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms*, 38 WAKE FOREST L. REV. 911, 912-33 (2003).

43. As will be seen below, in the UK, expanded nonfinancial disclosure came about as a direct result of attention being paid to matters of corporate governance, whereas in the rest of the EU and in various other European countries the new requirements arise more directly from financial integration and sustainable development policy initiatives.

44. Law No. 2001-152 of Feb. 19, 2001, J.O., Feb. 20, 2001, p. 2774 (Fr.) (amending CODE DU TRAVAIL arts. 443, 444) (setting forth the social, environmental, and ethical considerations that fund managers should take into account when buying or selling stocks).

many,[46] and the UK[47] have passed laws that require pension funds to disclose the extent to which they take ethical, social, and environmental information into account in constructing their investment portfolios.[48] The thinking behind these laws is that as pension fund managers start to ask companies for information on these issues, the companies will respond by making the information more generally available.[49] Acting more directly, Denmark,[50] the Netherlands,[51] Norway[52], and Sweden[53] have all required companies to provide expanded environmental information in their annual reports, starting with Denmark in 1999.[54]

It is France, however, that has been the leader in the field of required social and environmental disclosure. On May 15, 2001, as part of a package of amendments to French company law known as the "New Economic Regulations" (*Nouvelles Regulations Economiques* or "NRE"), France enacted what are by far the most extensive requirements for companies to disclose social and environmental information.[55] The NRE primarily dealt with issues such as financial transparency, corporate governance, and antitrust reform, but one section, Article 116, implemented a mandate for "triple-bottom-line" reporting for all companies traded on the French stock

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45. Law of April 28, art. 42(3), Moniteur Belge (2d ed.), May 15, 2003, p. 26,407 (Belg.) (requiring pension organizations to consider social, ethical, and environmental impact when formulating their investment strategies).

46. *See* Susan A. Aaronson & James T. Reeves, Corporate Responsibility in the Global Village: The Role of Public Policy 21 (2003); Gesetz zur Reform gesetzlicher Rentenversicherung und zur Förderung eines kapitalgedeckten Altersvorsorgevermögens (Altersvermögensgesetz—AVmG) v. 29.06.2001 (BGBl. I S. 403) (F.R.G.) (providing that pension funds must disclose how social and environmental factors affect their investment decision).

47. Occupational Pension Schemes (Investment and Assignment, Forfeiture, Bankruptcy etc.) Amendment Regulations, § 2(4), (1999) SI 1999/1849) (Eng.) (amending SI 1996/3127) requires trustees of occupational pension funds to disclose "the extent to which social, environmental, or ethical considerations are taken into account" when making investment decisions.

48. These various developments are summarized in Aaronson & Reeves, *supra* note 46, at 109 app. 4 (2002).

49. Since these requirements are relatively new, none dating back to before 1999, any assessment is necessarily tentative. *See id.*

50. The Ministry of Social Affairs has developed a "social index" that indicates companies' levels of social responsibility. An English explanation is at http://www.detsocial eindeks.dk/ (last visited Feb. 17, 2005).

51. Uitvoeringsregeling milieuverslaglegging, Dec. 14, 1998, Staatscourant 1998, 248 pag. 11 (Dec. 24, 1998) requires companies to report on any environmental effects of their activities. This is a regulation of the Ministry of Housing, Spatial Planning, and the Environment.

52. *See* Aaronson & Reeves, *supra* note 46, at 109 app. 4.

53. Lag om allmänna pensionsfonder [National Pension Funds Act], Svensk författningssamling [SFS] 2000:192, *available at* http://www.riksdagen.se/debatt/sfst/index.asp, requires companies to draw up an annual business plan that describes how investment decisions take environmental and ethical considerations into account.

54. *See* Aaronson & Reeves, *supra* note 46, at 109 app. 4.

55. *See* Decree No. 2002-221 of Feb. 20, 2002, J.O., Feb. 21, 2002, p. 3360 (regarding the application of Code de Commerce [C. com.] art. 155-102-1 and modifying Decree No. 67-236 of Mar. 23, 1967, J.O., Mar. 24, 1967, p. 2843).

exchange (the *Bourse de Paris*).[56]

Article 116 of the NRE requires each French company traded on the *Bourse* to provide extremely detailed environmental, labor, community involvement, health, and safety information in its annual reports to shareholders.[57] The required environmental information includes specifics on the use of resources such as water, energy, and raw materials; information on emissions that could cause air, water, noise, or olfactory pollution; a company's environmental management systems and efforts to reduce environmental impacts; accounting reserves for environmental risks; and the amounts of fines and monetary awards paid because of environmental damage.[58] This information must be supplied for both the company's locations in France and its sites abroad. The required social disclosures include very detailed information about the labor arrangements within companies, such as the numbers of short- and long-term workers and "external workers"; the organization of working hours and overtime; gender equity; labor relationships and collective bargaining agreements; health and safety; use of subcontractors; and how the company takes the territorial impact of its activity on employment and regional development into account.[59] While companies have been required to collect some of this labor information since 1977 and report it to plant-level Works Councils, it is only since Article 116 was passed that the information must be publicly disclosed in companies' annual reports.[60]

Despite these national precedents, progress at the EU level has come in fits and starts. Since 1968, the EU has been in the process of trying to harmonize the company laws ("corporate laws" in American parlance) of Member States in accordance with the Treaty of Rome, which created the European Economic Community.[61] While some aspects of this process have proceeded smoothly, such as harmonizing financial disclosure and recognizing the validity of corporate contract obligations,[62] certain issues

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56. *See* AARONSON & REEVES, *supra* note 46, at 21.

57. Law no. 2001-420, art. 116, May 15, 2001, J.O., May 16, 2001, p. 7776.

58. Decree No. 2002-221 of Feb. 20, 2002, art. 2, J.O. Feb. 21, 2002, p. 3360 (adding art. 148-3 to Decree No. 67-236 of Mar. 23, 1967, J.O., Mar. 24, 1967, p. 2843).

59. *Id.*

60. Mary Lou Egan et al., France's *Nouvelles Regulations Economiques*: Using Government Mandates for Corporate Reporting To Promote Environmentally Sustainable Economic Development 10 (2003), *available at* http://www.bendickegan.com/pdf/Egan MauleonWolffBendick.pdf.

61. *See* Company Law: Introduction, *at* http://europa.eu.int/scadplus/leg/en/lvb/l2 6002.htm (last visited Feb. 17, 2005). Harmonization typically proceeds by means of Directives, which are proposed by the European Commission (the EU executive) and passed by the Council of the European Union (a legislative body composed of Member State ministers). Introducing the European Union, *at* http://europa.eu.int/institutions/ index_en.htm (last visited Feb. 18, 2005). The European Parliament, which is directly elected by the EU citizenry, usually exercises its co-decisionmaking power to adopt EU legislation. *Id.* Member States are required to implement Directives through national legislation. Company Law: Introduction, *supra*; *see also* Decision-making in the European Union, *at* http://europa.eu.int/institutions/decision-making/index_en.htm (last visited Feb. 17, 2005).

62. These and other topics were encompassed in the First Council Directive 68/151, 1968 O.J. (L 065) 8, the Second Council Directive 77/91, 1977 O.J. (L 026) 1, the Third

have been more problematic and have taken more than thirty years to resolve. These include the role of employees in publicly-traded companies (that is, whether to adopt codetermination as a required element of EU company law)[63] and the proper role of the board of directors in evaluating takeover proposals.[64] The extended difficulty in arriving at a uniform resolution of these and other issues has been caused, in the EU's official estimation, "by political deadlock, revealing the fundamental differences between Member States' traditions in the company law field."[65] The specific basis for this deadlock, in our judgment, is the ongoing competition between the shareholder and stakeholder models of the corporation.

Notwithstanding these differences, in the last five years the harmonization process has seen extensive discussion of the social and environmental responsibilities of companies, culminating in the enactment of new social and environmental disclosure obligations.[66] These enactments are

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Council Directive 78/855, 1978 O.J. (L 295) 36, the Fourth Council Directive 78/660, 1978 O.J. (L 222) 11, the Sixth Council Directive 82/891, 1982 O.J. (L 378) 47, the Seventh Council Directive 83/349, 1983 O.J. (L 193) 1, *revised by* 1983 O.J. (L 211) 31, and the Eighth Council Directive 84/253, 1984 O.J. (L 126) 20; *see also* Company Law: Introduction, *supra* note 61 (discussing the evolution of EU company law).

63. This issue was raised in a Fifth Council Directive that was proposed in 1972 and withdrawn in 2001. *See* Company Law: Introduction, *supra* note 61. In its stead, the Council adopted a regulation in 2001 that established a new type of entity, a European Company (known as an "S.E." short for the Latin *Societas Europaea*), Council Regulation 2157/2001, art 1(1), 2001 O.J. (L 294) 1, 3, under which companies must choose either to have employees represented on the board or boards (depending on whether a one-tier or two-tier board structure is chosen), or represented by a separate body, such as a union. Council Regulation 2001/86, art. 3, 2001 O.J. (L 294) 22. Every S.E. must choose one of these forms of employee participation. *Id.* at art. 3(1). These statutes entered into force October 11, 2004, *id.* at art. 16, so it is too soon to tell how many companies will take advantage of them.

64. This issue was contained in the 1989 Proposal for a Thirteenth Council Directive on Company Law Concerning Takeover and Other General Bids, 1989 O.J. (C 034) 8, which was rejected by the European Parliament in 2001 and superseded in 2002. Proposal for a Directive of the European Parliament and of the Council on Takeover Bids, 2003 O.J. (C 045) 1. The substitute proposal issued in October 2002 was intended, among other things, to clarify employees' rights to information and consultation and "create a body of truly European company law." Company Law: Introduction, *supra* note 61. It was issued as a Directive in April 21, 2004. Directive 2004/25, 2004 O.J. (L 142) 12.

65. Company Law: Introduction, *supra* note 61.

66. *See, e.g.*, Communication from the European Commission, Corporate Social Responsibility: A Business Contribution to Sustainable Development COM(2002)347 final at 4, 8 (adopting "Principles for Community Action," and emphasizing the "voluntary nature of CSR"); Green Paper, Promoting a European Framework for Corporate Social Responsibility, COM(2001)366 final (discussing the goals of CSR in the EU). The Organization for Economic Cooperation and Development ("OECD") has also encouraged the discussion of the social and environmental responsibilities of publicly traded companies by recognizing a role for stakeholders in corporate governance. *See* OECD Principles of Corporate Governance, *supra* note 41, § IV, "The Role of Stakeholders in Corporate Governance." (The OECD is an international organization with thirty industrialized nation members.) The general principle articulated in Section III is that "[t]he corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises." *Id.* In developing the 2001 Principles of Corporate Governance, the OECD structured a process of discussion and debate that involved busi-

part of a complex of policies[67] adopted by Europe's heads of state and governments in Lisbon in March 2000 that are designed to make the EU "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion."[68] This "Lisbon Strategy" was then amended at a subsequent meeting of the European Council[69] in Stockholm to add an environmental dimension to the initial political and economic commitment. Thus, sustainable development that promotes "economic growth, social cohesion and environmental protection" is Europe's current goal.[70]

The EU's attention to corporate governance reform is informed by its efforts to promote sustainable development. Accordingly, a recent Communication on Corporate Governance from the European Commission to the Council and the European Parliament in 2003 proceeded on the assumption that "[w]ell managed companies, with strong corporate governance records and sensitive social and environmental performance, outperform their competitors."[71] The Commission recognized that these goals required an approach "fully integrated" into its related initiatives to integrate the capital markets, enhance the quality of financial reporting, develop industrial policies to achieve sustainable economic development, and examine corporate social responsibilities.[72]

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ness, labor, and civil society. *Id.* at 4. It also created a mechanism to try to implement the Principles, requiring each of the thirty countries (including the United States) to establish a National Contact Point to publicize the Principles, and resolve disputes about corporate behavior. *Id.* at 31. To date, the Principles have been poorly implemented, with France, Belgium and the Netherlands as exceptions, *see* AARONSON & REEVES, *supra* note 46, at 12, but they have kept issues of CSR on the European agenda, as well as provided standards by which to judge government policymaking in this area.

67. The complexity of the policies themselves and the networks of committees and organizations that design and implement them are a striking example of the "new governance" approach to regulation, which we discuss *infra* note 169.

68. Jennifer Blanke & Augusto Lopez-Carlos, World Economic Forum, The Lisbon Review, 2004: An Assessment of Policies and Reforms in Europe 1, *available at* http://unpan1.un.org/intradoc/groups/public/documents/UNTC/UNPAN010324.pdf (quoting remarks of the President of the European Council).

69. This "European Council" is not the same as the legislative body officially called the Council of the European Union, which is discussed in note 61 *supra*. In the bewildering world of "eurojargon," there are actually three different European bodies that have the word "council" in their names: the European Council, which is the quarterly policysetting meeting of the heads of state and government of the EU member countries, plus the president of the European Commission; the Council of the EU, just discussed; and the Council of Europe, a non-EU intergovernmental organization that seeks to promote human rights. *See* A Plain Language Guide to Eurojargon, *at* http://europa.eu.int/abc/eurojargon/index_en.htm (last visited Feb. 17, 2005).

70. Communication from the Commission to the Gothenburg European Council, A Sustainable Europe for a Better World: A European Union Strategy for Sustainable Development 2, COM(2001)264 final.

71. Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union—A Plan to Move Forward 3, COM(2003)284 final.

72. *Id.*; *see also* Communication of the Commission, Implementing the Framework for Financial Markets, COM(1999)232 final; Communication from the Commission to the Council and the European Parliament, EU Financial Reporting Strategy: The Way Forward, COM(2000)359 final; Communication from the Commission to the Council,

It is in the specific contexts of capital market integration and enhancement of financial reporting that the EU has issued regulations requiring expanded nonfinancial disclosure. In its May 15, 2001 Communication on the EU Strategy for Sustainable Development, the Commission "invited" companies with 500 employees or more to publish a triple-bottom-line report in their annual report to shareholders, evaluating their performance against economic, environmental, and social criteria.[73] At that time, the Commission also adopted Recommendation 2001/453/EC on the recognition, measurement, and disclosure of environmental issues in annual reports and financial accounts.[74] This Recommendation was described as necessary to meet the informational needs of "different stakeholders, including regulatory authorities, investors, financial analysts and the public in general," with a primary goal of ensuring that "users of financial statements [have] information about the impact of environmental risks and liabilities on the financial position of the company, and about the company's attitude towards the environment."[75] The Recommendation applies to a broad range of companies—all companies covered by the original directives aimed at harmonizing financial reporting[76]—and suggests that companies should be required to disclose and incorporate into their financial accounts thirty-nine highly specific categories of environmental information.[77] The Recommendation suggests that the annual report to shareholders discuss environmental issues facing a company and its response.[78] It calls specifically for descriptions of the company's policies and programs, improvements it has made in environmental protection, and information on its environmental performance in such areas as energy use, water use, emissions, and waste disposal.[79] As the Recommendation states, the purpose of this disclosure is to permit "users of the annual report to be able to ascertain to what extent environmental protection is an integral part of the

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the European Parliament, The Economic and Social Committee, and the Committee of the Regions, Industrial Policy in an Enlarged Europe, COM(2002)714 final; Communication from the Commission, Corporate Social Responsibility: A Business Contribution to Sustainable Development, COM(2002)347 final; Communication from the Commission to the Gothenburg European Council, A Sustainable Europe for a Better World: A European Union Strategy for Sustainable Development, COM(2001)264 final.

73. Communication from the Commission to the Gothenburg European Council, A Sustainable Europe for a Better World: A European Union Strategy for Sustainable Development 8, COM(2001)264 final.

74. Commission Recommendation, The Recognition, Measurement and Disclosure of Environmental Issues in the Annual Accounts and Annual Reports of Companies, 2001 O.J. (L 156) 33.

75. Commission Recommendation, Annex § 1(4), 2001 O.J. (L 156), at 35.

76. These were the Fourth and Seventh Commission Company Law Directives, enacted, respectively, in 1978 and 1983. *See supra* note 62 and accompanying text.

77. The recommendations for environmental accounting include principles for the recognition of environmental expenditures and liabilities, and site dismantling and restoration costs, for adjusting the values of impaired assets, provisions for site restoration or dismantling, and for discounting future costs to present value. Commission Recommendation, Annex § 3, 2001 O.J. (L 156), at 37-38.

78. *Id.* at Annex. § 4, 2001 O.J. (L 156), at 40.

79. *Id.* at Annex § 4(2).

company's policies and activities."[80]

In 2003, this Recommendation was followed by a Directive of Parliament and the Council amending the 1978 and 1983 directives that had begun the process of harmonizing financial reporting within Europe.[81] The 2003 amendments, referred to as the Modernization Directive, are part of a process of incorporating International Accounting Standards into EU companies' financial reporting.[82] As of 2005, companies will be required to include "a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces" in their annual reports.[83] The Modernization Directive requires that "[t]o the extent necessary for an understanding of the company's development, performance or position, the analysis shall include both financial and where appropriate, nonfinancial key performance indicators relevant to the particular business, including information relating to environmental and employee matters."[84] The Parliament and Council suggested that the requirement to provide nonfinancial information was "in line with current best practice." It added:

> [W]here appropriate [it should] lead to an analysis of environmental and social aspects necessary for an understanding of the company's development, performance or position. This is consistent also with Commission Recommendation 2001/453/EC of 30 May 2001 [discussed immediately above] on the recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of companies.[85]

While Member States were given the power to exempt small and medium enterprises from the nonfinancial disclosure obligations if they

80. *Id.* at Annex § 4(2)(a).

81. Directive 2003/51, 2003 O.J. (L 178) 16. This Directive was passed under the co-decision procedure, which requires passage by both Parliament and the Council. (The EU's decisionmaking process is discussed *supra* note 61.)

82. The international accounting standards are being promulgated by the International Accounting Standards Board ("I.A.S.B.") in London, Directive 2003/51, 2003 O.J. (L 178), at 16, pmbl. § 7, which is a private standards-setting organization. International Accounting Standards Board, About Us: Mission Statement, *at* http://www.iasb.org/about/index.asp (last visited Feb. 18, 2005). The European Commission is represented in the I.A.S.B. process. Press Release, International Accounting Standards Committee, European Consultative Group on Accounting Issues Affecting Financial Institutions To Be Created (Feb. 10, 2004), *available at* http://www.iasb.org/news/iascf.asp?showPageContent=NO&xml=10_80_38_10022004.htm.

83. Directive 2003/51, art. 1, 14(a), 2003 O.J. (L 178), at 18.

84. *Id.* We understand from Rob Lake, Head of Corporate Engagement, at Henderson Global Investment, and a member of the UK Operating and Financial Review Working Group on Materiality, discussed below, that the EU Parliament and Council used the language "to the extent necessary for an understanding" of a business's performance or position instead of the more familiar language "to the extent material to an understanding," in order to avoid the connotation that what was being asked for was more financial disclosure, since in many contexts "material" information is understood to be financial information. Rob Lake, Presentation to the Institute of Responsible Investment Conference on Nonfinancial Disclosure, Boston College Center for Corporate Citizenship (April 21, 2004) (notes on file with the authors).

85. Directive 2003/51/EC, pmbl. § 9, 2003 O.J. (L 178), at 17.

chose,[86] large public reporting companies throughout Europe will now be expected to provide much more social and environmental information annually, and, more specifically, to account for environmental costs and potential liabilities.

So far, then, several general trends can be identified in the EU and various of its Member States with respect to nonfinancial disclosure. First, these legal initiatives, whether at the EU or national level, are related to general policies to promote sustainable development. France, for instance, is operating under its second National Strategy for Sustainable Development (the first having been passed in 1997), which recognizes that sustainable development cannot be achieved by isolated policy initiatives, but "must be reflected in a systematic network of efforts involving numerous disciplines and partners."[87] Second, and consistent with the French policy statement, information-forcing regulations aim to encourage changes in firm behavior by empowering government agencies, NGOs, consumers, and investors to make decisions based on a wider range of information about firms' social and environmental records and impacts.[88] Third, the countries with the most expansive national disclosure regulations are also countries where a stakeholder concept of the firm predominates—France, Germany, the Netherlands, Belgium, Norway, Denmark, and Sweden.[89] Consequently, the EU's own gradual turn in the direction of mandatory disclosure can plausibly be read as a reflection of the broader European penetration of the stakeholder concept.[90] While this is not surprising, it is an important background construct against which to evaluate the developments in the UK to which we now turn.

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86. *Id.* at art. 1(14)(b), 2003 O.J. (L 178), at 18.

87. Egan et al., *supra* note 60, at 6.

88. Communication of the Commission, Corporate Social Responsibility: A Business Contribution to Sustainable Development, COM(2002)347 final, at 4-6 (discussing the impact of globalization, which has increased the responsibilities of businesses, and urging that consumers, NGOs, and investors need more information in order to "reward . . . socially and environmentally responsible firms," and financial stakeholders can "identify the success and risk factors inherent in a company and its responsiveness to public opinion").

89. *Cf.* Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 Tex. L. Rev. 1657, 1719-22 (2002) (discussing empirical evidence showing European companies engaging in more voluntary nonfinancial disclosure); Aguilera and Jackson, *supra* note 1, at 459-61 (discussing European stakeholder concept of the firm).

90. It is difficult to say whether acceptance of the stakeholder concept has facilitated greater acceptance of CSR objectives in Europe, or whether pressure from the CSR movement has forced greater recognition of stakeholders' informational interests. What is clear is that CSR and stakeholder corporate governance theory pursue similar goals, albeit with different structural mechanisms as with regard to employee participation in the firm. This is obviously an important difference concerning how power is exercised in the firm, but here we are focusing on understandings of the proper goals for the exercise of that power, and specifically who and what counts as an important interest to consider when exercising power.

B. The United Kingdom

Although the UK is a member of the EU in all respects except currency, it has pursued an innovative and independent course in dealing with corporate governance and CSR. Indeed, the past ten years have clearly been the decade of deliberation about corporate governance in the UK.[91] Five major committees have evaluated various aspects of corporate governance, making recommendations about accounting practices, executive compensation, board composition, and expanded nonfinancial disclosure.[92] The British government began a Company Law Review in 1998 to respond to these committees and modernize and integrate company law.[93] A number of specialized reviews have also been influential, including the Myners Review of the Responsibilities of Institutional Investors, which is discussed in detail below.[94]

1. *Cadbury Committee*

The first of these committees, the highly influential Cadbury Committee,[95] was constituted in 1991 by the accounting profession in a post-Enron type of environment caused by the spectacular collapse of Robert Maxwell's financial empire (and his apparent suicide)[96] and the collapse of the Polly Peck company.[97] Concerned that the two companies' accountants had failed to prevent the enormous losses that ensued, the Institute of

91. *See generally* Jones & Pollitt, *supra* note 26, at 162.

92. The results of these committees are embodied in the Commission on the Financial Aspects of Corporate Governance, Report of the Committee on Financial Aspects of Corporate Governance (1992), *available at* http://www.ecgi.org/codes/documents/cadbury.pdf [hereinafter Cadbury Report]; Director's Remuneration: Report of a Study Group (1995), *available at* http://www.ecgi.org/codes/documents/greenbury.pdf [hereinafter Greenbury Report]; Hampel Commission, European Corporate Governance Institute, Final Report (1998), *available at* http://www.ecgi.org/codes/documents/hampel_index.htm [hereinafter Hampel Report]; Institute of Chartered Accountants in England and Wales, Internal Control: Guidance for Directors on the Combined Code (1999), *available at* http://www.ecgi.org/codes/documents/turnbul.pdf [hereinafter Turnbull Report]; and Derek Higgs, Review of the Role and Effectiveness of Non-Executive Directors (2003), *available at* http://www.ecgi.org/codes/documents/higgsreport.pdf [hereinafter Higgs Report].

93. *See* Company Law Review Steering Group, Department of Trade and Industry, Modern Company Law for a Competitive Economy: The Strategic Framework (1999), *available at* http://www.dti.gov.uk/cld/comlawfw/.

94. *See infra* notes 251-263 and accompanying text.

95. *See* Jones & Pollitt, *supra* note 26, at 164 (describing Cadbury as "internationally recognised as having been seminal in the development of corporate governance in the U.K. and elsewhere.").

96. BBC News, Robert Maxwell: A Profile, *at* http://news.bbc.co.uk/2/hi/business/1249739.stm (last visited Feb. 18, 2005) (reporting on the mystery surrounding Maxwell's apparent suicide on November 5, 1991).

97. *See* Cadbury Report, *supra* note 92, at para. 2.2 (referring to "unexpected failures of major companies"); *see also* Roger Cowe, Corporate Governance: The Stakeholder Challenge, Report Issued by the Association of Chartered Certified Accountants ("A.C.C.A."), 2-3 (2001), *available at* http://www.accaglobal.com/pdfs/members_pdfs/publications/90640 (describing the events surrounding the convening of the Cadbury Committee). Roger Cowe is an author and business journalist in the UK, who regularly contributes to *The Guardian*, the *Financial Times*, and several news magazines.

Chartered Accountants in England and Wales, the London Stock Exchange, and the Financial Reporting Council (which supervises accounting standards) set up the Cadbury Committee.[98] While its "remit" was to study the finance and audit functions at Maxwell Communications and Polly Peck, the Cadbury Committee went further in its recommendations, drawing attention to the cozy boardroom atmosphere that had allowed these financial collapses to occur. In 1992, the Cadbury Committee issued recommendations that were incorporated into a Code of Best Practice for preserving auditor independence and enhancing the supervisory role of the nonexecutive members of the board of directors.[99] These recommendations were also incorporated into the LSE's Listing Rules, colloquially known as the Yellow Book.[100]

2. *Greenbury Committee*

As the nineties progressed, the issue of executive pay became increasingly controversial in Britain, particularly in newly privatized firms.[101] In response, the Confederation of British Industry established the Greenbury Committee to examine executive pay.[102] This Committee produced its own code,[103] this one aimed at improving accountability in executive pay by such strategies as stressing the role of nonexecutive directors in setting executive compensation and casting a disapproving chill on such practices as American-style stock options and "payment for failure" (executives with long contracts being paid to leave early).[104] It also suggested, but did not require, that top executives' and directors' annual pay increases be related to the pay increases that employees generally were receiving in the company.[105] Finally, the Greenbury Committee emphasized the importance of shareholder participation in the remuneration function and a "philosophy of full transparency," including detailed disclosure of directors' remuneration in annual reports.[106] This Code of Best Practice was also incorporated

98. Cadbury Report, *supra* note 92, at para. 2.1; *see also* Brian R. Cheffins, *Current Trends in Corporate Governance: Going from London to Milan via Toronto*, 10 DUKE J. COMP. & INT'L L. 5, 16-18 (1999) (providing more details on the circumstances under which the commission was convened).

99. These included suggestions to separate the functions of the CEO and Chair of the Board, and to establish audit and remuneration committees composed of non-executive directors. Cadbury Report, *supra* note 92, at para. 4.9.

100. *Id.* at 20.

101. Greenbury Report, *supra* note 92, at paras. 1.6-1.8, 8.1-8.4; *see also* Cowe, *supra* note 97, at 3-4 (discussing the events leading to the establishment of the Greenbury Committee).

102. Cheffins, *supra* note 98, at 20.

103. Greenbury Report, *supra* note 92, at 14-18 (section entitled "Code of Best Practices") [hereinafter Code of Best Practices]. The substantive portion of the Greenbury Report has two sections: the "Code of Best Practices," which contains general principles, and "Main Action Points," Greenbury Report, *supra* note 92, paras. 3.1-8.12 [hereinafter Main Action Points], which elaborate on these principles.

104. Code of Best Practice, *supra* note 103, at paras. C8-C10; Main Action Points, *supra* note 103, at para. 6.28-6.30

105. Code of Best Practice, *supra* note 103, at para. C3; Main Action Points, *supra* note 103, at para. 6.13.

106. Main Action Points, *supra* note 103, at para. 5.3.

into the LSE's Listing Standards.[107]

3. *Hampel Committee*

Both the Cadbury and Greenbury Comittees suggested that the impact of their respective Codes of Best Practice be reviewed after some time had passed,[108] and the Hampel Committee was established to undertake that review.[109] In 1998, the Hampel Committee issued its report, resulting in the "Combined Code,"[110] which structured corporate governance in listed companies until 2003, at which time a revised Combined Code was issued.[111] The Combined Code is a synthesis of the corporate governance recommendations of Cadbury, Greenbury, and Hampel, and was promptly added to the LSE's Yellow Book.[112] Moreover, the LSE added a new provision requiring companies to describe their corporate governance arrangements in their annual reports in order to allow shareholders to determine if the company's actions are in accordance with the Principles of Good Governance, as well as to "comply or explain non-compliance" with the specific provisions of the Code of Best Practice.[113] This "comply-or-explain" structure is still central to the Combined Code, as revised and reissued in July of 2003.[114]

The Hampel Committee's Report was significant for a number of reasons, including its emphasis on risk management, discussed below, and its encouragement of shareholder democracy.[115] The latter factor has led to the increasing engagement of the British pension fund community with companies on matters of financial performance, corporate governance, and

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107. *See* Cowe, *supra* note 97, at 6.

108. Cadbury Report, *supra* note 92, at para. 1.4; Greenbury Report, *supra* note 92, at para. 3.11.

109. Hampel Report, *supra* note 92, at 3.

110. The Combined Code: Principles of Good Governance and Code of Best Practice (2000) (derived from the Cadbury and Greenbury Reports), *available at* http://www.ecgi.org/codes/documents/combined_code.pdf [hereinafter 2000 Combined Code].

111. The Combined Code of Corporate Governance (2003), *available at* http://www.ecgi.org/codes/documents/combined_code_final.pdf [hereinafter 2003 Combined Code]. The 2003 Combined Code incorporates the work of the Higgs Report, *supra* note 92, and Audit Committees: Combined Code Guidance (2003) [hereinafter Smith Review of Audit Committees]. Both of these reviews were initiated after Enron, WorldCom, and related problems occurred in the United States to immunize the UK against a similar corporate governance contagion. *See* Jones & Pollitt, *supra* note 26, at 164.

112. Cheffins, *supra* note 98, at 22-23.

113. *See* 2003 Combined Code, *supra* note 111, at sched. C (Disclosure of Corporate Governance Arrangements).

114. 2003 Combined Code, *supra* note 111, at pmbl. § 4.

115. Roger Cowe emphasizes the importance of the Hampel Committee's encouragement of shareholder democracy in his report on behalf of the ACCA. Cowe, *supra* note 97, at 5, 11. Representatives of pension funds and institutional investors that we have interviewed have also emphasized the importance of shareholder democracy, *see, e.g.*, Institutional Investment in the United Kingdom: A Review (2001) [hereinafter Myners Review], in encouraging greater institutional investor engagement. For more on these interviews, see *infra* note 226 and accompanying text.

social and environmental concern.[116] The Cadbury Committee had recognized that shareholder voting power is an asset that should be used to improve corporate governance, and the Hampel Report emphasized that point, encouraging pension funds and other institutional investors to become more engaged in corporate governance by exercising voting rights and by communicating with management on a range of issues.[117] In fact, the 2003 Combined Code includes a section on shareholder democracy, requiring "proxy votes to be counted and announced, separate votes to be taken on key issues, chairmen of key board committees to be available to answer questions, and [annual general meeting] papers to be sent to shareholders four weeks ahead of the meeting."[118]

4. *Turnbull Committee*

The Hampel Committee's report also reiterated Cadbury's suggestion that boards of directors should evaluate their companies' systems of internal control and risk management.[119] The Combined Code had established as a Principle that boards should "maintain a sound system of internal control," and implementing provisions suggested that directors review the internal control system annually, covering "all controls, including financial, operational and compliance controls and risk management systems."[120] Implementing these concepts was left to yet another Committee, the Turnbull Committee, which issued its report in 1999.[121] Turnbull broadened the corporate governance discussion in the UK by its explicit recognition that an effective internal control system must address a wide range of risks, including "legal, health, safety and environmental, reputation, and business probity issues."[122] Turnbull thus excited the British CSR community with the possibility of increased corporate and accounting attention to these broader risks, and perhaps even mandatory expanded social and environmental disclosure about them in the near term.

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116. See generally Gordon L. Clark and Tessa Hebb, *Pension Fund Corporate Engagement: The Fifth Stage of Capitalism*, 59 INDUS. REL. REV. 192 (2004), for a theoretical analysis of the importance of this development. In particular, Clark and Hebb assert that pension fund engagement could help overcome the separation of ownership from control and encourage companies to operate in the long-term interest of their shareholders (and by implication pension fund beneficiaries), rather than being focused on short-term results.

117. *See* Cowe, *supra* note 97, at 5. In 1998, the British National Association of Pension Funds studied shareholder voting and found that only 40 to 45% of shares were typically voted at annual meetings. *See id.* at 12.

118. Cowe, *supra* note 97, at 5.

119. Hampel Report, *supra* note 92, at para. 6.10.

120. Code of Best Practice, *supra* note 103, at para. 6.21.

121. Turnbull Report, *supra* note 92. The substance of the Turnbull Report is included in the 2003 Combined Code in a section entitled "Guidance on Internal Control (The Turnbull Guidance)." 2003 Combined Code, *supra* note 111, at 27-41.

122. *See id.* at 39 app.

5. *Company Law Review*

Finally, in March of 1998, the Labour government launched an overall review of the country's company law, the Company Law Review ("CLR"), which is still ongoing as this Article is being written.[123] While part of that review has focused on the technical aspects of modernizing and integrating different aspects of company law,[124] a central issue in the Terms of Reference to the CLR Steering Group was the development of law that "protects the interests of those involved with the enterprise, including shareholders, creditors and employees."[125]

a) CLR Steering Group

The first phase of the CLR thus required an examination of the corporate purpose, engendering a vigorous debate between the "pluralist" model and the "enlightened shareholder value" view of the corporate purpose.[126] The pluralist model is essentially the stakeholder model. The enlightened shareholder value model, however, goes significantly beyond the narrow shareholder focus that is traditionally associated with the Anglo-American view of the corporation.[127] Like the traditional model, the enlightened view assumes that making profits for shareholders is the primary corporate purpose. But it also asserts that a corporation's relationships with employees, customers, NGOs, creditors, and communities can affect its long-term profitability, and therefore its shareholders' interests. In July of 2001, the Company Law Review Steering Group issued its Final Report, which adopted the enlightened shareholder model.[128] The Final Report recognized that the primary purpose of the corporation is to create profits for shareholders, but concluded that the time frame for assessing profit creation must be long-term, not short-term.[129] Moreover, the CLR Steering Group concluded that long-term shareholder value is best achieved by reducing a company's future social and environmental risk and enhancing its reputation by "bearing in mind the rights and needs of players other than shareholders."[130]

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123. Corporate Law and Governance: Modernising Company Law, *at* http://www.dti.gov.uk/cld/review.htm (last viewed Feb. 17, 2005). See also 1 Modern Company Law for a Competitive Economy: Final Report (2001), *available at* http://www.dti.gov.uk/cld/final_report/ [hereinafter Final Report] for CLR's preliminary recommendations and questions, and Response to Modernising Company Law White Paper (2003), *available at* http://www.dti.gov.uk/companiesbill/whitepaper.htm [hereinafter Government Response] for the British government's reaction and response to the CLR's recommendations and questions.

124. The relevant issues include how to form a corporation, the different types of corporations that can be formed, and the details of shareholder voting. Corporate Law and Governance, *supra* note 123.

125. CLR Steering Group, Modernising Company Law for a Competitive Economy: The Strategic Framework 10, (1999), *available at* http://www.dti.gov.uk/cld/comlawfw/index.htm.

126. *See* Cowe, *supra* note 97, at 19-22.

127. *See supra* notes 5-8 and accompanying text.

128. *See* Final Report, *supra* note 123, at 5.

129. *Id.* at xvii.

130. Cowe, *supra* note 97, at 20; *see also* Final Report, *supra* note 123.

Having settled on this enlightened shareholder view, the CLR Steering Group then proposed a number of mechanisms to reinforce its conclusion that companies need to be managed for the long term. One proposal was a statutory formulation of directors' duties that would emphasize that directors must make decisions with due regard for long-term as well as short-term consequences, and would recognize that a company's relationships with its stakeholders affects the returns to shareholders.[131] Another proposal was designed to meet the informational needs of long-term shareholders. Here, the CLR Group recommended a revised Operating and Financial Review ("OFR").[132] The OFR is an annual report that has been suggested as best practice since 1993 by the Institute of Chartered Accountants in England & Wales, and a number of large companies have been issuing OFRs for some years on a voluntary basis.[133] As currently practiced, the OFR is an analysis of the company's business, strategic objectives, and financial results.[134] The CLR Steering Group suggested that all companies of "significant economic size" be required to prepare an OFR as part of their Annual Report and Accounts, and that the OFR "provide a review of the business, its performance, plans and prospects, and information the directors judge necessary for an understanding of the business, such as relationships with employees, suppliers and customers, environmental and community impact, corporate governance and management of risk."[135]

b) Government Response to the CLR Steering Group

In July 2002, the government published its response to the CLR Steering Group Final Report.[136] It reacted favorably to many of the CLR propos-

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> Our law should provide the maximum possible freedom combined with the transparency necessary to ensure the responsible and accountable use of that freedom . . . . [C]ompany law should reflect the reality of the modern corporate economy, where those who run successful companies recognise the need to develop positive relationships with a wide range of interests beyond shareholders—such as employees, suppliers and customers.

Final Report, *supra* note 123, at xi.

131. *See* Final Report, *supra* note 123, at xvii.

> We recommend a statutory statement of directors' duties which will . . . encourage responsible behaviour by making clear that in promoting the success of the company for the benefit of its members as a whole, directors must take account of long-term as well as short-term consequences; and that they must recognise, where relevant, the importance of relations with employees, suppliers, customers and others, the need to maintain a reputation for high standards of business conduct, and the impact of their actions on the community and the environment.

Id.

132. *See id.* at xix.

133. The Operating and Financial Review ("OFR") Working Group on Materiality: A Consultation Document, 10 (2003), *available at* http://www.dti.gov.uk/cld/ofrwgcon.pdf.

134. *Id.*

135. Final Report, *supra* note 123, at para. 8.32.

136. *See* Government Response, *supra* note 123.

als, including the OFR initiative.[137] Throughout the UK's governance review process, it has been emphasized that what needs to be disclosed should be a matter for directors' informed judgment, that the categories of information that should be disclosed would vary company to company, and that there should be no incentive for directors to take a purely formulaic, "tick-the-box" approach. Yet it has also been understood throughout that directors need some guidance. The CLR Steering Group had recommended that information concerning a company's products and markets, acquisitions and disposals, purpose, strategy, and principal business drivers always be included in the OFR.[138] It had also recommended that information concerning a company's policy and performance on social, ethical, environmental, and community relationships be included "whenever the directors in good faith judge them 'material.'"[139] Given this dichotomy between categories of information, how the government ultimately defined "materiality" would be critical to whether social, ethical, and environmental information would be required to be disclosed.

c) OFR Working Group on Materiality

The government agreed with the logic of the CLR Steering Group, stating that it would propose laws to make the OFR mandatory and that it would delegate power to a Standards Board to draw up detailed rules. First, however, it would create an OFR Working Group on Materiality to advise on how that concept should be defined.[140] The Terms of Reference to the OFR Working Group on Materiality stated:

> The Working Group will develop broad principles and practical guidance on how directors can assess whether an item is material to their company and hence whether it must be included in an OFR. This will include the company's impact on the environment and the wider community, but the same broad approach to materiality is required across all the subject matter of the OFR.[141]

The Working Group's Consultation Document on Materiality likely gave comfort to the pluralists that their point of view had not been ignored. Quite to the contrary, stakeholder thinking is woven in throughout. The key concept, as stated by the Working Group, is that directors should ask, "Does this item matter to the [shareholders], either directly, or indirectly as a result of its significance to other stakeholders and thus to the company?"[142]

As expressed by the Working Group, its "starting point" was this:

> [T]he view put forward in the [Company Law Review] that the primary role of directors is to promote the success of the company for the benefit of its shareholders as a whole but that this duty can only be discharged effectively

137. *See id. passim.*
138. *See* Final Report, *supra* note 123, at para. 8.32.
139. *Id.* at para. 8.40.
140. *See* Government Response, *supra* note 123, at xx.
141. The OFR Working Group on Materiality, *supra* note 133, at 6.
142. *Id.* at 15-16.

> when directors look at long term as well as short term issues and when all the factors affecting the company's relationships and performance are taken appropriately into account. This implies an appreciation of the implications of a wide range of social and ethical, environmental and economic impacts.[143]

One of the criteria the Working Group used in developing its definition of materiality was "the importance of recognising who are the potential users of the OFR."[144] In addressing this criterion, the Working Group recognized that while the CLR had adopted an enlightened shareholder rather than broadly pluralist view of the corporate purpose, it is nonetheless true that "issues that are of significant interest to customers, to employees, to suppliers and to society more widely are, or will very likely become, matters of concern to shareholders too."[145]

The Working Group then defined materiality as follows:

> In making their good faith, honest judgements about what information is material and should be included in their OFR, directors should be governed by the high level objective of the OFR, which is to enable users to assess the strategies adopted by the business and the potential for successfully achieving them. Information will be material to the OFR if failure to disclose it clearly, fairly and unambiguously might reasonably be expected to influence members' [shareholders'] assessments of the company and hence the decisions they may take, either directly, or indirectly as a result of the significance that the information has for other stakeholders and thus the company. Information that is material to the OFR may be quantitative or qualitative; and may relate to facts or probabilities, and to the past, present or future events and decisions.[146]

The Working Group emphasized three ideas that should guide directors in producing an OFR: the high-level objective of the OFR, which is to enable users to evaluate the company's business strategies and likelihood of achieving them; an understanding of the particular company's purpose and values; and the need to take a broad view of the "approaches and perspectives that users of the OFR, in the first instance the members but also other key stakeholders, will bring to their assessment."[147] In explaining this latter idea, the Working Group explained:

> [T]ak[ing] a broad view about the approaches and perspectives that users of the OFR. . . will bring to their assessments. . . implies taking a proactive approach, including a willingness to consider society's changing norms and expectations of business, and to explore and understand the agendas of a range of different stakeholder groups that may reasonably be expected,

143. *Id.* at 11.

144. *Id.* at 6. Altogether, the Working Group used six criteria in developing its definition of materiality. In addition to the importance of recognizing who the potential users are, it took into account the "desirability of building on existing guidance; the need to recognise the context and the scope of the OFR; . . . the link between the OFR and decision-taking; and the need to couch guidance in as clear and simple language as possible." *Id.*

145. *Id.* at 15.

146. *Id.* at 16.

147. *Id.* at 18.

directly or indirectly, to affect significantly the performance of the business, including customers, employees, suppliers, and local, national and international interest groups of a variety of kinds. Such groups can often not only articulate the norms and expectations that society has of business but can anticipate future changes in consumer behaviour and can influence regulatory change.[148]

The Working Group also discussed the processes directors ought to use to make their materiality determinations. It emphasized that, as a result of the Turnbull Committee's report, directors likely had in place processes to get the information necessary to manage the long-term risks affecting their business, and that these processes probably included understanding the effects of decisions on key stakeholders such as employees, consumers, customers, and communities.[149] Nonetheless, in a bold suggestion, the Working Group proposed an additional step: that the process for determining materiality should "provide for appropriate consultation within the business and externally with key stakeholders."[150]

d) The Government's Legislative Response to the OFR Working Group on Materiality

On May 5, 2004, the UK government proposed OFR legislation that fully adopted the Working Group's stakeholder-infused vision of enlightened shareholder interest. It is worth quoting Patricia Hewitt, Secretary of State for the Department of Trade and Industry, who introduced the legislation, at some length:

> What are companies for? The primary goal is to make a profit for their shareholders, certainly. But the days when that was the whole answer are long gone. We all have higher expectations of companies not simply to perform well in the short term, but to have an effective strategy for delivering long-term profitability. . . . We save for the years ahead, not the months ahead, and we need the companies in which we invest to share our own horizons.
>
> We expect companies to generate the wealth that provides good public services and a decent standard of living for everyone. We need continuing recognition that wealth creation demands honest and fair dealings with employees, customers, suppliers and creditors. Good working conditions, good products and services and successful relationships with a wide range of other stakeholders are important assets, crucial to stable, long-term performance and shareholder value.
>
> We expect companies to create wealth while respecting the environment and exercising responsibility towards the society and the local communities in which they operate. . . . For this reason, I believe that increased, high quality shareholder engagements is vital to creating the modern economy that we all

148. *Id.*
149. The OFR Working Group on Materiality, *supra* note 133, at 23.
150. *Id.* The government did not adopt this suggestion explicitly, but does require an audit of the OFR to determine that the process used to make decisions as to what information to include was adequate, and that there is an "adequate, supportable basis for statements made, whether factual or judgemental[.]" Dep't of Trade & Indus., Draft Regulations on the Operating and Financial Review and Directors' Report: A Consultative Document, para. 3.57, *available at* http://www.dti.gov.uk/cld/pdfs/ofr_condoc.pdf.

want.[151]

Through the OFR, the government seeks to promote shareholder engagement as the mechanism for bringing about the proper relationship between the corporation and society. As it stated, "[i]t is through shareholders exercising informed influence over companies that their expectations and those of the wider community will best be met."[152] The government's approach is premised on the belief that shareholders, when presented with more comprehensive information, will conceive of the company's interests, and their own, in a more holistic way. As Secretary Hewitt put the point, "[t]he people who invest in companies are the same people who are employed by them, buy their products, live in the communities around them, and are concerned about their effect on the environment. So we have multiple reasons for wanting to see good companies."[153] The "full and accurate information" to be provided in the annual OFR is conceived, then, as necessary to empower shareholders "to hold the directors of their company to account for its performance."[154] This information "will cover the issues traditionally seen as key to a company's performance—an account of its business, objectives and strategy, a review of developments over the past year, and a description of the main risks. But it will also cover prospects for the future and, where necessary, information about the environment, employees, customers or social and community issues where that information is important for an assessment of the company."[155]

In introducing the OFR Regulations, the government stated that such disclosure should be a statutory requirement, not a matter of best practice, and that it should be mandatory for the largest companies.[156] The government also emphasized that it was "dovetailing" the OFR requirements with certain requirements of the EU's Modernization Directive,[157] so that companies which prepare an OFR would "not also have to report separately, in their directors' report, on the matters specified in the Directive," particularly since the Directive requirements are "less detailed and precise than those recommended for the OFR."[158] Because the Modernization Directive gives countries the option to exempt medium-sized companies from its nonfinancial reporting requirements, the "main issue on which the [UK] Government is consulting" is its proposal to create such an exemption in the OFR.[159]

151. Dep't of Trade & Indus., *supra* note 150, at 5-6.

152. *Id.* at 12, para. 2.3.

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.* at para. 1.4.

157. *See supra* notes 75-86 and accompanying text.

158. Dep't of Trade & Indus., *supra* note 150, at para. 1.5.

159. *Id.* at para. 1.5. The UK defines a company as medium-sized if two or more of the following requirements are met in a year: "Turnover: not more than £22.8 million; Balance sheet total: not more than £11.4 million; Number of employees: not more than 250." *Id.* at para. 2.12.

That the OFR is shareholder-oriented is clear throughout the draft regulations: the government recognizes that the OFR will be produced for shareholders, and will allow shareholders to assess a company's strategies and its likelihood of success.[160] Yet the government also recognizes that the OFR will be relevant to other users, including creditors and "other stakeholders . . . including employees,"[161] and it articulated the following goals:

- improved qualitative, nonfinancial and forward-looking reporting on the performance of the company, and
- directors deciding in good faith what would be most likely to promote the success of the company, taking account of a wide range of factors, within and outside the company, which are relevant to achieving its objectives and to an assessment of its business. These factors may well include the company's impact on the environment and on the wider community, and its relationships with employees, customers and suppliers.[162]

The draft regulations, as introduced, maintain the bifurcated structure of the CLR and Working Group on Materiality proposals. Strategic business issues are presumed to be material, and so should always be reported upon.[163] Other "details of particular matters" must be included to the extent necessary to provide the "balanced and comprehensive analysis" with respect to the company's position, performance, and strategic development that the OFR seeks to promote.[164] Significantly, these "particular matters" include information about "(a) the employees of the company and its subsidiary undertakings, (b) environmental matters, and (c) social and community issues," and require "analysis using financial and other key performance indicators, including information relating to environmental matters and employee matters."[165] The draft regulations also require auditors to opine on the OFR, including "whether in their opinion the directors have prepared the review after due and careful enquiry."[166]

In its introduction of the draft regulations, the government gave a number of examples of types of issues directors might determine to be

160. *See id.* at paras. 2.4, 3.5, 3.7 (asserting that "[t]he draft Regulations are designed to transform the CLR *objective* into a legislative requirement that results in useful, honest reporting of information that will allow *shareholders* to assess the company's strategies and their potential to succeed and is consistent with EU requirements").

161. *Id.* at para. 2.4.

162. *See id.* at para. 2.5.

163. *See id.* at 40, annex A, para. 7(1), (2) (proposing to amend the 1985 Companies Act to include Schedule 7ZA). The required matters include a statement of the company's business, objectives, strategic thinking, and future prospects; a description of the resources available to the company; the main trends and factors affecting the company's performance over the prior year and future prospects, including risks and uncertainties; and information on the company's financial performance, including capital structure, treasury policies, and liquidity. *Id.*

164. *Id.* at 40, annex A, para. 7(4)-(7).

165. *Id.* at 40, annex A, para. 7(4), (6)(1). The draft OFR regulations define "key performance indicators" as "[t]he factors by reference to which the development, performance or position of the business of the company and its subsidiary undertakings can be measured most effectively." *Id.* at 40, annex A, para. 7(6)(2).

166. *Id.* at 40, annex A, para. 7(8)(a).

material in the OFR "both where they constitute a significant external risk to the company, and where the company's impact on others through its activities, products or services, affects its performance."[167] These examples included:

- an explanation of risk management approaches employed by a company that stores, transports or uses significant volumes of hazardous or toxic substances that risk damaging the health of workers or others, or polluting the environment or;
- how a company that is a heavy user of natural resources, which may become scarce or the price of which may change significantly, is intending to reduce its dependency on such resources;
- how a company that may be susceptible to the impacts of climate change plans to mitigate the risks and take advantage of the opportunities presented by a changing climate;
- current and likely future compliance record for companies operationally dependent upon legal consents for discharges to air, land or water;
- an explanation of the risk management approaches employed by a company to assess the operational impact on biodiversity where failure to avoid or mitigate damage would put development consents at risk.[168]

The draft OFR regulations and the EU Modernization Directive use parallel language and require parallel information: "key performance indicators" concerning environmental, social, and employee matters "to the extent necessary" to provide an informed understanding of the company's strategic development, performance, current position, and future risks and uncertainties. Both seek a "fair" (EU) or "balanced and comprehensive" (UK) analysis of the directors' views on the environmental and social matters that are likely to have an effect on the company. The LSE is of major importance in the world of cross-border equity trading, and the European Modernization Directive will obviously affect companies' nonfinancial reporting throughout Europe. Thus, taken together, the requirements of the OFR and of the European Modernization Directive, if well implemented, will have the effect of requiring many large companies to produce more social and environmental information, potentially leading to more sustained thinking about stakeholders' interests. Moreover, from the perspective of the UK, the company law process and OFR requirements suggest a subtle but significant shift away from the United States model of corporate governance in a more European direction.[169] This point will be

167. *Id.* at 23, para. 3.33.

168. *Id.*

169. These developments can also be interpreted as an ongoing experiment in "new governance" or "the new governing paradigm." *See* Colin Scott, Regulation in the Age of Governance: The Rise of the Post-Regulatory State 5 (Nat'l Eur. Ctr., Austl. Nat'l Univ., Paper No. 100, 2003), *available at* http://www.anu.edu.au/NEC/scott1.pdf. New governance theory is complex, its terminology and taxonomies contested, and its theoretical framework still inchoate. However, a core element in virtually all formulations is the idea of the "postregulatory state." The essence of this idea is captured in the linguistic shift from *government* to *governance*. Regulatory power is diffused progressively among networks of state and nonstate actors that transcend national boundaries. *See id.*

developed in much greater detail in Part III of this Article.

C. The United States

In contrast to Europe and the UK, in the United States the requirements for companies to disclose nonfinancial information are limited, and there are no overarching government policies favoring sustainable development. Discussions of CSR, or at least of "corporate responsibility," have reemerged in the United States in the post-Enron era, but, again in contrast to Europe and the UK, these discussions have tended to be narrowly circumscribed. As used in the press and in the recent outpouring of government and regulatory action, the term corporate responsibility, social or otherwise, has referred almost exclusively to the obligations of companies to report their financial results accurately and reduce conflicts of interest; and also to lawyers', accountants', and securities analysts' responsibilities for the accuracy of information used by the capital markets.[170] While it is refreshing to hear the words "corporate" and "responsibility" in the same sentence in polite company, the primary results of the "corporate responsibility" debacle in the United States have been that Congress, the Securities and Exchange Commission ("SEC"), and the NYSE have tried to encourage companies to produce accurate financial statements—something they have been required to do by law for over seventy years—and to encourage accounting firms to do the job they are paid to do. Thus, the responsibility discussion in the United States to date has had the ironic effect of doing little more than further entrenching the idea of shareholder primacy.

Notwithstanding the narrowness of the corporate responsibility discussion in the United States, there are some requirements under federal securities law for companies to disclose environmental and, perhaps, social information. These requirements may have been given new emphasis by the passage of the Sarbanes-Oxley Act of 2002. In the discussion that follows, we will first describe the aspects of federal securities law that call for the disclosure of environmental[171] or social information and then suggest

at 2-4. Professor Ann-Marie Slaughter has emphasized the prominence of networks in the postregulatory "pluralist mix of global governance mechanisms." Anne-Marie Slaughter, *Global Government Networks, Global Information Agencies, and Disaggregated Democracy*, 24 MICH. J. INT'L L. 1041, 1044 (2003). These include many forms of "transgovernmental" networks, defined as interactions among subunits of governments that are not closely controlled by their respective legislatures or executives. *Id.* at 1045. Importantly, "transgovernmental networks" can be folded into larger "mixed networks" of governmental and private actors." *Id.* at 1057. In the case of the EU countries, governmental actors have participated, with the effect of triggering policy convergence. *Id.* The fact that CSR has yet to become part of U.S. regulatory policy may be a reflection less of differing ideologies than of the fact that network governance is far better developed within the EU than in this country. In fact, it has been widely argued that such governance—sometimes labeled "comitology"—is the very essence of the EU. *See id.* at 1058-62 (reviewing comitology scholarship).

170. NGOs, labor, and some business organizations use the term "corporate social responsibility" in a more encompassing sense.

171. Companies are also required to disclose environmental information under the federal Toxic Release Inventory ("T.R.I."), which requires companies to list their releases of specific toxins into the air and water, facility by facility. *See* Toxic Release Inventory

ways in which Sarbanes-Oxley might have an impact on such disclosure. We conclude the section by describing some recent legal developments in proxy regulation that have the potential to bring stakeholder interests more directly into the corporate governance relationship in the United States.

1. Required Environmental or Social Disclosure

A public reporting company's obligation to disclose environmental information under the federal securities laws is based on three sections of Regulation S-K: Items 101, 103, and 303.[172] Item 101(xiii) requires companies to disclose the costs of coming into compliance with new environmental regulations, either local, state, or federal.[173] Item 103 requires companies to discuss pending litigation, with special provisions forcing disclosure of pending environmental litigation wherever the litigation is brought by a government agency and the potential penalties are $100,000 or more.[174] Item 303, called "Management Discussion and Analysis," is a general obligation for companies to discuss their financial and operational results, and to disclose any known "events, trends, or contingencies" that might have a material financial impact in the future.[175] This item could, therefore, call for the disclosure of either social or environmental information depending on the circumstances. For instance, an extractive company could be required to disclose information about social and political instability in Indonesia that might shut down production; or a manufacturing company could be required to disclose information about toxic waste cleanup costs upon being identified as a potentially responsible party under Superfund legislation.[176]

While this combination of requirements could, in theory, serve to cause companies to disclose a considerable amount of social and environmental information, they do not operate that way in practice. The World

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Program, *at* http://www.epa.gov/tri/ (last updated Feb. 23, 2005). T.R.I. has been an important impetus toward improved environmental quality. The Environmental Protection Agency credits T.R.I. with declines of 55% in releases to the air between 1988 and 1997; declines in water releases of 63%; and declines in underground injection and on-site disposal of over 20%, while off-site disposal declined only 1%. U.S. Environmental Protection Agency, Innovation at the Environmental Protection Agency: A Decade of Progress, 33-35 (2000), *available at* http://www.epa.gov/opei/decade/decade.pdf. Since the data is presented facility by facility, rather than aggregated at a company level, this information is not as useful in comparing different companies' environmental approaches and potential litigation exposure as is securities' disclosure, which has comparability as one goal.

172. Since 1982, disclosure under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") has been integrated, such that information disclosed in quarterly or annual reports pursuant to the Exchange Act can be incorporated by reference into offering documents under the Securities Act. *See* Adoption of Integrated Disclosure System Release No. 6383, Exchange Act Release No. 18524, 24 SEC Docket 1262, 1262, 1300 (Mar. 3, 1982). Regulation S-K is the omnibus regulation that sets out the specific information that is to be disclosed in any document required to be produced under either statute.

173. Reg. S-K, Item 101, 17 C.F.R. § 229.101 (1998).

174. Reg. S-K, Item 103, 17 C.F.R. § 229.103 (1998).

175. Reg. S-K, Item 303, 17 C.F.R. § 229.303 (1998).

176. Superfund legislation is codified at 42 U.S.C. 9601-9675 (1994).

Resources Institute has performed several studies that show that disclosure of regulatory impact under Item 101(xiii) tends to be utterly uninformative.[177] In general, the companies were eager to downplay any competitive disadvantage and thus failed to provide meaningful financial disclosure or analysis of the likely impact of new environmental regulations. Many relied on boilerplate statements that they expected no material impact, or, if there would be a material impact, that all industry participants were similarly situated, which was, in fact, not true.[178]

Similarly, in 1998 the EPA did a study of companies' disclosure of their environmental litigation under Item 103, which provides a bright-line rule for when such disclosure is necessary. The EPA found that 74% of reporting companies were flagrantly violating Item 103.[179] Using a database of legal proceedings in 1996 and 1997, which it developed from its enforcement docket, the EPA found that only 26% of 136 defendants mentioned legal proceedings that were required to be disclosed, and of these, only 3% correctly identified both the statute under which they were potentially liable and the amount of the potential penalty.[180] Yet, the SEC has brought only one enforcement action in twenty years with respect to this aspect of Item 103.[181] While this lack of enforcement may be understandable in light of the other pressing disclosure issues the SEC must address, the point for this analysis is that, to date, Item 103 has not had the effect of forcing the disclosure of accurate information about companies' environmental litigation into the market, undermining the stakeholder influence that this Item could otherwise promote.

Finally, Item 303 (Management Discussion and Analysis), if broadly interpreted, could force much social and environmental information into the market. The SEC has given companies guidance on how to apply Item 303, suggesting a two-step process of (1) determining if a known event, trend, or contingency is likely to "mature" into having an actual effect on the company and (2) if the company cannot rule out the occurrence of the event, trend, or contingency, evaluating the potential financial impact on the assumption that it will occur.[182] Therefore, a wide range of business

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177. *See* Robert Repetto & Duncan Austin, World Resources Institute, Coming Clean: Corporate Disclosure of Financially Significant Environmental Risks (2000); Duncan Austin & Amanda Sauer, World Resources Institute, Changing Oil: Emerging Environmental Risks and Shareholder Value in the Oil and Gas Industry (2003).

178. Repetto & Austin, *supra* note 177, at 24.

179. *See* David Monsma & John Buckley, *Non-Financial Corporate Performance: The Material Edges of Social and Environmental Disclosure*, 11 U. BALT. J. ENVTL. L. 151, 202 (2004).

180. *See* Nicholas C. Franco, Corporate Environmental Disclosure: Opportunities To Harness Market Forces To Improve Corporate Environmental Performance 15 tbls.2-3 (2001) (delivered to the American Bar Association Section on the Environment, Energy, and Resources, copy on file with authors).

181. Clifford Rechtschaffen, *Enforcing the Clean Water Act in the Twenty-First Century: Harnessing the Power of the Public Spotlight*, 55 ALA. L. REV. 775, 813 (2004).

182. *See* Management's Discussion and Analysis of Financial Condition and Results of Operations: Certain Investment Company Disclosures, Securities Act Release No. 6835, Exchange Act Release No. 26,831, 54 Fed. Reg. 22,427, 22,430 (May 24, 1989).

risks are apparently required to be disclosed under this regulation. In practice, however, a majority of public reporting companies in the United States have not taken such a broad approach to their disclosure obligations under Item 303.[183]

It is possible that some of these trends of nondisclosure may change in light of the Sarbanes-Oxley Act of 2002, the statute passed in reaction to the Enron and WorldCom corporate governance failures. Sarbanes-Oxley requires both the chief executive officer and chief financial officer of a public reporting company to certify that the financial statements are accurate and that they have evaluated the effectiveness of their internal control systems and have confidence in them.[184] Another part of Sarbanes-Oxley requires annual disclosure of how the effectiveness of internal controls has been determined.[185] These provisions might cause companies and their accountants to disclose more information about contingent environmental liabilities and to disclose more information about a company's internal controls with respect to contingent liabilities, including environmental liabilities. But even this level of disclosure would be modest in comparison with either the new European or pending UK requirements.

2. *Proxy Voting and Stakeholder Concerns*

Despite the apparent weakness of the existing disclosure rules, there are pressures that may have the effect of introducing stakeholder concerns more directly into the American corporate governance system, albeit stealthily. One important enactment is contained in the new SEC Rules and Forms (effective August 2003) requiring mutual funds (and registered investment advisers, based on companion Rules) to disclose the policies and procedures that they use to determine how to vote proxies for portfolio securities. As of April 14, 2004, these Rules require these same entities to disclose annually how the fund or adviser actually voted proxies for each company in its portfolio.[186]

183. *See* Repetto & Austin, *supra* note 177, at 5-6; Michelle Chan-Fishel, Friends of the Earth, Third Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil and Gas, Petrochemical, and Utilities Companies 3 (2004) (finding that 39% of reporting companies discussed climate change, with wide variation among industries (90% in utilities versus 11% in insurance), and that European companies report at much higher rates than American companies). The Friends of the Earth survey also found wide variations in the quality of disclosure, even among companies that discussed climate change, with very few issuers providing quantitative estimates of the potential impacts of climate change, or providing other specifics. *See id.* Another recent report on Management's Discussion and Analysis ("MD&A") disclosure, this one focusing on the mining industry, similarly found that known material environmental risks were routinely not disclosed. *See* Robert Repetto, Silence Is Golden, Leaden, and Copper: Disclosure of Material Environmental Information in the Hard Rock Mining Industry 2 (2004), *available at* http://www.yale.edu/environment/downloads/repetto_report_full.pdf.

184. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7241 (2004).

185. *Id.* § 7262.

186. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, Exchange Act Release No. 47,304, 68 Fed. Reg. 6564 (Jan. 31, 2003).

The clear intent of these new requirements is to allow shareholders to monitor their funds' involvement in the corporate governance process by requiring transparency with respect to how voting power is being exercised. This transparency may prove to be particularly important in allowing shareholders to monitor formerly undisclosed conflicts of interest between a mutual fund's managers and its investors.[187] Such a conflict can exist when, for instance, a fund's investment adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund.[188] It has been argued that these kinds of conflicts of interest are a major constraint on institutional shareholders' engagement in corporate governance issues.[189] The new proxy voting disclosure rule may mitigate this constraint by pressuring mutual fund managers to vote proxies in their shareholders' interests, rather than in the interests of the managers of portfolio companies whose business they seek.

The impact of these new requirements may even go beyond reducing mutual fund conflicts of interest. The rule was proposed in response to rulemaking petitions brought by labor groups (the AFL-CIO and the Teamsters) and by the Domini Social Investment Fund, a prominent SRI mutual fund.[190] Proxy voting disclosure was opposed, quite vigorously, by large institutional investors such as Fidelity, Magellan, and TIAA-CREF, although these funds supported disclosure of a mutual fund's general proxy voting policies.[191] Previous SEC proposals (in 1971 and 1978) to require mutual fund proxy voting disclosure had been withdrawn in favor of SEC encouragement of voluntary proxy voting disclosure (in 1980 and 1992), an effort that enjoyed only limited success.[192] The fact that the SEC promulgated this proxy voting disclosure rule in 2003 at the urging of certain shareholders—labor and SRI investors—over the objections of more "mainstream" institutional shareholders could be evidence of the SEC's recognition that "shareholders" are not unidimensional, that some shareholders are interested in the social and environmental implications of their

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187. *See* Stephen J. Choi & Jill E. Fisch, *How To Fix Wall Street: A Voucher Financial Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 281 n.40 (2003).

188. *See id.* at 281-82 (describing pension fund management conflicts of interest and other types of conflicts of interest). As one example, the Fidelity family of funds, which is the largest fund family in the United States, is said to have earned more than half of its $9.8 billion operating revenues in 2001 by providing fee-based services to companies at which it voted proxies on behalf of fund investors. *Id.* at 279; *see also* Securities Act Release No. 8188, Exchange Act Release No. 47,304, 68 Fed. Reg. at 6564-65 (emphasizing the economic significance of mutual funds). Without proxy voting disclosure, it is unlikely that Fidelity (or any other mutual fund) would vote contrary to management's interests on corporate governance proposals at companies from which it earns significant fees, even if such votes would otherwise be in its shareholders' interests. *See id.* at 6464.

189. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 U.C.L.A. L. REV. 811, 816-19 (1992).

190. Securities Act Release No. 8188, Exchange Act Release No. 47,304, 68 Fed. Reg. at 6567 n.24.

191. *See id.* at 6565, 6567.

192. *See* Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Disclose?*, 23 CARDOZO L. REV. 1419, 1454-62 (2002).

investments, and that those shareholders, even if a minority, have a right to know how their mutual funds vote.[193]

Moreover, required disclosure is likely to have implications for developments in proxy voting that have become evident in the last two years. During that period, there has been a seeming convergence of voting patterns between some conventional corporate governance activists and SRI shareholder activists. The immediate impact of the convergence can be seen in proxy voting statistics. During the 2003 proxy season, many corporate governance shareholder proposals achieved majority votes, including initiatives to eliminate staggered boards, to separate the CEO from the chairman of the board, and to limit executive pay.[194] Social and environmental proposals are also getting higher than usual levels of support. Average support for social and environmental proposals in 2002 was 9.4%, the highest level in ten years, and about one in seven proposals got at least 15% support.[195] At the same time, some social and environmental shareholder proposals achieved votes in the 20 to 40% range—levels of shareholder concern that one assumes firm managers will not reflexively ignore.[196]

193. *See* Securities Act Release No. 8188, Exchange Act Release No. 47,304, 68 Fed .Reg. at 6568. A recent shareholder resolution seeking to persuade the Teachers Insurance and Annuity Association—College Retirement Equities Fund ("TIAA-CREF") to disclose its proxy votes on social and environmental proposals got "significant support" from fund shareholders (18.7% of shares voted). *Id.* The SEC discussed this example in promulgating its proxy disclosure rules, stating that "regardless of whether all, or a majority of, investors are interested in proxy voting disclosure, we believe that fund shareholders who are interested in this information have a fundamental right to know how the fund has exercised its proxy votes on their behalf." *Id.*

194. A report on resolutions on CEO compensation and staggered boards issued by the Investor Responsibility Research Center ("IRRC") indicates that a majority of resolutions on these two subjects received majority votes in the 2003 proxy season. CEO Compensation/Golden Parachutes, *at* www.irrc.org/company/ceo_comp.html (last visited Feb. 20, 2005); Classified Boards, *at* www.irrc.org/company/classified.html (last visited Feb. 20, 2005).

195. *See* Press Release, Social Investment Forum, Report: 2003 Proxy Season Expected To Set Records, with CEO Pay and Global Warming Among Top Issues (Feb. 12, 2003), *available at* http://www.socialinvest.org/areas/news/030212_san_proxy.htm. The very narrow range between the average (9.4%) and the high level (over 15%) of support for social and environmental proposals (in statistical terms, a small standard deviation) suggests that most positive votes on social proposals are coming from about the same coalition of SRI funds and activist public pension funds.

196. *See* Press Release, Interfaith Center on Corporate Responsibility ("I.C.C.R."), Top Vote-Getting Resolutions of 2002 (Aug. 16, 2002), *available at* http://www.iccr.org/news/press_releases/art_topvotes02.htm (stating that 36.8% of votes cast in Hudson Bay's 2002 proxy supported adopting an I.L.O. code of conduct, and that in 32.8% of votes cast in Unocal's 2002 proxy supported implementing an employee policy based on I.L.O. principles). In addition, several climate change resolutions put to vote in the 2003 proxy season have garnered over twenty percent. Thus, 32% of Chevron Texaco's shares and 21% of Exxon Mobil's shares were voted in favor of a resolution calling for the development of renewable energy alternatives; and 26.9% of American Electric Power's shares, 24.2% of TXU's shares, 22.6% of General Electric's shares, and 22% of Exxon Mobil's shares were voted in favor of reporting on greenhouse gas emissions or global climate change risks. Press Release, IRRC, Global Warming (May 19, 2003), *available at* http://www.irrc.org/company/global.html. Other notable votes on resolutions concerning social or environmental concerns include 44.3% of Cooper Industries' shares voted in favor of a proposal to issue a sustainability report, and 42.8% of Dover Corporation's

Another result of disclosure of mutual fund and investment advisers' proxy voting records may be to permit organized labor to exert greater pressure on portfolio companies' management to take social and environmental issues seriously. If union pension fund managers' voting records are more transparent to their union beneficiaries, the percentage of votes for social and environmental initiatives that organized labor favors will presumably increase. According to the AFL-CIO, union and other worker-based pension, health, and savings funds represent $6 trillion in capital markets investment.[197] Analysis of the kinds of shareholder proposals that labor has brought forward shows them to be overwhelmingly concerned with corporate governance,[198] and the AFL-CIO has continued to emphasize corporate governance concerns such as executive compensation, board independence, and board accountability. Nonetheless, the AFL-CIO's proxy voting guidelines also emphasize that workers' funds should be invested in companies that support working families and their communities and that are aligned with a long-term view of sustainable value.[199] Moreover, those same guidelines suggest that fund managers should generally vote to support shareholder proposals that require adherence to International Labor Organization ("I.L.O.") principles; call for monitoring and reporting on domestic and global labor practices; or seek better environmental stewardship, reduced greenhouse emissions, and the like. Given labor's stake in the market, a concerted effort to demand fidelity to these principles, with voting transparency to allow monitoring of that fidelity, could increase the pressure on corporate management to take stakeholder concerns more seriously.

Developments such as these may or may not portend a shift in the American model of the primacy of shareholder value. On the one hand, the pressures just described are likely to enhance the ability of non-shareholder constituencies to influence U.S.-based global companies. On the other hand, however, the vehicle through which this influence will be exerted is eminently traditional: informed voting by a company's owners. Perhaps the fairest reading of what is happening is that shareholders are being given the opportunity to define *shareholder* value to include *stakeholder* concerns. Shareholders might take up this invitation for either of two reasons: because they believe that stakeholder issues really are economic at their core, or because they choose to use their voting power to pursue noneconomic ends. In either case, the result may be the same:

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shares voted in favor of a proposal to adopt a policy against discrimination based on sexual orientation. I.C.C.R., Companies, Resolutions, and Status: 2002-2003 Season, *at* http://www.iccr.org/news/press_releases/pr_dover.htm (last visited Feb. 20, 2005).

197. *See* AFL-CIO President John Sweeney Demands Corporate Reform, Announces Action Plan, *at* http://www.aflcio.org/corporateamerica/ns07302002.cfm (last visited Feb. 21, 2005).

198. *See* Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1045-46 (1998).

199. *See* Exercising Authority, Restoring Accountability: AFL-CIO Proxy Voting Guidelines (2003), *available at* www.aflcio.org/corporateamerica/capital/upload/proxy_voting_guidelines.

some increased pressures on American corporate managers to converge on the European model of thinking about stakeholders without any fundamental restructuring of the American governance model.

II. Implications: England as a Special Corporate Governance Case

On many corporate governance issues the United States and the UK remain similar to each other, and distinct from Europe (or Japan). Accordingly, it still makes sense for some purposes to refer to an Anglo-American corporate model. Both countries are understood to exhibit a "shareholder" form of capitalism, under which the purpose of the corporation is to maximize shareholder wealth.[200] As noted above, the United States and the UK continue to share a pattern of dispersed share ownership; have well-developed securities markets; and depend upon similar mechanisms to promote managerial accountability, including financial transparency, stock market valuations, and (at least in theory) the market for corporate control.[201] And despite some differences, in both countries stock ownership has become increasingly concentrated in institutions such as mutual funds or pension funds.

Notwithstanding these structural similarities, the details of shareholder capitalism in the United States and the UK are different, and likely to become more so as firms in the UK are pressed to diverge from the American model by a variety of forces at work in Britain and the Europe[202]—forces that are presently either nonexistent or much weaker in the United States. These forces include actions by such public institutions as the governments of the EU and the UK and a variety of private actors. The latter include pension funds, insurance companies, and other institutional investors, as well as the fund managers that advise them; NGOs; labor unions; and consumers. We will consider the impact of these factors in turn.[203]

A. Government Influences

1. *The EU*

Through its Modernization Directive, the EU is requiring large companies throughout Europe (including, of course, the UK) to engage in a very general version of sustainability reporting.[204] This requirement is not

200. See Cheffins, *supra* note 22, 498-506 for an overview of the divide between shareholders and stakeholders.

201. See *supra* note 21 and accompanying text for caveats about relying on the market for corporate control as a corporate accountability mechanism.

202. *See* Armour et al., *supra* note 12, at 541-49.

203. Space constraints preclude us from closely describing the important impact of NGOs (or labor unions) on the corporate governance divergence that we are examining here. We look more carefully at the role of NGOs in *Engage, Embed and Embellish: The Theory and Practice of Corporate Social Responsibility*, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=691521.

204. It is beyond the scope of this paper to examine the overarching EU sustainability reporting requirement in comparison to national developments regarding sustainability reporting within EU member states, but it would be interesting to see the extent to which

nearly as specific as that imposed by French Article 116,[205] but it seems likely that the process will continue to evolve in the direction of more, and not less, sustainability reporting. Since the Modernization Directive came after the UK was already embarked on the Company Law Review process and was already seriously considering expanded nonfinancial disclosure in the OFR, its main import in Britain is not the fact of the enactment itself, but rather as an example of a more general point. That is, as a member of the EU, the UK will certainly be more strongly influenced by European approaches to corporate governance than the United States will be. While this is a reciprocal process,[206] the UK will have to conform to the more stakeholder-oriented views of other EU Member States to the extent such views become part of EU directives. The potential for reciprocity is evident in the controversial Thirteenth Directive on Takeovers. Because of the influence of individual Member States, its final version was less shareholder-centric than originally proposed by the EU's High Level Group of Company Law Experts (requiring employee consultation, for example), but it also provided for more shareholder power to effect hostile bids than exists in most EU states.[207] EU employment law has also brought stakeholder thinking to the UK in the form of requirements for employee consultation in connection with mergers, large-scale layoffs, or insolvencies.[208] While it is impossible to predict exactly where the equilibrium between the UK and the EU will be reached, we expect the EU to exert the stronger gravitational influence, ultimately leading the UK to a significantly greater recognition of stakeholder influence than the United States.[209]

2. *The UK Government*

a) Corporate Governance

Of probably greater importance, the UK government has been more active over the last decade than its American counterpart on such issues as board structure and independence, financial reporting, executive compensation, and shareholders' rights, and, more recently, companies' social, eth-

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Europe is developing a distinctly European approach to such reporting, as opposed to different states' approaches.

205. The environmental component is quite specific, though, by virtue of the May 30, 2001, EU Recommendation on the Recognition, Measurement, and Disclosure of Environmental Issues in Annual Reports and Financial Accounts. *See supra* notes 73-80 and accompanying text.

206. See generally Barnard et al., *supra* note 13, for a discussion of the reciprocal influence dynamic. They discuss the particular example of the UK's influence on the EU on the matter of labor flexibility. *Id.* at 462-69.

207. *See id.* at 471-73.

208. *See* Armour et al., *supra* note 12, at 541-44 (discussing the influence of EU labor policy on the UK).

209. Where this equilibrium will be reached will also depend on the differing influences of the individual EU member states on issues of companies' social and environmental responsibilities, since we are reminded by readers from Europe that there are few areas on which there is a unified "European" perspective—that the Danish view on the environment or labor partnerships is different from the Spanish or Hungarian, and so on.

ical, and environmental responsibilities and reporting. This may be partly attributable to the fact that the UK had a head start on the United States in reevaluating core aspects of corporate governance, since their "Enron equivalent" (the Maxwell and Polly Peck debacles)[210] occurred in 1991, not 2002. Another important difference between the two countries is that in the UK the corporate governance inquiry and development of best practice are consolidated at the national level, rather than being split between the states and the federal government as here. Delaware exerts disproportionate influence over state corporate law in the United States, so as a practical matter, state power is not divided fifty ways. Nonetheless, Delaware's common law contribution to corporate governance reform is not as systematic as the UK's committee process has been, nor has the federal government in the United States been explicitly involved in regulating corporate governance until recently.

Whether as a consequence of these factors or as a combination of these and other factors, on a number of corporate governance issues companies in the UK have diverged from United States' practice over the past decade.[211] For instance, 90% of the UK's largest companies split the role of CEO and Chairman,[212] as recommended by the Cadbury Committee, versus only 19% of a comparable group of United States' companies.[213] Differences can be seen in the levels and composition of executive compensation as well, although the trends here are towards convergence on a more American model, both in the UK and throughout Europe.[214] Average executive (CEO) compensation in the United States is still twice that in the UK, even though pay levels in the UK (as throughout Europe) are rising.[215]

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210. *See supra* notes 96-97 and accompanying text.

211. For a somewhat informal discussion of differences between UK and U.S. approaches to corporate governance, see Jack Keenan, *Corporate Governance in UK/USA Boardrooms*, 12 Corp. Governance 172 (Apr. 2004).

212. *See* Higgs Report, *supra* note 92, at para. 5.3.

> There is already a high level of compliance with the Code's provision to separate the roles of chairman and chief executive, recommended by Cadbury a decade ago. Around 90 per cent of listed companies now split these roles. Separation of the roles of chairman and chief executive is one of the strengths of the UK corporate governance regime.

Id. The Higgs Report was commissioned in 2002 to evaluate the adequacy of the UK corporate governance regime in light of Enron and similar failures in the United States, and in order to continue to reevaluate UK corporate governance post-Cadbury, in particular given the sustained drop in share values between 2000 and 2002. *See id.* at paras. 1.2-1.3.

213. *See* Jeswald W. Salacuse, *Corporate Governance, Culture, and Convergence: Corporations American Style or with a European Touch?*, 9 Law & Bus. Rev. Ams. 33, 56 (2003) (citing statistics showing that, in 2001, only 19% of U.S. S&P 500 companies separated the positions of CEO and Chairman, as compared to 100% of Germany's DAX 30 and 100% of Holland's top eleven companies); *see also* Higgs Report, *supra* note 92, at 16, para. 2.9.

214. *See* Cheffins, *supra* note 22, at 506-09 (discussing statistics on the United States, UK, and Germany on executive pay).

215. *See* Brian R. Cheffins, *Will Executive Pay Globalise Along American Lines?*, 11 Corp. Gov. 8, 9 (2003). In fact, Professor Cheffins has noted that "[e]mpirical studies lend support to the proposition that 'if you averaged out US pay and German pay, you would probably come out close to current UK pay levels for chief execs.'" Cheffins, *The*

Moreover, the long-term "incentivised" portion of CEO pay (long-term incentive plans and stock options), which is a corporate governance measure designed to align the interests of top managers and shareholders, constitutes 161% of the average U.S. CEO's salary, versus only 44% in the UK.[216]

b) Corporate Social Responsibility

In addition to the UK government's concentrated attention to corporate governance, it has also offered strong support for bringing social, environmental, and ethical concerns into the discussion of corporate law and obligation. Comparing CSR developments in the UK, EU, and United States, one pair of researchers concluded that "[m]ore than any nation we studied, Great Britain has developed policies and incentives, asked for public feedback and communicated to citizens that responsible global corporate behavior is imperative."[217] This attention to social, environmental, and ethical concerns clearly informed the OFR process and outcome, but other government initiatives have also been important in encouraging stakeholder thinking by corporate directors and managers. These initiatives have included both regulatory actions, active encouragement of voluntary initiatives, and public-private partnerships.

One new law of particular significance is an amendment to the Occupational Pension Schemes (Investment) Regulations, which went into effect in July 2000, and which requires UK pension fund trustees to include in their annual statement of investment principles ("S.I.P.") comments on the following:

> The extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; [and]
>
> Their policy (if any) directing the exercise of rights (including voting rights) attaching to investments.[218]

While this is, on its face, a disclosure statute, its purpose is to encourage pension funds to ask their investment managers to consider these stakeholder issues in constructing investment portfolios, and to encourage the investment managers to ask pertinent questions of the companies in which they invest. The intended effect of this statute is thus to

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Metamorphosis of "Germany, Inc.", *supra* note 22, at 508 (quoting Charles Arthur, *The Fat Cats Are Back, Purring Excuses as They Lap up Rich Rewards for Their Work*, THE INDEPENDENT (LONDON) 3 (July 25, 2000)).

216. *See* Cheffins, *Current Trends in Corporate Governance*, *supra* note 98, at 9. These two points could be related, in that a company that does not split the CEO and Chairman position would generally lack a board counterweight to the power of the CEO to effectively set his own compensation. For a discussion of the "managerial power" hypothesis as the explanation for the exceptionally high levels of CEO compensation in the United States, see Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 CHI. L. REV. 751 (2002).

217. *See* AARONSON & REEVES, *supra* note 46, at 25.

218. Occupational Pension Schemes (Investment) Regulations (1996) SI 1996/3172, *available at* www.hmso.gov.uk/sr/sr1996/Nisr_19960584_en_1.htm.

compel company managers to give more information to pension fund trustees and investment managers on their companies' economic, social, and environmental performance.[219] Perhaps as a consequence, as of 2001, 89% of the top 100 companies in the UK included health, safety, environmental, or social information in their financial reports, and 49% of them published a separate report containing this information.[220] Since pension funds hold 35% of the financial assets held by institutional investors in the UK,[221] their questions "beyond the bottom line" could have a significant impact on the business practices of portfolio companies.

The actual effect of this law is currently under review, both by Just Pensions, an NGO committed to encouraging more socially responsible investment, and by the government, and neither seems terribly impressed with what they have found to date. A survey by Just Pensions does show that almost half of the pension fund trustees it surveyed do expect their questions and engagement with portfolio companies eventually to have an impact on how those companies manage their social and environmental issues.[222] The general conclusion of the Just Pensions report is that the promise of the pension fund amendment has yet to be fully realized, however, and that "a gap has emerged between policy and practice."[223] Similarly, the government's analysis concluded that pension funds' engagement with portfolio companies and the funds' policies on socially responsible investment have not changed substantially since the S.I.P. amendment went into effect, except in the case of very large funds.[224] Yet the government recognized that changes in the largest funds' behavior may well produce profound consequences, since "changes made by just seven per cent of occupational pension schemes affect 64% of all memberships."[225]

Our interviews bore out the view that the S.I.P. amendment is having a profound effect on large pension fund behavior. The S.I.P. amendment was identified by one fund manager we interviewed as having been an "amazing and powerful catalyst" for socially responsible investment and for encouraging some fund managers to engage with their portfolio companies

219. *See* Aaronson and Reeves, *supra* note 46, at 29-30.

220. *See* KPMG International Survey of Corporate Sustainability Reporting 2002, *supra* note 16, at 16.

221. *See* Organisation for Economic Co-operation and Development, Institutional Investors Statistical Yearbook: 1992-2001, at 19 (2004).

222. *See* Chris Gribben & Leon Olson, Ashbridge Center for Business & Society, UK Social Investment Fund, Will U.K. Pension Funds Become More Responsible? 3-4 (2004), *available at* http://www.uksif.org/J/Z/Z/lib/2004/files/01/jp-ukpf-will/ukpf 2004-justpens.pdf (finding that 42% of pension trustees who responded think that pension fund activism will lead to "substantial improvements" in the way companies manage social and environmental issues in the next ten years).

223. *Id.* at 4.

224. *See* 2 Sarah Horack et al., The Myners Principles and Occupational Pension Schemes: Findings from Quantitative Research 5 (Dep't for Work & Pensions Research, Report No. 213, 2004), *available at* http://www.dwp.gov.uk/asd/asd5/rports2003-2004/rrep213.asp.

225. *Id.* at 3.

on CSR issues.[226] Another fund manager said that his firm had recently been asked by one of its largest clients, a public pension fund, to report back on progress on the CSR principles identified in the fund's S.I.P. As he put the point, "when one of your largest clients is asking about the environment and labor issues in the supply chain, you listen."[227] Unlike most developments in the CSR field, the S.I.P. amendment is not a voluntary self-regulatory endeavor initiated by companies.[228] Accordingly, this law has the potential to affect the thinking and actions of a broader range of companies than does self-regulation by corporate leaders. Moreover, since the government is currently in the process of evaluating the law, it may eventually do more to advance its underlying policy goals.[229] The S.I.P. amendment, when evaluated in conjunction with the OFR requirements directed specifically to companies' management, is yet another source of pressure for divergence from the U.S. short-term shareholder wealth maximization model.

In addition to promulgating these laws, the UK government has been active in encouraging companies to think more carefully about social and environmental responsibilities, and has been a leading influence in a number of public/private partnerships on specific CSR issues.[230] It has appointed a Minister for Social Responsibility, currently Stephen Timms,[231] and has a website detailing all of the government's CSR initia-

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226. We did not promise anonymity in our interviews. Nonetheless, in keeping with what we believe to be the spirit of the interviews, we do not name persons or organizations except where we were asking questions about public statements or public actions by that person or organization, or except where we have explicit authorization from the named individual. We have notes on file for all of our interviews and have sent draft copies of this Article to everyone we interviewed, asking for comments and providing an opportunity to correct quotes if necessary.

227. Interview with Rob Lake, Head of Corporate Engagement, Henderson Global Investors, London, England (Feb. 25, 2005) (notes on file with author).

228. We recognize that in the globalizing economy there is an increasingly blurred line between voluntary industry self-regulation and mandatory law, particularly given "new governance" understandings of how Governments interact with private entities. *See supra* note 169.

229. The UK Government also passed a law in 2000 specifically directed at the trustees of UK charities requiring them to ensure that investments are "suitable." Trustee Act, 2000, c. 29, § 4(3)(a). According to the Charity Commission's interpretation, this means that trustees are required to take into account not only financial suitability but also suitability with regard to the charity's stated aims, "applying relevant ethical considerations as to the kind of investments that are appropriate for the trust to make." Charity Commission, Operational Guidance, Trustee Act 2000: General Power of Investment, para. 7.3 (2002), *available at* http://www.charity-commission.gov.uk/supportingcharities/ogs/g086b001.asp. This has the effect of requiring charitable trusts to engage in SRI screening.

230. *See* Cynthia A. Williams, *Civil Society Initiatives and "Soft Law" in the Oil and Gas Industry*, 36 N.Y.U. J. INT'L L. & POL. 457 (2004) (discussing actions of the UK government to address specific human rights issues in the oil and gas industry by convening public and private partnerships to develop standards of best practices).

231. *See* DTI Ministerial Team, Stephen Timms MP, *at* http://www.dti.gov.uk/ministers/ministers/timms.html (last visited Feb. 23, 2004).

tives.[232] As the website states, the UK government has "[a]n ambitious vision for UK businesses to consider the economic, social and environmental impacts of their activities, wherever they operate in the world."[233] Various documents linked to the website portray a wide array of UK government initiatives, both domestic and international, to promote CSR, to develop public-private partnerships to address such specific issues as climate change or economic inequality, to make the business case for CSR, and to develop a CSR Academy.[234] While a distinct flavor of self-promotion is to be expected in such a website, it is probably not an exaggeration when Minister Timms states that "[t]he UK is increasingly seen as one of the leading contributors internationally on CSR thinking and practice."[235]

B. Market Influences

Signals from the government and the Commissions it establishes only represent a part of the relevant influences on corporate managers' thinking and action. There are powerful market influences encouraging shareholder thinking in the UK, Europe in general, and the United States: stock options as an important part of executive compensation; market and financial press pressures to show quarter-by-quarter increases in growth and profits; and the market for corporate control, to name three of the strongest.[236] Still, we suggest that in the UK there are stronger pro-stakeholder influences, even among some market actors, particularly institutional investors. In addition, these market signals are amplified in the UK by the sophisticated NGO community, and by the geographic concentration of many of these actors in and around London, leading to a situation where norms of responsible corporate conduct are shifting more rapidly than in the United States to encompass stakeholder concerns.

1. *Institutional Investors*

One corporate governance development of importance in both the United States and the UK is that institutional investor concentration in both markets has increased dramatically since the 1970s.[237] The pattern observed by Professors Black and Coffee at the beginning of the 1990s, that "[t]he UK equities market is. . . more institutionally dominated than

232. The UK Government Gateway to Corporate Social Responsibility, *at* http://www.csr.gov.uk/ (last visited Feb. 23, 2005).

233. *See id.*

234. *See* Dep't of Trade & Indus., Corporate Social Responsibility: A Government Update 4 (2004), *available at* http://www.csr.gov.uk/pdf/dti_csr_final.pdf (quoting CSR Minister Stephen Timms that "[m]ainstreaming CSR into management practice is central to maximising its contribution to business success and to achieving our sustainable development goals[,]" and that one of his priorities "is to establish . . . a CSR Academy which will support the development of CSR skills across business practice").

235. *See id.* at 3.

236. *See supra* notes 21 and 38 and accompanying text.

237. *See also* Bernard S. Black and John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2001-02 (1994) (discussing the influence of institutional investors in the UK).

the U.S. stock market,"[238] remains true. "[I]institutional investors collectively account for about seventy per cent of listed UK equities,"[239] while accounting for only 60% of listed U.S. equities.[240] But the differing compositions of institutional ownership in the two countries may be even more significant. In the UK, insurance companies hold 51% of institutionally-owned or managed financial assets, pension funds hold 35%, and mutual funds hold 14%; in the U.S., insurance companies hold 21% of institutionally-owned or managed financial assets, pension funds hold 33%, and mutual funds hold 34%, with 14% held by other institutional investors (such as bank trust departments).[241] Thus, in the UK, 86% of institutional assets are held by insurance companies and pension funds—entities that have long-term pay-out obligations—versus 54% in the United States.[242] In contrast, the U.S. market has a heavier concentration of mutual funds (34% versus 14% in the UK), and these might generally be assumed to have a shorter-term investment horizon.[243]

We suggest that the greater concentration of longer-term investors in the UK is one factor that has led to more attention being paid in that market to longer-term social and environmental risks. We recognize that there is not a direct translation between pension funds' or insurance companies' putative long-term interests and their investment and voting behavior, particularly since both pension funds and insurance companies typically dele-

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238. *See id.* at 2002.

239. *See* Geof Stapledon, Analysis and Data of Share Ownership and Control in the UK, *available at* http://www.dti.gov.uk/cld/staple.pdf (analyzing 1997 data); *see also* National Statistics, Share Ownership: A Report on Ownership of Shares as at 31st December 2003, *available at* http://www.statistics.gov.uk/downloads/theme_economy/ShareOwnership2003.pdf.

240. *See* Insurance Information Institute, Savings, Investment, and Debt Ownership: Ownership of Equities and Corporate Municipal Bonds, *available at* http://financialservicesfacts.org/financial2/savings/investments (analyzing 2003 data).

241. *See* OECD, INSTITUTIONAL INVESTORS STATISTICAL YEARBOOK, 1992-2001, fig.1 (2001).

242. Most of the business of life insurance companies in the UK is effectively savings and investment, and customers can earn annual bonuses depending on the success of the insurance company's investments. *See* Myners Review, *supra* note 115, at para. 90. As a result, insurance companies compete in commercial markets selling to individuals, *id.* at 33-34, and cannot be considered an unmitigated long-term influence in the market. However, their turnover rates are low compared to U.S. institutional investors, *see* Black & Coffee, *supra* note 237, at 2010, and a number of insurance companies are participating in projects to address long-term challenges such as climate change or emerging markets government corruption. *See infra* notes 281&282 and accompanying text. Professors Black and Coffee note that the annual turnover rate for life insurers in the UK is lower than only a few "heavily indexed U.S. pension funds and a few exceptional U.S. money managers." Black & Coffee, *supra* note 237, at 2010.

243. In specific cases, this would depend on whether they are actively managed or indexed, whether they practice socially-responsible investing, and in which investment sector they operate. Yet, as one Wall Street investment manager recently said, to understand the short-term orientation in the United States, "you just need to look at who's paying the Street today—hedge funds—and they have the highest turnover and shortest time horizon of any type of institutional investor." Remarks at the CERES and Wirth Chair Conference on Climate Change Risks and the SEC (October 18, 2004) (authors' notes on file).

gate fund management to investment professionals who may not share those long-term perspectives or who are under their own short-term competitive pressures.[244] Yet British insurance investors have typically been long-term investors, with much lower turnover in their portfolios than all but a few U.S. institutional investors.[245] And eleven of the twenty leading fund managers for the UK pension industry are members or affiliates of the UK Social Investment Forum, as are seven of the top ten fund managers in the UK charity sector,[246] which is some evidence that concerns about long-term social and environmental risks are being translated into fund management. Moreover, the government has created a policy framework that encourages both a long-term perspective and institutional investor activism on corporate governance and CSR.[247]

As described above, the 1998 Hampel Committee Report was significant for a number of reasons, including its attention to shareholder democracy and its observation that institutional investors were not using their voting power in proportion to their concentration in the market.[248] One response to this conclusion was the promulgation of Section 2 of the Combined Code, directed to institutional investors' responsibilities.[249] This section contains three principles: that institutional investors should "enter into a dialogue with companies based on the mutual understanding of objectives," that they should carefully evaluate companies' disclosure concerning corporate governance arrangements, and that "[i]nstitutional shareholders have a responsibility to make considered use of their votes."[250]

a) The Myners Review

In 2000, the government responded further to Hampel by initiating a review of institutional investment behavior. This review, the Myners

244. *See* Stapledon, *supra* note 239, at 5.

245. Black and Coffee, *supra* note 237, at 2012. Professors Black and Coffee note that the annual turnover rate for life insurers in the U.K. was lower than only a few "heavily indexed U.S. pension funds and a few exceptional U.S. money managers." *Id.*

246. *See* European Sustainable Responsible Investment Forum, Socially Responsible Investment Among European Institutional Investors: 2003 Report, at 21 (2003), *available at* http://www.eurosif.org/pub2/lib/2003/10/srirept/eurosif-srireprt-2003-all.pdf. This high level of fund management affiliation with the U.K. Social Investment Forum may reflect the fact that pension funds are asking their fund managers to create social and environmental policies for the pensions' S.I.P., pursuant to the pension funds legislation described above, and so fund managers recognize a business advantage in having some expertise in this regard. A number of our interviews with pension fund personnel and investment fund managers in the UK suggest this interpretation.

247. This framework includes not only the legislation specifically addressed to pension funds and charitable trusts discussed above, but also the Hampel Committee and the Myners Review of Institutional Investment. *See supra* notes 111-120 and accompanying text; *supra* notes 218-229 and accompanying text regarding legislation addressed to pension funds and charitable trusts; *infra* notes 251-259 and accompanying text regarding the Myners Committee.

248. *See supra* notes 218-229 and accompanying text.

249. *See* 2003 Combined Code, *supra* note 111, § 2 (section entitled "Institutional Shareholders").

250. *Id.* at paras. E.1-E.3.

Review,[251] ultimately focused much of its attention on the management of the assets of the occupational pension fund sector of the market, recognizing the importance of the pension fund sector both to the economy, by providing capital, and to individuals' long-term economic well-being. A number of problems were identified, including the unrealistic expectations of pension fund trustees who were typically not professionals, who were "under-resourced," and who consequently relied on a "narrow range of expertise."[252] Myners criticized the vagueness of the time frames by which these investment firms would be measured. The consultants pointed to the quarterly trustees' meeting, which focused fund managers' attention on short-term performance, while trustees insisted that they would not replace fund managers for "poor performance over the short term."[253] The Myners Review found this lack of clarity to be a possible contributor to short-termism in the City, and inconsistent with the long-term nature of pension funds' obligations.[254] The Myners Review also identified as a problem pension fund managers' general reluctance to intervene "to tackle corporate underperformance in investee companies, particularly pre-emptive action to prevent troubled companies developing serious problems."[255]

To address these problems, Myners made a number of proposals to increase the professionalism of fund trustees and provide clarity to their relationship with fund managers.[256] It also recommended that "the U.S. Department of Labor Interpretive Bulletin on Employment Retirement Income Security Act (ERISA) 1974 which deals with [shareholder voting and engagement] be included in fund management mandates, and incorporated in law."[257] Myners construed the Bulletin as "clearly articulat[ing]

251. *See* Myners Review, *supra* note 115, at 1-2.

252. *Id.* at 9.

253. *Id.* at 10.

254. *See id.* at 10.

255. *Id.*

256. These included suggestions that trustees should clarify their investment objectives and include information about them in their Statement of Investment Principles, to be sent out to members annually; should normally be paid; should attend to asset allocation; should be clearer in their instructions to their investment managers on whether to index or not and on the time frame over which performance would be judged; should set investment objectives for their professional managers that are consistent with the funds' investment objectives; and should measure the performance of the funds and of their professional managers. *See id.* at 21-22.

257. *Id.* at 14. The interpretive bulletin to which the Myners Review refers is Interpretive Bulletin 94-2, which identifies the voting of proxies as a fiduciary duty and requires that, in voting proxies, "the responsible fiduciary consider those factors that may affect the value of the plans' investment and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives." Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, 29 CFR § 2509.94-2 (2004). This Interpretive Bulletin also recognizes the following:

> [Shareholder activism] intended to monitor or influence the management of companies in which the plan owns stock is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management . . . is likely to enhance the value of the plan's investment[.]

the duties of managers to intervene in companies—by voting or otherwise—where there is a reasonable expectation that doing so might raise the value of the investment."[258] The Review also endorsed use of the Cadbury model, which required companies to "comply [with best practice] or explain," to shape behavior in this regard.[259]

b) The Government's Response to the Myners Review

In response, in 2001 the UK government announced that it would "take forward all the Myners Review's recommendations,"[260] that it would endorse Myners' voluntarist approach of defining best practice and asking funds to "comply or explain," but that in two years it would conduct a qualitative and quantitative review to determine if industry practices had changed to follow the principles.[261] The clear implication was that there could be a legislative solution to the identified problems if the voluntary approach proved insufficient. The two-year review has just been completed, and it concluded in general that there has been "significant voluntary progress towards adopting the Myners Principles," particularly among large pension funds (those with 1,000 members or more), and particularly in the areas of asset allocation, establishing clear objectives, and selecting appropriate benchmarks.[262] The government found that less progress had been made on shareholder activism, except among the largest funds.[263] How the government will respond to these findings remains to be seen.

c) Institutional Investor Initiatives

According to our preliminary interviews of investment professionals, pension fund employees, and SRI fund managers in London, the threat of potentially onerous legislation has been an important motivator for some

Id. It is ironic that Myners, and the Government in its response, would so explicitly endorse the approach of the Interpretive Bulletin, since many observers in the United States have interpreted it as potentially limiting the extent to which fund managers may incorporate concerns about social, environmental, or ethical issues into their voting behavior. *See* Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1076 (1998) (discussing the controversy over whether fund managers have the power to consider other values beyond shareholder wealth maximization, given the Interpretative Bulletin mentioned above); *see also* WILLIAM M. O'BARR & JOHN M. CONLEY, FORTUNE AND FOLLY: THE WEALTH AND POWER OF INSTITUTIONAL INVESTING 229-32 (1992) (discussing the influence of fund managers in shaping the corporate governance debate over the Interpretive Bulletin).

258. *Id.*

259. *See id.* at 16. Myners suggested, however, that the "scale of the distortions it has identified would justify requiring funds to report their compliance with the principles through legislation, if the industry does not adopt them voluntarily." *Id.*

260. HM Treasury & Dep't for Work and Pensions, Myners Review: Institutional Investment in the UK: The Government's Response 2 (2001), *available at* http://www.dwp.gov.uk/publications/dss/2001/myners/response.pdf.

261. *See id.* at 29, annex B.

262. Sarah Horack et al., Dep't for Work and Pensions, Research Summary: The Myners Principles and Occupational Pension Schemes (2004), *available at* http://www.dwp.gov.uk/asd/asd5/summ2003-2004/213summ.pdf.

263. *See id.*

to become more actively engaged with portfolio companies.[264] The threat of legislation, in conjunction with Myners' emphasis on the S.I.P., also provided activists within some of these institutions with additional leverage to promote greater sensitivity to social and environmental issues at portfolio companies, particularly where such issues pose long-term financial risks.

Increased engagement and activism are evident in a number of actions by coalitions of institutional investors in the UK. Thus, in 2002, in a direct response to Myners, members of the Institutional Shareholders Committee ("ISC") issued its own revised Statement of Principles for Institutional Shareholders and Agents (revised from its 1991 Statement), which has now been incorporated into the Combined Code.[265] The ISC includes the major trade associations for insurers (the Association of British Insurers), for pension funds (the National Association of Pension Funds), for investment trusts (the Association of Investment Trust Companies), and for investment managers (the Investment Management Association), and represents over 80% of institutional investment in the UK.[266] These Principles deal with how ISC members will monitor corporate governance and performance in portfolio companies, when they will intervene with management of portfolio companies, and how they will evaluate the effectiveness of their engagement and report to clients and beneficial owners.[267] Reasons for intervening with companies include strategy or performance concerns; and corporate governance concerns, such as independent directors "failing to hold executive management properly to account," "unjustifiable failure to comply with the Combined Code," "inappropriate remuneration levels/incentive packages/severance packages," or "the company's approach to CSR."[268] The ISC stated that it would monitor its own actions in light of its Statement of Principles, and would be "refreshing" them, if need be, in two years "in light of experience and market development."[269] That evaluating a company's approach to CSR is part of the identified responsibilities of institutional investors, and that it is included in a policy

264. We recognize that, as law professors, we may have a tendency to overstate the importance of legal and regulatory explanations for shifts in market behavior. Pension funds and other institutional investors also have financial reasons to become engaged owners—to exercise voice rather than exit—given the size of their investments, and given that they may own broad swathes of the market as a whole. *See* JAMES HAWLEY & ANDREW WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC 1-29 (2000) (describing how growing concentration of institutional investors has created a new category of "universal owners" with interests in the entire market, and incentives to exercise "voice" rather than "exit").

265. *See* 2003 Combined Code, *supra* note 111, para. E.1 (urging institutional shareholders to apply the principles set out in the Institutional Shareholders' Committee's document entitled "The Responsibilities of Institutional Shareholders and Agents-Statement of Principles" and stating that those responsibilities should be reflected in fund manager contracts).

266. *See* Institutional Shareholders' Committee, The Responsibilities of Institutional Shareholders and Agents: Statement of Principles 1 n.1 (2002), *available at* http://www.abi.org.uk/Display/File/38/Statement_of_Principles.pdf.

267. *See id.*

268. *Id.*

269. *Id.* at 5.

statement issued by over 80% of the entire institutional investment community, is evidence that the concept of CSR has become more generally accepted in the British investment community than in the United States.

This evidence is buttressed by another set of guidelines, those of the Association of British Insurers ("ABI"), issued in 2000, which represents about 50% of institutional funds under management in the UK. In this document, the ABI's Disclosure Guidelines on Socially-Responsible Investment, the ABI stated:

> Public interest in CSR has grown to the point where it seems helpful for institutional shareholders to set out basic disclosure principles, which will guide them in seeking to engage with companies in which they invest.
>
> In drawing up guidelines for this purpose they are mindful of statements made at multilateral level through the Guidelines for Multinational Corporations published in 2000 by the Organisation for Economic Cooperation and Development, as well as by the European Union and UK Government. These, coupled with legal disclosure obligations on UK pension funds and local authority investments, point to clear responsibility both for companies and for institutions that invest in them.
>
> Institutional shareholders are also anxious to avoid unnecessary prescription or the imposition of costly burdens, which can unnecessarily restrict the ability of companies to generate returns. Indeed, by focusing on the need to identify and manage risks to the long and short-term value of the business from social, environmental and ethical matters, the guidelines highlight an opportunity to enhance value through appropriate response to these risks.[270]

The ABI Disclosure Guidelines, which predate the OFR, seek information on an annual basis concerning the board's approach to taking regular account of social, environmental, and ethical matters. This information includes assurances that the board has identified short- and long-term risks to the company from such matters, based on adequate information; and that the company has an effective system in place to manage such issues.[271] The guidelines also seek companies' actual analyses of short- and long-term risks from social, environmental, and ethical issues, and what processes were used to verify the information being provided.[272] The ABI explicitly articulated its hopes that the use of the guidelines would "help companies to develop appropriate policies on CSR," and that "[e]xamples of initiatives for reducing and managing risks [would] include regular contact with stakeholders and mechanisms to ensure that appropriate standards are maintained in the supply chain."[273] In an explicit incentive to companies to develop CSR initiatives, the ABI stated that "[e]vidence of such initiatives would be viewed positively by shareholders."[274] Again, that an industry association representing 50% of institutional investment

270. ABI, Disclosure Guidelines on Socially-Responsible Investment 1 (2003), *available at* http://www.abi.org.uk/Display/File/85/SRI_Guidelines.doc.

271. *See id.* at paras. 2(1.1)-(1.4).

272. *See id.* at paras. 2(2.1)-(2.4).

273. *Id.* at 2-3.

274. *Id.* at para. 5, at 3.

has articulated such a clear statement of its expectations about CSR action and disclosure indicates that CSR is more central to the ongoing discussions of corporate conduct and governance in the UK than in the United States, and understood as such by a wider swath of institutional investors.[275]

One early example of institutional investor interest in CSR issues was the leadership of Friends, Ivory & Sime (which became ISIS Management and is now F&C) on labor standards in the retail sector.[276] Starting in December of 1999, Friends Ivory & Sime ("Friends, Ivory") began discussions about the conditions of labor in the global supply chains of eleven UK clothing retailers whose stock it held, having formed the opinion that there was significant reputational risk to those companies from these international labor issues.[277] Over the course of the next eighteen months, Friends, Ivory met with each of the retailers, developed information about best practice to manage the risks of having child labor and sweatshops in the supply chain, and organized seminars with industry participants to develop greater awareness of these risks.[278] By late 2001, Friends, Ivory was satisfied that each of the eleven companies had made improvements and was "on course for best practice risk management in this area."[279] ISIS Management carried forward Friends, Ivory's concerns with CSR issues, both by its active participation in a number of the institutional investor

275. A research report commissioned by the ABI provides further evidence of the penetration of socially-responsible thinking among British insurers. *See* Roger Cose, Association of British Insurers, Investing in Social Responsibility: Risks and Opportunities (2001), *available at* http://www.abi.org.uk/Display/File/364/csr_Report.pdf (examining the various rationales for businesses to adopt CSR policies). The author identified two strands of thinking about corporate governance risk, and its relation to CSR. One strand

> has created dedicated teams using the research skills built up by the ethical investment industry to create an 'engagement' approach to [social, ethical, and environmental] risks. The aim of 'engagement' is to raise issues such as human rights and environmental risk and to safeguard shareholder value by encouraging companies to improve the management of such risks.

Id. at 8. Cowe identified a second, "broader SRI strand" as having developed among a "range of institutions concerned with how to evaluate the quality of companies' SEE risk management." *Id.* The SRI Forum, an informal network, includes a number of the largest insurance and pension fund managers, including Barclays Global Investors, Baillie Gifford, BP Pension Fund, Legal and General, ISIS, Gartmore, Hermes, Newton Investment Management, Morley Investment Management, Railpen Investments, as well as PricewaterhouseCoopers and the ABI. *Id.*

276. ISIS Asset Management plc was formed by the merger of Friends Ivory & Sime and Royal & SunAlliance Investments, and it was one of the UK's ten largest investment companies. London Sustainability Exchange, Investment Firm Is Top Company for Sustainable Business in City of London, *at* http://www.lsx.org.uk/news/default.aspx?id=331 (Feb. 21, 2003). ISIS and F&C announced a merger in 2004, stating that they would become the 4th largest asset manager in the U.K., and one of the top ten pension fund managers in Europe, with £120 billion of assets under management ($216 billion dollars, using late September 2004 exchange rates). *See* Press Release, ISIS, Merger of ISIS and F&C To Create UK's Fourth Largest Asset Manager (July 2, 2004), *available at* http://www.isisam.com/newsDetail.asp?newsID=325.

277. *See* Association of British Insurers Report, *supra* note 275, at 14.

278. *See id.*

279. *See id.*

collaborations described below, and in its corporate governance policy, which specifically evaluates the extent to which companies in which it invests manage CSR issues properly and to which they disclose information to shareholders consistent with the ABI Disclosure Guidelines on Socially Responsible Investment.[280]

Institutional investor leadership can also be seen in a number of collaborative efforts in the UK to address other long-term social and environmental issues such as climate change, HIV and AIDS, and developing country government corruption. For instance, the Institutional Investors Group on Climate Change ("IIGCC") engages with its members' portfolio companies to "address any material risks to and opportunities for their businesses associated with climate change and a shift to a lower carbon economy."[281] This coalition of institutional investors, currently chaired by Raj Thamotheram of the Universities Superannuation Scheme (the fourth-largest pension fund in the UK), includes a broad range of public and private pension funds, insurance investors, and asset managers, including a number of mainstream entities such as Merrill Lynch Investment Managers (third-largest pension fund manager in the UK), Prudential Property Investment Managers, and Schroder Investment Management (sixth-largest pension fund manager in the UK).[282] Another British-based coalition of global institutional investors, the Carbon Disclosure Project, recently issued the results of its second survey of the Global 500 companies on the strategic and financial implications of climate change.[283] The response to this survey almost tripled (from thirty-five to ninety-five companies) from 2002 to 2003; and the amount of assets represented by the Project's membership more than doubled from $4.5 trillion to over $10 trillion.[284] While the list of participating institutions includes a number of U.S.-based socially responsible investment ("SRI") funds (Calvert, Domini Social Investment, and Trillium Asset Management), public pension funds (New York), and state treasurers (California, Maine, and Vermont), the overwhelming majority of institutions were from the UK and the EU, despite efforts to get broader U.S. representation.[285] Other institutional investor coalitions in the UK address HIV and AIDS risks in their pharmaceutical

280. *See* F&C Asset Management, Corporate Governance Operational Guidelines 1 (2005), *available at* http://www.isisam.com/uploadFiles/co_gsri_cgo_guidelines_general.pdf.

281. Institutional Investors Group on Climate Change, About the I.I.G.C.C., *at* http://www.iigcc.org (last visited Feb. 20, 2005).

282. *See* European Social Investment Forum, SRI among European Institutional Investors: 2003 Report 21 (2003), *available at* http://www.eurosif.org/pub2/lib/2003/10/srirept/eurosif-srireprt-2003-all.pdf.

283. *See* Press Release, Carbon Disclosure Project, $10 Trillion Investor Initiative Rates 500 Largest Global Companies' Action on Climate Change (May 19, 2004), *available at* http://www.cdproject.net/press_release.asp.

284. *See id.*

285. Interview with Paul Dickinson, Coordinator, Carbon Disclosure Project (Jan. 17, 2004) (on file with authors).

portfolio companies,[286] and institutional investors have taken a leadership role working with the UK government and NGOs to address corruption and transparency issues in the extractives sector in emerging markets.[287]

This is not to suggest, however, that all institutional investors in the United States have been completely quiet on these long-term issues. There are sectors that are pursuing the same complex of issues that UK institutional investors advance. SRI mutual funds engage with portfolio companies on a broad range of social and environmental issues in the United States, including long-term issues such as climate change, both informally, through discussions with management, and formally, by putting proxy resolutions on the agenda of annual meetings.[288] SRI funds and social activist investment continued to grow in the United States in 2001 and 2002, despite equity market declines and net outflows from the rest of the mutual fund industry, and this sector of the market is now about 11% of professional money under management.[289] A number of public pension funds are activists on social and environmental issues, such as the California Public Employees Retirement System, which is the largest public retirement fund in the United States.[290] Recently, thirteen public pension and labor funds in the United States formed the Investors' Network on Climate Risk, which has called on the SEC to issue more explicit guidance to companies about disclosing their risks from climate change.[291] So there is the potential that climate change might become a "wedge issue" even in the United States, drawing more institutional investors into the process of thinking about the consequences of long-term social and environmental issues for the value of their portfolios.

Yet, mutual funds are a larger sector of the institutional investor mar-

286. Interview with Raj Thamotheram, Universities Superannuation Scheme (Jan. 16, 2004) (on file with authors).

287. Interview with Karina A. Litvack, Director, Head of Governance and Socially Responsible Investment, and Richard Singleton, Director, Corporate Governance, ISIS Asset Management (Jan. 16, 2004) (on file with authors); *see also* Williams, *supra* note 230, at 485-91 (describing extractive industry transparency initiative).

288. *See* Interview with Adam Kanzer, General Counsel, Domini Social Investments (Feb. 20, 2004) (authors' notes on file) (discussing informal dialogues that occur between SRI investors and managements of investee companies); I.C.C.R., Companies, Resolutions, and Status, *supra* note 196.

289. *See* Social Investment Forum, 2003 Report on Socially Responsible Investing Trends in the United States, at ii (2004), *available at* www.socialinvest.org/areas/research/trends/sri_trends_report_2003.pdf.

290. *See* Gordon L. Clark and Tessa Hebb, Why Do They Care? The Market for Corporate Global Responsibility and the Role of Institutional Investors 22-24 (Econ. Geography Research Group, Univ. of Oxford, Working Paper No. 04-15, 2004), *available at* http://www.geog.ox.ac.uk/research/wpapers/economic/wpg04-15.pdf. (discussing California Public Employees Retirement System ("CalPERS") engagement with companies to raise social and environmental standards); *see also* CalPERS Shareowner Forum, *at* http://www.calpers-governance.org/forumhome.asp (last visited Feb. 19, 2004) (forum for discussing corporate governance and other topics).

291. *See* Press Release, Coalition for Environmentally Responsible Economies, Thirteen Pension Leaders Call on SEC Chairman To Require Global Warming Risks in Corporate Disclosure (April 15, 2004), *available at* http://ceres.org/newsroom/press/invest_sec_disclosure.htm.

ket in the United States than in the UK,[292] and U.S. mutual funds show little evidence of serious consideration of social and environmental issues. That the largest institutional investors in the United States generally consider social and environmental issues to be unrelated to shareholder value can be seen in their proxy voting policies. An analysis by the Investor Responsibility Research Center ("IRRC") in August 2003 reviewed the voting policies of 100 of the largest U.S. equity mutual funds, representing half of equity mutual fund money under management. It found that "most funds generally vote with management on shareholder proposals addressing environmental, labor and other social issues."[293] While most funds characterize social issues as "ordinary business," to be left to the discretion of management, a number stated that they would make exceptions where "a proposal might have a substantial economic impact on a company they own," and yet "none provided specific examples of social proposals that pose such economic impacts."[294] The IRRC's analysis of actual voting, as of August 2004, found that "a majority of the nation's 100 largest mutual funds opposed all social issue shareholder resolutions," another 15% voted against nearly all such proposals, while about 30% cast abstentions.[295]

It is possible that the new proxy voting disclosure requirements will start to have an impact on these trends in the United States as well, although we do not see changes so far, as the recent IRRC study indicates. As argued above, proxy voting disclosure will likely increase the power of labor to ensure that fund managers investing workers' pension funds vote consistent with the AFL-CIO's voting policies.[296] It may reveal pervasive but previously hidden conflicts of interest that have, "for the most part, limited institutional willingness to engage in activism."[297] Yet, proxy voting disclosure alone seems unlikely to be strong enough to bridge the gap between mainstream institutional investor behavior in the United States and the UK.

Institutional shareholder activism on social and environmental risks in the United States has so far failed to garner as broad a level of support as in the UK. A further factor that may account for this gap is the political and economic context in London, which has created conditions especially conducive to changes in the norms concerning responsible corporate action. We turn now to that subject.

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292. The comparable institutions in the UK are called investment trusts or unit trusts. OECD, Corporate Governance: A Survey of OECD Countries 33 (2004) (comparing composition of institutional investors between countries).

293. *See* I.R.R.C., *Mutual Funds Seldom Support Social Proposals*, IRRC Social Issues Rep., Aug.-Sep. 2003, at 1, *available at* http://www.irrc.org/company/0903_Mutual Funds.pdf.

294. *See id.*

295. *See* Press Release, IRRC, Most Mutual Funds Opposed All Social Proposals (Sept. 15, 2004), *available at* http://www.irrc.com/company/Mutual_Funds_0904.html.

296. *See supra* notes 190-193 and accompanying text.

297. *See* Choi & Fisch, *supra* note 187, at 281. Professors Choi and Fisch claim that institutions unhappy with a firm's management are unlikely to be activists in a proxy contest or engaging in tough discussions with management. We assert that this point applies equally to social and environmental engagement.

2. *The Economic Culture of London*

We have argued that institutional investors in the UK are taking more of a long-term perspective and activist role than their counterparts in the United States, and have suggested a number of reasons why this might be the case. The difference may be partially attributable to the differing compositions of the institutional investor populations in the two countries, with that in the UK more heavily weighted towards investors with long-term obligations. Yet pension funds comprise about a third of the institutional market in both countries.[298] One might therefore expect to see a similar long-term orientation in that sector in the United States, but it is not as apparent.[299] Another possible explanation for the difference is the fact that in the UK, unlike in the United States, government is playing a strong role in encouraging institutional investor engagement in both corporate governance and CSR, using regulatory tools to compel companies and investors to identify and disclose social and environmental risks. This government leadership will surely continue to influence both institutional investors and companies, so we would expect to see continued divergence between the two countries as long as the U.S. government maintains its passive stance.

But these explanations may not fully account for the greater willingness of institutional investors in the UK to identify long-term social and environmental risks as material. Leading members of the institutional investor community in the UK have identified climate change, HIV and AIDS, global labor standards, and government corruption in emerging markets as long-term financial threats to their portfolio companies. Indeed, Professors Clark and Hebb have argued that it is because of the long-term financial risks inherent in these issues that institutional investors care about them at all.[300] Why would they be any less threatening to U.S. global corporations than to their British counterparts? Surely U.S. multinationals are equally vulnerable to the damage to reputation, stock price volatility, and rising cost of capital that social, ethical, and environmental misconduct can bring about.[301] The question thus remains why institu-

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298. *See supra* note 241 and accompanying text.

299. As noted above, many retirement funds delegate portfolio management to external fund managers, which, in the United States, are often mutual fund companies such as Vanguard or Fidelity—the companies the IRRC found seldom supported social or environmental proxy proposals. *See supra* notes 293-295 and accompanying text. (Having no other direct source of information, we use their voting behavior as an indication of concern for social and environmental risk.) In the UK, external delegation also occurs, but half of the money managers to whom authority is delegated are members of the UK Social Investment Forum, a socially responsible investment coalition. *See supra* note 246 and accompanying text.

300. *See* Clark & Hebb, *supra* note 116, *passim*. To be fair, some large institutional investors in the country—most notably CalPERS—have demonstrated similar concerns, as have members of the SRI community.

301. *See* Clark & Hebb, *supra* note 116, at 3, 6-7 (describing increasing vulnerability of global companies to attacks on their brand and reputation from publicized CSR failings).

tional investors in the UK have been more aggressive in recognizing these risks than their American counterparts.

In addition to the factors discussed above, we believe that geography matters. Specifically, the unique economic culture of London has played a significant role in promoting change in the norms regarding responsible investing and corporate management. London is at once a predominant center of international finance[302] and the perceived center of gravity of the CSR movement.[303] Although London's capital markets are considerably smaller than America's in terms of sheer volume, they are still huge[304] and especially important with respect to cross-border listings and trades.[305] At the same time, the NGO community, which has become increasingly important in world finance and world politics generally,[306] is large and well-established in London. As Simon Zadek has put the point, the UK has "what are probably the world's most powerful set of development, environmental, and human rights organizations. Multinational NGOs like Amnesty and Oxfam represent merely the tip of a powerful cocktail of pressure groups that top the charts of every UK public opinion poll when it comes to matters of trust. . . ."[307]

That important financial institutions, powerful companies, and influential NGOs are concentrated in and around London means that personal communication is possible and relationships of trust and respect can be, and are being, created. Ten years ago, relationships between NGOs and large companies were primarily adversarial, while today partnerships and multistakeholder dialogues among institutional investors, NGOs, and companies are becoming common.[308] While our interviews in this regard are preliminary, everyone we have spoken to in London has emphasized that lines of communication are now in place throughout the corporate, institu-

302. *See* Gordon L. Clark, *London in the European Financial Services Industry: Locational Advantage and Product Complementarities*, 2 J. ECON. GEOGRAPHY 433, 438 (2002). Professor Clark identifies four markets that are brought together in London: the domestic UK market, with its highly concentrated institutional character; an "interchange" market between the United States and Europe, facilitating currency trades and corporate transactions in both directions, and extending to Asia; a European market, providing financial services and products to European firms and Governments; and services to private equity markets and sovereign institutions from the rest of the world. *Id.*

303. *See* SIMON ZADEK, THE CIVIL CORPORATION: THE NEW ECONOMY OF CORPORATE CITIZENSHIP 30-33 (2001) (discussing British leadership in the CSR movement).

304. The differences between the United States and the UK as well as the size of the British markets can be appreciated by comparing the size of the NYSE to the LSE: the NYSE has a $19.5 trillion market capitalization with just under 2,800 listed companies as of December 2004, NYSE, Market Statistics, *at* http://www.nyse.com/Frameset.html?displayPage=/Marketinfo/1022221393893.html (last visited Feb. 19, 2005) (NYSE data), while the LSE has just under 2,700 listed companies and a $6.2 trillion market capitalization as of March 2004. Exchange—The Magazine of the London Stock Exchange, *at* http://www.londonstockexchange.com/NR/rdonlyres/1D1B3D0F-2C59-431E-B22D-A9DC54923312/0/2834.pdf (last visited Feb. 19, 2005).

305. *See* Clark, *supra* note 302, at 433-34.

306. *See generally* RESTRUCTURING WORLD POLITICS: TRANSNATIONAL SOCIAL MOVEMENTS, NETWORKS & NORMS (Sanjeev Khagram et al. eds., 2002).

307. ZADEK, *supra* note 303, at 32.

308. *See id.* at 32, 82.

tional investor, government, and NGO communities. In many cases, ties among these actors are long-term and based on shared cultural assumptions.[309] There are also quiet but regular conversations between institutional investors and companies on a range of corporate governance and CSR issues that go directly to the top of the company, bypassing the investor relations departments or scripted analysts' calls that typify such communications in the United States.[310]

Significantly, each of the people we have interviewed in London has had recent experiences communicating with people from U.S. institutional investment houses. All have come away with the view that on corporate governance there are similarities between U.S. and British perspectives, but, on CSR, the United States "is ten years behind us," as one person put it. Another person suggested that the debate over CSR in the United States is more polarized than in Britain.[311] The London market's unique combination of financial clout, physical compactness, and economic culture seems to be a major factor in promoting this differential evolution.[312]

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309. *See* Clark, *supra* note 302, at 435 n.4 for historical sources on the social and cultural networks within the City of London.

310. *See* Clark & Hebb, *supra* note 116, at 20-21 (describing "quiet diplomacy" of the Universities' Superannuation Scheme, the UK's third largest pension fund, on climate risk and HIV/Aids); Armour et. al., *supra* note 12, at 548 (describing actions of Hermes Investment Management, Ltd. regarding corporate governance and CSR); *cf.* Black & Coffee, *supra* note 237, at 2000 (describing close-knit world of institutional investors and communications among them on matters of performance and corporate governance).

311. He provided a hypothetical example to illustrate his point. So, he stated, assume one argued that ExxonMobil shouldn't push to open the Artic for more oil drilling because of the controversy that could be drummed up by activist shareholders or NGO campaigners. That would be considered "a perfectly reasonable view" in London, but he'd be called a "communist" by colleagues in the U.S. branch of his firm for making that argument. This "mainstream" institutional investor (whose company is part of U.K. Social Investment Forum) is not convinced that the social and environmental information to be required in the OFR "moves share price," and also thinks that some of the institutional investors that care about these issues have a disproportionate voice in the discussion. Still, he acknowledged that how a company handles social and environmental risks is indicative of the quality of management generally, and so is useful information to have, and that "no one can be against more disclosure."

312. Space constraints preclude our contrasting the importance of labor arrangements in the UK to United States and their effects on corporate governance, but here, too, varying institutional pressures can be observed. Labor density is much higher in the UK than in the United States: 32% of full-time employees are members of labor unions in England, 38% in Wales, 35% in Scotland, and 39% in Northern Ireland, compared to 12.5% in the United States. Stephen Hicks & Tom Palmer, Dep't of Trade & Indus., Trade Union Membership: Estimates from the Autumn 2003 Labour Force Survey (2004), *available at* http://www.statistics.gov.uk/articles/labour_market_trends/Trade_union_membership.pdf (UK statistics); Press Release, U.S. Dep't of Labor, Union Members in 2004 (Jan. 27, 2004), *available at* http://www.bls.gov/news.release/pdf/union2.pdf (U.S. statistics). As a result, the "working out" of shareholder wealth maximizing will be different in the two countries, even without the different views of corporate purpose that we observe, since companies in the UK will be required to take more cognizance of employees. Professors Armour, Deakin & Konzelmann have studied this issue in depth and have concluded that "[b]eyond the core [UK corporate governance arrangements], in particular at the intersection of insolvency and employment law,

Conclusion

The past decade has seen parallel, incremental changes in some international corporate governance law and practice that may portend a fundamental shift in governance theory. On the legal front, in some jurisdictions, there has been a subtle shift in focus from shareholder wealth alone to a broader conception of stakeholder interests, although this shift may be swamped by market forces that promote shareholder interests, at least in the short term. This legal evolution has coincided with the growing visibility and respectability of the CSR movement, which demands that corporations engage in a dialogue with their diverse stakeholders and act in response to their concerns about the social and environmental impact of corporate behavior. Both trends are evident in the countries of Continental Europe, which have adopted a variety of measures that require corporations to respond explicitly to the concerns of employees and other non-shareholder constituencies, and to report on matters that affect short-term share prices indirectly if at all. Similar momentum has manifested itself in the European Union, which has gone so far as to endorse sustainable growth as a proper corporate goal, with due attention to the social and environmental consequences of corporate actions.

The United States, despite some small changes at the legal margins, continues to adhere to a legal regime focused almost entirely on short-term shareholder wealth maximization. Until very recently, the UK has followed a similar path, the two countries presenting to the rest of the world an ostensibly unified Anglo-American front. Recently, however, a distinctly British approach has emerged: the "third way" of our title. On a number of governance issues, including takeovers and the role of labor, the UK continues to resist European influences. In other respects, though, shareholder capitalism in the UK is beginning to diverge from its American counterpart. Indeed, the UK has very recently emerged as a leader in demanding that companies recognize and report to their extended stakeholder constituencies. The expanded social and environmental disclosure mandate in the UK, seen within the context of changes in institutional investor legal regulation, norms and behavior, is evidence that a British "enlightened share value" corporate governance theory is coming to occupy a unique third position between the American shareholder wealth-maximizing position and the continental stakeholder model. The UK's goal appears to be to maintain its corporations' financial accountability to a constituency of dispersed, independent shareholders while simultaneously using market forces to push companies in the direction of greater social responsibility, and a longer-term evaluation of corporate value.

Perhaps the major question for American readers is whether the United States will follow Britain's lead. We believe that the global CSR movement has played a major role in motivating the changes in corporate governance theory that we have described. Although the origins of the CSR

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stakeholder interests are better represented, thanks largely to European Community influence." Armour et al., *supra* note 12, at 1.

movement may lie in the United States, specifically in the agitation for South African divestment in the 1970s, its subsequent influence has been felt more prominently in Europe. In this country, although stakeholders' interests are starting to be articulated with more vigor and efficacy, the CSR movement has yet to gain the mainstream acceptance that it enjoys in the UK and the rest of Europe. This would suggest that the United States will let the UK go its third way and cling to shareholder value primacy unless and until a maturing CSR community compels it to do otherwise. It may be that there is no causal relationship between CSR and corporate governance reform, and that they are unrelated movements, or at most manifestations of the same underlying concerns. Even if this is correct, a broadening conception of what is economically material to a company may drive the United States in Britain's direction. Only time will tell.