

Disclosure Law and the Market for Corporate Social Responsibility

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Introduction

While the social role of public companies is an issue that has bubbled near the surface of broader debates about corporate governance for some time now,¹ only fairly recently has corporate social responsibility become an issue of such prominence that it has earned its own acronym: ‘CSR’ has been the subject of numerous non-binding declarations by governmental bodies, non-governmental organisations and business groups, particularly in the last decade.² While there is no clear consensus about what exactly CSR means, at a minimum the term implies an obligation on the part of large

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¹ In the United States, arguments about the purposes and public obligations of corporations date from at least the 1930s. See, e.g., A. A. Berle, Jr., ‘Corporate Powers as Powers in Trust’, *Harvard Law Review* 44 (1931), 1049; E. Merrick Dodd, Jr., ‘For Whom are Corporate Managers Trustees?’, *Harvard Law Review* 45 (1932), 1145; A. A. Berle, Jr., ‘For Whom Corporate Managers Are Trustees: A Note’, *Harvard Law Review* 45 (1932), 1365.

² Early examples are the *OECD Guidelines for Multinational Enterprises*, a series of recommendations first issued in 1976 as part of the Organisation for Economic Co-operation and Development’s *Declaration on International Investment and Multinational Enterprises*, and the *Global Sullivan Principles*, launched in 1977 by Reverend Leon Sullivan of Philadelphia and initially directed at US companies with investments in South Africa. Both statements subsequently have been expanded in their scope. Other examples of influential declarations include the United Nations’ *Global Compact*, a statement of nine principles proclaimed in 1999 and meant to serve as the foundation for a UN-sponsored platform for promoting good corporate practices; the Coalition for Environmentally Responsible Economies’ *Statement of Principles*, made in 1989, and the Global Reporting Initiative’s *Sustainability Guidelines*, issued in 1999, which focused on the environmental consequences of corporate activities; the Caux Round Table’s *Principles for Business*, first published by a coalition of business leaders in 1994; the *ETI Base Code*, issued in 1998 by the Ethical Business Initiative, a coalition of trade unions, non-governmental organisations and business groups based on various conventions adopted by the International Labour Organisation; and *Social Accountability 8000 (SA8000)*, a set of standards for the protection of workers’ rights promulgated by the Council on Economic Priorities Accreditation Agency in 1997.

companies to pursue objectives advancing the interests of all groups (or ‘stakeholders’, in today’s parlance) affected by their activities – not just shareholders but also employees, consumers, suppliers, creditors and local communities. These interests are not just economic but also include environmental, human rights and ‘quality of life’ concerns. The obligation to be socially responsible is usually conceived of as being over and above the minimum requirements imposed on companies by formal legal rules,³ although this is not invariably the case.⁴

As a concept, CSR directly challenges the dominant Anglo-American paradigm of corporate governance,⁵ which emphasises profit-maximisation for investors as the most efficient means of promoting wealth creation for society as a whole. Consistent with this paradigm, the corporate governance debate in the United Kingdom has focused primarily on making those who run companies accountable to those who effectively own them, the company’s members (shareholders), and the preoccupation of company law has been with assuring that company directors act in the best interests

³ See, e.g., Commission of the European Communities, *Communication from the Commission Concerning Corporate Social Responsibility: A Business Contribution to Sustainable Development* (Brussels, 2.7.2002) Com. (2002) 347 final, p. 5; Department of Trade and Industry, *Business and Society: Corporate Social Responsibility Report 2002*, p. 7.

⁴ Mandatory legislation sometimes contains what are classified as CSR initiatives. Recent examples include the Anti-terrorism, Crime and Security Act 2001, which provided that UK companies and company directors could be prosecuted for bribery and corruption offences wherever they are committed in the world (sections 108-10); amendments to the Income and Corporation Taxes Act 1998 which disallowed tax deductions for payments made outside the UK which would be criminal offences if made within the UK; and the Employment Act 2002 and Maternity and Parental Leave etc. and the Paternity and Adoption Leave (Amendment) Regulations 2006 SI 2006 No. 2014, concerning entitlement to maternity, paternity, and adoption leave and pay. Mandatory environmental, health and safety, and anti-discrimination laws are also sometimes seen as part of the CSR agenda.

⁵ For purposes of the issues addressed in this chapter, it is useful to refer to an Anglo-American model of corporate governance that is distinguishable from models prevalent in continental Europe. Notwithstanding differences between capitalism as experienced in the United States and the United Kingdom, particularly in connection with welfare provision, there are strong parallels between the two countries in connection with the historical evolution of the corporate form, the law governing it, corporate governance structures and preferred methods of raising finance capital.

of the company for the benefit of its members.⁶ Policy-makers have been reluctant to interfere with this system – for example, by requiring direct participation of other stakeholder groups in the management of economically significant companies, or by imposing legally-enforceable duties on directors that would benefit groups other than shareholders – and have instead preferred to encourage companies to adopt CSR policies voluntarily. Thus, instead of compelling companies to adopt CSR-related policies or undertake CSR-related activities, the present Government’s strategy for encouraging corporate social responsibility has been to require companies to publicly disclose such policies and activities. In recent years, partly as a consequence of Government pressures from within the UK and elsewhere, there has been a significant growth in CSR self-reporting, with ‘social responsibility’ statements becoming a common feature in company annual reports.

A basic assumption underlies the Government’s disclosure strategy: that a company’s interests – and the interests of its shareholders – are best served by maintaining a ‘positive’ CSR profile (the ‘enlightened shareholder value’ theory). CSR activities, it is assumed, are value-creating because they strengthen a company’s relationships with its key stakeholders and because they make the company more attractive to potential customers. This would positively affect a publicly-traded company’s share price: if

⁶ In this regard, it has been said that the UK corporate system revolves around three groups – directors, shareholders and auditors – with shareholders and auditors monitoring the activities of directors to ensure that they do not act in a way that is contrary to the best interests of the company. See Saleem Sheikh, ‘Introduction to the Corporate Governance Themed Issue’, *International Company and Commercial Law Review* 9 (1998), 267. The important role of institutional shareholders in the UK was addressed in 2001 by the Myners Report, which called for pension fund managers to take a more proactive role in the companies in which they invested. The report argued that they should take ‘an active interest in the appointment and performance of non-executive directors, exhibiting vigilance in determining an appropriate degree of independence and a proper level of engagement’. *Institutional Investment in the United Kingdom: A Review* (2001), p. 93.

investors believe that disclosure of information demonstrating that a company has a ‘good’ CSR record will enhance the value of a company, this will be reflected in the price investors are willing to pay for the company’s shares. Financial economists postulate that for a publicly-traded company, the most relevant measure of investor perceptions of the value of a company is the market price of the company’s shares. In a properly functioning market, a company’s share price will reflect the collective assessment made by investors of all available relevant information about that company and expectations about the company’s future cash flows. If this is true, it is possible to test the validity of the voluntarism principle at the heart of the Government’s CSR policy by comparing the market performance of companies perceived to have a good CSR record with that of publicly-traded companies that are not.

This chapter will consider how CSR affects the value of companies to shareholders by examining the market performance of companies included in the recently introduced FTSE4Good ethical indices. Developed by the FTSE Group, an independent company that creates and manages indices and related data services used by investment analysts, the FTSE4Good indices provide the ‘ethical investment’ sector with tools to measure the performance of companies meeting certain CSR criteria. While FTSE has been criticised for failing to apply their criteria as stringently as they might, nonetheless inclusion in the FTSE4Good indices is, in itself, a signal to the investment community that a company has a desirable CSR reputation. By comparing the companies included in these indices with excluded companies and the market as a whole, it is possible to obtain some empirical evidence concerning investor perceptions of the value-creating potential of CSR activities.

The next section will examine in greater detail the legal approach to corporate social responsibility under the Anglo-American model of corporate governance. The Government's CSR strategy is predicated on the notion that companies will produce 'public goods' at levels beyond what is strictly required by law, a notion that challenges the neo-classical conception of the company as a strictly profit-maximising entity. In order to reconcile CSR with established assumptions about the purposes of companies and company law, it is necessary to justify the pursuit of CSR objectives as ultimately being in the company's economic interests. We then discuss the emergence of ethical investment indices in general and the FTSE4Good indices in particular, examining the measurement method employed by FTSE to select companies for these indices. Finally, we describe the results of the empirical tests used to measure the relative performance of companies included in the FTSE4Good indices. By studying the apparent growth of CSR activity from these various perspectives, we can better evaluate whether New Labour's approach in encouraging corporate social responsibility will have a meaningful effect on corporate conduct.

Contextualising corporate social responsibility

1. The Anglo-American Model of Corporate Governance

The notion that companies – or at least ‘companies of economic significance’⁷ – should act in a ‘socially responsible’ manner begs more fundamental questions about the nature and purposes of companies. Under the Anglo-American model of corporate governance, a company is considered to be the product of individual initiative, possessing powers conferred by its members, and the purpose of companies is to maximise the profits of those members.⁸ This has not always been the case: before the mid-nineteenth century, the corporate entity was widely conceived as an artificial creation of the State and entirely dependant on the State for its powers, and incorporation was thought not only to confer privileges on incorporators but to impose responsibilities to further the general public welfare.⁹ The relationship between corporate activity and the public welfare was explicit, and company law could almost be seen as an aspect of public law.¹⁰ After the emergence of general incorporation statutes, however,¹¹ the company was gradually reconceptualised as fundamentally private in nature. So conceived, many questioned the legitimacy of asking corporate

⁷ Whether a company is a ‘company of economic significance’, of course, is often a subject of debate. Tests that have been used have taken into account factors such as whether the company is private or publicly-traded; the size of the company’s annual turnover or balance sheet; and the number of persons employed by the company.

⁸ See, e.g., Brian R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford: Oxford University Press, 1997), p. 15.

⁹ David Millon, ‘Theories of the Corporation’, *Duke Law Journal* (1990) 201. .

¹⁰ *Ibid.*, 211.

¹¹ See, e.g., Joint Stock Companies Act 1844.

executives to spend money ‘belonging’ to the company’s owners to further social interests commonly thought to be the responsibility of the State.¹²

In the United Kingdom, the modern foundations of company law were laid by the Joint Stock Companies Act 1856. As Walter Horowitz observed, this Act was adopted when ‘liberalism was at its peak’, and ‘the guiding principle then fixed was fullest freedom for shareholders in the formation and management of companies on the condition that fullest information was given to the public’.¹³ Company law has evolved since then into a fragmented system of minimal common law and statutory duties and relatively more expansive self-regulation through, for example, the City Code issued by the Panel on Takeovers and Mergers¹⁴ and the codes of best practice and corporate governance applicable to companies listed on the London Stock Exchange.¹⁵ This system is predicated upon a philosophy of minimal state interference with the freedom and flexibility of companies to interpret and respond to

¹² Milton Friedman, for example, dismissed CSR as a dangerous ‘socialist’ concept in a 1970 article published in the *New York Times Magazine*: see Milton Friedman, ‘The Social Responsibility of Business is to Increase Its Profits’, reprinted in W. Michael Hoffman and Jennifer Mills Moore, *Business Ethics: Readings and Cases in Corporate Morality*, 2nd edition (New York: McGraw-Hill, 1990), pp. 153-57. Apparently Friedman later moderated his views. See Saleem Sheikh, *Corporate Social Responsibilities: Law and Practice* (London: Cavendish, 1996), pp. 24-27.

¹³ Walter Horowitz, ‘Historical Development of Company Law’, *Law Quarterly Review* 62 (1946), 375.

¹⁴ See *City Code on Takeovers and Mergers* (‘Takeover Code’) and the *Rules Governing Substantial Acquisitions of Shares* (‘SARs’), collectively referred to as ‘the Code’.

¹⁵ See, e.g., *The Combined Code: Principles of Good Governance and Code of Best Practice* (May 2000), at http://www.fsa.gov.uk/pubs/ukla/lr_comcode.pdf, which was based on the *Final Report of the Hampel Committee on Corporate Governance* (London: Gee, 1998), the *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee, 1992) (‘The Cadbury Report’), and *Directors’ Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury* (London: Gee, 1995) (‘the Greenbury Report’). The Hampel Committee’s Combined Code has been replaced by *The Combined Code on Corporate Governance* (July 2003), available at <http://www.frc.org.uk>, in response to Derek Higgs’ *Review of the Role and Effectiveness of Non-Executive Directors* (January 2003), at <http://www.dti.gov.uk/files/file23012.pdf>, and the report by Sir Robert Smith’s Group, *Audit Committees Combined Code Guidance* (January 2003), at <http://www.frc.org.uk/images/uploaded/documents/ACReport.pdf>. Applicable to all companies listed on the London Stock Exchange from 1 November 2003, the new Code, like its predecessor, requires listed companies to describe how they apply the Code’s main and supporting principles and state whether they comply with the Code’s provisions.

market forces. Moreover, it is centred upon a model of agency which sees the company's owners (the shareholders) as principals and company directors as their agents. The owners appoint their agents to run the company, and the agents are required to report back to their principals periodically. While a company's directors may delegate their management function to others, they are ultimately responsible to the shareholders for how a company is operated.

Economically, this model has been justified as the most effective and efficient way to promote wealth maximisation for society as a whole: giving the owners of companies the freedom to pursue their self-interest will lead to productive and allocative efficiency.¹⁶ Companies are the most desirable form of business organisation, and favouring shareholders will induce market investment and thus facilitate the capitalisation of companies.¹⁷ Legally, this model is effectuated through a rights-orientated approach that recognises and gives priority to property interests in shares. Strictly speaking, the duties imposed on those who manage a company are owed to the 'company', but the company's interests are usually equated with the interests of the company's present and future shareholders.¹⁸ There are limited exceptions to this general rule: directors have a duty to consider the interests of employees in

¹⁶ Productive efficiency is maximised when production takes place at the lowest possible cost, minimising the waste of resources; allocative efficiency is maximised when goods and services are produced in the quantity and quality demanded by consumers.

¹⁷ In addition, favouring the position of shareholders potentially provides motivation for shareholders to exercise a supervisory role in relation to the conduct of corporate managers.

¹⁸ See, e.g., J. E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford: Clarendon Press, 1993), pp. 76-92. Parkinson notes that a requirement to benefit an artificial entity like 'the company' is, in and of itself, meaningless; an inanimate legal fiction does not really have 'interests' to protect. See *ibid.*, p. 76. As Megarry J. observed in *Gaiman v. Association for Mental Health* [1971] Ch. 317, p. 330, 'I would accept the interests of both present and future members of the company as a whole, as being a helpful expression of a human equivalent' to the legal notion of 'the interests of the company'.

performing their functions (although this duty is virtually unenforceable);¹⁹ and directors are required to consider the interests of creditors when the company is insolvent or on the verge of insolvency.²⁰ In most situations, however, the notion that directors' duties are owed to a corporate 'entity' is simply a vehicle for protecting the interests of one group of stakeholders, the company's shareholders, at the expense of other groups affected by the company's activities. While courts will not necessarily interfere if a company's directors decide to award other stakeholders, such as employees or local communities, with benefits or gratuities that go beyond the strict limits of the company's legal obligations,²¹ they do require that the ultimate objective in awarding these benefits must be 'getting the greatest profit from the business of the company' that is possible²² – for example by allowing the company to recruit and retain the best employees or improve employee productivity. Finally, to the extent that unconstrained profit-maximisation harms the interests of other groups affected by corporate activities or causes social problems, the Anglo-American system has preferred to deal with these problems from the 'outside' – through legal requirements and prohibitions imposed by primary or secondary legislation – rather than the 'inside' – by incorporating non-shareholder interests into corporate decision-making itself.

¹⁹ See Companies Act 1985, s. 309 (originally enacted as s. 46 of the Companies Act 1980). Section 309 has been described as 'cosmetic' because employees lack the *locus standi* to bring enforcement actions on behalf of the company unless they are also company shareholders. Sheikh, 'Introduction to the Corporate Governance Themed Issue', 268. See also Ben Pettet, 'Duties in Respect of Employees under the Companies Act 1980' *Current Legal Problems* 34 (1981), 199. Section 719 of the Companies Act 1985 (originally s. 74 of the Companies Act 1980) allows a company to 'make provision' for current or former employees upon cessation or transfer of the company's business, provided this is sanctioned by the company's memorandum or articles, an ordinary resolution, or a resolution of the directors.

²⁰ See *Lonrho Ltd. v. Shell Petroleum Co. Ltd.* [1980] 1 W.L.R. 627; Insolvency Act 1986, s. 214. See also Andrew Keay, 'The Duty of Directors to Take Account of Creditors' Interests: Has It Any Role to Play?', *Journal of Business Law*. (2002), 379.

²¹ See, e.g., *Hampson v. Price's Patent Candle Co.* (1876) 24 W.R. 754.

²² *Hutton v. West Cork Railway Co.* (1993) 23 Ch. D. 654, at pp. 665-66 (Cotton L.J.).

The shareholder primacy at the heart of the Anglo-American corporate governance model has not gone unchallenged. E. Merrick Dodd, Jr., in a US law review article published in 1932, argued that a concept of citizenship applicable to individuals – a concept that envisages that sometimes social circumstances require pursuit of other-regarding goals that do not necessarily benefit the individual financially – should also apply to ‘corporate persons’, and that it should be within the legitimate powers of a company’s managers to disregard the company’s purely economic self-interest to further other compelling social obligations.²³ This argument recognises that the activities of large, publicly-traded companies affect a wider range of interests than simply those of investors, and asserts in effect that the ‘company’ to which directors owe duties encompasses those interests as well as the economic interests of shareholders. For example, it is often the case that creditors, employees and local communities bear a far greater risk of loss in the event of a company’s failure than the company’s ‘owners’, who individually may possess only a small fraction of the company’s shares and are in any event protected by the doctrine of limited liability.²⁴ A good corporate ‘citizen’ sometimes must act in a way that shareholders might oppose, even if not expressly required to do so by the strictures of the law (or even by considerations of ‘enlightened self-interest’), and such actions should not be regarded as legally or ethically suspect.²⁵

²³ See Dodd, ‘For Whom are Corporate Managers Trustees?’, 1161-62.

²⁴ Moreover, many interests affected by corporate activity – job security and job satisfaction, the environment, the stability of communities in which a company’s operations are centred – cannot be translated into economic formulae allowing easy comparison with the financial interests of shareholders.

²⁵ See Dodd, ‘For Whom are Corporate Managers Trustees?’, 1161.

Ultimately, Dodd's pluralist vision of corporate governance was not realised. Adolph Berle, for example, argued that if the managers of economically significant companies were allowed to pursue social objectives on behalf of vaguely defined interest groups, they would be able to exercise tremendous economic, social and political power without really being accountable to anyone.²⁶ Berle felt that the only effective way to place limits on the power of corporate executives was to make them legally answerable to the one identifiable group unambiguously affected by the company's activities – its shareholders – who through self-interest will monitor management's activities. In fact, the problem of accountability caused by the separation of ownership and management in large, publicly-traded companies soon came to dominate corporate governance discourse in the United States²⁷ and concerns about corporate social responsibility faded to the background.²⁸ This does not mean that US executives did not want to cultivate an image of their companies as caring, socially responsive institutions. But their primary motives seemed to have been to discourage adoption and stricter application of mandatory legislation and anti-monopoly laws and to obtain public relations benefits that could be used for marketing purposes.²⁹

²⁶ See Berle, 'For Whom Corporate Managers Are Trustees', 1367-69. See also Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932), p. 310; 'As an economic organism grows in strength and its power is concentrated in a few hands ... the demand for responsible power becomes increasingly direct'.

²⁷ See especially Berle and Means, *The Modern Corporation*. The mainstream view came to be that without a reaction to the actions of managers by investors in the stock market, those managers would be largely unaccountable. The theory is that managers are made accountable by competition in the managerial labour market (investors will force the replacement of under-performing managers) and by the corporate takeover market (a company performing at sub-optimal levels will have stock prices below its true value, making it an attractive takeover target). See Jonathan P. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries* (Oxford: Clarendon Press, 1994), pp. 308-19; Henry Manne, 'Mergers and the Market for Corporate Control', *Journal of Political Economy* 73 (1965), 110.

²⁸ They did not disappear, however. See, e.g., Howard R. Bowen, *Social Responsibilities of the Businessman* (New York: Harper, 1953); J. W. McGuire, *Business and Society* (New York: McGraw Hill, 1963).

²⁹ See Sally Wheeler, *Corporations and the Third Way* (Oxford: Hart, 2002), p. 34. See also Roland Marchand, *Creating the Corporate Soul: The Rise of Public Relations and Corporate Imagery in*

In the United Kingdom, CSR remained in ‘the realm of “otherness”’³⁰ until the 1970s, when mainstream participants in public policy debates, like the Confederation of British Industry (CBI), began suggesting that companies must ‘have functions, duties and moral obligations that go beyond the immediate pursuit of profit and the requirements of the law’.³¹ Shortly thereafter, shareholder primacy was directly challenged when the Bullock Committee contemplated employee representation on company boards.³² This period also saw a dramatic rise in academic interest in corporate governance issues in general and CSR in particular, an interest that has rarely subsided since then.³³ Often those expressing dissatisfaction with the dominant Anglo-American paradigm looked to the alternative models of corporate governance used in countries like Germany and Japan, whose economies were once considered more successful than those of the United States or Britain. Particularly popular – at least before the economic stresses of reunification damaged the reputation of the

American Big Business (Berkeley, CA: University of California Press, 1998); Andrea Tone, *The Business of Benevolence* (Ithaca, NY: Cornell University Press, 1997).

³⁰ Wheeler, *Corporations and the Third Way*, p. 34. Wheeler notes that for many years, CSR was marginalised from mainstream corporate governance debate, seen as ‘being the province of non-conformists such as Congregationalists and Quakers’. *Ibid.*, pp. 34-35.

³¹ *ibid.*, p. 35, quoting Confederation of British Industry, *A New Look at the Responsibilities of the British Public Company* (London: Confederation of British Industry, 23 January 1973). Around the same time, the accounting profession began devising methods for measuring and publicising a company’s community activities: *ibid.*, p. 36.

³² Committee of Inquiry on Industrial Democracy, *Report* (1977) Cmnd. 6706.

³³ Leading works include Charkham, *Keeping Good Company*; Janice Dean, *Directing Public Companies: Company Law and the Stakeholder Society* (London: Cavendish, 2001); Will Hutton, *The State We’re In* (London: Cape, 1995); Parkinson, *Corporate Power and Responsibility*; John Plender, *A Stake in the Future: The Stakeholding Solution* (London: Nicholas Brealey, 1997); Sheikh, *Corporate Social Responsibilities*; Wheeler *Corporations and the Third Way*; G. Kelly and J. E. Parkinson, ‘The Conceptual Foundations of the Company: A Pluralist Approach’, *Company, Financial and Insolvency Law Review* (1998), 174; Paddy Ireland, ‘Corporate Governance, Stakeholding, and the Company: Towards a Less Degenerate Capitalism’, *Journal of Law and Society* 23 (1996), 287; Ben Pettet, ‘The Stirring of Corporate Social Conscience: From ‘Cakes and Ale’ to Community Programmes’ *Current Legal Problems* 50 (1997), 279. See also Max B. E. Clarkson (ed.), *The Corporation and Its Stakeholders: Classic and Contemporary Readings* (Toronto: University of Toronto Press, 1998); Klaus J. Hopt and Gunther Teubner (eds), *Corporate Governance and Directors’ Liability: Legal, Economic and Sociological Analyses of Corporate Social Responsibility* (Berlin: W. de Gruyter, 1984).

German system – was the so-called Rhine Model of corporate governance, which was far less rights-orientated than its Anglo-American counterpart.³⁴ The Rhine Model conceived the primary function of companies not as profit-maximisation but as assuring that goods and services that a community needs are delivered on a continuing basis.³⁵ Profits were important, but only as a means to serve this ultimate purpose. This greater emphasis on protecting stakeholders other than shareholders is in part reflected in, and in part a consequence of, the legal rules governing the dual-board management structure of German companies. For example, German law gave Work Councils rights to co-determination with the Management Board in connection with dismissal, employee vocational training and grievances; employees were legally entitled to representation on the Supervisory Board of larger companies; and rules requiring banks to act as proxies for shareholders at general meetings assured that a company's major creditors often had a strong influence over corporate behaviour.³⁶

While CSR debates continued to be waged by academics in the 1980s and 1990s, it dropped from the policy agenda with the ascendancy of the New Right and its attendant social and economic priorities. In the Thatcher era, Milton Friedman's argument that 'the social responsibility of business is to increase its profits' won out. The pursuit of goals other than profit by company managers was deemed economically inefficient (and thus damaging to the long-term well-being of society as

³⁴ The foundation of the German system could be found in Article 14(2) of the Basic Law, at <http://www.iuscomp.org/gla/statutes/GG.htm#14>, which proclaimed that 'property imposes duties [and its] use shall also serve the public good'.

³⁵ Charkham, *Keeping Good Company*, p. 10.

³⁶ See generally *ibid.*, pp. 6-58. Perhaps the most striking example of a pluralist approach to corporate governance are the regional public broadcasting companies in Germany, which are governed by 'Broadcasting Councils' consisting of representatives of the 'socially significant groups', including ethnic, political, cultural, religions and economic groups. See generally Peter J. Humphreys, *Media and Media Policy in Germany: The Press and Broadcasting Since 1945*, 2nd edition (Oxford: Berg, 1994).

a whole); an unfair infringement of the property rights of shareholders; and an undemocratic concession of power to unelected and publicly unaccountable company directors making decisions about wealth redistribution more properly reserved to a community's elected representatives.³⁷ In this period, the United Kingdom led the opposition to proposals such as the early version of the EC Draft Fifth Directive on Company Law³⁸ which would have required larger companies to adopt a German-style two-tier board structure and some form of employee participation in corporate decision-making.³⁹ Indeed, UK policy-makers resisted any interference with decision-making structures that might have undermined the principle of shareholder primacy, instead identifying the areas of corporate governance in need of greatest reform to be directors' competence, directors' remuneration, directors' conflicts of interest and shareholders' remedies.⁴⁰

³⁷ See Friedman, 'The Social Responsibility of Business'.

³⁸ Proposal for a Fifth Directive (company structure and the power and responsibilities of company boards) OJ No. C131, 13 December 1972; amended proposal OJ No. C240, 9 September 1983; further amended OJ Nos. C 7, 11 January 1991 and C 321, 12 December 1991; finally withdrawn OJ No. C5/20, 12 December 1991.

³⁹ See Pettet, 'The Stirring of Corporate Social Conscience', 307. See also J. J. Du Plessis and J. Dine, 'The Fate of the Draft Fifth Directive on Company Law: Accommodation Instead of Harmonisation', *Journal of Business Law* (1997), 23. In 2001, after years of negotiation, a Council Regulation was adopted allowing a *Societas Europaea* (European company) registered in one Member State to operate throughout the European Union under a single set of rules. See Council Regulation (EC) No. 2157/2001 of 8 October 2001 on the Statute for a European Company (SE) [2001] OJ L294/1. The Regulation allows incorporators to adopt either a one-tier or two-tier governance structure. The EU has refused to adopt a single model of employee participation for the European company in light of the wide divergence of existing laws in Member States, however, though certain disclosure and consultation requirements have been imposed. See Council Directive 2001/86/EC [2001] OJ L294/22; Directive 2002/14/EC of the European Parliament and the Council [2002] OJ L80/29. See also Paul L. Davies, 'Workers on the Board of the European Company?', *Industrial Law Journal* 32 (2003), 75.

⁴⁰ See, e.g., *Report of the Committee on the Financial Aspects of Corporate Governance* (The Cadbury Report); *Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury* (The Greenbury Report); Committee on Corporate Governance, *Final Report* (London: Gee, 1998); Law Commission, *Shareholder Remedies* (1997) Cm. 3769; Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (1999) Cm. 4436.

The approach to CSR taken by the Hampel Committee is indicative of the consensus that had formed by the 1990s.⁴¹ The Committee insisted that good corporate governance should take into account the various stakeholders affected by the company's operations, but was unwilling to mandate particular management structures giving those stakeholders representation in decision-making processes or to impose legally enforceable duties benefiting those stakeholders. The Hampel Committee enthusiastically embraced the proposition that the ultimate objective of the company was profit maximisation. It concluded that it would be difficult to devise a system where corporate managers would be legally responsible to stakeholders other than shareholders, as it would require specific identification of the groups to whom duties would be owed and careful definition of the nature and extent of the duties owed to each group. The Committee maintained, as had Berle decades before, that company directors effectively could end up being accountable to no one, since the criteria for judging their performance would inevitably be conflicting and unenforceable. Instead, the Committee proposed that public companies should be required by the London Stock Exchange's Listing Rules to disclose in their annual report how they have applied principles of good governance (including CSR principles), whether they have complied with the provisions of the Combined Code of Best Practice, and when they have not, explain their failure to do so. This combination of voluntary participation and mandatory disclosure would form the bedrock of New Labour's CSR policy after they rose to power in 1997.

⁴¹ Committee on Corporate Governance, *Final Report*.

2. Corporate social responsibility and New Labour

Before considering New Labour's CSR policies in greater detail, it is worth restating that more direct – and intrusive – options are available to the Government than the strategy it prefers, ranging from giving stakeholder groups the right to participate in corporate decision-making to providing mandatory consultation to bestowing a legally enforceable right (akin to that enjoyed by shareholders) to have one's interests considered by directors in decision-making processes. An example of a more robust approach to CSR is found in a Private Members' Bill introduced by Labour backbenchers in 2002 but subsequently dropped.⁴² The Corporate Responsibility Bill would have required all companies based or operating in the UK with an annual turnover of £5 million or more to publish an annual report addressing the broader environmental, social and economic effects of their operations; their employment policies and practices; their financial relationships with governments (including those suspected of human rights abuses) and political parties; and the manner in which they discharged various environmental and social obligations identified in the Bill. In addition, the Bill would have required these companies to consult with and respond to all groups affected by any of their proposed major projects, and would have required companies to file impact statements with regulators concerning the environmental, social and economic implications of those projects, with these statements and associated background papers being made available to public inspection. In annual company reports, directors would have been required to disclose whether they had any training, qualifications or experience in connection with environmental or social matters. The Bill's provisions were to be supported by criminal penalties. In addition,

⁴² This discussion of the Bill is adapted from the analysis in Stephen Copp, 'Corporate Governance: Change, Consistency and Evolution: Part I', *International Company and Commercial Law Review* 14 (2003), 65, at 70.

stakeholders other than shareholders would have been able to bring private actions against companies or their directors for any breach of the statutory duties imposed by the Act, and if any significant adverse environmental or social effects arising out of a company's operations were associated with the negligence or wilful misconduct of company directors in connection with their duties or disclosure obligations under the Bill, those directors would have been held personally liable.

This robust approach to CSR does not reflect the policy of the current Labour Government. Instead, New Labour's Third Way agenda for the corporate sector emphasises 'non-intervention in a regulatory sense' except where necessary to promote competitiveness, with a strong inclination towards 'allow[ing] markets a free reign'.⁴³ The Government is primarily concerned that the UK's company law remains 'internationally competitive' and assuring 'that we retain our existing companies and attract new ones'.⁴⁴ The Government has been reluctant to interfere with the management structures of business or the exercise of business judgment by corporate managers. At the same time, the Government recognises that market forces alone will not 'create or sustain ethical frameworks'.⁴⁵ In March 2000 a Minister within the Department of Trade and Industry (DTI) was given specific responsibility for CSR, and a DTI website dedicated to CSR emphasises the Government's support of a voluntary approach to CSR.⁴⁶ However, this emphasis on voluntarism is combined

⁴³ See Wheeler, *Corporations and the Third Way*, p. 36.

⁴⁴ DTI, *Modern Law for a Competitive Economy: Final Report: Vol. I* (2001), para. 1.13, quoted by Robert Goddard, 'Modernising Company Law': The Government's White Paper' *Modern Law Review*. 66 (2003), 402.

⁴⁵ See Wheeler, *Corporations and the Third Way*, p. 53.

⁴⁶ See <http://www.societyandbusiness.gov.uk/>.

with various rules compelling disclosure of the nature and extent of those CSR activities actually undertaken.

One example of this approach is found in secondary legislation adopted in 1999 requiring trustees of occupational pension schemes to include in their published investment policy statements an indication as to the ‘the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments’.⁴⁷ A parallel requirement was imposed on local government pension schemes.⁴⁸ The rationale behind these rules is that institutional investors (particularly pension funds) hold a high proportion of publicly traded shares, and given the public scrutiny such disclosure requirements invite, these investors may be encouraged to exercise their power as shareholders in a socially responsible way. This focus on investors is part of the Government’s efforts to encourage voluntary engagement in ‘socially responsible investing’ (which has its own acronym, SRI).⁴⁹ The Government identified ‘the enhancement of shareholder engagement and a long-term investment culture’ as one of the four key objectives of its Company Law Reform Bill, introduced to the Houses of Parliament in November

⁴⁷ Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc.) (Amendment) Regulations 1999, S.I. 1999/1849, reg. 11A(a) (amending Occupational Pension Schemes (Investment) Regulations 1996, S.I. 1996/3127). The amendments were introduced pursuant to section 35 of the Pensions Act 1995.

⁴⁸ Local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 1999, S.I. 1999/3259 (amending Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998, S.I. 1198/1831). These regulations were issued pursuant to section 7 of the Superannuation Act 1972.

⁴⁹ SRI investing has strong religious roots. In the mid-1700s, John Wesley, the founder of Methodism, noted that the use of money was the second most important subject of New Testament teachings. As Quakers settled in North America, they refused to invest in weapons and slavery, a tradition that is echoed in more modern SRI strategies that avoid so-called ‘sin’ stocks – typically companies in the alcohol, tobacco and gaming industries. See Social Investment Forum, *2001 Report on Socially Responsible Investing Trends in the United States* (Washington, DC, 2001).

2005⁵⁰ and passed into law in November 2006 as the Companies Act 2006. The Act includes a section which gives the Government authority to require institutional investors to disclose how they have exercised their voting rights on resolutions tabled at company meetings.⁵¹

The Companies Act 2006 is the end product of a lengthy and comprehensive Company Law Review (CLR) launched by the Government in March 1998.⁵² Although carried out under the auspices of the DTI, much of the work was undertaken by an independent Steering Group consisting of lawyers, academics, business representatives and civil servants. The Steering Group was guided by a larger consultative committee which included representatives from the TUC, and utilised several Working Groups in investigating specific issues of company law and governance. Upon completion of the CLR the Government issued an initial, partial response in the form of a White Paper in July 2002 and, following further consultations, a final White Paper, published in March 2005.⁵³ This latter document

⁵⁰ The other key objectives of the Company Law Reform Bill are: ensuring better regulation and a 'Think Small First' approach; making it easier to set up and run a company; and providing flexibility for the future. The Bill was introduced to the House of Lords in November 2005 and brought forward to the House of Commons in May 2006. It received Royal Assent in November 2006 as the Companies Act 2006. It is the longest Act ever to have been passed by Parliament as it repeals, and restates in plain English, almost all of the current Companies Acts, which it largely replaces.

⁵¹ The Government's preference is for disclosure to be made on a voluntary basis, but s. 1277 of the Companies Act 2006 provides a reserve power to compel disclosure should a voluntary disclosure regime fail to deliver. See Joanna Gray, 'New company law reform bill: Power to order greater disclosure of exercise of voting rights by institutional investors', *Journal of Financial Regulation and Compliance* 14 (2006), 122.

⁵² For an overview, see John De Lacy (ed.), *The Reform of United Kingdom Company Law* (London: Cavendish, 2002); Goddard, 'Modernising Company Law'. Among the consultation documents resulting from the Review are *Modern Law for a Competitive Economy* (1998); *Modern Law for a Competitive Economy: The Strategic Framework* (1999); *Modern Law for a Competitive Economy: Developing the Framework* (2000); *Modern Law for a Competitive Economy: Completing the Structure* (2000); *Modern Law for a Competitive Economy: Final Report: Vols. I and II* (2001).

⁵³ Department of Trade and Industry, *Modernising Company Law* (July 2002) Cm. 5553 – I, II; and, Department of Trade and Industry, *Company Law Reform* (March 2005) Cm. 6456.

contained draft clauses that formed the bulk of the first printing of the Company Law Reform Bill.⁵⁴

From the outset of the review process, the CLR Steering Group indicated that it would not consider fundamental changes to the Anglo-American model of corporate governance:

We interpret our terms of reference as requiring us to propose reforms which promote a competitive economy by facilitating the operations of companies so as to maximise wealth and welfare as a whole. We have not regarded it as our function to make proposals as to how such benefits should be shared or allocated between different participants in the economy on the grounds of fairness, social justice or any similar criteria.⁵⁵

Moreover, the CLR Steering Group's Final Report and the Government's subsequent White Papers all unambiguously endorse the principle of shareholder primacy, reflected in a key section in the Companies Act 2006, which states that 'a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members [shareholders] as a whole'.⁵⁶ However, the section goes on to state that, to achieve this goal, directors should 'have regard (amongst other matters) to:

⁵⁴ For an overview of the main issues involved in the consultations on the Government's White Papers, culminating in the publication of the Company Law Reform Bill, see House of Commons Library Research Paper 06/30, *The Company Law Reform Bill [HL]* [Bill 190 2005-2006] (2 June 2006).

⁵⁵ *Modern Law for a Competitive Economy: The Strategic Framework* (1999), para. 2.5.

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company's employees,
- (c) the need to foster the company's business relationships with suppliers, customers and others,
- (d) the impact of the company's operations on the community and the environment.⁵⁷

These additional considerations reflect the Government's acceptance of the 'enlightened shareholder value' approach to company law reform, which assumes that a company's relationship with its stakeholders affects the returns to shareholders, and that it is therefore in shareholders' interests that directors take account of broader stakeholder concerns.⁵⁸

Another CLR Steering Group proposal accepted by the Government and incorporated in early drafts of the Company Law Reform Bill (but later discarded) was that all companies of significant economic size be required to produce an Operating and Financial Review (OFR) statement as part of their annual reports.⁵⁹ The OFR was envisaged as a forward-looking, qualitative statement concerning a company's performance and future prospects, that was intended to supplement the essentially

⁵⁶ Companies Act 2006, s. 172; Directors' general duties have hitherto been found only in case law. By introducing a statutory statement on directors' duties the Government's intention is to make the law in this area more consistent and understandable.

⁵⁷ *Ibid.*, s 172: two further considerations to which directors should have regard are listed: '(e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company'.

⁵⁸ The Government also considered, and rejected, an alternative approach identified by the CLR Steering Group – referred to as the 'pluralist' approach – in which the interests of a range of stakeholders are accommodated without the interests of a single group (shareholders) being overriding. See House of Commons Library Research Paper 06/30, p. 11.

⁵⁹ The 2002 White Paper indicates that companies of significant economic size are public companies where at least two of three criteria are met: the company's annual turnover is greater than £50 million; the company's balance sheet exceeds £25 million; or the company employs over 500 people. Private companies can also be considered economically significant, but the criteria are more demanding: a

quantitative and historic information that has long been disclosed. For the most part, the specific content of a company's OFR was to be left to the judgment of company directors,⁶⁰ but it was anticipated that any material information relevant to the company's various stakeholders would be included in the statement.⁶¹ The Government hoped that the OFR would further the interests of transparency and openness, and that over time the quality of the information disclosed to stakeholders and investors would improve without unduly burdening businesses.

Following extensive consultation, the statute requiring companies to produce an OFR was passed in March 2005⁶² and clauses relating to the OFR were included in the Company Law Reform Bill published in early November 2005.⁶³ However, the Government suddenly decided to abandon the OFR in late November 2005. The surprise announcement was made by the Chancellor of the Exchequer, who cited as the reason for the U-turn the impending introduction, as part of the EU Accounts Modernisation Directive, of a new narrative reporting requirement called the Business Review, as part of the directors' report.⁶⁴ It was argued that the Business Review included the key improvements from the OFR but in a more flexible form, and that substituting the Business Review for the OFR would avoid 'gold plating' an EU regulation and help to reduce the regulatory burden on business. However, the

turnover of over £500 million; a balance sheet total of over £250 million; or a work force of over 5,000 employees. See DTI, *Modernising Company Law*, para. 4.36.

⁶⁰ The Steering Group did identify a few mandatory items that should be included in the OFR. See Saleem Sheikh, 'Company Law for the 21st Century: Part 2: Corporate Governance', *International Company and Commercial Law Review* 13 (2002), 88, at 92.

⁶¹ See DTI, *Modernising Company Law*, para. 4.32.

⁶² The Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 (SI 2005/1011). The OFR was due to come into force for the financial year ending on or after 31 March 2006.

⁶³ *Company Law Reform Bill [HL]*. Clauses 393 to 395.

⁶⁴ Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 (OJ No. L178, 17 July 2003).

Business Review makes no explicit references to the need for companies to report on social and community matters, unlike the OFR, nor does it require companies to declare their policies on social, environmental and employee issues.⁶⁵ Regulations repealing the original OFR regulations were introduced in December 2005,⁶⁶ and in subsequent parliamentary debates on the Company Law Reform Bill, Government ministers found themselves in the uncomfortable position of arguing against legislation that they had promoted on previous occasions. The decision to scrap the OFR in favour of the ‘lighter-touch’ Business Review may thus signal a weakening of the Government’s enthusiasm to promote the ‘business case’ for CSR.

The Government’s CSR strategy may be viewed as an extension of a long-standing preference for disclosure regimes in company law, designed to facilitate market efficiency by improving information flows. As L. S. Sealy observed a generation ago, given the choice between ‘having a fixed rule about something . . . and having no fixed rule as to what a company must do but saying that whatever it does has to be openly disclosed’, UK policy-makers usually favour the latter option.⁶⁷ Consistent with this predilection, the Business Review does not require companies to act in a socially responsible manner but rather encourages them to disclose their CSR policies and activities.

⁶⁵ See Julian Oram, ‘The end of the OFR – and Corporate Responsibility? An Inadequate Approach’, *Accountancy Age*, 12 January 2006. However, as pointed out by Timothy Copnall (‘The End of the OFR – and Corporate Responsibility? An Adequate Replacement’, *Accountancy Age*, 12 January 2006), although the Business Review does not compel companies to report on employees, the environment, and on social and community issues, neither was there a blanket requirement for such disclosures in the OFR, as they were only required where necessary to enable shareholders to assess the success of strategies adopted by a company.

⁶⁶ The Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005 (SI 2005/3442).

⁶⁷ L. S. Sealy, *Company Law and Commercial Reality* (London: Sweet and Maxwell, 1984), p. 21.

The ‘business case’ for CSR, as discussed in Chapter 1, is straightforward: by pursuing policies and activities beneficial to society and the environment that go beyond the minimum standards of conduct required by the law, a company enhances its value, provided other stakeholders are aware of these policies and activities. Once information about a company’s CSR policies and activities becomes widely available, ‘caring’ companies, it is believed, will benefit economically in the long term, and those with a reputation for the single-minded pursuit of shareholder value at the expense of other considerations ultimately will do less well as a result of this ‘less enlightened’ approach. As Robert Goddard observed, the validity of the Government’s contentions about the ‘business case’ for CSR is ‘dependent on the effect that increased disclosure brings’.⁶⁸ To some extent, it is possible to measure this effect, and thereby test the validity of the voluntarism principle at the heart of the Government’s policy. The rise of socially responsible investing, and the creation of ethical funds and market indices to cater to socially responsible investors, makes it possible to compare the market performance of publicly traded companies perceived to be ‘socially responsible’ with that of ‘less enlightened’ companies. If CSR activities are value-creating, as the Government’s policy assumes, this should be reflected in the share price for companies with a good CSR record. The remainder of this chapter investigates whether there is empirical evidence that this is the case.

⁶⁸ Goddard, ‘Modernising Company Law’, 418.

Doing Well by Doing Good?

1. The Rise of SRI and the Ethical Funds

Even without formal disclosure requirements of the kind contemplated by the Government, it was common by the second half of the 1990s for companies to include ‘social responsibility’ sections in their annual reports (which often were addressed to their ‘stakeholders’). In part this was a response to the growth of ‘socially responsible’ investment strategies worldwide. This expansion was led by US investors: by 2001, one out of every eight dollars under professional management in the US (\$2.32 trillion out of \$19.9 trillion) was invested in a portfolio utilising an SRI strategy.⁶⁹ In the UK, SRI evolved from an activity carried out largely by church-based investors and a few ethical unit trusts to one that is now a mainstream activity among institutional investors (see Table 1). SRI assets under management in the UK grew from £22.7 billion in 1997 to £224.55 billion in 2001.⁷⁰

Table 1

Growth in UK SRI Investment Assets 1997-2001

	1997	1999	2001
	<i>£bn</i>	<i>£bn</i>	<i>£bn</i>
Church Investors	12.5	14.0	13.0
SRI Unit Trusts	2.2	3.1	3.5
Charities	8.0	10.0	25.0
Pension Funds	0.0	25.0	80.0
Insurance Companies ¹	0.0	0.0	103.0
TOTAL	£22.7 bn	£52.2 bn	£224.5 bn

1. Note: unit trust assets have been netted off from insurance totals.

Source: Russell Sparkes, *Socially Responsible Investment: A Global Revolution* (London: John Wiley & Sons, 2002).

⁶⁹ Social Investment Forum, *2001 Report on Socially Responsible Investing Trends in the United States* (Washington, DC, 2001), p.4.

⁷⁰ Russell Sparkes, *Socially Responsible Investment: A Global Revolution* (London: John Wiley & Sons, 2002).

Two major developments spurred the growth in the institutional SRI market in the UK: the disclosure requirements imposed on trustees of occupational pension schemes discussed above,⁷¹ and the move by a number of insurance companies to apply SRI criteria across all their equity funds by actively engaging with companies through dialogue and voting at AGMs.⁷² This form of shareholder activism, or ‘engagement’, seeks to protect shareholder value by integrating consideration of SRI issues into the mainstream corporate governance process. An alternative approach to socially responsible investing is to screen companies included in investment portfolios on CSR grounds.⁷³ Screening is typically the method used by retail ethical funds.⁷⁴ The first ethical fund in the UK was a unit trust called the Stewardship Fund, launched by Friend Provident in 1984; now there are over seventy such funds.⁷⁵ Table 2 below reveals that the average performance of these ethical funds between June 1998 and June 2003 was inferior to the performance of the UK stock market as a whole (represented by the FTSE All Share Index) and to non-ethical funds, whether measured as a one-year, three-year or five-year investment.

Advocates of ethical investing argue that, standing alone, these figures can be somewhat misleading. For example, it may be that lower returns to ethical funds

⁷¹ See nn. 46-47 above.

⁷² Further impetus to shareholder activism was provided in October 2002 by the launch of a new set of principles, *The Responsibilities of Institutional Shareholders and Agents – Statement of Principles*, drawn up by the Institutional Shareholders’ Committee (ISC). This body comprises the Association of British Insurers (ABI), the Association of Investment Trust Companies (AITC), the Investment Management Association (IMA), and the National Association of Pension Funds (NAPF). It speaks for a membership that controls the vast majority of institutional funds in the UK.

⁷³ Screening is usually divided into ‘negative’ screening to exclude unacceptable shares from a portfolio and ‘positive’ screening to select companies with superior CSR performance.

⁷⁴ As the term is used here, a ‘fund’ is a portfolio (or collection) of assets, normally shares, that are typically professionally managed.

simply reflect the fact that they incur higher risk than unscreened funds because they are insufficiently diversified – the process of ethical screening limits the universe of investments that can be included within an ‘ethical’ portfolio. Several empirical studies have attempted

Table 2

Performance of UK Ethical Funds/ Ecological Unit Trusts/OEICs¹

	£1,000 after 5 years²	% Return	£1,000 after 3 years³	% Return	£1,000 after 1 year⁴	% Return
Average for UK ethical/ecological UT/OEICs	£745.66	-25.4	£661.98	-33.8	£793.84	-20.6
FTSE All Share (xd adj)	£803.66	-19.6	£711.24	-28.9	£824.16	-17.6
Average for All UK UT/OEICs	£908.50	-9.2	£739.53	-26.1	£830.61	-16.9

1. Open-ended Investment companies
2. Showing how much an investment of £1000 would be worth after 5 years (from 01.06.98 to 01.06.03) in each fund.
3. Showing how much an investment of £1000 would be worth after 3 years (from 01.06.00 to 01.06.03) in each fund.
4. Showing how much an investment of £1000 would be worth after 1 year (from 01.06.02 to 01.06.03) in each fund.

Source: Standard & Poor’s Micropal, 4 June 2003.

to control for possible differences in risk associated with different classes of investments in order to determine whether investors value a company’s good CSR reputation. Those studies – most of which have been based on US data, but a few of which have dealt with the performance of UK ethical funds – usually conclude that ethical screening leads to similar or slightly lower performance relative to comparable unrestricted portfolios, with any differences in the performance of ethically screened and unscreened portfolios usually found to be statistically insignificant.⁷⁶

⁷⁵ Standard & Poor’s Micropal, 4 June 2003.

⁷⁶ See, e.g., J. D. Diltz, ‘Does Social Screening Affect Portfolio Performance?’, *The Journal of Investing* Spring (1995), 64-69; J. B. Guerard, ‘Is There a Cost to Being Socially Responsible in Investing?’, *The Journal of Investing* Summer (1997), 11-18; D. A. Sauer, ‘The Impact of Social-Responsibility Screens on Investment Performance: Evidence from the Domini 400 Social Index and

There are other difficulties with trying to draw conclusions about the investor response to CSR from studies involving ethical funds. One early UK study found that the companies whose shares are selected by ethical funds for investment tend to be smaller than those included in the market indices typically used for purposes of comparison.⁷⁷ When this size bias is adjusted for, the relative performance of ethical funds improves.⁷⁸ A number of US papers have also identified industry sector and investment ‘style’ biases that can distort comparisons between ethical and conventional funds.⁷⁹ In addition, the performance of ethical funds is affected by manage-

Domini Equity Mutual Fund’, *Review of Financial Economics* 6 (1997), 137. Two studies comparing the returns of ethical and non-ethical US funds to each other, to the S&P 500, and to the Domini Social Index (DSI) (containing only ethically-screened companies), concluded that, after risk was adjusted by using Jensen’s alpha (discussed below), there were no significant differences between the returns for ethical and non-ethical funds. S. Hamilton, H. Jo and M. Statman, ‘Doing Well While Doing Good? The Investment Performance of Socially Responsible Mutual Funds’, *Financial Analysts Journal* 49 (1993), 62; M. Statman, ‘Socially Responsible Mutual Funds’, *Financial Analysts Journal* May-June (2000), 30-39. A study using an extended sample of US ethical funds – including equity, bond and balanced funds – found that, after differences in risk were controlled by using Jensen’s alpha and the Sharpe and Treynor ratios (see n. 104 below), there was no evidence that social screening affected the investment performance of ethical mutual funds in any systematic way. E. F. Goldreyer and J. D. Diltz, ‘The Performance of Socially Responsible Mutual Funds: Incorporating Sociopolitical Information in Portfolio Selection’, *Managerial Finance* 25 (1999), 23. One early UK study even found some weak evidence that ethical unit trusts outperformed market indices. See R. G. Luther, J. Matatko and D. Corner, ‘The Investment Performance of UK Ethical Unit Trusts’, *Accounting, Auditing and Accountability Journal* 5 (1992), 57.

⁷⁷ Luther, Matatko and Corner, ‘The Investment Performance of UK Ethical Unit Trusts’.

⁷⁸ One study, which confirmed this size bias, found that comparing ethical funds to a small cap benchmark improved their relative performance. See R. G. Luther and J. Matatko, ‘The Performance of Ethical Unit Trusts: Choosing an Appropriate Benchmark’, *British Accounting Review* 26 (1994), 77. Another study compared a sample of ethical and non-ethical funds matched on the basis of fund size and formation date and found evidence that ethical mutual funds out-performed on a risk-adjusted basis. See C. A. Mallin, B. Saadouni and R. J. Briston, ‘The Financial Performance of Ethical Investment Funds’, *Journal of Business Finance & Accounting* 22 (1995), 483. Another study which adjusted for the small cap bias of ethical funds by using a more sophisticated benchmark model found no significant difference between the financial performance of ethical and non-ethical unit trusts. A. Gregory, J. Matatko and R. Luther, ‘Ethical Unit Trust Financial Performance: Small Company Effects and Fund Size Effects’, *Journal of Business Finance & Accounting* 24 (1997), 705.

⁷⁹ See, e.g., D. Di Bartolomeo, ‘Explaining and Controlling The Returns on Socially Screened US Equity Portfolios’, Presentation to New York Society of Security Analysts, 10 September 1996; Guerard, ‘Is There a Cost to Being Socially Responsible in Investing?’, L. Kurtz, ‘No Effect, or No Net Effects? Studies on Socially Responsible Investing’, *The Journal of Investing* Winter (1997), 37-49. A recent paper by Bauer, et al. addressed this issue by investigating the investment styles of 103 German, UK and US ethical mutual funds and adjusting their performance for any style tilts. They found little evidence of significant differences in risk-adjusted returns between ethical and conventional funds for the 1990-2001 period after such adjustments. However, when they split their sample by time they

ment fees and transactions costs which are not uniform, and will reflect the ability of individual fund managers to make appropriate decisions concerning asset allocation, sector selection and security selections within each sector. Together, these confounding factors make it difficult to conclude that differences in the performance of ethical funds reflect the impact of SRI strategies on investment performance.⁸⁰

On the other hand, by focusing on the performance of ethical *indices* rather than the performance of ethical *funds*, some of these difficulties can be minimised.⁸¹ A stock market index, in essence, is a number based on a statistical compilation of the share prices of representative stocks. Indices are used by investors as tools for investment analysis, measuring performance, allocating assets and creating index-tracking investment funds. The rise of SRI encouraged the creation of market indices that take into account a company's social and environmental impact as well as the financial factors typically considered when decisions about inclusion in indices are made. Ethical indices represent well-diversified portfolios of screened stocks that are not subject (at least to the same degree) to the confounding effects of small firm bias, differences in transaction costs and management 'style' biases that plague studies of ethical funds. A comparison of the performance of ethical indices with the performance of alternative benchmark portfolios could provide a better indication of the potential costs, or benefits, associated with CSR investment behaviour.

found evidence of a 'learning effect' whereby older ethical funds catch up after a period of strong under-performance while younger funds continue to under-perform both the index and conventional peers. See Rob Bauer, Kees Koedijk and Rog er Otten, *International Evidence on Ethical Mutual Fund Performance and Investment Style*, Working Paper (2002).

⁸⁰ See, e.g., Sauer, 'The Impact of Social-Responsibility Screens on Investment Performance'.

⁸¹ This argument was outlined by Sauer, 'The Impact of Social-Responsibility Screens on Investment Performance', 140.

2. The FTSE4Good Indices

The oldest ethical index, dating from May 1990, is the Domini 400 Social Index, which monitors the performance of 400 US corporations that pass multiple, broad-based social screens. Other prominent indices used by US investors are the Dow-Jones Sustainability Group Index and the Calvert Social Index. The first indices of this type used in the United Kingdom were the FTSE4Good Index Series. Introduced by the FTSE Group⁸² in February 2001 after several years of development, this series initially consisted of eight indices – four benchmark series used as yardsticks for performance measurements, and four tradable series upon which financial products based on their value can be bought and sold. The series allows investors to track the performance of SRI-screened companies in all major financial markets.⁸³ The FTSE4Good indices cover up to 90% of the world's financial markets, giving investors an unrivalled level of exposure to companies meeting international CSR standards. The FTSE4Good Advisory Committee, consisting of independent experts, oversees the process of determining which companies should be included in the FTSE4Good indices. Company research is provided by the UK firm Ethical Investment Research Service (EIRIS) and its international partners. All the indices are managed and calculated by FTSE according to a published set of ground rules. Certain companies are excluded from the indices altogether because their core business is particularly controversial. Thus, tobacco companies, weapons manufacturers, owners or operators of nuclear power stations, companies involved in

⁸² The FTSE Group, an outgrowth of a joint venture between the *Financial Times* and the London Stock Exchange formed in the 1930s, creates and manages a wide range of market indices. See http://ftse.com/About_Us/index.jsp.

⁸³ The series covers four markets – the United States, the United Kingdom, Europe and Global – and a benchmark and tradable index exists for each market covered.

mining or processing uranium and companies involved in the production of nuclear weapons systems are ineligible for inclusion in the indices.⁸⁴

The criteria for selecting companies for inclusion in the indices were devised after FTSE identified several common themes running through various statements concerning CSR issued by governmental bodies, non-governmental organisations and business groups.⁸⁵ The inclusion criteria are revised regularly and, as of 2006, were grouped under the following five headings: ‘environmental’; ‘social and stakeholder’; ‘human rights’; ‘supply chain and labour standards’; and ‘countering bribery’.⁸⁶

Under the environmental criteria, companies are given an ‘impact weighting’ of low, medium or high, depending on the industry sector to which they belong: the higher the sector’s potential environmental impact, the more demanding the policy, management and reporting criteria that must be met.⁸⁷ Under the social and stakeholder criteria, companies must meet at least two of seven indicators to qualify for inclusion.⁸⁸ Under the human rights criteria, companies are assessed on a sliding scale, with the most demanding requirements applied to companies in the ‘global resource sector’ (oil, gas, mining) because of their unique power to influence human

⁸⁴ *FTSE4Good Index Series Inclusion Criteria*, http://www.ftse.com/Indices/FTSE4Good_Index_Series/Downloads/FTSE4Good_Inclusion_Criteria_Brochure_Feb_06.pdf, p. 1.

⁸⁵ FTSE indicated that it had considered, inter alia, the United Nations’ Universal Declaration of Human Rights; the OECD Guidelines for Multinational Enterprises; The United Nations Global Compact; annual reports from Human Rights Watch and Amnesty International; the Ethical Trading Initiative; Social Accountability International; and the Fair Labour Association. See *ibid.*, pp. 5-7.

⁸⁶ *Ibid.*, pp. 3-11. The first three categories have been used since the launch of the FTSE4Good index in 2001, while the supply chain and labour standards category was introduced in 2004-5 and the countering bribery category was introduced in 2005-6. See *ibid.*, p. 2.

⁸⁷ *Ibid.*, p. 3.

⁸⁸ These criteria are: adopting an equal opportunities policy; adopting a Code of Ethics or Business Principles; providing evidence of equal opportunities systems; providing evidence of health and safety systems; providing evidence of training and employee development systems; providing evidence of systems designed to maintain good employee relations; and, participating in charitable or community support schemes. See *ibid.*, p. 4.

rights practices in developing countries, with slightly less stringent standards applied to companies with significant involvement in ‘countries of concern’ because of their poor human rights records.⁸⁹

The launch of the initial two FTSE4Good indices in July 2001 provoked immediate controversy. Environmental and human rights campaigners protested the inclusion of companies such as BP and questioned the stringency of FTSE’s inclusion criteria. On the other hand, CBI was critical of the potential damage caused to companies that failed to make the list. The exclusion of several leading companies, including Tesco, Marconi and The Royal Bank of Scotland, from the initial FTSE4Good indices attracted significant media attention. However, these companies and others that were initially excluded managed to get in when the Index was reviewed in September 2001. At the second review in March 2002, it was announced that another twenty-four companies had joined the FTSE4Good UK Index, and that index is now made up over 300 companies, including scores of household names. The inclusive approach that FTSE has adopted has left the FTSE4Good indices open to criticism for not being ethical enough, despite the detailed criteria for admission FTSE has developed. Some of those who think of themselves as ethical investors probably would not want their money going anywhere near some of the oil, gas and drugs companies and high street banks included in the indices.

Notwithstanding the criticism the FTSE4Good indices have attracted, however, it remains true that some companies have been excluded from them. This allows some basis for comparison of the performance of the companies included in the

⁸⁹ *Ibid.*, pp. 5-6.

FTSE4Good indices with the ‘non-ethical’ companies that have been excluded, which in turn allows some empirical testing of the ‘business case’ for CSR that is at the heart of the Government’s CSR policy. The results of the empirical tests we have run concerning the performance of the FTSE4Good indices are described in the sections that follow.

3. Absolute Investment Performance of the FTSE4Good Indices

To assess the attractiveness of CSR-screened stocks to investors, we compared the performance of the two FTSE4Good indices created for the UK market (the FTSE4Good UK Index and the FTSE4Good UK 50 Index) with appropriate unrestricted benchmark indices (the FT All Share Index and the FTSE100 Index respectively), and a hypothetical ‘Sin Index’ comprised of stocks excluded from the FTSE4Good indices.⁹⁰ The unrestricted benchmark indices are representative of the performance of the UK’s publicly traded shares on average. However, there is considerable overlap between the companies included in the FTSE4Good indices and those comprising the benchmark market indices. For example, the FTSE4Good UK 50 Index contains half of the stocks that comprise the FTSE 100 Index, as it was constructed so as to enable investors to gain exposure to the ethical stocks with the highest market values.

Moreover, after the second review of the constituents of the FTSE4Good indices in March 2002, companies in the FTSE4Good UK Index represented 83% of the FTSE All-Share Index. Thus, comparison of the FTSE4Good UK Index with the ‘Sin Index’ – a market value-weighted portfolio comprising the tobacco producers, weapons manufacturers, uranium extractors and nuclear power station operators excluded from

⁹⁰ The use of a specially created ‘Sin Index’ was inspired by the ‘Sindex’ created by the UK magazine *Money Observer* to track the value of twenty-five FTSE 100 index companies initially excluded from the FTSE4Good UK index at its launch in July 2001, and by the US ‘Vice Fund’ launched on 30 August 2002 by MUTUALS.com, a Dallas-based money management firm.

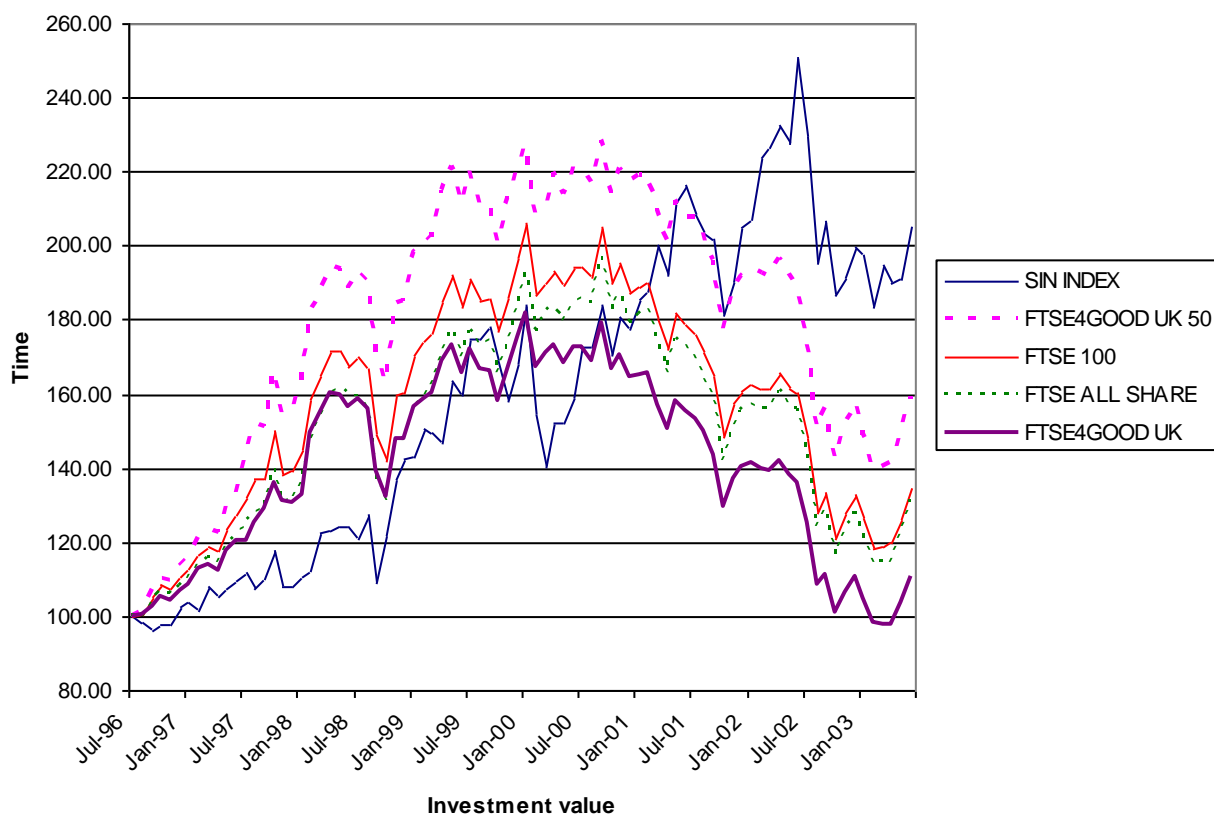
FTSE's ethical indices⁹¹ – may give a clearer indication of the relative merits of ethical versus non-ethical investment.

Although the FTSE4Good family of indices were only launched on 31 July 2001, it is possible to analyse the performance of the identical hypothetical indices back to 1 July 1996 (assuming the hypothetical indices include the same companies comprising the indices in July 2001).⁹² Three time periods are examined. The first period extends from 1 July 1996 (by which time many companies were including CSR reports in their annual statements) to 1 June 2003. The second and third time periods represent a partitioning of the full data-set into two almost equal components; the later component contains the entire period in which the FTSE4Good indices have been in existence. Figure 1 depicts the Value of £100 invested on 1 July 1996 in a portfolio tracking each index, assuming a notional 'buy-and-hold' investment strategy.

⁹¹ Specifically, the Sin Index is constructed as a market value-weighted average of the return on three FTSE sector indices (Tobacco, Mining, and Aerospace & Defence) and on the nuclear power stock British Energy.

⁹² Index values based on the initial index constituents are available on a backdated basis through Datastream, a company that provides 'Asset Performance Management' software and services.

Figure 1: Value of £100 invested in a tracking fund in July 1996



It is evident from Figure 1 that the ‘Sin Index’ was the worst performer in the earlier part of the investment time horizon depicted above, when the stock market was rising in what has now come to be recognised as a stock market ‘bubble’ fuelled by unrealistic optimism about the prospects for technology-based stocks, particularly those related to telecommunications and the Internet.⁹³ When the bubble burst in early 2000 and markets began to slide, however, the Sin Index began to outperform the others and has ended up with the greatest value at the end of the investment period. Interestingly, the Sin Index performed the best – and the FTSE4Good UK Index performed the worst – in the period after the creation of FTSE’s ethical indices. Table 3 shows that an investment tracking the hypothetical FTSE4Good Index from July

⁹³ See generally Robert J. Shiller, *Irrational Exuberance* (Princeton: Princeton University Press, 2000).

1996 to the beginning of the new millennium would have yielded returns exceeding the value of the other indices, but by the middle of 2003 the Sin Index had appreciated to achieve the greatest value while the FTSE4Good Index had slumped to record the lowest value. This ‘reversal of fortune’ is not entirely surprising. ‘Sin’ stocks such as tobacco and defence have been amongst the UK stock market’s best performers after the market peaked in early 2000.⁹⁴ Tobacco companies are usually considered safe investments in bear markets because they have a reasonably safe and predictable profit flow, and defence companies have benefited from increased arms spending following the terrorist attacks on the United States on 11 September 2001. On the other hand, technology-based companies, which are more likely to be classified as socially responsible as they generally have the least impact on the environment, have been among the worst hit by the new century’s stock market slump.⁹⁵

Table 3

Value of £100 invested in a tracking fund in July 1996

Date	SIN INDEX	FTSE4GOOD UK 50	FTSE 100	FTSE ALL SHARE	FTSE4GOOD UK
01/07/1996	£100.00	£100.00	£100.00	£100.00	£100.00
01/01/2000	£184.14	£227.27	£205.87	£192.52	£181.96
01/06/2003	£205.36	£159.42	£135.04	£131.17	£110.81

⁹⁴ For example, in 2002 the UK tobacco sector rose in value by 20% compared to a 25% fall in the FT All Share Index. See R. Miles, ‘Fund closes as ethics lose lustre’ *The Times*, 15 February 2003.

⁹⁵ The lacklustre performance of FTSE4Good stocks is highlighted by the performance of the ‘Sindex’ created by *Money Observer* magazine (see n. 89 above). Over the twelve-month period to 4 April 2002, the stocks in this ‘Sindex’ outperformed the seventy-five companies that were included in the FTSE4Good UK Index by 13%. This means that £100 invested in the Sindex would have grown to £108, while the seventy-five FTSE 100 companies included in the FTSE4Good Index fell in value to £95. Over the three-year period to 4 April 2002, £100 invested in the Sindex stocks would have grown to £106, while the ‘Saints’ would have shrunk to £90. See H. Connon, ‘Sinners set to feel the heat’, *The Guardian*, 28 May 2002.

4. Risk-adjusted performance of the FTSE4Good indices

Judging investments on their value alone can be misleading, however, because this does not take account of differences in risk associated with different investments.⁹⁶

The interaction between the risk associated with particular investments and the potential financial returns from those investments is a central preoccupation of financial economics. In this context, risk is a measure of the *variability* of an investment's performance, not an indication that the company will perform more poorly than low-risk investment options. To perform a risk-and-return analysis of an investment's relative performance, it is first necessary to calculate the returns on the investment. For an individual company, returns are determined by aggregating the capital gain or loss with dividend income over a given period of time on a percentage basis (so that the performance measure taken can be assessed independent of the size of the investment in the company). For a group of companies, such as those included in a market index, a mean (or average) return ('MR') can be calculated. 'Variance' is a measure of the 'risk' associated with the investment; the greater the variability (or 'volatility'), the greater the risk. Variance is a statistical measure of the deviation of the actual returns ('AR') on the shares from the MR calculated over a time frame immediately before the period studied: one can visualise a graph with a time line in which ARs appear as a dispersion of dots plotted around a line representing the MR. Mathematically, the difference of each AR from the MR is squared,⁹⁷ and these squared deviations are added together and averaged. The square root of this average is

⁹⁶ This has been a particular problem in assessing the performance of ethical funds, since the process of restricting the 'investment universe' (and the ability to diversify holdings) by using ethical criteria may result in a higher-risk portfolio.

⁹⁷ They are squared so that the 'positive' and 'negative' deviations do not cancel each other out; all of the deviations are thereby converted into positive numbers.

the standard deviation – and taking the square root of the variance transforms the number into the same units as the returns being analysed.

When the mean monthly returns for the two FTSE4Good indices are compared with appropriate benchmark indices (see Table 4), we see that the average monthly return for the FTSE4Good UK Index is less than that for the FTSE All Share Index between 1 July 1996 and 1 June 2003, but that the average monthly return for the top fifty companies in the FTSE4Good UK Index over that period was greater than that of the top 100 UK companies (represented by the FTSE 100) (see Panel A). These observed differences, however, are not statistically significant – that is, there is insufficient evidence to reject the hypothesis that any observed differences are simply the result to chance.⁹⁸ Moreover, no statistically significant differences in monthly returns for the two sub-periods (1 July 1996 to 31 December 1999 and 1 January 2000 to 1 June 2003) were observed (see Panels B and C). Similarly the observed differences in volatility (as measured by the standard deviation) for the three time periods studied were not statistically significant.⁹⁹ Given the large overlap of companies in the indices compared, these results are unsurprising.

⁹⁸ ‘Statistical significance’ has a specialised meaning among statisticians. Statistical evidence is usually used to test some hypothesis. For example, the hypothesis might be that the difference in the average monthly returns of the indices being compared is zero (the null hypothesis). Whenever the difference in actual returns differs from zero, this could simply be the product of chance. Statisticians will apply an appropriate statistical test to assess the probability of observing the data actually observed if the null hypothesis is true. The test will yield a ‘significance level’; if the significance level is .10, for example, one would expect to observe data like that actually observed in one out of every ten times a measurement is taken, if the null hypothesis is indeed true. The smaller the significance level, the less likely it is that the sample came from the population studied assuming the null hypothesis to be true; if the significance level is large, one must conclude that there is insufficient evidence against the null hypothesis for it to be rejected. It has been common practice for researchers in the physical and social sciences to refer to a significance level of .05 as ‘statistically significant’ because at this significance level there is a less than 5% chance of erroneously rejecting the hypothesis being tested.

⁹⁹ For the statistically minded, a two-tailed *t*-test assuming unequal variance was used for the difference in mean monthly returns, yielding significance levels ranging from 0.7758 to 0.8973; and a two-tailed

Table 4

**Mean monthly Return and Volatility comparison
FTSE4Good UK Index versus FTSE All Share Index and
FTSE4Good UK 50 Index versus FTSE 100 Index**

	FTSE4Good UK	FTSE All Share	FTSE4Good UK 50	FTSE 100
Panel A: July 1, 1996 to June 1, 2003				
Mean monthly return	0.23%	0.44%	0.68%	0.48%
Standard deviation	4.71%	4.77%	4.94%	4.88%
Panel B: July 1, 1996 to December 31, 1999				
Mean monthly return	1.47%	1.59%	2.06%	1.77%
Standard deviation	4.29%	4.24%	4.75%	4.48%
Panel C: January 1, 2000 to June 1, 2003				
Mean monthly return	-0.97%	-0.68%	-0.66%	-0.77%
Standard deviation	4.83%	5.04%	4.80%	4.97%

Table 5 compares the risk and return of the ‘Sin Index’ with the two FTSE4Good indices. The mean returns earned by the ‘sin’ stocks are greater than the mean returns earned by the two FTSE4Good indices over the entire period and in period 2 (Panel C) but not in period 1 (Panel B). Although the significance levels for these results are lower than the findings displayed in Table 4 (indicating there is less of a probability that the observed differences were due to chance), none reach the level that financial economists consider statistically significant. In contrast, the stocks comprising the Sin Index are considerably more volatile than the stocks which comprise the FTSE4Good indices over the full period and also in period 2 (Panel C), and these findings are

F-test assuming unequal variance of each sample was used for the difference in volatility, yielding significance levels ranging from 0.7100 to 0.9393.

statistically significant. Again, these results are unsurprising in view of the shift in the dynamics of the stock market at the turn of the millennium discussed above.

Table 5

**Mean monthly Return and Volatility Comparison:
UK 'Sin Index' versus FTSE4Good UK indices**

	Sin Index	FTSE4Good UK	FTSE4Good UK 50
Panel A: July 1, 1996 to June 1, 2003			
Mean monthly return	1.06%	0.23%	0.68%
Significance level		0.3325	0.6651
Standard deviation	6.14%	4.71%	4.94%
Significance level		0.0171	0.0510
Panel B: July 1, 1996 to December 31, 1999			
Mean monthly return	1.42%	1.47%	2.06%
Significance level		0.9668	0.5737
Standard deviation	5.44%	4.29%	4.75%
Significance level		0.1384	0.3968
Panel C: January 1, 2000 to June 1, 2003			
Mean monthly return	0.71%	-0.97%	-0.66%
Significance level		0.1971	0.2920
Standard deviation	6.80%	4.83%	4.80%
Significance level		0.0310	0.0284

Simple comparisons of raw mean monthly returns and standard deviations between the FTSE4Good indices, the Sin Index and the unrestricted benchmark portfolios ignores possible biases caused by the interaction between the shares included in the indices. The risk of a portfolio of shares depends not only upon the risk associated with individual shares included within the portfolio, but also on how the shares interact with one another. For example, a single set of macroeconomic factors could favour some industries represented in the portfolio and disfavour others. Therefore, it is desirable to examine the performance of the FTSE4Good indices and the Sin Index

relative to their unrestricted benchmark portfolios using a commonly applied measure of portfolio performance which adjust for risk, Jensen's *alpha*.¹⁰⁰ Jensen's *alpha* is ordinarily used to provide a risk-adjusted measure of the performance of well-diversified portfolios, and the FTSE4Good indices are intended to provide well-diversified investment options for the 'ethical' investor. Investors in well-diversified portfolios are primarily concerned with their exposure to the investment risk which cannot be diversified away, known as 'market' or 'systematic' risk.¹⁰¹ Jensen's *alpha* measures the actual return over and above what would be a fair return based upon the widely used capital asset pricing model (CAPM), which incorporates a coefficient (*beta*) to measure the portfolio's exposure to systematic risk. Jensen's *alpha* is calculated as:

$$\alpha_p = r_{p,t} - [r_{f,t} + \beta_P (r_{m,t} - r_{f,t})]$$

where the term in brackets is the equation for the CAPM; $r_{p,t}$ is the monthly return to the portfolio studied; $r_{f,t}$ is the return earned by a risk-free asset (we use the monthly return to three-month UK Treasury Bills); $r_{m,t}$ is the average return earned by the market as a whole in the relevant time period; and β_p represents the CAPM *beta* coefficient, which is a measure of the portfolio's sensitivity to the stock market as a whole. In our study, the unrestricted FT All Share Index was selected as a proxy for the monthly return to the market portfolio ($r_{m,t}$) in deriving an *alpha* for the FTSE4Good UK Index and the Sin Index, while the FTSE 100 Index was selected as

¹⁰⁰ See M. Jensen, 'The Performance of Mutual Funds in the Period 1945-1964', *Journal of Finance* 23 (1968), 389.

¹⁰¹ The evidence suggests that an investment in a random sample of around 15-20 stocks eliminates most of the unique (or unsystematic) risk associated with an investment, leaving the investor with exposure to market-wide (or systematic) risk. See, e.g., M. Statman, 'How Many Stocks Make a Diversified Portfolio?', *Journal of Financial and Quantitative Analysis* 22 (1987), 353. The companies included in the FTSE4Good indices are not randomly selected, and thus it cannot be said with confidence that all unsystematic risk has been eliminated. Nonetheless, they consist of large numbers of companies of substantial size, and this significantly reduces unsystematic risk. The Sin Index, on the other hand, is less well-diversified.

the market proxy for the smaller FTSE4Good UK 50 Index. A positive *alpha* implies superior investment performance relative to the market as a whole for a portfolio with the same market sensitivity (as reflected in the *beta*); a negative *alpha* implies substandard investment performance relative to the market for a portfolio with the same *beta*.

Table 6 summarises the Jensen *alpha* values obtained for the FTSE4Good indices and the Sin Index over the entire period and over the two sub-periods respectively.¹⁰² Over the entire period from July 1996 to June 2003, the *alpha* for the FTSE4Good UK Index was negative and the *alpha* for the FTSE4Good UK 50 Index was positive, but it cannot be comfortably assumed that these results were not the result of chance.¹⁰³ Similarly, the positive *alpha* observed for the Sin Index over the entire study period was not statistically significant. However, when the data is partitioned by time, both the negative *alpha* value obtained for the FTSE4Good UK Index between 1 January 2000 and 1 June 2003 and the positive *alpha* value obtained for the Sin Index over the same period are statistically significant.¹⁰⁴ It is less clear whether these observed

¹⁰² These values were obtained from an Ordinary Least Squares (OLS) regression of the sort commonly used to test hypotheses about the relationship between variables. The OLS model used was:

$$r_{p,t} - r_{f,t} = \alpha_p + \beta_p (r_{m,t} - r_{f,t}) + \varepsilon_{p,t}$$

where $r_{f,t}$, $r_{m,t}$ and $r_{p,t}$ are respectively the monthly returns to three-month UK Treasury Bills, the relevant market proxy, and the particular index being studied. The OLS regression was of the excess returns of the index studied against excess returns of the appropriate benchmark index, with excess portfolio returns being defined as those returns obtained over and above the risk-free return (i.e. $r_{p,t} - r_{f,t}$).

¹⁰³ The *p*-value represents the significance level. See n. 97 above. The null hypothesis is that Jensen's *alpha* is zero. The significance level for the *alpha* value actually observed for the FTSE 4Good UK Index was .10, indicating that one would expect to observe data like that actually observed once out of every ten times a measurement is taken, if the null hypothesis is true. Financial economists usually do not deem this significance level low enough to reject the null hypothesis with any confidence; typically, a significance level of .05 or lower is required to deem the result 'statistically significant'.

¹⁰⁴ Jensen's *alpha* for the FTSE4Good UK 50 Index returns are positive in value but insignificantly different from zero, regardless of the time period examined. This suggests that well-diversified investors who restrict their CSR investments to the top 50 CSR stocks did not suffer any adverse impact on their risk-adjusted returns when the FTSE 100 Index is used as the benchmark portfolio.

differences are *economically* significant: the results indicate that a well-diversified investor who notionally held a tracker fund tracking the FTSE4Good UK Index over the second period would have had a 0.34% lower risk-adjusted return compared to an investment in an FT All Share Index-tracker, and an investor in a fund tracking the Sin Index would have enjoyed a risk-adjusted return of 1.41% greater than that obtained through a market-tracker. It thus appears that there was a slight penalty suffered by investors who held stocks in the FTSE4Good UK Index in the period from 2000 onward and a somewhat greater reward for investors ‘in sin’ in the same period, which coincides with bursting of the stock market bubble in March 2000.¹⁰⁵

¹⁰⁵ A second statistical measure of the risk-adjusted performance of an investment is the Sharpe Index, which represents the average risk premium per unit of *total* risk (as opposed to just the systematic risk adjusted for by Jensen’s *alpha*). See W. F. Sharpe, ‘Mutual Fund Performance’, *Journal of Business* 39 (1966), 119, and ‘The Sharpe Ratio’, *Journal of Portfolio Management* Fall (1994), 49. See also J. D. Jobson and B. Korkie, ‘Performance Hypothesis Testing with the Sharpe and Treynor Measures’, *Journal of Finance* 36 (1981), 888. Some argue that total risk is a better measure of risk for a socially responsible investor than systematic risk, because the use of CSR screens inadvertently subject investors to otherwise diversifiable risk because the ‘investment universe’ for them is restricted. The Sharpe Index is calculated as $(r_p - r_f)$ divided by σ_p , where r_p and r_f are the average monthly return to the portfolio and three-month UK Treasury Bills respectively, and σ_p is the standard deviation of monthly portfolio returns over the period in question. The Sharpe index values obtained for the data we have studied pointed in the same direction as the statistical results we have reported here, but none of the values were statistically significant.

Table 6
Jensen's Alpha
FTSE4Good UK Index versus the FTSE All Share Index as the Market proxy;
FTSE4Good UK 50 Index versus the FTSE 100 Index as the Market proxy;
'Sin Index' versus the FTSE All Share Index as the Market proxy

FTSE4Good UK						
	<i>July 1, 1996 to June 1, 2003</i>		<i>July 1, 1996 to Dec 31, 1999</i>		<i>Jan 1, 2000 to June 1, 2003</i>	
	α_p	β_p	α_p	β_p	α_p	β_p
	-0.0021	0.9575	-0.0007	0.9468	-0.0034**	0.9538
<i>p-value</i>	0.10		0.79		0.00	
FTSE4Good UK 50						
	<i>July 1, 1996 to June 1, 2003</i>		<i>July 1, 1996 to Dec 31, 1999</i>		<i>Jan 1, 2000 to June 1, 2003</i>	
	α_p	β_p	α_p	β_p	α_p	β_p
	0.0020	0.9918	0.0025	1.0301	0.0006	0.9519
<i>p-value</i>	0.07		0.18		0.64	
'Sin Index'						
	<i>July 1, 1996 to June 1, 2003</i>		<i>July 1, 1996 to Dec 31, 1999</i>		<i>Jan 1, 2000 to June 1, 2003</i>	
	α_p	β_p	α_p	β_p	α_p	β_p
	0.0062	0.8604	0.0015	0.7033	0.0141*	1.0231
<i>p-value</i>	0.23		0.84		0.05	

Notes: The *p*-value gives the 'significance level'

* denotes significant at the 5% level

** denotes significant at the 1% level

5. Summary of the Empirical Evidence

To date, most empirical assessments of socially responsible investment strategies have focused on the relative performance of retail ethical funds. In absolute terms, the average performance of such funds has been inferior to that of funds that are not ethically 'screened', and inferior to the stock market as a whole (see, e.g., Table 2).

The picture is not as discouraging when the measurements of the comparative performance of ethical funds are controlled for risk: in those studies, the evidence indicates that the performance of ethical funds is similar or slightly worse than that of unscreened portfolios, and that the evidence of weaker performance is not statistically significant.

These studies have limitations, however. Ethical funds typically are not well-diversified and are subject to the confounding effects of ‘small firm’ bias, differential transaction costs and management ‘style’ biases. The study described in this chapter largely overcomes these limitations by focusing on the relative performance of ethical indices rather than ethical funds, but the use of indices have limitations of their own. Most problematically, the FTSE4Good indices used in this study have been criticised for being insufficiently selective: as of March 2002 the criteria for inclusion in the FTSE4Good UK Index were satisfied by 83% of the companies in the FTSE All-Share Index, and all of the companies in the FTSE4Good UK 50 Index were in the unscreened FTSE 100 Index. Nonetheless, some companies were excluded from the FTSE4Good indices, and a portfolio containing these companies (a ‘Sin Index’) provides some basis for comparison.

In absolute terms, a clear pattern is discernible: in the period before the March 2000 stock market crash, the FTSE4Good UK 50 Index (representing the largest companies satisfying the FTSE4Good inclusion criteria) outperformed the market while the FTSE4Good UK Index and Sin Index performed slightly worse than the market as a whole; and after the crash, the Sin Index outperformed the market by a large margin while the ethical indices underperformed the unrestricted market indices (see Figure 1 and Table 3). After adjustments are made for risk, the observed differences in performance of the various indices over the period from 1 July 1996 to 1 June 2003 are not statistically significant, but the better performance of the Sin Index and the weaker performance of the FTSE4Good UK Index after 1 January 2000 is statistically significant (if, perhaps, not particularly great in economic terms) (see Table 6).

In sum, the empirical evidence presented in this chapter concerning the relative performance of the FTSE4Good indices, used as a proxy for socially responsible investments, indicates that over the entire period of our study, the application of CSR screens did not necessarily result in higher volatility or reduced returns. Over the long term, investors would not have been penalised for choosing to invest in the stocks that comprise the FTSE4Good indices. On the other hand, there was no evidence that a good reputation for CSR enhanced a company's value on the stock market, either. There is also clear evidence that as investments 'sin' stocks are substantially more volatile than socially responsible investments and CSR-neutral investments. However, it appears that during bear markets, 'sin' pays: the relative returns of the Sin Index (both in absolute terms, and when adjusted for systematic risk) were much greater, and the relative returns of the ethical investments worse, when times were hard on the stock market. Between 1 January 2000 and 1 June 2003, there was a premium for 'sin' and a discount for 'virtue'.

Conclusion

The central focus of the Government's CSR strategy has been to place CSR within a model of the company as a profit-maximising entity. In this view, resources allocated by companies to environmentally benign conduct, enlightened employment policies, charitable giving and other socially worthy activities constitute investments in relationships with key stakeholders. Warm attitudes on the part of customers, suppliers, employees and regulators lead, it is claimed, to enhanced brand value, lower employee turnover, reduced risks of adverse government action and ultimately,

to greater returns on investors' capital. In other words, charitable giving and regulatory over-compliance are inputs to the company's overall production process – applied, it can be supposed, at levels calibrated to maximise profits and shareholder returns. The dramatic growth of SRI in recent years indicates that there may be something to the argument that there is a market for corporate social responsibility.

Theories explaining CSR in terms of disguised profit maximisation, however, can generate testable hypotheses. Previous empirical studies of the comparative performance of 'ethical' and 'non-ethical' companies did not provide clear evidence that CSR improved a company's value in the stock market, but they did not clearly indicate that CSR activities hurt performance, either. While the results obtained in our study of the FTSE4Good ethical indices are similarly equivocal, in one respect they are not encouraging: they suggest that while companies recognised by FTSE as having a good CSR record (putting aside questions of whether this reputation was earned) did not fare worse than companies in the 'Sin Index' during bull markets, they were punished by investors when the markets turned bearish.

There are some caveats to keep in mind. FTSE has not been particularly selective in determining whether a company can be included in the FTSE4Good indices, giving rise to the criticism that our study has not compared 'truly' ethical companies with unethical ones, although the strength of tobacco and defence industries in times of economic uncertainty provides little comfort to socially responsible investors. It is also possible that the full effects of the Government's disclosure strategy have not been felt, and that once consumers and other stakeholders become more aware of the CSR records of companies in the marketplace, a good CSR reputation will have a

more positive effect on company value. Our study also does not take full account of the psychological benefits of the Government's CSR policy: arguably, if company executives are forced to make CSR disclosure statements, they will internalise CSR considerations, and this will subtly affect how they carry out their duties.

Nonetheless, the results obtained in our study at least cast doubt on the vitality of the 'business case' for CSR, which in turn draws into question the Government's reliance on the interplay of voluntary action by company executives and mandatory disclosure rules. It may be that the most direct way to assure that companies meet social responsibilities is to impose legally enforceable obligations through compulsory legislation. Certainly, the results of our study do not support the abandonment of a strategy to encourage voluntary CSR, but they do indicate that the benefits of this approach may only be supplemental to a core strategy based around mandatory regulation.