VALUES AND VALUE: UNIVERSITY ENDOWMENTS, FIDUCIARY DUTIES, AND ESG INVESTING

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I. INTRODUCTION

Universities and other charities[1] often hold significant funds in endowments.[2] A university typically seeks to make annual distributions from its endowment fund, while maintaining the value of the fund over time so that support for the university will continue into the future.[3] Endowments can grow through investment returns and through additional contributions, and university endowments typically grow in both ways.[4]

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1. The legal definition of charity, derived from the English Statute of Charitable Uses of 1601, encompasses universities. *See, e.g.*, UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 2(1) (2006) ("'Charitable purpose' means the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose the achievement of which is beneficial to the community."); RESTATEMENT (THIRD) OF TRUSTS § 28 (2003). This article focuses on universities, but the analysis applies to all types of charities.

2. A legal definition of "endowment" is a donor-restricted fund that cannot be spent in its entirety in the current year. UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 2(2) (2006) (UPMIFA). Universities and others often use the term to refer to all investible assets, both restricted and unrestricted. The amount being invested may include donor-restricted endowment, board-designated endowment, and unrestricted funds set aside for uses beyond the current year and invested as part of the overall strategy. The discussion in this article applies equally to donor-restricted endowment as defined in UPMIFA and to endowment as often used in the lay sense to apply to any pool of investment assets. Some universities manage their endowments directly, and some universities, particularly state universities, have created separately incorporated foundations to manage their endowments. The discussion of university endowments in this article applies to both university-managed endowments and separate endowments managed for the benefit of universities.

3. The Yale University Investments Office begins its description of its strategy for supporting the university by stating: "The Endowment spending policy, which allocates Endowment earnings to operations, balances the competing objectives of supporting today's scholars with annual spending distributions while promising to maintain support for generations to come." *See Supporting the University*, YALE UNIVERSITY INVESTMENTS OFFICE, http://investments.yale.edu/index.php/2011-09-22-18-13-43/support (last visited Mar. 4, 2016). Yale and Harvard both say their endowments provide approximately a third of their net revenues. *Id. See also Investment Return of 20.2% Brings Yale Endowment Value to $23.9 Billion*, YALENEWS (Sept. 24, 2014), http://news.yale.edu/2014/09/24/investment-return-202-brings-yale-endowment-value-239-billion; *Harvard at a Glance*, HARVARD UNIV., http://www.harvard.edu/about-harvard/harvard-glance/endowment (Last visited June 6, 2015).

4. *See Harvard Endowment Raises to 36.4 Billion*, HARVARD MAGAZINE (Sept. 23, 2014), http://harvardmagazine.com/2014/09/harvard-endowment-rises-to-36-4-

As of June 30, 2014, U.S. colleges and universities reported holding $516 billion in endowment assets.[5]

University fiduciaries responsible for university endowments may wonder whether investment policies can consider environmental, social, and governance (ESG) factors as part of the investment strategy. Misinformation about the fiduciary duties of trustees has misled trustees and their lawyers and sometimes blocked even a discussion of this question.[6] The trustees and their advisors need legal guidance that explains how the consideration of ESG factors as part of an investment policy fits within the fiduciary duties of loyalty and prudence.[7] Little recent legal discussion of this topic exists, at least in the U.S.,[8] and some people

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billion.

5. National Association of College and University Business Officers and Commonfund Institute, *2014 NACUBO-Commonfund Study of Endowments* 1 (2015) [hereinafter NCSE]. The study reported that the 832 colleges and universities that participated in the study held $516.0 billion in combined endowment assets and 91 institutions had endowments of over $1 billion. Harvard reported a $36.4 billion endowment for the fiscal year ending June 30, 2014, *see* Harvard, *supra* note 4, while Yale's endowment was $23.9 billion. *See* Yale, *supra* note 3.

6. *See* Commonfund Institute, *Commonfund Study of Responsible Investing: A Survey of Endowments and Their Affiliated Foundations* (Apr. 2015), *available at agb.org/sites/default/files/u27175/nct15_commonfund.pdf*. [hereinafter Commonfund Study of Responsible Investing]. The study surveyed 200 institutions who agreed to participate as a follow-up to the NCSE. *Id.* at 1. When asked about impediments to adoption of ESG integration, 15% identified violation of fiduciary duty as a substantial impediment and 47% identified it as a moderate impediment. *Id*. at 7, 15. Concern about investment performance was identified as a substantial impediment by 35% and as a moderate impediment by 43%. *Id.* Only 58% of respondents said their boards had at least a "good" understanding of the difference between ESG integration and SRI. *Id. See also infra* Part V.C.

7. The Commonfund Study of Responsible Investing found that only 9% of the participants had concluded that responsible investing was consistent with fiduciary duties and 3% had concluded that it was not. Most respondents said that they did not know. *Id*. at 16.

8. Much of the legal discussion in the U.S. has focused on investments by pension plans. *See, e.g.*, Jay Youngdahl, *The Time Has Come for a Sustainable Theory of Fiduciary Duty in Investment*, 29 HOFSTRA LAB. & EMP. L.J. 115 (2011); Benjamin J. Richardson, *Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?*, 22 BANKING & FIN. L. REV. 145 (2007) (arguing that SRI can be implemented using methods that comply with the duties of prudence and loyalty). With respect to SRI and charities, see Joel C. Dobris, *A Letter About Investing to a New Foundation Trustee, with Some Focus on Socially Responsible Investing*, 34 ACTEC J. 234 (2009); Lewis D. Solomon & Karen C. Coe, *Social Investments By Nonprofit Corporations And Charitable Trusts: A Legal And Business Primer For Foundation Managers And Other Nonprofit Fiduciaries*, 66 UMKC L. REV. 213 (1997). *See also* Edward J. Waltzer & Douglas Sarro, *Fiduciary Society Unleashed: The Road Ahead for the Financial Sector*, 69 BUS. LAW. 1081 (2014) (describing the evolution of fiduciary duty law in the financial services sector); Benjamin J. Richardson, *Fiduciary Relationships for Socially Responsible Investing: A Multinational Perspective*, 48 AM. BUS. L.J. 597 (2011) (discussing whether a fiduciary should consult with beneficiaries

concerned about fiduciary duties in this context worry about statements made in the early years of socially responsible investing ("SRI").[9] In the past 30 years, SRI has changed. New strategies for investing for value have developed, and ESG investing, a term often used to capture this idea, differs significantly from the negative screens used when the apartheid system in South Africa drove interest in SRI funds.[10]

In recent years, some investors have begun to focus on the significance of ESG factors in improving returns while reducing risk.[11] Yet only a small

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to determine whether SRI follows the beneficiaries' "best interests" and then the complexity of determining "best interests" in trusts with a large group of beneficiaries with conflicting views (e.g. pension plans)). In the U.K., discussion of the fiduciary issues has been more robust. On Sept. 24, 2014, the U.K. Law Commission issued a recommendations paper, which suggests the creation of a new statutory rule to clarify the ability of charities to engage in social investment. *Social Investment by Charities: The Law Commission's Recommendations*, U.K. LAW COMM'N (2014), *available at* www.lawcom.gov.uk/wp-content/uploads/2015/06/cp216_charities_social_investment_recommendations.pdf. The paper concludes that trustees can make social investments if they determine that the investments are in the best interests of the charity and provide both "mission benefit" and financial return. *Id.* at 2. The U.K. Law Commission also issued a report focusing on the fiduciaries who manage pensions. *Fiduciary Duties of Investment Intermediaries*, U.K. LAW COMM'N (2014), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/325509/41342_HC_368_LC350_Print_Ready.pdf. The report concludes that trustees may take ESG factors into consideration "given the evidence that ESG factors can lead to better returns over the longer-term. . ." *Id.* at 97. The report noted that some comments submitted on an earlier Consultation Paper argued that "trustees have a fiduciary obligation to take ESG factors into account and to expedite engagement with their portfolio companies." *Id.* at 98. The report found that because the ESG label was used in so many different ways, stating categorically that trustees must take an ESG approach would not make sense. However, the report concluded that trustees "should take account of risks to their investments. When investing in long-term equities, this includes risks to the long-term sustainability of a company's performance." *Id.* at 101. *See also A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*, UNEP FINANCE INITIATIVE 114 (2005) http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf (referred to as the "Freshfields report").

9. *See infra* Part VI.A.

10. *See* John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72 (1980) (discussing the use of SRI by trustees in the context of screens related to divestment from South African and other social concerns). In the 1960s protests in the U.S. began to raise public awareness of apartheid, a system of racial segregation in South Africa. Student organizations pushed universities to divest all or part of their endowments of any companies doing business in South Africa. "The college-based divestment efforts may or may not have played a role in immediately affecting the South African economy. But they did raise awareness about the problem of apartheid." Gregory Gethard, *Protest Divestment and the End of Apartheid*, INVESTOPEDIA (Jul. 16, 2008), http://www.investopedia.com/articles/economics/08/protest-divestment-south-africa.asp.

11. *See infra* Part V.D. One reason for the growth in awareness of ESG factors is

percentage of university endowments report using ESG factors as part of their investment strategies.[12] Some university trustees may have considered whether to adopt an ESG policy and decided against it, but many university fiduciaries may have failed to consider the use of ESG factors due to concerns about potential breaches of fiduciary duties.

The legal concerns about proper fiduciary behavior rest on two issues. The duty of loyalty requires a trustee[13] to act "in the sole interests" of the beneficiaries – in the case of a charity the charitable mission.[14] The duty of care or prudence requires the trustee to exercise the care of a reasonably prudent person in managing the property of the organization, and in particular in investing its funds.[15] Further, fiduciaries should review their endowment's investment policies periodically, to consider changes in investment norms reflected in those policies.[16]

This article examines whether the fiduciaries who manage university endowments can consider ESG factors when developing investment policies. After a brief introduction, Part II examines the fiduciary duties of

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the concern over climate change. Climate change threatens to alter social, economic, and environmental structures. Investors worry not only about effects on the quality of life, but also on the impact climate change will have on investments. For example, changes in regulations on the burning of fossil fuels may affect the value of companies with oil, gas, and coal reserves. Climate change may also affect both supply chains and markets. Attempts to address climate change through investment choices can protect a portfolio against risk (oil and gas investments may lose value if regulations curtail extraction) and may protect the overall investment structure in a more general way, by focusing on long-term value rather than short-term returns. If climate change adversely affects the economy, an economic downturn will lower all boats (except those floating in the areas flooded by expanding seas). *See, e.g.*, Terry Macalister, *Investors Could Lose $4.2tn Due to Impact of Climate Change, Report Warns*, THE GUARDIAN (Jul. 24, 2015), http://www.theguardian.com/environment/2015/jul/24/investors-could-lose-42tn-due-to-impact-of-climate-change-report-warns.

12. *See* NCSE, *supra* note 5, at vii (stating that 14% of the respondents reported using ESG factors, 25% reported using negative screens, 15% reported investments that further the institution's mission, 7% said they were considered changing their investment policies to include ESG integration, and 6% reported that their boards "had voted to exclude responsible investing considerations").

13. Fiduciary duties for anyone acting on behalf of another in a fiduciary capacity derive from trust law. *See* Tibble v. Edison Int'l, 135 S. Ct. 1823 (2015) ("We have often noted that an ERISA fiduciary's duty is 'derived from the common law of trusts.'") This case discusses fiduciary duties in the context of "trustees." The same duties apply to the fiduciaries of all charities, whether the charity is organized as a nonprofit corporation and managed by directors, as a charitable trust and managed by trustees, as a governmental unit managed by regents, or in some other form.

14. *See infra* Part II.B (describing the duty of loyalty).

15. *See infra* Part II.C (describing the duty of care and the prudent investor standard).

16. *See* Tibble, 135 S. Ct. at 1823 (confirming a fiduciary's ongoing duty to monitor investments).

those who manage university endowments, with particular attention to the duty to act as a prudent investor. Part III turns to the history of SRI, with an explanation of terminology and strategies. Part IV examines the use of ESG factors in investing, with attention to performance data. This Part discusses early concerns about SRI, particularly an argument that SRI necessitated a financial cost due to restrictions on diversification. Part IV then reviews recent empirical research that shows that ESG investing can result in returns that meet or exceed non-SRI benchmarks. Part IV also discusses growing financial industry interest in ESG factors and the development of integrated reporting. Based on changes in investing practices, Part V concludes that the prudent investor standard has evolved to include ESG investing. Recent guidance from the Department of Labor supports this conclusion. Thus, fiduciaries responsible for university endowments can adopt investment policies directing the use of ESG factors without breaching the fiduciary duties of loyalty and prudence.

II. FIDUCIARY DUTIES OF TRUSTEES OF UNIVERSITY ENDOWMENTS

The trustees who manage university endowments must act as fiduciaries with respect to the endowments. Whether the endowment is structured as a trust or a nonprofit corporation, the fiduciary duties of obedience, loyalty, and care (prudence) apply.[17] These duties developed in trust law and now apply in any circumstance in which one person manages property for someone else, or in the case of a charity for the charity's purposes.[18] The standards vary somewhat between trust law and business law, but the standards as applied to charities should be essentially the same, whether the charity is organized as a charitable trust or a nonprofit corporation.[19]

Fiduciary duties address the problem that would otherwise occur when one person manages property for someone else's benefit. In a private trust, the trustee controls the property and might be tempted to use the property for her own benefit, rather than that of the beneficiaries. In a charitable trust the same concern, that the trustee might not put the interests of the charity first when making decisions, applies. As this section describes, the

17. RESTATEMENT (THIRD) OF TRUSTS § 76 (obedience), § 77 (prudence), § 78 (loyalty) (2007); UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3 (2006).

18. RESTATEMENT (THIRD) OF TRUSTS § 76 (2007).

19. UNIF. PRUDENT MGMT. OF INST. FUNDS ACT Prefatory Note (2006); RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS § 1.02 cmt. d (Choice of Legal Form) (Tentative Draft No. 1 Apr.13, 2016).).

duties require the trustee to follow the wishes of the settlor[20] as expressed when the settlor created the trust, to act for the benefit of the beneficiaries or the charitable purposes, and to manage the property with care and prudence. The fiduciary of a charity must act to carry out the charity's purposes, subject to any restrictions imposed by donors. The duties are of particular importance in the charitable context, given the limited amount of oversight of the actions of charitable fiduciaries.[21]

A. Duty of Obedience

In trust law the duty of obedience is the duty to carry out the terms of the trust, as established by the settlor.[22] For a charitable trust or nonprofit corporation, the duty of obedience is the duty to carry out the charitable purposes of the charity. The duty encompasses both the duty to keep the charity's mission in mind in decision making and to respect donor intent associated with restricted gifts. The duty of obedience complements the other two key duties—the duties of loyalty and care —and plays an important role in the way fiduciaries manage an organization.[23]

B. Duty of Loyalty

The duty of loyalty requires a trustee to act in the "sole interests" of a trust beneficiary[24] and requires a director of a nonprofit corporation to act in the "best interests" of the corporation.[25] The utility of a "sole interests" standard has been challenged in connection with private trusts, with the view that a "best interests" standard will yield better results for beneficiaries.[26] For a charity, a best interests standard seems optimal. In essence, the duty of loyalty is a duty to avoid conflicts of interest in

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20. Trust law uses the term settlor to mean the person who "settles" the trust by transferring property to another to act as trustee, following the directions of the settlor. The Uniform Trust Code treats any donor to a charitable trust as a settlor with respect to the portion of the trust contributed by the donor. UNIF. TRUST CODE § 103(15) (2010).

21. Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749, 817–19 (2008); Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law and Tax Law*, 21 U. HAW. L. REV. 593, 609 (2000).

22. RESTATEMENT (THIRD) OF TRUSTS § 76 (2007).

23. *See* Rob Atkinson, *Obedience as the Found. of Fiduciary Duty*, 34 J. CORP. L. 43 (2008), for a thorough analysis of the duty of obedience.

24. RESTATEMENT (THIRD) OF TRUSTS § 78 (2007).

25. RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS § 2.02(a) (Tentative Draft No. 1 Apr.13, 2016).

26. John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 980–86 (2005).

connection with actions taken on behalf of the trust if the conflicted transaction will hurt the beneficiaries.[27] An action need not benefit the trustee personally to be prohibited.[28]

For charities the duty of loyalty can be understood as a duty to act for the benefit of the charitable mission and not for the fiduciary's personal benefit. Sometimes a conflict of interest transaction will benefit the charity, for example if a trustee provides goods or services to the charity below cost. However, every decision a trustee makes should put the interests of the charity first, above any interest the trustee may have and above the interests of third parties.[29]

C. Duty of Care [30] - Prudent Investor Rule

The third general duty is the duty to manage the property of the trust or nonprofit corporation as a prudent person would, keeping in mind the purposes of the charity.[31] A trustee or director must exercise reasonable care and skill in managing the property, and must use the level of caution appropriate to the circumstances of the charity.[32] The fiduciary must keep the property safe,[33] must not commingle the property with the fiduciary's own property,[34] and must keep proper records and accountings related to

27. RESTATEMENT (THIRD) OF TRUSTS § 78 (2007). Under both trust law and nonprofit corporation law, exceptions have developed so that trustees and directors can engage in conflict of interest transactions that are in the best interests of the charity. *See* UNIF. TRUST CODE § 802(b) (transactions authorized by the terms of the trust, by all beneficiaries, or by a court do not violate the duty of loyalty) (last amended 2010).

28. *Id.*

29. RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. f (2007).

30. This duty has been historically called the duty of care and now is also referred to as the duty of prudence. See RESTATEMENT (SECOND) OF TRUSTS § 174 (1959) (Duty to Exercise Reasonable Care and Skill). The Restatement (Third) of Trusts now refers to the general duty as the duty of prudence, and provides that the duty "requires the exercise of reasonable care, skill and caution." RESTATEMENT (THIRD) OF TRUSTS § 77(2) (2007).

31. *See* RESTATEMENT (THIRD) OF TRUSTS § 77 (2007); UNIF. TRUST CODE § 804 (2010) ("Prudent Administration"); UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3 (2006).

32. *See* RESTATEMENT (THIRD) OF TRUSTS § 77 cmt. b (2007).

33. GEORGE G. BOGERT, GEORGE T. BOGERT, & AMY MORRIS HESS, THE LAW OF TRUSTS AND TRUSTEES § 541 (3d. 2014); UNIF. TRUST CODE § 809 (2010).

34. BOGERT, BOGERT & HESS, *supra* note 33, at § 596; RESTATEMENT (THIRD) OF TRUSTS § 84 (2007).

the property.[35] The fiduciary must act as a prudent investor with respect to any investment assets.[36] This article focuses on the prudent investor rule.

The understanding of what a prudent investor should do has changed over time. Indeed, the evolving ideas of what constitutes prudent behavior makes prudence valuable as a legal standard. If the standard applies industry norms to the task of managing investments, then as the norms change, the standard can adjust and continue to be useful.[37] An overview of the history of the prudent investor standard reveals changes in the application and meaning of the standard over the years since the idea surfaced in the nineteenth century.

1. Prudence in Trust Law. – The first judicial articulation of a prudence standard for trustees in the United States occurred in 1830, in the famous case of *Harvard College vs. Amory*.[38] The Supreme Judicial Court of Massachusetts declared that a trustee must act with the care a prudent man would use to manage his own assets.[39] The court explained that trustees should "observe how men of prudence . . . manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."[40] The prudent man standard set forth in this

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35. RESTATEMENT (THIRD) OF TRUSTS § 83 (2007); BOGERT, BOGERT & HESS, *supra* note 33 at 961.

36. *See* RESTATEMENT (THIRD) OF TRUSTS § 77 cmt. a (2007) (referring to §§ 90–92).

37. The Introductory Note to the Prudent Investor Rule in Restatement (Third) of Trusts concurs: "Trust investment law should reflect and accommodate current knowledge and concepts. It should also avoid repeating the mistake of freezing its rules against future learning and developments." RESTATEMENT (THIRD) OF TRUSTS § 90 Reporter's General Note (2007).

38. 26 Mass. 446 (1830). The court's famous statement, which became the foundation of the prudent man rule, was either an alternative holding or dictum. *See* Harvey P. Dale et al., *Evolution Not Revolution: A Legislative History of the New York Prudent Management of Institutional Funds Act*, 17 N.Y.U. J. LEGIS. & PUB. POL'Y 377, 385 (2014).

39. Prior to this case, trustees relied on "legal lists" to guide their decision making. The trustees could invest in anything on the list, but had to avoid anything not on the list. *See* John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 643–45 (1996) (describing the history and development of the prudence standard prior to the Uniform Prudent Investor Act (UPIA). *See also* Max M. Schanzenbach & Robert H. Sitkoff, *The Prudent Investor Rule and Market Risk: An Empirical Analysis,* Discussion Paper 816, The Harvard John M. Olin Discussion Paper Series, http://www.law.harvard.edu/programs/olin_center/; Max M. Schanzenbach & Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Allocation?* 50 J.L. & ECON. 681, 683–686 (2007).

40. Harvard Coll., 26 Mass. at 461.

case was then adopted by many state legislatures and courts[41] and eventually by the Restatement (Second) of Trusts.[42] Although initially a flexible standard in contrast to the legal lists of acceptable investments prevailing in 1830, interpretations of the standard restricted much of the flexibility.[43]

Cases interpreting the prudent man standard focused on the language "not in regard to speculation" and "safety of capital" to assert that trustees should avoid risk.[44] As a result, the standard came to mean that investments in long-term government and corporate bonds were prudent but investments that involved buying stock on margin or investing in land or new enterprises were not.[45] As the twentieth century wore on, the standard grew increasingly out of date.

In the second half of the twentieth century an influential study showed that the inflation-adjusted returns for stocks far exceeded those of bonds.[46] Economists developed the theory of efficient markets in connection with modern portfolio theory, and professional investment managers influenced by those theories began to develop new strategies for better investment results.[47] The evolving view of what a prudent investor should do led to several changes in the fiduciary laws applicable to trustees.

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41. *See* RESTATEMENT (THIRD) OF TRUSTS § 90 Reporter's General Note (2007). In 1942 the American Bankers Association created a model act that influenced adoptions in state legislatures. The Model Prudent Man Investment Act provided that in connection with investment decision making, "a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which men of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as probable safety of their capital." *See* Mayo A. Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 OHIO ST. L.J. 491, 508–09 (1951), for the text of this model act.

42. *See* RESTATEMENT (SECOND) OF TRUSTS § 174 (1959) (describing the duty "to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property. . ."). The prudent man rule became the prudent person rule and then the prudent investor rule, to avoid the gendered "prudent man" language.

43. *See* RESTATEMENT (THIRD) OF TRUSTS § 90 Reporter's General Note (2007).

44. Langbein, *supra* note 39 at 644–45.

45. *See* RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. f (1959). The Restatement also explains that although "a man of intelligence" may invest in something if the risk of loss is not out of proportion with the opportunity for gain, a trustee could not do so because preservation of the fund must be a primary consideration. *Id.* at cmt. e.

46. *See* Roger G. Ibbotson & Rex A. Sinquefield, STOCKS, BONDS, BILLS, AND INFLATION: HISTORICAL RETURNS (1926-1978) 29-30 (2d ed. 1979).

47. *See* Jonathan R. Macey, AN INTRODUCTION TO MODERN FINANCIAL THEORY (ACTEC Foundation, 2d ed. 1991). *See also* Langbein, *supra* note 39 at 642 (explaining the effect of these theories on the development of UPIA).

In the 1980s several states enacted new prudent man or prudent person standards.[48] Commentators voiced concern about the way the prudent man rule had been interpreted and characterized by the commentary of the Restatement (Second) of Trusts, other treatises, and courts.[49] Responding to that concern, the American Law Institute undertook a project to modernize and clarify the prudence standard.[50] The result of that effort was the adoption in 1990 and publication in 1992 of the prudent investor rule as part of the Restatement (Third) of Trusts.[51] Shortly thereafter, the Uniform Law Commission[52] (ULC) promulgated the Uniform Prudent Investor Act (UPIA),[53] a model states could use to adopt a standard based on then-current thinking about investment decision-making by fiduciaries.

UPIA directs trustees to manage risk across the trust's portfolio, and to consider "the risk and return objectives" of the trust in making decisions.[54] Rather than making the goal risk avoidance, under UPIA a trustee should manage risk, as appropriate for the particular trust. UPIA also emphasizes a prudent investor's duty to diversify investments,[55] in keeping with the

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48. *See* RESTATEMENT (THIRD) OF TRUSTS § 90 Reporter's General Note (2007). In 1991 Illinois became the first state to adopt a prudent investor rule.

49. *See* BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986); Jeffrey N. Gordon, *The Puzzling Survival of the Constrained Prudent Man Rule,* 62 N.Y.U. L. REV. 52 (1987); Harvey E. Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721 (1976).

50. *See* RESTATEMENT (THIRD) OF TRUSTS § 90 Reporter's General Note (2007).

51. The American Law Institute adopted the prudent investor rule in 1990 and published the rule as §§ 227–229 of the Restatement (Third) of Trusts in 1992. The prudent investor rule was renumbered and now appears as §§ 90-92. *See* RESTATEMENT (THIRD) OF TRUSTS Pt. 6, Ch. 17, Forenote (2007). The wording of the Restatement standard intentionally avoided taking a position on the issue of whether the trustee should invest as a prudent manager investing his own funds (the structure of the Restatement (Second) of Trusts version) or investing the funds of others (the version in Uniform Probate Code § 7-302). *See* RESTATEMENT (THIRD) OF TRUSTS § 90 Reporter's General Note (2007). The UPC described the standard as the duty to "observe the standards in dealing with the trust assets that would be observed by a prudent man dealing with the property of another. . ." UNIF. PROBATE CODE § 7-302 (2010). *See also* BOGERT, BOGERT & HESS, *supra* note 33, at § 612 (citing cases that explain that this duty, to act as a prudent trustee for another, means that the trustee is not simply dealing with the property as he would for himself, but is dealing with the property as if for someone for whom he has a moral obligation).

52. At the time it adopted UPIA, the organization was known as the National Conference of Commissioners on Uniform State Laws or NCCUSL. UNIF. PRUDENT INVESTOR ACT (1994).

53. *See id.*

54. *Id.* at § 2(b).

55. *Id.* at § 3.

findings of modern portfolio theory.[56] UPIA permits delegation of investment decision making authority so long as the trustees "exercise reasonable care, skill, and caution" in establishing the scope and terms of the delegation and in selecting and monitoring financial managers.[57] Finally, UPIA directs trustees to consider the purposes of the trust in making investment decisions.[58] Statutes based on UPIA or the prudent investor rule of the Restatement have been adopted in all states.[59]

2. Prudent Investor Standard for Nonprofit Corporations. – The Uniform Prudent Investor Act applies to trustees, but the prudent investor standard applies more broadly to other fiduciaries.[60] Trust law has long informed legal rules related to charities, and the prudent investor rule will likely apply to any charity, however structured.[61] In addition, the Uniform Prudent Management of Institutional Funds Act (UPMIFA) adopts the prudent investor standard from UPIA for charities organized as nonprofit corporations.[62]

Due to concerns in the 1960s that trust law governed the investment and spending of university endowments,[63] the Uniform Law Commission developed a uniform act called the Uniform Management of Institutional Funds Act (UMIFA).[64] The act, promulgated in 1972 and eventually enacted in almost all states,[65] provided guidance on endowment spending

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56. A central tenet of modern portfolio theory is that diversification reduces risk. *See* UNIF. PRUDENT INVESTOR ACT § 3 cmt. (1994).

57. UNIF. PRUDENT INVESTOR ACT § 9 (1994). *See also* Tibble, 135 S. Ct. at 1823 (confirming the ongoing duty to monitor the prudence of investments and investment policy).

58. UNIF. PRUDENT INVESTOR ACT § 2(a) (1994).

59. Forty-five states have adopted statutes based on UPIA or adopting its principles. The other states have comparable statutes that pre-dated the promulgation of UPIA in 1994. Thus, the principles discussed as the "prudent investor rule" guide fiduciary practice in all states. *See* UNIF. PRUDENT INVESTOR ACT, Editor's Notes (1994).

60. *See* UNIF. PRUDENT INVESTOR ACT, Prefatory Note (1994).

61. *See id.* ("Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations.").

62. UNIF. PRUDENT MGMT. OF INST. FUNDS ACT, Prefatory Note (2006).

63. Trustees that felt constrained by trust standards invested endowment funds primarily in bonds. *See* WILLIAM L. CARY & CRAIG B. BRIGHT, THE LAW AND THE LORE OF ENDOWMENT FUNDS 66 (1969).

64. UNIF. MGMT. OF INST. FUNDS ACT, 7A U.L.A. 484 (1972).

65. UNIF. PRUDENT MGMT. OF INST. FUNDS ACT, Prefatory Note (2006) (explaining that UMIFA was enacted in 47 jurisdictions).

and adopted a prudent investor standard for managers of charities organized as nonprofit corporations.[66]

In 2006 the ULC completed a revision to UMIFA.[67] The new act, UPMIFA, adopted the language from the Uniform Prudent Investor Act, with minor changes to make the language applicable to charities.[68] UPMIFA directs fiduciaries to consider the purposes of the charity along with the other economic factors a prudent investor should consider.[69] Every state except Pennsylvania has adopted UPMIFA,[70] and the prudent investor rule applies to charities throughout the country, either through UPIA or UPMIFA or because the rule influences general fiduciary standards.

3. Evolution of the Prudence Standard. — As the prior section describes, a prudent man-person-investor standard has applied to trustees since 1830. For its first 100 years or so interpretations of the standard led to conservative investment strategies for trustees. In the mid-twentieth century, investors familiar with modern portfolio theory began to change their strategies, and as the industry standard changed, the prudent investor standard for trustees needed to change as well. The Restatement and UPIA provided statutory protection and direction for trustees who wanted to invest prudently within the new understanding of what it meant to be a prudent investor.[71] After the adoption of UPIA throughout the country, trustees increased stock holdings relative to investments such as government bonds that had been considered more "safe."[72] In addition, trustees expanded investment strategies to include hedge funds, buying on margin, and buying futures. In the right circumstances, a variety of investments that might have been considered too risky in the past are now considered acceptable, when considered as part of an entire portfolio.

Prudence is undergoing another change, as awareness that ESG factors affect the financial bottom line of companies grows. Ideas about how an investor can best use ESG factors in making prudent decisions continues to

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66. UNIF. MGMT. OF INST. FUNDS ACT, 7A U.L.A. 484 (1972).

67. UNIF. PRUDENT MGMT. OF INST. FUNDS ACT (2006)

68. UNIF. PRUDENT MGMT. OF INST. FUNDS ACT Prefatory Note (2006).

69. UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3(a) (2006).

70. *See Legislative Fact Sheet – Prudent Management of Institutional Funds Act*, UNIFORM LAW COMMISSION, http://www.uniformlawcommission.com/LegislativeFactSheet.aspx?title=Prudent%20Management%20of%20Institutional%20Funds%20Act.

71. RESTATEMENT (THIRD) OF TRUSTS §§ 90–92 (2007); UNIF. PRUDENT INVESTOR ACT (2006).

72. Schanzenbach & Sitkoff, *supra* note 39 at 682.

develop, but whether an investor can consider those factors is no longer problematic. The Introductory Note to the Restatement's explanation of the prudent investor rule anticipated the changes to come:

> [T]he rules must be general and flexible enough to adapt to changes in the financial world and to permit sophisticated, prudent use of any investments and courses of action that are suitable to the purposes and circumstances of the diverse trusts to which the rules will inevitably apply.[73]

The "purposes and circumstances" of charitable trusts, and in particular university endowments, lead fiduciaries to the use of ESG investing as part of an overall investment policy. The explanation of this evolution in the prudent investor rule requires an understanding of the changes in socially responsible investing since the 1980s and of recent financial information about SRI funds and ESG investing strategies.

III. THE USE OF EXTRA-FINANCIAL FACTORS IN INVESTMENT DECISIONS

This section looks at the development of investment strategies – from SRI screens to ESG investing – that use extra-financial factors together with traditional financial information to make investment decisions. Although the environmental, social, and governance factors are typically referred to as non-financial factors, investors have realized that extra-financial data can provide useful information about a company's long-term risks and opportunities. In effect, the so-called extra-financial data has financial implications.

In discussions of SRI several different terms are used, sometimes interchangeably even though the terms often convey different concepts. Socially responsible investing (SRI) was the earliest term used and continues to be used to cover various types of investing strategies that use extra-financial factors, although the terms "responsible investing" and "sustainable investing" are increasingly used.[74] Other terms have been devised to convey differences in strategy. This article uses the term ESG investing to convey a particular strategy, but some observers use the term

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73. RESTATEMENT (THIRD) OF TRUSTS, Pt. 6, Ch. 17, intro note (2007).

74. *See Demystifying Responsible Investment Performance*, THE ASSET MANAGEMENT WORKING GROUP OF THE UNITED NATIONS ENV'T PROGRAMME FINANCE INITIATIVE AND MERCER, (2007), *available at* http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf [hereinafter UNEP-FI & MERCER]. *See* COMMONFUND INSTITUTE, FROM SRI TO ESG, THE CHANGING WORLD OF RESPONSIBLE INVESTING (2013), for an excellent explanation of the development of SRI and the terminology used.

SRI to describe the same kind of strategy. This section reviews the history of SRI and the development of investment strategies that use extra-financial factors. This section also discusses the term "mission-related investing," a term that describes the way some charities use the investment strategies.

Although this section provides explanations of various terms used in connection with social investing, broadly understood, it is important to recognize that these terms are not used with precision.[75] The discussion is provided here for readers who may be unfamiliar with the terms and may benefit from a general sense of some of the differences. This section also describes a bit of the history of social investing.

A. Socially Responsible Investing

Socially responsible investing (SRI) has roots in the anti-slavery efforts of Quakers in the 18th century.[76] Interest in SRI grew in the 1960s and 1970s when critics of South African apartheid urged universities and pensions to divest any stocks held in companies located in or doing business in South Africa.[77] Over time SRI expanded to include a variety of social, ethical, and environmental issues.[78] As SRI strategies developed, a general definition of an SRI fund was a fund that considered social or ethical issues as well as financial information in building its portfolio, and an SRI investor was someone who sought to effect positive social change as well as generate financial gain.[79] Early SRI funds used negative screens, refusing to invest in companies that did not fit a fund's guidelines,[80] and positive screens, seeking companies with practices that

75. *See* Commonfund Study of Responsible Investing, *supra* note 6, at 2 (providing definitions and noting the "fluid nature of the current responsible investing environment" when it comes to terminology).

76. Benjamin J. Richardson, *Putting Ethics into Environmental Law: Fiduciary Duties for Ethical Investment*, 46 OSGOODE HALL L.J. 243, 245 (2008), *available at* http://ohlj.ca/english/documents/OHLJ46.

77. *See* Joel C. Dobris, *Arguments in Favor of Fiduciary Divestment of "South African" Securities*, 65 NEB. L. REV. 209 (1986); Langbein & Posner, *supra* note 10, at 72.

78. *See* SOCIAL INVESTMENT FORUM, *After South Africa: The State of Socially Responsible Investing in the United States* (1995), *available at* http://www.ussif.org/files/Publications/95_trends_Report.pdf. (describing issues addressed in early negative and positive screens) [hereinafter *1995 Trends Report*].

79. *See* Maria O'Brien Hylton, *Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market*, 42 AM. U.L. REV. 1, nn. 2–3 (1993) (citing several attempts at defining socially responsible investing).

80. *1995 Trends Report*, *supra* note 78. The 1995 Trends Report found that of managers using screens, 86% avoided tobacco stocks, 73% avoided alcohol stocks, and

supported the guidelines.[81] SRI funds also engaged in shareholder advocacy, using proxy voting to encourage behavior in keeping with the fund's guidelines.[82] For example, in 2002, Domini Social Investments and a coalition of investors holding 500,000 shares of stock in Procter & Gamble urged the company to offer Fair Trade Certified coffee.[83] The coalition eventually filed a related shareholder resolution, and in 2003, Procter & Gamble announced that it would begin marketing Fair Trade Certified coffee products.[84] Pressure from consumers and humanitarian organizations also influenced Procter & Gamble, but the shareholder action played a role in the company's decision.[85]

As SRI developed, fund managers and policy makers developed new strategies, with new labels to express the differences from early SRI. ESG investing and ESG integration are terms used to describe a different way of engaging in responsible investing. After a quick review of how ESG investing differs from the screens of early SRI, and then explanations of some other terms that are used in connection with SRI, the article will turn to financial experience with various forms of SRI, including ESG investing.

64% avoided weapons stocks. *Id.*

81. *See id*. Of managers who applied screens, 42% applied a positive screen for human rights, 38% for environmental concerns, 24% for animal rights, and 22% for employee relations, including unions and advancement of women and people of color in the workplace.

82. The 2005 Trends Report identified assets involved in SRI as 68% in social screening only, 26% in shareholder advocacy, 5% in screening and shareholder advocacy, and 1% in community investing. SOCIAL INVESTMENT FORUM, *2005 Report on Socially Responsible Investing Trends in the United States*, Figure 1.1. (2005), *available at* http://www.ussif.org/files/Publications/05_Trends_Report.pdf.

83. Press Release, Global Exchange, Advocacy Groups and Shareholders Persuade Procter and Gamble, GLOBAL EXCHANGE (Sept. 15, 2003), *available at* http://www.globalexchange.org/update/press/1043.html. Domini worked with the Center for Reflection, Education and Action (CREA), a research, education, and action organization. *Id*.

84. *Id.*

85. *Id.*

B. ESG investing[86]

ESG investing uses environmental, social, and governance factors related to a potential investment as part of a decision-making process that includes financial factors.[87] The goals are to improve stock selection by expanding the information considered about a company and to invest in a sustainable and responsible manner. An ESG investor seeks to identify material risks and opportunities related to investment performance that may not be reflected in traditional financial data. The term "ESG investing" is used to distinguish this strategy from some other forms of SRI and to emphasize an overall investment strategy that seeks to maximize financial gain. An investor with no interest in addressing social or environmental problems could use ESG investing as a strategy to seek better returns, and as the reporting mechanisms become more useful,[88] more investors will likely consider ESG factors in their overall investment strategies.[89] ESG investing should yield blended value, as that term is described in

86. RCM uses the term "sustainability investing" and its definition matches the general understanding of ESG investing:

> Sustainability investing is broader than an ethically or socially responsible investment strategy. Material environmental, social and governance factors are considered alongside financial factors, identifying risks and opportunities that have not been fully priced in by the markets thus supporting enhanced stock selection and providing RCM with an information advantage.

RCM SUSTAINABILITY WHITE PAPER, SUSTAINABILITY: OPPORTUNITY OR OPPORTUNITY COST?, (2011), *available at* https://www.allianz.com/media/responsibility/documents/rcmsustainabilitywhitepaper2011.pdf. *See also* COMMUNFUND INSTITUTE, *supra* note 74. (explaining that in contrast with early SRI, "ESG analysis takes a broader view, examining whether environmental, social and governance issues may be material to a company's performance, and therefore to the investment performance of a long-term portfolio.").

87. *See* GOVERNANCE & ACCOUNTABILITY INSTITUTE, *2012 Corporate ESG/Sustainablity/Responsibility Reporting; Does it Matter?* 6 (2012). ("How a company performs in terms of managing environmental and energy issues, how it addresses and resolves societal or civic issues and the state of corporate governance of the enterprise are three important groups of determinants.").

88. *See infra* Part IV.E (discussing sustainability reporting and integrated reporting).

89. *See* Lloyd Kurtz, *No Effect or No Net Effect? Studies on Socially Responsible Investing*, 6 J. INVESTING 37, 39–40 (1997) (discussing the possibility of an "SRI effect" that could lead to better returns). If integrated reporting becomes the norm, market prices may reflect more of the ESG factors than is currently the case. Some of the current financial benefits in ESG investing lie in identifying undervalued stocks. If market value more accurately reflects the ESG risks and opportunities, then some of the current financial benefit of ESG investing may be reduced. However, given that ESG investing emphasizes long-term value over short-term returns and given that the market is not completely efficient, the purposes of ESG investing will not be completely altered. Also, as more investors use ESG factors, those who do not may be at a competitive disadvantage.

connection with impact investing, but this article will analyze ESG investing as a tool that seeks to improve financial, as well as non-financial, performance.[90]

The difference between a strategy that depends on negative screens and one that uses ESG investing can be described, simplistically, with two examples.[91] A fund using exclusionary screens might screen out oil and gas companies.[92] The exclusionary screens would reduce the choices the fund manager could make in constructing the portfolio, but many other choices still exist.[93] Whether the fund matches, exceeds or falls below its benchmarks will depend in part on how the oil and gas sector performs and in part on other selections made for the fund. If the oil and gas stocks decline in value more than stocks in other sectors, perhaps due to increased regulation,[94] the fund might outperform its benchmarks. Alternatively, if the oil and gas stocks go up, as they did in 2004,[95] the screened fund might do less well than its benchmarks, depending on its other investments. The screen may have an effect on performance, and that effect could be to improve or reduce performance or there might be no effect at all. The important distinction in comparison with the ESG investing strategy described below, is that certain decisions were made for the screened fund without regard to the value of the stocks being excluded, except to the extent that someone had concluded that the entire group of stocks would perform less well.[96]

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90. The author agrees with the premise of the Emerson book that investing for blended value is preferable to investing solely for financial value, but for purposes of analysis of existing fiduciary duty laws, the article will assume that the duty of prudence requires a fiduciary to invest for financial value or for values that match the interests of private beneficiaries or the mission of a charity.

91. *See* G.M. HEAL, WHEN PRINCIPLES PAY: CORPORATE SOCIAL RESPONSIBILITY AND THE BOTTOM LINE (2008), for the basic ideas for these examples.

92. The divestment movement operates like a negative screen.

93. The fact that SRI funds have fared well financially suggests that other choices can counter any perceived downside for a constrained universe of potential investments. *See infra* Part IV.C.

94. Adam M. Kanzer, *Exposing False Claims about Socially Responsible Investing: A Response to Adler and Kritzman*, ADVISOR PERSPECTIVES 3 (Jun. 4, 2013), http://www.advisorperspectives.com/newsletters13/Exposing_False_Claims_about_Socially_Responsible_Investing.php. ("Some investors argue that fossil-fuel companies are dramatically overvalued and at risk of collapse due to peak oil or unburnable carbon, the estimated 80% of proven fossil fuel reserves that must remain in the ground if we are to hold global temperature increases to 2 degrees Celsius.")

95. HEAL, *supra* note 91.

96. *See* Kanzer, *supra* note 94, at 3.

In contrast, a fund manager using ESG factors might start with her usual process to create a list of potential stocks.[97] For example, a manager whose strategy is to look for undervalued stocks could do so, in whatever sectors the manager or the fund favors (large cap, small cap, etc.). The manager could create a list of stocks that meet her goals in terms of financial data. Then the manager would narrow the initial list by analyzing the companies' ESG ratings. The ESG factors add information that can help the manager identify stocks more likely to perform well. In this scenario no stock is screened out, except based on financial quality.

Domini Social Investments uses a different process that also incorporates both ESG and financial factors in creating a portfolio.[98] Domini starts with an internal research process and creates a list of companies that meet its standards based on extra-financial criteria. Domini's analysts create a profile for each company being considered, and

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97. *See* HEAL, *supra* note 91.

98. Domini Social Investments LLC, founded in 1991, operates three mutual funds and "specializes exclusively in socially responsible investing." *See* DOMINI, *About Domini*, https://www.domini.com/why-domini/about-domini (last visited June 6, 2015). The company serves "investors who wish to create positive social and environmental outcomes while seeking competitive financial returns." *Id.* Domini's website explains its research process. *See Evaluating Corporations-Our Research* Process, DOMINI, *available at* https://www.domini.com/responsible-investing/choosing-our-investments/evaluating-corporations-—-our-research-process (last visited June 6, 2015). *See also Approving Corporations for our Funds*, DOMINI, *available at* https://www.domini.com/responsible-investing/choosing-our-investments/approving-corporations-our-funds (last visited June 6, 2015). Domini has created 24 industry classifications and four to seven subcategories within each industry. Domini analysts use Key Performance Indicators for each industry and subindustry to guide the research with respect to business alignment and stakeholder relations. Each industry is classified as fundamentally aligned, partially aligned, partially misaligned, or fundamentally misaligned with Domini's standards. Companies are evaluated on where their business model fits within the industry alignments and on their stakeholder relations—how they treat employees and customers and how they address their environmental impacts. Domini uses a matrix, so that a company that is fundamentally aligned (e.g. a solar energy company) would have more leeway on stakeholder relations than a company that is partially misaligned (an oil and gas company). A company that is fundamentally misaligned (a tobacco company) would not be eligible for inclusion in the funds. The website explains that Domini seeks "to identify companies that are responsibly addressing the key sustainability challenges and rewards presented by their business model." Domini does not look for "socially responsible companies," because all companies face some challenges. *See Socially Responsible Companies*, DOMINI, https://www.domini.com/responsible-investing/socially-responsible-companies (last visited June 6, 2015). Domini tries to find the companies that are making the best efforts given their challenges. Most companies fall within the middle of the matrix, and Domini looks for companies that are trying to address the challenges they face. Domini also uses shareholder advocacy in some situations to move companies toward actions that are, in Domini's view, more responsible. *See* DOMINI, *How We Invest*, *available at* https://www.domini.com/why-domini/how-we-invest (last visited June 6, 2015).

inclusion on the list depends not on a finding that the company is "perfect," but instead on whether the company is working to address sustainability challenges it faces.[99] Domini then provides the list to Wellington Management, an investment company that constructs the portfolios using its usual financial analysis tools.[100]

C. Impact Investing and Blended Value

The term "impact investing" conveys the idea of an investor who invests in selected projects or companies to have an impact on a social or environmental issue.[101] An impact investor invests in a project or a company with two goals: the social or environmental benefit the project will create and the financial return on the investment. The investor considers the social or environmental benefit as part of the investment, to be considered together with the financial return to determine whether the investment has generated value for the investor.

A recent book by Antony Bugg-Levine and Jed Emerson describes impact investing as a way to created "blended value," meaning economic value combined with social or environmental value.[102] The authors explain that all companies create three forms of value: economic, social, and environmental, or put another way, that any company that creates economic value will also generate or destroy social or environmental value.[103] A common view, however, is that the business world creates economic value and the nonprofit world creates social or environmental value.[104] This bifurcated view affects investing when investment decisions focus on economic value and fail to acknowledge the other value that the investments create. Bugg-Levine and Emerson use the term impact

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99. *Id.*

100. *Id.*

101. *See* COMMONFUND INSTITUTE, *supra* note 74; ANTONY BUGG-LEVINE & JED EMERSON, IMPACT INVESTING: TRANSFORMING HOW WE MAKE MONEY WHILE MAKING A DIFFERENCE (2011).

102. *Id.* Mr. Emerson was part of a group that coined the term "blended value" in 2000. *Id.* at 5. For other articles by Mr. Emerson discussing impact investing, blended value, and total foundation asset management, see Jed Emerson, *The Nature of Returns: A Social Capital Markets Inquiry into Elements of Investment and the Blended Value Proposition*, (Harvard Bus. Sch., Social Enterprise Series No. 17, 2000); Jed Emerson, *A Capital Idea: Total Foundation Asset Management and the Unified Investment Strategy*, STANFORD (2002); Jed Emerson, *Where Money Meets Mission: Breaking Down the Fire Wall Between Foundation Investments and Programming*, STANFORD SOC. INNOVATION REV. (2003); Jed Emerson, *The Blended Value Proposition: Integrating Social and Financial Returns*, CAL. MGMT. REV. (2003).

103. *Supra* note 101, at 10.

104. *Id.* at 10.

investing to mean both investment in specific projects and investment in funds that analyze social and environmental factors in making investment decisions about companies to include in the funds.[105] The latter fits within the scope of SRI funds, while the former represents more direct engagement.

Organizations that engage in micro-financing are early examples of impact investors. For example, Dr. Mohammad Yunus began lending to poor women in Bangladesh and eventually founded Grameen Bank, a bank that lends to poor people without requiring collateral.[106] A loan might assist in the creation or expansion of a business, with resulting social benefits in employment and improvement of the local economy, as well as income in the form of interest.[107] A more recent example involves John McCall-McBain, who invested through his for-profit investment fund in a wood chipping business in Liberia. The new business converted old rubber trees into renewable fuel for power plants, to help reduce dependency on existing coal-fired plants. Mr. McCall-McBain combined an impact investment with grant-making to pursue his goal of addressing climate change.[108]

Bugg-Levine and Emerson discuss the difficulty of rating companies based on their generation of social and environmental value.[109] The authors explain that information about companies' performance on social and environmental metrics will need to be transparently available for research and benchmarking.[110] A system that could analyze a company's value in all three categories would give investors a better understanding of the company and would permit more informed investment decisions. An additional challenge is that standard metrics must be created so that an

105. *Id*. at 9–11.

106. *See* GRAMEEN BANK, http://www.grameen.com/index.php?option=com_content&task=view&id=16&Itemid=112 (last visited Mar. 25, 2016).

107. *Id.* Grameen Bank is a for-profit entity.

108. Bugg-Levine, *supra* note 101, at 188. The man-made grants to advocacy campaigns in Europe to block development of coal-fired power plants, using the impact investment and the grants to further his goal of reducing the use of fossil fuels.

109. *Id.* at 165.

110. *Id.*

investor can compare companies consistently.[111] Work has begun on rating systems and standardized terminology, but more work remains.[112]

Impact investing need not result in lower financial returns,[113] but the concept Bugg-Levine and Emerson describe looks at blended value rather than value that is limited to financial value. The authors conclude by saying:

> You can execute investment strategies that achieve an appropriate level of financial performance while simultaneously generating social and environmental value. Only you can define an appropriate mix of financial and social return for you. You do not need to give up financial returns to generate impact, but flexibility on financial expectations and risk appetite will expand the investment options available to you.[114]

Any investor can engage in impact investing, but for a charity impact investing can be viewed as a more sophisticated way to think about mission-related investing. Charities often view their investments as separate from their mission, and the idea of obtaining blended value from investments may help a charity think about an investment policy that is consistent with the charity's mission.[115] The Internal Revenue Code's authorization of program-related investments (PRIs) for private foundations reflects the idea that an investment may serve a dual purpose.[116] PRIs are

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111. *Id.* at 175. The Impact Reporting and Investment Standards (IRIS), launched in 2009, include definitions of clinic, hospital and patient treated so medical care providers can report with greater consistency. *See infra*, Part IV.E (discussing integrated reporting).

112. Bugg-Levine, s*upra* note 101, at 173. One intriguing idea is the creation of a three-dimensional valuation system. The current system puts risk on the x axis and return on the y axis. The authors would add a z-axis for the social impact of an investment.

113. *See infra* Part IV.C (describing studies that have found neutral or positive returns when compared with benchmarks).

114. Bugg-Levine, s*upra* note 101, at 252.

115. *See, e.g.*, the Jessie Smith Noyes Foundation's explanation of its decision to engage in mission-related investing. JESSIE SMITH NOYES FOUNDATION, *Foundation Investment Policy*, http://www.noyes.org/mission-based-investing/investment-policy (last visited May 8, 2015). Bugg-Levine and Emerson would argue that any investment analysis should incorporate blended value returns. *See* Bugg-Levine, *supra* note 101. The idea that a fiduciary acting as a prudent investor should go beyond a focus on financial returns and include social and environmental value, even without specific directions to do so, is worthy of additional consideration, as is the idea that a fiduciary should consider blended value when making decisions in a beneficiary's best interests. Although interesting, a conclusion that a fiduciary can invest for blended value is not necessary for purposes of the arguments made in this article that a fiduciary can consider ESG factors as part of a prudent investment strategy.

116. I.R.C. § 4944(c) (2012). PRIs are exceptions to the general rule that imposes a

more narrowly defined than the general concept of mission-related investing, however, because a PRI is an investment for which the primary goal is to further the charity's mission and the production of financial return is not a significant purpose.[117]

D. Mission-Related Investing

Mission-related investing does not refer to a different investment strategy, and any of the three terms already described can, depending on the circumstances, be used in connection with mission-related investing. Mission-related investing or mission-related investments (MRIs) are terms used to describe investments that carry out a charity's mission.[118] If a charity acquires an asset with a dual purpose, both as an investment and as a means to carry out its mission, then the charity is complying with its duty of loyalty even if the acquisition does not generate as much return as another investment might. The mission part of the investment can compensate for a somewhat lower investment return.

Whether an SRI fund can be considered mission-related depends on a charity's mission and whether the fund's guidelines help carry out that mission. A cancer organization might choose not to invest in tobacco stocks; an environmental organization might choose to invest in a company developing solar energy. The concept of blended value is particularly relevant in thinking about mission-related investing. The charity receives two types of value from the investment, something that helps carry out its mission and the financial return. The fiduciary of the charity has not breached her duty of loyalty, assuming otherwise prudent behavior, because the investment brings both types of returns.

Mission-related investing does not necessarily result in lower-than-benchmark returns. The Jessie Smith Noyes Foundation, for example, ties its investments to a mission-driven portfolio, but monitors the funds and the fund managers against non-screened benchmarks.[119] The Noyes Foundation's investment policy states that its goals include producing

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penalty on a charity and its managers for a "jeopardizing investment," defined as an investment for which the foundation managers "have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes." Treas. Reg. § 53.4944-1(a)(2)(i).

117. *Id.*

118. *See* Susan N. Gary, *Is It Prudent to be Responsible: The Legal Rules for Charities that Engage in Socially Responsible Investing and Mission Investing*, 6 NW. J.L. & SOC. POL'Y 106 (2011), for a discussion focused on mission-related investing

119. Noyes-Foundation, *supra* note 115.

income and capital gains to support operations and grant-making, providing capital directly to enterprises that further the mission, owning equity or debt in companies that further its mission, and avoiding investments in "companies whose environmental or social impacts contribute to the issues that the Foundation's grant-making seeks to address."[120] The Foundation strives for a six percent 6% annual payout while seeking to preserve the inflation-adjusted value of its assets over the long term,[121] which suggests that it is unwilling to reduce financial returns based on its ESG policy. The rigorous review process for managers[122] suggests that any managers who do not succeed financially as well as with respect to the Foundation's mission will be replaced.

In response to growing interest in—and questions about—mission-related investing, the IRS issued Notice 2015-62 in September 2015.[123] The Notice applies to private foundations, a category of charities that typically have only one or a few donors,[124] but the analysis of fiduciary duties applies to any charity. The Notice confirms that an investment made both to further the charity's purposes and to produce financial returns, is not a breach of fiduciary duties, even if returns are lower than they might otherwise be.[125]

The Internal Revenue Code (I.R.C) imposes penalties on private foundation managers who make investments that jeopardize the carrying out of the foundation's exempt purposes.[126] Jeopardizing investments are those entered into by managers who "have failed to exercise ordinary business care and prudence."[127] The focus of this rule is the financial performance of the investments.[128] An exception to the rule permits program-related investments (PRIs), defined as investments entered into primarily to accomplish one or more of the charitable purposes of the private foundation.[129] A PRI might produce some financial gain, but any financial return is considered incidental to the primary purpose of carrying out the charity's mission.

120. *Id.*
121. *Id.*
122. *Id.*
123. Notice 2015–62, 2015–39 I.R.B. 1 (Sept. 14, 2015).
124. I.R.C. § 509 (2012).
125. Notice, *supra* note 123.
126. IRC, *supra* note 116.
127. IRC, *supra* note 116.
128. *Id.*
129. *Id.*

Until Notice 2015-62 no I.R.C. provision directly addressed the treatment of mission-related investments that were not *primarily* related to mission. The Notice clarifies that a mission-related investment will not be considered a jeopardizing investment, even if the return on the investment is less than would be expected for an investment unrelated to the charity's purposes.[130] The Notice explains that this result is consistent with state law.[131] Thus, Notice 2015-62 supports the conclusion that a charity's trustees or directors can engage in mission-related investing without breaching their fiduciary duties.

E. Corporate Social Responsibility

Corporate social responsibility (CSR) describes an approach taken by a company to integrate ESG policies and practices throughout the operations of the company. CSR can include policies related to corporate governance, employee relations, supply chain relationships, customer relationships, environmental management, philanthropy, and community involvement.[132] An ESG investor might use information a company reports about its CSR practices as indications of strong management, reduced risk, and enhanced ability to attract capital. Companies increasingly issue reports concerning their CSR practices, both to respond to investor interest and so that the company will focus on issues such as exposure to social and environmental risk.[133]

F. Evolution of SRI

A review of biennial reports describing the extent of the use of SRI in the United States provides a snapshot of the evolution of SRI investing. The Social Investment Forum issued the first Trends report, called *After South Africa: The State of Socially Responsible Investing in the United States*, in 1995.[134] That report discusses the aftermath of the end of apartheid and the end, in 1993, of negative screens applied to businesses located in or doing business with South Africa. The report found that SRI funds operating in 1995 used negative screens (tobacco, alcohol and

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130. Notice, *supra* note 123.
131. *Id.*
132. UNEP-FI & MERCER, *supra* note 74, at 7.
133. Ioannis Ioannou & George Serafeim, *The Impact of Corporate Social Responsibility on Investment Recommendations: Analysts' Perceptions and Shifting Institutional Logics*, 36 STRATEGIC MGMT. J. 1053 (2015) (citing to a number of studies and scholarly articles describing the importance to companies of establishing CSR policies and practices).
134. Social Investment Forum, *supra* note 78.

weapons) and had increased the use of positive screens (human rights, environment, animal rights, and employee rights).[135]

Ten years after the first Trends report, the Social Investment Forum issued a ten-year review. This report discussed the growth in funds under SRI management "using one or more of the three core socially responsible investing strategies—screening, shareholder advocacy, and community investing."[136] The report talks about the growth in the use of SRI funds, and increases in shareholder advocacy and community investing, but the report describes strategies that were more or less the same as those used in 1995.

By the time the organization, now called The Forum for Sustainable and Responsible Investment, issued the 2014 Trends report, the SRI landscape had changed significantly. In the 2014 report,[137] the word screening has disappeared. The report talks about ESG incorporation and shareholder advocacy as the two general categories. ESG incorporation includes the following strategies: negative/exclusionary, ESG integration (what this article calls ESG investing), positive/best-in-class, impact investing, and sustainability themed investing. The term "ESG incorporation" better conveys the idea that exclusion is based on thoughtful application of ESG criteria, rather than an automatic screen. The Executive Summary of the report notes, "the incorporation strategy that affected the highest number of assets, $4.74 trillion, was ESG integration."[138]

A similar report but on a global scale, the 2014 Global Sustainable Investment Review,[139] identifies some strategies as screens but the report explains that sustainable investment includes the following strategies: negative/exclusionary screening, positive/best-in-class screening, norms-based screening, integration of ESG factors, sustainability-themed investing, impact/community investing, and corporate engagement and shareholder action.[140] The report notes that sustainability-themed investing and ESG integration were the fastest growing strategies, and that the U.S.

135. *Id.* at Executive Summary.

136. Social Investment Forum, *supra* note 82.

137. THE FORUM FOR SUSTAINABLE AND RESPONSIBLE INVESTING, *Report on US Sustainable, Responsible and Impact Investing Trends* 2014 (2014), *available at* http://www.ussif.org/Files/Publications/SIF_Trends_14.F.ES.pdf.

138. *Id.*

139. GLOBAL SUSTAINABLE INV. ALLIANCE, *Global Sustainable Investment Review* (2014), *available at* http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf.

140. *Id.* at 3.

and Europe were the biggest contributors to ESG integration growth, in percentage terms.[141]

SRI has changed dramatically since the 1970s and 1980s, and ESG investing as a strategy now plays an important role in SRI. Funds continue to use screens and shareholder advocacy, but the difference in the way SRI funds function, with an emphasis on ESG integration and significant attention to ESG investing, changes the fiduciary analysis with respect to SRI.[142] A prudent investor considers available financial information, so the next section examines performance data for SRI funds.

IV. SRI AND ESG INVESTING – PERFORMANCE DATA REGARDING THE USE OF EXTRA-FINANCIAL FACTORS IN INVESTMENT DECISIONS

Ever since the interest in SRI began, researchers have wondered whether a decision to use SRI in building a portfolio will lead to lower returns for the portfolio. This section discusses some of the studies analyzing this question but does not provide independent analysis of financial information, which is beyond the scope of this article.[143] The purpose of the section is to provide a look at existing financial information from the perspective of a legally prudent fiduciary. Two themes emerge from a review of recent research. First, in the majority of portfolios under study the use of SRI strategies has had a neutral or positive effect on returns. Second, the use of ESG investing as a strategy, in contrast with screening, may improve returns. The studies refute the old idea that

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141. *Id.* at 8. The report uses five regions: Europe (63.7% of global SRI assets), U.S. (30.8%), Canada (4.4%), Australia/NZ (0.8%), and Asia (0.2%). *Id*. at 7.

142. The Jessie Smith Noyes Foundation's investment policy provides a good example of a current ESG investment policy. The policy describes the Foundation's expectations that each investment manager will use ESG factors in investment decisions for a fund and will also meet or exceed the peer group universe benchmark and market index benchmark set for the fund. The Foundation "views its investments as an integrated component of its overall mission" and includes in its investment philosophy consideration of "the environmental impact of a business," "issues of corporate governance," and "a corporation's openness and accountability to all stakeholders." To guide the investment managers, the policy details factors the managers should consider in avoiding or including companies as investments. *See Jessie Smith Noyes Foundation Investment Policy*, JESSIE SMITH NOYES FOUND., http://www.noyes.org/mission-based-investing/investment-policy (last visited May 8, 2015).

143. This article cites to some of the most recent studies and discusses a few of them, but given the flood of published work on this topic from the financial perspective in recent years, the article does not provide a comprehensive review of the existing literature. The focus is primarily on the U.S.

"SRI"[144] necessarily leads to underperformance.[145] Before turning to the empirical studies, this section reviews the now out-of-date concerns about diversification.

A. The Diversification Issue

1. Diversification and Modern Portfolio Theory. – Some commentators have argued that constraints imposed by an SRI strategy on portfolio development necessitate a cost to the portfolio.[146] As already discussed,[147] the prudent investor standard adopted in UPIA is based on the concepts of modern portfolio theory, and modern portfolio theory emphasizes the importance of diversification as a way to reduce risk in the portfolio.[148] Any restriction on the universe of potentially available stocks could reduce the risk-adjusted return of the portfolio.[149] The use of negative screens, a common strategy in the early development of SRI, limits the universe of available stocks, so some commentators have argued that the restriction necessarily results in costs to the portfolio.[150]

The importance of diversification, and hence the duty to diversify in UPIA,[151] are based on efficient market theory, the idea that the market reflects all relevant information.[152] If the market is efficient, then broad

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144. I have put SRI in quotes because part of the problem is in the definition used by commentators. As discussed *infra* Part IV.A.3, Mark Kritzman, who still insists that SRI necessitates a cost, defines SRI as a type of strategy that is no longer (and probably never was) used. *See infra* Part IV.A.3.

145. *See* UNEP-FI & MERCER, *supra* note 74, at 7.

146. *See* Christophe Revelli & Jean-Laurent Viviani, *Financial Performance of Socially Responsible Investing (SRI): What Have We Learned? A Meta-Analysis*, 24 BUSINESS ETHICS: A EUROPEAN REVIEW 158, 161 (Apr. 2015) (citing a number of articles on both sides of the argument).

147. *See supra* Part II.C.

148. *See* UNIF. PRUDENT INVESTOR ACT, Prefatory Note (1992).

149. Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952). *See also* UNIF. PRUDENT INVESTOR ACT, Prefatory Note (1992), for articles cited therein. Langbein and Posner "are skeptical that a portfolio constructed in accordance with consistent, and consistently applied, social principles could avoid serious under-diversification." Langbein & Posner, *supra* note 10, at 88. However, they conclude "that a social-investing portfolio will probably have the same expected return as a standard investment portfolio (of the same systematic risk)" but with higher administrative costs as compared to a passive fund, although "it need not generate higher administrative costs than an investment strategy that involves research and active trading." *Supra* note 10, at 93.

150. Adler and Kritzman continue to make this argument. Timothy Adler & Mark Kritzman, *The Cost of Socially Responsible Investing*, 35 J. PORTFOLIO MGMT. 52 (2008). *See infra* Part IV.A.3 for a discussion of their argument.

151. *See* UNIF. PRUDENT INVESTOR ACT § 3 (1992).

152. Markowitz, *supra* note 149, at 7.

diversification should reduce risk. In the years since the adoption of UPIA, a number of studies have challenged the efficient market theory.[153] Diversification becomes less important if the market is shown to be less efficient.

Andreas Hoepner analyzed portfolio diversification in connection with the use of ESG criteria and found that although using negative screens reduces the number of stocks available, a firm's ESG rating reduces its specific risk and therefore improves portfolio diversification by reducing specific stock risk.[154] Hoepner found that negative screening produced a diversification penalty, but best-in-class screening produced a diversification bonus.[155]

Renneboog, Jenketer Horst, and Zhang studied the question of diversification by measuring net selectivity.[156] They found that the SRI and non-SRI funds did not differ significantly in net selectivity, and therefore did not differ in costs of diversification.[157] They noted that this finding is consistent with "the classic view that a well-diversified portfolio does not require a large number of stocks . . . ."[158] Comparing SRI funds with each other, the authors found that returns increased with the number of screens – more screens led to better returns.[159] The authors conclude: "This

153. In 1987 Merton demonstrated that a perfectly diversified market portfolio was no longer efficient given the presence of incomplete information. He argued that assets with concentrated information should show increased returns. *See* Revelli & Viviani, *supra* note 146, at 161 (citing R.C. Merton, *A Simple Model of Capital Market Equilibrium with Incomplete Information*, 42 J. FIN. 483 (1987)). *See also* Hylton, *supra* note 79, at 92–113 (discussing theoretical and empirical work that has eroded the efficient markets hypothesis and citing, at n. 97, a number of those articles).

154. Andreas Hoepner, *Portfolio Diversification and Environmental, Social or Governance Criteria: Must Responsible Investments Really Be Poorly Diversified?*, UNIV. OF ST ANDREWS (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1599334.

155. *Id.*

156. Luc Renneboog, Jenketer Horst, & Chendi Zhang, *The Price of Ethics: Evidence from Socially Responsible Mutual Funds*, ECGI FINANCE, (Working Paper No. 168/2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=985265 (2007).

157. *Id.* at 20.

158. *Id.* The study explains: "A number of studies show that 5 to 30 stocks are needed to make a well-diversified portfolio" (citing J. Evans & S. Archer, *Diversification and the Reduction of Dispersion: An Empirical Analysis*, 23 J. FIN. 761(1968); M. Statman, *How Many Stocks Make a Diversified Portfolio?*, 22 J. FIN. & QUANTITATIVE ANALYSTS 353 (1987); M. Brennan & W. Torous, *Individual Decision Making and Investor Welfare*, 28 ECON. NOTES 119 (1999)).

159. Renneboog *et al., supra* note 157, at 25. The study found that the returns of funds employing a corporate governance and social screen increased while those of funds employing environmental screens decreased. *Id.* The study found that using in-house research increased returns, which they thought "supports the hypothesis that the screening process generates value-relevant non-public information." *Id.* at 26.

finding supports the hypothesis that SRI criteria help fund managers to pick stocks."[160]

2. "There Must Be a Cost". – In a 2007 article, Dylan Minor observes: "according to fundamental economic principles, there must be a net *financial* cost to SRI."[161] He then analyzes SRI and non-SRI funds against three principles: (1) supply and demand,[162] (2) portfolio theory's emphasis on diversification,[163] and (3) externalities.[164] Minor's conclusion, after testing these principles, is that the cost that "must" occur cannot be seen.[165] He finds no statistically significant difference between the SRI and non-SRI funds.[166] He then says that perhaps the cost does not appear because SRI managers are superior to non-SRI managers, and that superior performance compensates for higher management fees.[167] He suggests that the superior results for the SRI managers could come from working with a more narrowly defined universe of stocks, because the narrowing may allow SRI managers to find value in stocks overlooked by "the masses."[168] Thus, limiting diversification may have contributed to better performance. He does not identify as a possible reason for better performance by the SRI managers the idea that the externalities that SRI managers consider help them make better choices. The studies he cited in connection with environmental events and corporate social performance did not find correlations between those events and stock market pricing.[169]

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160. *Id.* at 25. As the use of ESG information increases, stock prices may begin to reflect this information.

161. Dylan B. Minor, *Finding the Financial Cost of Socially Responsible Investing*, 18 J. INVESTING 55 (2007). The full sentence reads: "This study's purpose is to show while there may be no net *total* cost (i.e., financial *and* social costs and benefits) with SRI, according to fundamental economic principles, there must be a net *financial* cost to SRI." *Id.* at 54.

162. *Id.* at 54-58.

163. *Id.* at 58–63. Portfolio theory says that constrained choices should result in a diversification cost.

164. *Id.* at 63–66. Externalities include non-financial criteria like environmental events and corporate social performance. *Id.* at 63.

165. *Id.* at 66. Minor used the Domini 400 Social Equity Fund to test the principles.

166. Minor compared the Domini 400 Society Equity Fund with the Vanguard 500 fund and found approximately a 1% higher return for Vanguard based on the supply and demand analysis, but deemed the difference not statistically significant. *Id.* at 58.

167. Minor, *supra* note 161, at 58.

168. *Id.* at 67.

169. *Id.* at 63. He cites Paul H. Rubin and Kari Jones, *Effects of Harmful Environmental Events on the Reputations of Firms*, 6 ADVANCES FIN. ECON, 161 (2001), and says that this study looked at all negative environmental events reported in the Wall Street Journal from 1970-1992 and found no statistically relevant effects on companies' stock prices. He also cites Marc Orlitzky, Frank L. Schmidt, & Sara L.

3. Kritzman and Adler's Simulation. – Another article by authors who assume there must be a cost to SRI due to economic principles has gotten attention in connection with discussions about fossil-fuel divestment.[170] Mark Kritzman and Timothy Adler used a Monte Carlo simulation[171] to find a cost to a portfolio when a percentage of otherwise available stocks are randomly excluded. The problem with Kritzman and Adler's methodology is that their simulation does not simulate the way an SRI fund actually works.

Kritzman and Adler explain that their simulation only applies to non-actively managed funds, and add that if an investor expects to get improved returns by investing in "good" companies then the investor is not engaging in SRI.[172] Adam Kanzer, the Managing Director and General Counsel of Domini Social Investments, points out that all SRI funds are actively

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Rynes, *Corporate Social and Financial Performance: A Meta-analysis*, 24 ORG. STUD. 403 (2003) and explains that this meta-analysis reviewed CSP studies "spanning some 30 years and found a positive bi-directional relationship between CSP and corporate financial performance (CFP). However, they found little relation between *stock performance* and CSP." *Id.* at 63–64. The studies discussed later in this section do find correlations, but the correlations focus on financial performance rather than stock performance. The ESG factors affect long-term performance and may not be immediately reflected in market pricing.

170. Kritzman participated in a panel on the topic of divestment at Middlebury. *See* Kanzer, *supra* note 95. Kanzer quotes Kritzman as saying, "I know you all accept that there's a cost [to fossil-fuel divestment], right? I'm going to tell you how you go about measuring it." *Id.* *See also* Adam Jared Abt, *Measuring the Cost of Socially Responsible Investing*, ADVISOR PERSPECTIVES (May 21, 2013) (reporting on Kritzman's remarks at a meeting of analysts in Boston).

171. Monte Carlo simulations are used in finance to model the probability of different outcomes based on random variables. *See What is the 'Monte Carlo Simulation'*, INVESTOPEDIA, http://www.investopedia.com/terms/m/montecarlosimulation.asp (last visited Apr. 18, 2016).

172. "If investors are motivated to own good companies because they expect higher returns from them, they are not socially responsible investors. They are simply pursuing an active management strategy centered on the belief that good companies generate above average returns and bad companies generate below average returns." Adler & Kritzman, *supra* note 151. In an essay in the Chronicle of Higher Education, Kritzman said about his simulation: "The analysis showed that the financial cost of excluding investments based on criteria *other than expected performance* can be substantial. . ." [emphasis supplied] Mark Kritzman, *What Fossil-Fuel Divestment Would Cost*, CHRON. HIGHER EDUC. (Mar. 18, 2013). As Domini's explanation of how it selects stocks for its portfolios, *see* Part III.B, shows, all decisions are based on a combination of financial and non-financial factors. No decisions are made "based on criteria other than expected performance" and therefore the simulation does not apply to SRI as currently practiced. Further, an investor considering ESG factors may well seek financial benefits. Kritzman and Adler would exclude those investors from the simulation as well.

managed.[173] Decisions about which stocks to include or exclude are not made randomly, as in the simulation. In some cases, a fund might exclude all stocks in a particular sector, for example tobacco stocks or oil and gas stocks, but in that case the fund manager would then construct the portfolio with that information in mind. Further, economic as well as social or environmental reasons may be part of the decision to screen a category of stocks.[174] Kanzer writes, "Each of these decisions [in selecting stocks to include or exclude], often driven by moral concerns, carries a set of financial implications. One fails to see this by viewing the world through the distorting lens of so-called good and bad companies.[175]

Kritzman and Adler use as their definition of SRI a quotation from the 1980 Langbein and Posner article that addressed SRI in the context of the anti-apartheid divestment movement.[176] As the prior section of this article explains, SRI has evolved beyond its roots in anti-apartheid divestment.[177] SRI as currently practiced is complex and involves careful analysis of both financial and extra-financial factors. ESG investing as a strategy focuses on factors that may have financial consequences for a company but may not be reflected in the company's market value and therefore may improve returns for investors.[178]

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173. Kanzer, *supra* note 94, at 2 ("All forms of social investment are forms of active management, because SRI involves a process of principled decision- making. Even passively managed SRI funds track indices that are themselves actively managed (compare, for example, the management of the MSCI KLD 400 Social Index with the Russell 3000). Truly passive SRI is a contradiction in terms."). In writing about the Adler and Kritzman article, Adam Jared Abt said, "A failure to recognize this distinction between active and passive socially responsible investing is the principal misconception that underlies many of the criticisms of his paper." Abt, *supra* note 170. If in fact passive SRI funds do not exist, then the simulation simulates non-existent funds and should not be used as a critique of existing SRI funds.

174. Kanzer notes: "Some investors argue that fossil-fuel companies are dramatically overvalued and at risk of collapse due to peak oil or unburnable carbon. . ." Kanzer, *supra* note 94, at 3.

175. *Id.* at 4.

176. Adler & Kritzman, *supra* note 150. The Langbein & Posner definition states that SRI involves "excluding the securities of otherwise attractive companies from an investor's portfolio because the companies are judged to be socially irresponsible, and including the securities of certain otherwise unattractive companies because they are judged to be behaving in a socially laudable way." Langbein & Posner, *supra* note 10, at 73. The Langbein and Posner article goes beyond the South African screens, but the context of the article is the SRI situation in the late 1970s.

177. *See supra* Section III.F.

178. Adler and Kritzman say that they "withhold judgment" about the assertion that "good" companies may perform better than "bad companies" and therefore that SRI may enhance performance. Adler & Kritzman, *supra* note 150. *See supra* note 154 (discussing articles showing that the market is not entirely efficient).

The simulation might have the most relevance in connection with divestment, which removes stocks on a list from an existing portfolio.[179] However, divestment does not remove stocks randomly, and any analysis of the consequences of divestment would need to examine the industry subject to removal.[180] Divestment of fossil-fuel stocks might have different financial results than divestment of tobacco stocks. Further, other decisions for that portfolio will be made based on the knowledge of which stocks were removed, so the portfolio can be adjusted accordingly (and not randomly).

Adler and Kritzman ignored the existing empirical work on SRI performance, preferring to rely on a hypothetical scenario. Kritzman has stated that "[h]is objection to these studies, often adduced in opposition to his argument, is that they rely on historical data, and so reflect just the particular period of the study, which can't be taken as representative of the future."[181] While this is true, and is true of any financial analysis based on historical returns, a simulation does not demonstrate what will happen any more than an analysis of historical returns would. The results in a simulation are not a representation of what *will* happen but only what *might* happen. The historical returns demonstrate what has happened, and can be analyzed against overall stock market behavior during the periods tested.[182] As the studies use longer timeframes, the data have become more useful.

B. Why ESG Factors Have Financial Consequences

A question in considering whether the use of ESG factors will improve performance is whether the environmental, social, and governance information that will affect a company's performance is already reflected in the company's financial data. If the market and the financial indicators already reflect all of the potential social and environmental harms or benefits that could affect the company, the ESG factors will contribute no additional information. Under some circumstances, consideration of ESG factors may lead to that information. The two hypotheticals that follow

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179. Kritzman spoke on a panel at Middlebury concerning divestment. He started by saying, "I know you all accept that there's a cost [to fossil-fuel divestment], right? I'm going to tell you how you go about measuring it." Kanzer, *supra* note 94 at 2.

180. *See id* at 2–3.

181. Abt, *supra* note 170, at 4.

182. *See* HEAL, *supra* note 91. G.M. Heal has noted that SRI funds might have been overweighed in tech stocks during the 1990s when those stocks did well, and underweighted in oil and gas in 2004 when those stocks surged. Neither of those situations will necessarily repeat, but as data covers longer periods, the information should become more useful. Also, ESG factors are more likely to correspond to financial benefit over the long-term rather than on a short-term basis.

provide examples of the types of information that might not be included in the financial indicators.

Assume that Company A uses international suppliers that keep costs down by allowing employees to work long hours under unsafe conditions. The suppliers have had no dramatic problems, and the supply chain has never been broken. Company B uses suppliers that conform to production standards it imposes. Factories are safe and employees work under conditions that minimize on-the-job accidents. Company B has also faced no dramatic problems. Company B may have a slightly higher cost for the goods produced by its suppliers, and that information could make Company B's financial data look slightly less favorable than Company A's data. What the data will not reflect is the possibility that a catastrophic fire in a factory used by one of Company A's suppliers could kill hundreds of workers. The repercussions for Company A could include a break in the supply chain, loss of consumer goodwill if the company is linked to the supplier, and even a consumer boycott. The financial impact on Company A could be significant, but current financial data probably does not reveal that risk. The risk is a long-term risk, and merely a risk, not a certainty, but in a process that purports to evaluate financial risk, the risk to Company A may be missing if the evaluator uses only traditional financial data.

Adam Kanzer explains the reason that SRI/ESG information should improve analysis as follows:

> The core financial performance claim for SRI is that corporate value depends upon numerous relationships, including those with employees, customers, communities and the natural environment. Companies that manage these relationships well should prosper in the long run, and those that damage them will face obstacles to their long-term success.[183]

ESG factors relate to a company's long-term value, and will have a greater impact when viewed on a long-term basis. Short-term financial strategies

183. Kanzer, *supra* note 94, at 3. The website of Domini Social Investments explains that its funds "seek to invest in companies committed to the following:
Strong stakeholder relations, including investments in employees;
High labor and environmental standards for suppliers;
Serving the greatest needs of local communities;
Managing environmental affairs responsibly;
Monitoring the human rights implications of their activities.
Domini also favors companies involved in clean technology and energy efficiency, alternative energy, microfinance, mobile communications, organic agriculture and vaccines." (May 19, 2015),
https://www.domini.com/responsible-investing/socially-responsible-companies.

are less likely to benefit from ESG analysis,[184] but an investor concerned about long-term value may benefit from an investment strategy that incorporates an ESG analysis.[185] If variables are predictive then a prudent investor would want to consider those variables.

C. Research on SRI and ESG Performance

Various academic and financial industry studies have attempted to understand whether different types of SRI strategies have a negative, positive, or neutral effect on portfolios.[186] Several challenges exist in reviewing the studies. First, the studies review different SRI strategies (e.g., screening, shareholder advocacy, ESG investing), often without differentiating among the strategies. Second, the time frame for some of the studies is short (e.g. five years) and ESG factors are more likely to affect long-term performance than short-term performance.[187] Third, the strategies continue to evolve so information gained from reviewing one set of funds or factors has to be considered in light of changing strategies. Fourth, as more investors and investment managers become familiar with

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184. As the use of ESG information increases, share prices may reflect some of the information. If an investor purchased an undervalued stock that then experiences a price increase as the ESG information becomes more widely used, the investor might take short-term profits. However, an ESG strategy is typically concerned with long-term value rather than short-term returns. *See* John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012), for a critique of the U.K. equity market, which concluded that "the central problem was "short-termism", in which many investment managers traded on the basis of short-term movements in share price rather than "investing" on the basis of the fundamental value of the company." U.K. Law Comm'n, *Fiduciary Duties of Inv. Intermediaries* 1 (2014) (a report focused on fiduciaries and pensions).

185. The Domini funds benefitted from the exclusion of two companies, BP and Toyota, even before their problems became obvious to the market. "Domini avoided investments in BP [and] Toyota. . .major companies that have recently experienced devastating public scandals and catastrophes. That Domini avoided these three companies demonstrates that social and environmental standards can help to mitigate certain investment risk by providing early warning signals for major disasters to come." *Annual Report 2010*, DOMINI SOCIAL INV. TRUST, http://www.sec.gov/Archives/edgar/data/851680/000119312510222939/dncsr.htm (last visited May 28, 2015) at 4.

186. Curiously, the Adler and Kritzman article ignored the existence of the empirical work. As Adam Kanzer pointed out, "When a hypothetical model produces results that directly contradict the empirical data, it is incumbent upon the researcher to address these conflicts and adjust the model if necessary." Kanzer, *supra* note 94, at 5.

187. *See* UNEP-FI & MERCER, *supra* note 74 (noting that "some of the studies still refer to a relatively short sample period that makes statistical analysis difficult to interpret.").

SRI/ESG investing strategies, the potential for arbitrage in the face of market inefficiency may be lost.[188]

Two generalizations follow from a review of the studies. First, the use of ESG factors in analyzing stocks independently or in building portfolios may improve investment results.[189] Second, the performance of SRI funds compared with non-SRI funds has been, in most cases, neutral or positive. Few of the studies show negative results when comparing SRI funds with non-SRI funds,[190] and none of the empirical studies support the idea that SRI necessarily leads to lower returns.[191]

While some studies found outperformance using ESG factors and comparison of fund performance with benchmarks provides information about the performance of the fund, any attempts to draw conclusions must be done carefully.[192] The difference in performance between an SRI fund and a conventional fund may relate to any of a number of variables, including the skill of the fund manager,[193] investment style, time period, and decisions about when to be in cash and when to be in the market.[194] Thus, the difference may not be caused by the decision to invest based on an SRI policy.[195] Another caution is that some of the studies focus on the

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188. Minor, *supra* note 161, at 68 ("In the meantime, we witness a paradox as SRI investors continue their campaign to convert Non-SRI to SRI investors; they are, ironically, increasing their financial cost.").

189. Among other studies, the two meta-studies described in this section reach this conclusion. In addition, Commonfund notes, "Studies identify issues such as energy efficiency, carbon emissions, toxic waste treatment, workplace safety, employee relations and corporate governance as materially affecting traditional financial indicators such as price/earnings ratio and reputation with investors." *Commonfund White Paper*, COMMONFUND (2013), https://www.commonfund.org/InvestorResources/Publications/Pages/WhitePapers.aspx, at 2. *See also* SUSTAINABLE INVESTING/ESTABLISHING LONG-TERM VALUE AND PERFORMANCE, DEUTSCHE BANK GROUP (June 2012); Hoepner, *supra* note 154 (best in class leads to better returns).

190. Both the Deutsche Bank meta-study and the UTEP-FI & Mercer meta-study conclude that the performance of funds that use negative screens is more likely to be neutral than negative or positive when compared with benchmarks.

191. Adler and Kritzman base their assertion that this is the case on a simulation and do not back their assertion with empirical evidence. *See* Adler & Kritzman, *supra* note 150.

192. HEAL, *supra* note 91. *See also Commonfund White Paper*, *supra* note 189. "Preliminary studies suggest that while integrating ESG issues into fundamental investment analysis procedures can improve investment performance, it is too early to draw comprehensive conclusions." *Id.* at 3.

193. Katzer notes that SRI funds are managed funds, so the manager's skill in using the data will affect performance. Kanzer, *supra* note 94. Some SRI funds could be non-managed funds, for example a fund following the Domini Index.

194. HEAL, *supra* note 91. *See* UNEP-FI & MERCER, *supra* note 74, at 8.

195. G.M Heal describes an example of the ways in which short-term market

strength of the companies in the study rather than on current returns to investors. That is, a determination of out-performance may not translate into immediate benefits to investors. However, the long-term strength of companies may benefit investors over the long-term by reducing risk.

This Part IV.C briefly reviews some of the studies, beginning with two meta-studies that capture a lot of the empirical work done over the past several years. As will be noted, the studies explore different SRI strategies. The growth of interest in ESG factors at major investment firms is discussed in the following section.

1. Deutsche Bank Meta-Study (2012) – Outperformance in Corporate Financial Performance. – A meta-study published by the Climate Change Investment Research division of Deutsche Bank found that companies with high ratings in CSR and ESG outperformed in corporate financial performance.[196] The study examined more than 100 academic studies of responsible investing, 56 research papers, two literature reviews, and four meta-studies.[197] The report categorized the studies based on CSR, ESG (and E, S, and G separately), and SRI, and then looked for a correlation between scores in those three categories and the cost of capital (equity or debt), corporate financial performance (both market based returns and accounting measures), and fund returns for funds based on these factors (most funds were SRI).[198] The report is useful both because of the large number of studies included in the research and because the analysis differentiated between different investment strategies.

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conditions can affect comparisons of SRI and non-SRI funds. He noted that several SRI funds outperformed benchmark indices in the period 1995-2000. A possible reason, he suggests, is that SRI funds would be underweighted in companies that pollute or deal in alcohol, guns or tobacco. As a consequence, they would likely be overweighed in tech stocks, which are less likely to be screened out for environmental or social reasons. The tech stocks did particularly well during that five year period, so perhaps the overweight position improved returns for the fund. If so, that relatively better performance might not be repeated in another time period. Similarly, oil stocks experienced a surge in 2004. Funds that were underweighted in oil stocks might have had below-benchmark results for a period that included 2004. Again, both of these circumstances would be unlikely to repeat in long-term comparisons. HEAL *supra* note 91.

196. DEUTSCHE BANK GROUP, *Sustainable Investing/Establishing Long-term Value and Performance* (2012). In a statement introducing the report the Managing Director describes the study as "one of the most comprehensive reviews of the literature ever undertaken." Although that language was written to promote the report, the study was broad-ranging and conducted with attention to quality control. *See id.* at 5 (discussing papers excluded because they did not meet "a minimum level of academic rigor").

197. *Id.*

198. *Id.*

For securities, the Deutsche Bank report found "overwhelming evidence" that companies with high ratings for CSR and ESG have a lower cost of capital, both debt and equity.[199] The study found "compelling evidence" that high ratings in either category correlated with outperformance in corporate financial performance.[200] The correlations for SRI securities were weaker, but more studies found a positive or neutral correlation between high SRI ratings and outperformance in corporate financial performance than negative.[201] With respect to fund performance, most studies were neutral or mixed.[202] The report found no studies that reported underperformance at either the security or fund level.[203]

2. UNEP-FI and Mercer Meta-Study (2007) – New Strategies Show Positive Results. – A prior meta-study, conducted by the United Nations Environmental Program Financial Initiative (UNEP-FI) and Mercer, examined 20 academic studies and 10 broker studies that examined the link between ESG factors and investment performance.[204] Most studies found the use of ESG factors led to neutral or positive results.[205]

The UNEP-FI and Mercer report characterizes the academic studies based on the type of responsible investing strategy studied. Fifteen of the studies focused on screening, three on activism,[206] one on ESG integration, and one was described as ESG/screening.[207] Of the studies that focused on screening, two showed a positive relationship between ESG and

199. The researchers found evidence within 100% of the studies that companies with high ratings for either CSR or ESG have a lower cost of capital. *Id.* Note that a lower cost for capital may not benefit investors in the short-term.

200. The report found that for CSR, 100% of the studies showed that firms with higher ratings showed both market and accounting based outperformance. For ESG, 89% of the studies showed market based outperformance and 85% showed accounting based outperformance. The report notes that governance has had the strongest influence, followed by environment and social factors, which appear to be increasingly gathering impact (particularly environment). A literature review used in the analysis of CSR securities had found 9 neutral and 2 negative studies, but was counted as positive because the majority of studies (23) were positive. Deutsche Bank Group, *supra* note 196.

201. *Id.* For SRI securities, 42% of the studies found that companies with high ratings exhibited higher market-based performance than lower-scoring securities. *Id.*

202. *Id.* at 8–9.

203. *Id.* at 9.

204. UNEP-FI & MERCER, *supra* note 74.

205. *Id.* The three studies that showed negative results all focused on screening as the ESG strategy.

206. The report defines activism as "Intervention by shareholders using their ownership rights to influence the actions of corporate management with a view to enhancing the value of the company." *Id.* at 68.

207. *Id.* at 13–14.

performance, six were neutral (with one neutral-positive and one neutral-negative), and three were negative.[208] One activism-focused study was neutral and all the other strategies showed positive results. Thus, only three of the 20 studies found a negative relationship and all of those were studies that analyzed screening as a strategy.[209]

Of the 10 broker studies discussed in the UNEP-FI report, half were thematic in nature and the other half used some form of quantitative analysis. Although the authors of the thematic studies all discussed positive effects of ESG factors on performance, because no quantitative tests were conducted, the meta-study reported these five studies as "neutral." Of the other studies, three were positive and two were neutral. Only one study examined screening as a strategy, and it reached a neutral result.

3. Revelli and Viviani International Meta-Study (2015) – Neutral Results. – An international study[210] found that consideration of CSR in stock selection neither strengthens nor weakens portfolios.[211] Christophe Revelli of the KEDGE Business School in Marseilles, France, and Jean-Laurent Viviani of the Université de Rennes I examined 85 studies and 190 experiments to test the relationship between SRI and financial performance while also analyzing researcher methodologies with respect to dimensions of SRI.[212] They found that differences between the studies they examined resulted from the differences in the dimensions studied.[213] The authors conclude that CSR does not result in stronger or weaker returns compared with conventional investments.[214] They suggest that because SRI does not

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208. The three studies that found that ESG factors had a negative effect on fund performance all focused on negative screens, particular those related to sin stocks. James Chong, Monica Her & G. Michael Phillips, *To sin or not to sin? Now that's the question*, 6 J. ASSET MGMT. 406–417 (2006); Christopher C. Geczy, Robert F. Stambaugh & David Levin, *Investing in Socially Responsible Mutual Funds* (Working Paper, 2005); Harrison G. Hong & Marcin T. Kacperczyk, *The Price of Sin: The Effects of Social Norms on Markets* (Working Paper, 2006).

209. UNEP-FI & MERCER, *supra* note 74.

210. Revelli & Viviani, *supra* note 146. The authors believe their study represents the first international meta-analysis of financial performance of SRI. *Id.* at 159.

211. *Id.*

212. *Id.* at 158–59.

213. These dimensions included markets, financial performance measures, investment horizons, SRI thematic approaches, family investments and journal impact. *Id.* at 158.

214. A problem with the study is that it reaches one conclusion without differentiation for changes in ESG strategies over time. It does not differentiate between screening and ESG integration or consider changes in strategies over the time period of the studies, which spanned the period 1972 – 2012, with most studies from the 1990s on.

increase costs, investors can invest in SRI funds without financial sacrifice while addressing the investors' social, environmental, and ethical concerns.[215]

4. Renneboog, ter Horst and Zhang (2007) – Underperformance in Europe, not in U.S. and U.K. – A 2007 study analyzed SRI funds around the world to test the authors' hypothesis that investors pay a price for SRI screening.[216] The authors studied the risk and return characteristics of SRI mutual funds, grouped in the following regions: the U.S., the U.K., Europe (other than the U.K.), and "the Rest of the World," and compared them with conventional (non-SRI) benchmarks from the U.S. and the U.K.[217] Confirming the authors' hypothesis in part, the study found that SRI funds in Europe and Asia-Pacific countries underperformed benchmarks on average 5% per year.[218] In contrast, however, in the U.S. and the U.K. the returns of SRI and non-SRI funds were not statistically different.[219] The finding of underperformance in Europe supports the hypothesis "that ethical considerations influence the stock prices and that ethical firms are overpriced by the market"[220] but only in certain countries.[221] The study did not differentiate by type of SRI strategy, so it is possible that differences in strategies may have led to differences in results.

5. Eccles, Ioannou, and Serafeim (2011) - High Sustainability Companies Outperform Low Sustainability Companies. – In a 15-year study,[222] Robert G. Eccles, Ioannis Ioannou, and George Serafeim analyzed

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215. Revelli & Viviani, *supra* note 146, at 171.

216. Renneboog, et al., *supra* note 156. The working paper provides a list of earlier studies in note 15.

217. The 463 SRI funds in the study come from 23 countries and offshore jurisdictions. Europe includes Austria, Belgium, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Norway, Sweden, and Switzerland. U.K. includes Guernsey and the Isle of Man. The "Rest of the World" includes Australia, Canada, Cayman Islands, Japan, Malaysia, the Netherlands Antilles, Singapore, and South Africa. Benchmark data comes from 716 conventional funds in the U.K. and 12,624 conventional funds in the U.S. *Id.* at 4–6 (explaining the methodology in creating the sample and the sources of data).

218. *Id.* at 12.

219. *Id.* SRI funds in the U.K. and the U.S. underperform at 1%, which is not statistically significant.

220. *Id.* at 28. The authors suggest that perhaps "ethical companies" are less risky and hence should earn a lower return or that higher demand for ethical companies may cause the companies to be priced higher than their fundamental values. Renneboog, *supra* note 156. at 13.

221. "SRI funds in Belgium, France, Ireland, Japan, Norway, Singapore, and Sweden are lower than -5% per annum." *Id.* at 12.

222. Robert G. Eccles, Ioannis Ioannou, & George Serafeim, *The Impact of Corporate Sustainability on Organizational Processes and Performance* (Mar. 1, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1507874.

the governance and organizational structure and financial performance of 180 U.S. companies. Half of the companies had "voluntary incorporation of social and environmental issues into a company's business model and operations"[223] by 1993 and half had few or no sustainability policies.[224] The companies in the first group were dubbed High Sustainability companies and those in the second group were Low Sustainability companies.[225]

The researchers matched and then compared companies in the two groups so they could "shed light on the organizational and performance implications of integrating social and environmental issues into a company's strategy and business model through the adoption of corporate policies."[226] Among other organizational findings, High Sustainability companies were more likely to create a process to engage stakeholders in identifying risks and opportunities, to be long-term oriented, and to measure and disclose more extra-financial data.[227] The researchers found that High Sustainability companies outperformed Low Sustainability companies in both stock market performance and accounting performance.[228] Further, the market underestimated the future profitability of the High Sustainability companies compared to the other group.[229]

6. Private Equity and Venture Capital Funds. – In June 2015 Cambridge Associates and the Global Impact Investing Network (GIIN) announced that they had collaborated to create the Impact Investing Benchmark.[230] The new benchmark gathers data from 51 private equity and venture capital funds with a range of social objectives.[231] The funds operate across sectors, target both risk-adjusted market rate returns and social impact objectives, are available to institutional rather than individual

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223. *Id.* at 2.
224. *Id.* at 3–4.
225. *Id.*
226. *Id.* at 3.
227. Eccles, *supra* note 222, at 3–4.
228. *Id.* at 4.
229. *Id.*
230. Amit Bouri et al., *Introducing the Impact Investing Benchmark* (2015), *available at* http://www.thegiin.org/binary-data/Introducing_the_Impact_Investing_Benchmark.pdf.
231. *Id.* at i. The funds included pursue one or more of the following themes: financial inclusion, employment, economic development, sustainable living, agriculture, and education. Although environmental funds are excluded, some of the social themes address sustainability issues. *Id.* at 3.

investors, and were launched from 1998 to 2010.[232] Cambridge Associates will update the benchmark on a quarterly basis.[233]

The report analyzing the funds in the benchmark found the returns of funds launched from 1998 to 2004 in line with or better than returns of non-impact investing funds.[234] More recently launched impact investing funds trailed their non-impact investing comparators, but the report suggests that the returns for the impact investing funds were largely unrealized at the time of the analysis.[235] Emerging market impact investing funds raised from 1998 to 2004 outperformed their comparators 15.5% to 7.6%, while later funds lagged behind their non-impact investing peers.[236] Many smaller impact investing funds, defined as those raising less than $100 million, outperformed their smaller non-impact investing counterparts, especially the older funds.[237]

The new benchmark will become more useful as the sample size and available data grow, and the report notes that definitive conclusions on performance would be premature, but the report observes: "Despite a perception among some investors that impact investing necessitates a concessionary return, the Impact Investing Benchmark has exhibited strong performance in several of the vintage years studied."[238] The report also notes that the findings support the view that manager selection and due diligence are key to superior returns and risk management, in impact investing just as much as in non-impact investing.[239]

7. Other Studies – Neutral or Positive. – Other studies generally have found either neutral or positive effects of ESG factors on investment performance.[240] An 18-year study compared a U.S. social investment

232. *Id.* at 1–2. The report notes that some impact investing funds seek concessionary returns, but explained that the Benchmark is limited to funds that target risk-adjusted market rate returns consistent with other private investment funds.

233. *Id.* at 1.

234. Bouri, *supra* note 230, at 8–9.

235. *Id.* at i.

236. *Id.* at 10.

237. *Id.* at 14.

238. *Id.* at 19.

239. Bouri, *supra* note 230, at 19.

240. This section describes a handful of the many recent studies looking at various aspects of ESG investing. For additional reports of empirical work analyzing the link between CSR and financial performance and between environmental performance specifically and financial performance, *see* Ioannou & Serafeim, *supra* note 133, at 13 ("The studies addressing environmental performance argue that "positive relationship between environmental and financial performance may represent a focus on innovation and operational efficiency, reflect superior organizational or management capabilities, enhance a company's legitimacy, and may empower the firm to meet the needs of

index, the MSCI KLD 400 Social Index, with the S&P 500.[241] The study found that differences between the two indices could be explained by conventional investment factors.[242] That is, the ESG factors did not affect the returns in either a negative or positive way. The author's conclusion is that any risk exposures created by SRI can be addressed through portfolio construction.[243] The authors noted that they found no evidence of market advantage in using ESG factors, perhaps because "the field is getting crowded."[244] They concluded that "values-based investors" can achieve financial results comparable to non-SRI investing, but that alpha-seeking social investors may be disappointed.[245]

A study published in 2011 by RCM, a global asset management company, analyzed the best-in-class strategy.[246] The study used data mainly from MCI ESG Research for the period of December 2005 to September 2010. The researchers evaluated ESG factors on a sector-by-sector basis to identify best-in-class companies and worst-in-class companies. The researchers then created portfolios using the data and found that the best-in-class portfolios outperformed the benchmark during the test period, while the worst-in-class portfolios underperformed. The white paper reports: "investing in companies that operate best-in-class ESG strategies did not detract from returns. Even in extreme market conditions, performance was not negatively impacted. Not only that, but

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diverse stakeholders [citations deleted].") *Id. See* Sally Hamilton, Hoje Jo, & Meir Statman, *Doing Well While Doing Good? The Investment Performance of Socially Responsible Mutual Funds*, FINANCIAL ANALYSTS JOURNAL 62 (1993), for one of the first studies, which found that SRI funds obtained competitive returns

241. Lloyd Kurtz & Dan DiBartolomeo, *The Long-Term Performance of a Social Investment Universe*, 20 J. INVESTING 95 (2011).

242. *Id.* at 97–98.

243. *Id.* at 100.

244. *Id.* Another long-term study, 1990-2008, found slight underperformance of SRI funds when compared with non-SRI funds, and slight outperformance on a risk-adjusted basis, in both cases with results that were neither statistically nor economically significant. David M. Blanchett, *Exploring the Cost of Investing in Socially Responsible Mutual Funds: An Empirical Study*, 19 J. INVESTING 93, 102 (2010). The Blanchett article also provides descriptions of eleven prior studies, with most finding a neutral impact on cost and performance. *Id.* at 93–94.

245. *Id.*

246. *Sustainability: Opportunity or Opportunity Cost? Applying ESG factors to a Portfolio Does Not Negatively Impact Performance and May Enhance it*, RCM (2011), *available at* https://www.allianz.com/media/responsibility/documents/rcmsustainabilitywhitepaper2011.pdf.

outperformance was seen across the range of global sectors and geographies."[247]

A recent European study analyzed eight SRI funds and the five top holdings of each, evaluating the five holdings by using four categories of factors: intellectual capital, financial and economic performance, social and environmental performance, and sustainability performance.[248] The study found a relationship between the social and environmental factors of companies and the financial performance of those companies. The study also found that the intellectual capital and social and environmental performance of companies held by the funds influenced fund performance.[249]

Finally, studies have shown that corporate responses to ESG issues benefit the company. A 2013 study by EY (formerly Ernst & Young) and Boston College reported that a large institutional shareholder's successful interventions in corporate social responsibility increased share price by an average of 4.4% a year. The study also found that the most transparent companies tended to have higher cash flows, innovation in processes, reduction in waste, and greater insight into where growth may come from. A 2009 study published in the Harvard Business Review found that corporations that complied fully and as early as possible with environmental regulations benefitted financially even if initial costs were substantial.[250] The study showed that sustainable practices, rather than being a financial burden on the cost of doing business, can lower that cost and increase revenues.[251] Earlier studies demonstrated a positive relationship between the adoption of CSR practices and policies and corporate financial performance.[252] Recent information from Europe shows similar results.[253]

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247. *Id.* at 12. The study also found that investing in companies identified as best-in-class on sustainability did not lead to greater volatility when compared with the market. *Id.*

248. *See* Jelena Stankevičienė & Julija Čepulytė, *Sustainable Value Creation: Coherence of Corporate Social Responsibility and Performance of Socially Responsible Investment Funds*, 27 ECONOMIC RESEARCH – EKONOMSKA ISTRAŽIVANJA 882 (2014).

249. *Id.*

250. Ram Nidumolu, CK Prahalad & MR Rangaswami, *Why Sustainability is Now the Key Driver of Innovation*, HARV. BUS. REV. (2009) (studying 30 large corporations over a long time period).

251. *Id.* A study published in 2011 showed that companies with strong employment practices outperformed the market over a period of many years. *See* Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices,*101 J. FIN. ECON. 621 (2011).

252. *See* Jennifer J. Griffin & John F. Mahon, *The Corporate Social Performance*

8. "Apparent Contradictions". – After reviewing these recent studies, it is interesting to reflect on an article published in 1997, in the early years of SRI expansion after the end of the anti-apartheid divestment period.[254] Lloyd Kurtz reviewed the available literature but explained that only a few studies existed at that time.[255] At the outset of his paper he notes three "apparent contradictions:"

> First, despite apparently unavoidable diversification costs, the universe of SRI stocks does not appear to have systematically underperformed the market portfolio in recent years, on either a nominal or risk-adjusted basis. . . .
>
> Second, some management science studies have found that factors monitored by social investors, such as environmental policies, employee relations, and R&D spending, could be associated with positive abnormal returns. The results are mixed, however . . . .
>
> The third contradiction is born of the first two. Money managers who have handled both screened and unscreened accounts for many years report that, over time, the performance of these accounts does not differ materially.[256]

The studies discussed in this section have helped to explain the contradictions. SRI strategies do not result in "unavoidable diversification

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and Corporate Financial Performance Debate: Twenty-Five Years of Incomparable Research, 36 BUS. & SOC'Y 5 (1997); Ronald M. Roman, Sefa Hayibor & Bradley R. Agle, *The Relationship Between Social and Financial Performance: Repainting A Portrait*, 38 BUS. & SOC'Y 109 (1999); Marc Orlitzky, Frank L. Schmidt & Sara L. Rynes, *Corporate Social And Financial Performance: A Meta-Analysis*, 24 ORGANIZATION STUDIES, 403 (2003); M. L. Wu, *Corporate Social Performance, Corporate Financial Performance, and Firm Size: A Meta Analysis*, 8 J. AM. ACADEMY BUS. 163 (2006).

253. *See* John Howell, *European Companies Profit from Sustainability*, 3BL MEDIA, LLC, (June 15, 2015), *available at* https://3blmedia.com/News/European-Companies-Profit-Sustainability-Minute#sthash.KNFyirX0.dpuf. "CDP, a research firm that collects environmental data on more than 5,000 companies worldwide, reports that companies with published targets for cutting their CO2 emissions are more profitable, delivering a return on invested capital of 9.9 percent, compared with 9.2 percent for those with no targets. And Euronext's Low Carbon 100 Europe index, which includes those European firms with the lowest CO2 emissions in their respective industries, has risen by 60 percent since the end of 2010. That rise compares with a 45 percent lift in the same time period in the broader STOXX Europe 600 index, from which the Low Carbon 100 Europe list was selected."

254. *See* Kurtz, *supra* note 89.

255. *Id.* at 37.

256. *Id.* "[D]espite apparently unavoidable diversification costs, the universe of SRI stocks does not appear to have systematically underperformed the market portfolio in recent years, on either a nominal or risk-adjusted basis."

costs" and SRI strategies, in particular ESG investing, can improve financial investment results.[257]

D. Investor Interest and Investment Company Responses

1. Numbers. – The attention devoted to ESG investing by investment firms reflects both a response to demands of investors[258] and a growing awareness that integrating ESG factors into overall analysis can improve returns, especially on a risk-adjusted basis.[259] The most recent Trends report from the Forum for Sustainable and Responsible Investment shows a growth in investment funds incorporating ESG factors from $12 billion in assets in 1995, when the first Trends report was compiled, to $4,306 billion in 2014.[260] Further, the report identified $6,572.2 billion in assets engaged in sustainable and responsible investing in 2014.[261] A dramatic upward shift in assets engaged in ESG investing began between the 2007 and 2010 Trends reports, and since 2010 the numbers have risen rapidly.[262] Not

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257. An outlier, as of 2009, appeared to be "sin" stocks. Companies involved in producing alcohol or tobacco and companies involved in gambling have historically outperformed the market. *See* Harrison Hong & Marcin Kacperczyk, *The Price of Sin: The Effect of Social Norms On Markets*, 93 J. FIN. ECON. 15 (2009). *See also* Hoje Jo, et al., *Socially Responsible Investing vs. Vice Investing*, ACADEMIC & BUS. RESEARCH INST., *available at www.aabri.com/LV2010Manuscripts/LV10107.pdf* (comparing VICEX, a mutual fund established in 2002 to invest in alcohol, gaming, tobacco, and defense, with DSEFX, an SRI fund based on the DS 400).

258. *Report on US Sustainable, Responsible and Impact Investing Trends 2014*, THE FORUM FOR SUSTAINABLE AND RESPONSIBLE INVESTMENT (2014), *available at* http://www.ussif.org/Files/Publications/SIF_Trends_14.F.ES.pdf. "Of the managers that responded to an information request about reasons for incorporating ESG, the highest percentage, 80 percent, cited client demand as their motivation." *Id.* at 16.

259. DEUTSCHE BANK GROUP, *supra* note 196. The Managing Director of the division stated: "We believe that ESG analysis should be built into the investment processes of every serious investor, and into the corporate strategy of every company that cares about shareholder value. ESG best-in-class focused funds should be able to capture superior risk-adjusted returns if well executed." *Id. See also* Michael E. Porter & Mark R. Kramer, *Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility*, 84 HARV. BUS. REV. 75 (2006) (advocating that companies develop and implement corporate-wide CSR initiatives because doing so would "add quantifiable value to companies.").

260. *Report on Investing Trends 2014*, *supra* note 258. This number includes mutual funds and various types of pooled products, but it does not include separate account vehicles and community investing institutions.

261. *Id.* at 15. This number includes community-investing institutions.

262. *Id.* The numbers from 1995 to 2014, with the number of funds preceding amount of assets, in billions, are as follows: 1995: 55, $12; 1997: 144, $96; 1999: 168, $154; 2001: 181, $136; 2003: 200, $151; 2005: 201, $179; 2007: 260, $202; 2010: 493, $569; 2012: 720, $1,013; 2014: 925, $4306.

surprisingly, investment firms have increased the resources they devote to ESG investing.[263]

2. Investment Firms Integrate ESG Analysis. – Firms that offer traditional investment services to institutional investors and individuals increasingly tout their sustainability products or ESG approaches. Russell Investments says on its "about Russell" page that it has "five distinct capabilities that we believe are required to run money."[264] The second of these is responsible investment, and Russell explains: "Russell Investments recognizes the importance of environmental, social, and corporate governance issues. They not only affect our clients' investments and financial security. They affect our business and communities in which we live and work. To reinforce our commitment to these issues, we are a signatory of the UN Principles for Responsible Investment (UN PRI)."[265] The website then describes the work of the Russell Sustainability Council.[266]

Breckinridge Capital Advisors has incorporated the use of ESG factors into its analysis of fixed income assets.[267] Nicholas Elfner, Director of Corporate Research, explains that ESG analysis is "fully integrated in the credit research group."[268] Current methodologies to analyze fixed income assets may not assess extra-financial risks affecting companies and municipalities.[269] With its focus on fixed income investments, Breckinridge is particularly concerned with risk mitigation and has found that ESG factors may identify risks that do not surface in the traditional credit process.[270] Mr. Elfner explained that the result of ESG factor analysis is a "better, more comprehensive, forward looking assessment of a debt issuer's creditworthiness. Additionally, Breckinridge believes that a company or

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263. *Id.* at 14. As of 2014, 480 registered investment companies incorporated ESG factors in their investment management. The amount managed in the ESG funds more than tripled from 2012 to 2014. *Id.*

264. RUSSELL INVESTMENTS, *About Russell*, http://www.russell.com/us/about-russell/default.page (last visited March 14, 2016).

265. RUSSELL INVESTMENTS – RESPONSIBLE INVESTMENTS, http://www.russell.com/us/about-russell/corporate-responsibility/responsible-investment.page (last visited March 14, 2016).

266. *Id.*

267. Beckinridge, *Learn More About Our ESG Approach*, FAST.WISITA (Apr. 19, 2016), http://fast.wistia.net/embed/iframe/2sy4yochuj.

268. *Id.*

269. *Id.*

270. *Id.*

municipality that works to manage its material ESG risks may be a more stable credit and a better long-term investment."[271]

Goldman Sachs integrates ESG analysis into its financing, investing, and asset management work, and applies ESG considerations in how it runs itself.[272] The firm established an Environmental Policy Framework in 2005, and its Board continues to review the framework.[273] Under the framework Goldman has "committed to deploy our people, capital and ideas to help find effective market-based solutions to environmental issues."[274] To that end, Goldman finances, co-invests, and serves as a financial advisor for a variety of clean energy transactions.[275] Goldman also incorporates ESG analysis in its own business structure, for example by reducing the carbon footprint of its offices,[276] and uses ESG factor analysis in work for asset management clients. The website for Goldman Sachs Asset Management[277] explains:

> [W]e believe responsible and sustainable investing extends beyond the evaluation of quantitative factors and traditional fundamental analysis. Where material, it should include the analysis of an entity's material impact on its stakeholders, the environment and society. We recognize that these environmental, social and governance (ESG) factors can affect investment performance, expose potential investment risks and provide an indication of management excellence and leadership. As a result, it is important for our investment professionals to understand how environmental, social and governance factors influence our

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271. *Id.* Email from Kristin Wetherbee to author (Feb. 12, 2016).

272. *See* GOLDMAN SACHS, ENVIRONMENTAL, SOCIAL, AND GOVERNANCE IMPACT REPORT, http://www.goldmansachs.com/citizenship/esg-reporting/index.html (last visited May 21, 2015). Goldman began publishing an Environmental Report in 2006. It became an Environmental, Social and Governance Report in 2010. *Id.*

273. GOLDMAN SACHS, OUR IMPACT DRIVES GLOBAL PROGRESS: SELECTED HIGHLIGHTS FROM 2012 ESG REPORT, (2012), *available at* http://www.goldmansachs.com/citizenship/esg-reporting/esg-2012-highlight-pdf-report.pdf. Board engagement reflects a high-level commitment to the environmental framework. Goldman also prepares a governance report each year, following the G3 reporting framework.

274. *Id.*

275. *Id.* at 2–3.

276. *Id.* at 4 (describing Goldmans's operational impact).

277. As an investment firm Goldman Sachs engages in investment banking, securities work, investing and lending, and investment management. GSAM is one of two divisions within investment management; the other is private wealth management. Thus, GSAM is the core of Goldman Sachs' investment management work, not a separate "socially responsible" division. *See* GOLDMAN SACHS, http://www.goldmansachs.com (last visited May 21, 2015).

> investment decisions. To this end, GSAM is working to more formally integrate the analysis of these factors into our investment processes, where appropriate and consistent with our fiduciary duties.[278]

Goldman views its use of ESG in part as "good citizenship" as indicated by the discussion of ESG in the citizenship link on the website, but as the quoted passage explains, Goldman's asset managers view ESG analysis as an important tool to improve results for clients.

BNY Mellon makes its own corporate social responsibility a central part of its explanation of "who we are." The firm files a CSR report annually,[279] and says that it is expanding its social responsibility "beyond our already strong employee engagement, environmental stewardship and community commitments."[280] BNY Mellon uses the term "social finance" to mean "investment activities that include both financial and significant social and/or environmental impact."[281] BNY Mellon has created a framework that integrates ESG factors into investment decisions and includes environmental finance, impact investing, and development finance. The website notes: "Social finance has increasing value for mainstream investors because it can provide a sustainable set of tools to help manage investment risk, diversify portfolios and support long-term financial performance."[282] The description of social finance recognizes that some investors want to build their investments around their social and environmental values, but also notes that for mainstream investors "we believe there's untapped market potential in social finance."[283]

One more example is Mirova, a subsidiary created by the international investment firm, Natixis Asset Management.[284] In 2013 Natixis established

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278. *Responsible and Sustainable Investing*, GOLDMAN SACHS, http://www.goldmansachs.com/s/esg-impact/governance/responsible-and-sustainable-investing/. Goldman became a signatory of the U.N. Principles for Responsible Investing in 2011. *Id.*

279. *See* 2013 ANNUAL CSR REPORT, BNY MELLON, https://www.bnymellon.com/us/en/who-we-are/social-responsibility/2013-annual-report.jsp (last visited May 21 2015).

280. *Corporate Social Responsibility*, BNY MELLON, https://www.bnymellon.com/us/en/who-we-are/social-responsibility/index.jsp (last visited May 21, 2015).

281. *Social Finance*, BNY MELLON, https://www.bnymellon.com/us/en/who-we-are/social-finance/index.jsp (last visited May 21, 2015).

282. *Id.*

283. *Id.*

284. *Natixis Asset Management announces the creation of Mirova, a management company*, MIROVA (Jan. 6 2014), *available at* http://www.mirova.com/Content/Documents/Presse/va/PR%20Mirova.pdf.

Mirova as an investment division focused on responsible investment.[285] Then in January 2014 Natixis moved the division into a management company called Mirova, a wholly owned subsidiary.[286] The creation of the subsidiary reflects the desire "to accelerate the development of its responsible investment activities."[287] Mirova seeks to offer "a new approach to responsible investment" and its "philosophy is based on the conviction that integrating sustainable development themes can generate solutions that create value for investors over the long term."[288]

The websites and other materials produced by these investment firms provide examples of the integration of ESG factors into their investment analysis and other work. The websites provide evidence of the growing interest large investment firms have in ESG analysis and its potential to improve financial results for their clients.[289]

3. Financial Analysts Use ESG Factors. – In addition to managing and promoting SRI funds to investors interested in social responsibility and sustainability,[290] investment firms increasingly seek extra-financial information disclosed by companies to make better financial decisions.[291] A study published in 2011 by Robert G. Eccles, Michael P. Krzus, and George Serafeim found a high level of market interest in ESG disclosure, based on an analysis of "hits" accessing extra-financial metrics in the Bloomberg database during three bimonthly periods in late 2010 and early

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285. *See id.*

286. *See id.*

287. *See id*.

288. *See* MIROVA – PHILOSPOHY, http://www.mirova.com/en-INT/mirova/Philosophy (last visited Mar. 14, 2016).

289. The selection of these investment firms does not reflect research on all investment firms. Another firm, Morgan Stanley, integrates ESG investing less directly, listing it as a separate entry, separate from wealth management and investment management, but recognizes its growing importance to clients. The website includes "sustainable investing" as a link under a list of "what we do." MORGAN STANLEY, http://www.morganstanley.com (last visited May 21, 2015). The firm has established an Institute of Sustainable Investing, which has produced a number of short articles, including one called "Sustainable Investing Enters the Mainstream." That article notes: "Today's sustainable investors do not expect to compromise financial return for positive environmental and social impact." SUSTAINABLE INVESTING ENTERS THE MAINSTREAM, MORGAN STANLEY, http://www.morganstanley.com/ideas/sustainable-investing-enters-mainstream/ (last visited May 21, 2015).

290. Client demand is certainly an incentive for the development of ESG investing resources.

291. Robert G. Eccles, Michael P. Krzus & George Serafeim, *Market Interest in Nonfinancial Information*, (Harv. Bus. School, Working Paper 12-018 at 1, 2011) (providing information about market interest in ESG data at a "granular" level).

2011.[292] Their report suggests that investors may be interested in transparency concerning ESG performance and policies as a way to understand whether companies are using that extra-financial information.[293] In addition, the authors' hypothesize that the market perceives less risk in transparent companies, because there is less uncertainty about them.[294] The companies are better positioned to deliver on expected performance if they are "using effective ESG management to capture revenue- generating opportunities, achieve cost savings, and minimize the downside of failures, fines, and lawsuits."[295]

Transparency and governance information also appear to be used as a proxy for good management,[296] because "more capable executives are confident in providing more performance information for which they are held accountable."[297] Investors may be relying in part on research that shows the connection between governance and firm performance,[298] and in part on management's ability to address ESG factors to the long-term benefit of the company.[299]

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292. *Id.* at 6. The Bloomberg database contains 247 extra-financial metrics, which the study grouped into five categories: disclosure scores, environmental metrics, social metrics, governance metrics, and Carbon Disclosure Project data. Bloomberg calculates the disclosure scores based on how many of the other metrics a company reports. *Id.* The study answers the question: "What specific types of nonfinancial information are being used by investors?" *Id.* To do so the study compares data from the global and U.S. markets, across different components of ESG, and across asset classes and firm types. *Id.* at 15.

293. Eccles, *supra* note 291, at 7. The paper explains, "While these disclosure scores are not specific performance metrics, they indicate the degree to which a company is using and reporting on nonfinancial information." *Id.* Another paper, *see also* RCM SUSTAINABILITY WHITE PAPER, *supra* note 86, reports that analysts rated "high-visibility companies with evolved ESG policies" higher that other companies, and that "high-visibility businesses with poor ESG ratings were disproportionately penalized."

294. Eccles et al., *supra* note 291, at 7.

295. *Id.*

296. UNEP-FI & MERCER, *supra* note 74, at 50–51.

297. Eccles et al., *supra* note 291, at 10.

298. *Id*. The article describes the existence of "[a] long and significant stream of literature and research findings on the implications of governance for firm performance and riskiness. *Id*. at 1 (citing Marco Becht, Patrick Bolton & Ailsa Roell, *Corporate Governance and Control,* in G.M. CONSTANTINIDES, M. HARRIS & R. M. STULZ (ED.), HANDBOOK OF THE ECONOMICS OF FINANCE 1 (2003).

299. Eccles et al., *supra* note 292, at 2 ("transparency around ESG performance and policies is used as a proxy for management quality and the potential for the management to grow profitably the business in the future."). *See also* GOLDMAN SACHS, http://www.goldmansachs.com (last visited May 22, 2015). Although ESG factors often relate to long-term performance, the UNEP-FI study found that consideration of long-term investment factors may provide guidance on short-term investment volatility. *See* UTEP-FI & MERCER, *supra* note 74, at 51 (citing J. Hudson

Overall, analysts increasingly rate companies with strong CSR ratings higher than those without strong CSR ratings.[300] Ioannis Ioannou and George Serafeim studied sell-side analysts' stock recommendations for a large sample of companies from 1993-2007[301] and found a change in the analysts' views of CSR ratings over that period of time.[302] In the early years of the study, companies with relatively high CSR ratings received less favorable recommendations than other companies.[303] The authors attribute this finding to the fact that analysts were influenced by the then prevailing agency theory, which saw CSR policies as serving non-shareholder stakeholders and destroying shareholder wealth.[304] In the later years of the study, analysts' recommendations for companies with high CSR ratings shifted to less pessimistic and eventually to optimistic recommendations.[305] The authors attribute this shift to a change in the perceptions of CSR for both shareholders and analysts.[306] The authors explain that by the end of the period of the study CSR had been re-interpreted "as a legitimate part of corporate strategy, minimizing operational risks and even contributing positively towards long-term financial performance."[307] In an interesting related finding, the authors showed that analysts with more experience or higher status were likely to adjust their assessments of CSR ratings more quickly than other analysts.[308]

& S. Knott, *Alternative alpha: Infrastructure – The long view*, UBS INVESTMENT RESEARCH (2006)). The report noted that this finding could indicate "that dealing properly with ESG issues could have a positive contribution to financial risk mitigation, hence, a proxy for good management." *Id*. (discussing a study published by Goldman Sachs in 2007: "Their research has discovered a strong link between the management's ability to address ESG issues and its ability to steer the company towards sustained growth and profitability and, accordingly, enhanced stock valuation.").

300. Ioannou & Serafeim, *supra* note 133.

301. *Id.* at 4.

302. The study used CSR ratings based on policies and practices adopted by corporations with respect to corporate governance, environmental and social issues. *Id.* at 4, 18.

303. *Id.* at 4.

304. The authors describe the analysts as influenced by the then prevailing agency theory which saw CSR policies as serving non-shareholder stakeholders and destroying shareholder wealth. They note the influence of Milton Friedman who wrote, in 1970 that "the social responsibility of the firm is to increase its profits". *Id.* at 7–8 (citing Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, NEW YORK TIMES MAGAZINE 32(13), 122–126 (1970)).

305. UNEP-FI & MERCER, *supra* note 74, at 4, 26–27.

306. *Id.* at 3.

307. *Id.* at 12.

308. *Id.* at 27.

4. U.N. Principles for Responsible Investment. – The Principles for Responsible Investment (PRI) provide additional evidence of investor interest in ESG investing.[309] Convened by the U.N. Secretary-General, a group of international institutional investors developed the Principles in 2006.[310] The preamble states:

> As institutional investors we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.[311]

Over 1300 institutions have signed the Principles,[312] agreeing to "incorporate ESG issues into investment analysis and decision-making processes,"[313] to incorporate ESG issues into active ownership practices, to seek appropriate disclosure on ESG issues, and to promote the implementation of the Principles.[314] The Principles encourage investors to consider ESG factors as part of a conventional investment analysis.

E. Sustainability Reporting and Integrated Reporting

Investors, customers, and other stakeholders increasingly request extra-financial as well as financial information about companies.[315] In response,

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309. *The Six Principles*, U.N. PRINCIPLES FOR RESPONSIBLE INVESTING, http://www.unpri.org/about-pri/the-six-principles/ (last visited May 22, 2015).

310. *Id.*

311. *Id.*

312. *Signatories to the Principles for Responsible Investing*, U.N. PRINCIPLES FOR RESPONSIBLE INVESTING, http://www.unpri.org/signatories/signatories/ (last visited Feb. 4, 2016). There are three signatory categories: asset owners (304), investment managers (969), and professional service partners (203). *Id.* Russell Investments, Breckinridge Capital Advisors, Goldman Sachs Asset Management, Mellon Capital Management Corporation, and Mirova are signatories in the investment manager's category. *Id.*

313. *The Six Principles*, *supra* note 309. This is the first of six Principles.

314. *The Six Principles*, *supra* note 309.

315. *2012 Corporate ESG/Sustainability/Responsibility Reporting – Does It Matter?*, GOVERNANCE AND ACCOUNTABILITY INSTITUTE 3, http://www.ga-institute.com/fileadmin/user_upload/Reports/SP500_-_Final12-15-12.pdf (last visited May 22, 2015) at 5–6; Eccles et al., *supra* note 291, at 4; MIKE KRZUS, BRIAN BALLOU & DAN L. HEITGER, THE ECONOMICS OF SUSTAINABILITY INITIATIVES 2 (2013), *available at* http://www.aicpa.org/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/whitepaper_economics_of_sustainability_initiatives.pdf.

the numbers of companies reporting on ESG factors has risen sharply in recent years.[316] As already noted, analysts use transparency as a proxy for good management, so companies that do not report will increasingly be at a disadvantage.[317] Thus, reporting that includes extra-financial information will continue to increase. Indeed, Robert G. Eccles, Michael P. Krzus, and George Serafeim predict an exponential increase in interest in ESG reporting "as more companies disclose more nonfinancial information, as more knowledge is developed by research and teaching programs in business schools and as more sophisticated valuation models are developed by investors . . . ."[318]

Sustainability reporting refers to reporting by a company about its environmental, social, and economic impacts.[319] Sustainability reporting began in a somewhat piecemeal fashion, but growing interest led to the development of a framework and guidelines. CERES, the Coalition for Environmentally Responsible Economies, working with the Tellus Institute, took the lead.[320] In the early 1990s, advisors connected with

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316. The Governance and Accountability Institute reports that as of 2012 more than half the S&P 500 companies disclosed ESG information. The number increased from 19-20% of S&P 500 companies in 2010 to 53% in 2012. GOVERNANCE AND ACCOUNTABILITY INSTITUTE, *supra* note 315; *see also* Eccles et al., *supra* note 291, at 1; *Sustainability Reporting – The Time is Now*, EY & GRI, http://www.ey.com/Publication/vwLUAssets/EY-Sustainability-reporting-the-time-is-now/$FILE/EY-Sustainability-reporting-the-time-is-now.pdf (last visited May 23, 2015) at 11 ("Growth in reporting has been driven in large part by the out-performance of those companies that do report.").

317. *See supra* Part IV.D; *see also* EY& GRI, *supra* note 316, at 4, 21 ("Failure to engage with the reporting process could have a negative impact on performance, reputation, and even the ability to raise capital."); *see also* Eccles et al., *supra* note 291 (showing that analysts use transparency as a proxy for good management); Krzus, Ballou & Heitger, *supra* note 315, at 3 ("effective use of relevant, reliable nonfinancial reports represents an opportunity for organizations to enhance trust and create value with shareholders and key stakeholders.").

318. Eccles et al., *supra* note 291, at 15.

319. The Global Reporting Initiative (GRI) defines sustainability reporting as follows:

A sustainability report is a report published by a company or organization about the economic, environmental and social impacts caused by its everyday activities.

A sustainability report also presents the organization's values and governance model, and demonstrates the link between its strategy and its commitment to a sustainable global economy.

Sustainability Reporting, GLOBAL REPORTING INITIATIVE, https://www.globalreporting.org/information/sustainability-reporting/Pages/default.aspx (last visited May 22, 2015).

320. *See Sustainability Reporting: Ceres Catalyzes a Worldwide Movement*, CERES (Mar. 2014), http://www.ceres.org/about-us/our-history/sustainability-reporting-ceres-catalyzes-a-worldwide-movement; *What Is GRI?*, GLOBAL REPORTING INITIATIVE, https://www.globalreporting.org/information/about-gri/what-is-GRI/Pages/default.aspx

CERES began developing a framework for environmental reporting, and in 1997 CERES created the Global Reporting Initiative (GRI).[321] As work on the initiative continued, the scope expanded to include social, governance and economic reporting.[322] GRI issued the first Sustainability Reporting Framework, with Reporting Guidelines, in 2000.[323] At that time, CERES separated from GRI and GRI became a separate international nonprofit organization.[324] GRI's mission is to "to make sustainability reporting standard practice for all companies and organizations."[325] GRI has continued to update the Reporting Framework, and issued the most recent version of its Sustainability Reporting Guidelines, G4, in May 2013.[326]

Integrated reporting is the merging of financial and extra-financial information about a company based on an assumption that both financial and extra-financial information are needed to assess a company's true value.[327] While sustainability reporting focuses on the extra-financial data, integrated reporting presents all data relevant to a company in one report.[328] Integrated reporting can assist those who manage a company to link long-

(last visited May 22, 2015).

321. *See Sustainability Reporting: Ceres Catalyzes a Worldwide Movement*, CERES (Mar. 2014), http://www.ceres.org/about-us/our-history/sustainability-reporting-ceres-catalyzes-a-worldwide-movement.

322. *Id.*

323. *Id.*

324. *Id.* GRI is now based in Amsterdam, The Netherlands, and has regional offices in Australia, Brazil, China, India, South Africa, and the United States. Its most recent biannual conference, held in 2013, drew 1500 delegates from 69 countries. *Id.*

325. *About GRI*, GLOBAL REPORTING INITIATIVE, https://www.globalreporting.org/information/about-gri/Pages/default.aspx (last visited May 22, 2015).

326. *What Is GRI?*, *supra* note 320.

327. *See Integrated Reporting: Tips for Organizations*, EY, http://www.ey.com/GL/en/Services/Specialty-Services/Climate-Change-and-Sustainability-Services/EY-integrated-reporting-tips-for-organizations (last visited May 22, 2015) (explaining: "Intangible assets have gone from accounting for just 17% of market value in 1975 to 80% in 2010.").

328. *See* ROBERT G. ECCLES & MICHAEL P. KRZUS, ONE REPORT: INTEGRATED REPORTING FOR A SUSTAINABLE STRATEGY (2010) (describing the "emerging trend" of integrated reporting" and the value it can bring to a company, its shareholders, and its other stakeholders). *See also* ROBERT G. ECCLES & MICHAEL P. KRZUS, THE INTEGRATED REPORTING MOVEMENT: MEANING, MOMENTUM, MOTIVES, AND MATERIALITY (2014) (examining the evolution of integrated reporting, explaining the current frameworks and standards, and making recommendations for effective implementation); J.C. Jensen & N. Berg, *Determinants of Traditional Sustainability Reporting Versus Integrated Reporting. An Institutionalist Approach*, 21 BUS. STRAT. ENV. 299–316 (2012) (comparing companies that use sustainability reporting with those that use integrated reporting, against the backdrop of country-level determinants).

term strategies with environmental, social, and financial objectives. Integrated reporting has been defined as follows:

> An integrated report is a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium, and long term.[329]

The International Integrated Reporting Council (IIRC), "a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs,"[330] was created to develop a globally accepted reporting framework that would integrate information about the creation of value over time into one concise report.[331] The initial version of its International Integrated Reporting <IR> Framework was released in December 2013. This framework incorporates six types of capital: financial, manufactured, human, social and relationship, intellectual and natural, and it provides Guiding Principles and Content Elements,[332] but it does not establish measurement and reporting standards.

A company can use the Generally Accepted Accounting Principles (GAAP) for financial information included in an integrated report. For extra-financial information, the Climate Change Reporting Framework[333] developed by the Climate Disclosure Standards Board and the G4 Guidelines provide guidance on disclosures but do not provide reporting standards. The Sustainability Accounting Standards Board (SASB),[334] created in July 2011,[335] has already developed seven standards for sustainability information for seven sectors and will finish the remaining

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329. The International Integrated Reporting Council (IIRC), *The International <IR> Framework*, at 7 (2013), http://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf.

330. *The IIRC*, http://integratedreporting.org/the-iirc-2/ (last visited July 22, 2015).

331. *Id.*; *see also* Robert G. Eccles & George Serafeim, *A Tale of Two Stories: Sustainability and the Quarterly Earnings Call*, 25 J. APPLIED CORP. FIN. 66 (Summer 2013) (explaining that The Prince's Accounting for Sustainability Project (A4S) and the GRI collaborated to create the IIRC).

332. International Framework, *supra* note 329, at 4–5.

333. *See CDSB Reporting Framework*, CLIMATE DISCLOSURE STANDARDS BOARD, http://www.cdsb.net/cdsb-reporting-framework (2013).

334. SASB has been accredited to establish sustainability standards by the American National Standards Institute (ANSI). SASB's website states: "The mission of SASB is to develop and disseminate sustainability accounting standards that help public corporations disclose material, decision-useful information to investors." *Vision and Mission*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD, http://www.sasb.org/sasb/vision-mission/ (last visited May 23, 2015).

335. *See id.*

standards by 2016.[336] These standards are industry-specific, and create performance metrics and a process for determining materiality of issues.[337]

Although a standardized reporting format that captures extra-financial data has not been available, increasing numbers of companies provide some form of sustainability reporting or integrated reporting.[338] The reports assist investors and other stakeholders in understanding a company's progress and overall strategy[339] and assist companies in developing sustainability strategies that can be incorporated into business operations.[340] In a poll taken by people attending GRI's Global Conference on Sustainability and Reporting a majority of respondents said that principal objectives of a sustainability strategy were "to add value" and "to identify and mitigate risks."[341] Business reasons, including financial benefits, appear to be leading to greater use of sustainable and integrated reporting

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336. *See* SUSTAINABILITY ACCOUNTING STANDARDS BOARD, http://www.sasb.org/standards/status-standard/ (last visited May 23, 2015); *Vision and Mission*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD, http://www.sasb.org/sasb/vision-mission/ (last visited May 23, 2015).

337. *See Conceptual Framework*, SUSTAINABILITY ACCOUNTING STANDARDS BOARD 3–4, http://www.sasb.org/wp-content/uploads/2013/10/SASB-Conceptual-Framework-Final-Formatted-10-22-13.pdf (last visited May 23, 2015). "SASB standards are designed for disclosure in mandatory filings to the Securities and Exchange Commission (SEC), such as the Form 10-K and 20-F." *Id.* at 3.

338. *See The KPMG Survey on Corporate Responsibility Reporting 2013*, KPMG (2013), http://www.kpmg.com/global/en/issuesandinsights/articlespublications/corporate-responsibility/pages/corporate-responsibility-reporting-survey-2013.aspx. The survey found that 71% of companies worldwide reported on corporate responsibility or sustainability, and 93% of the world's 250 largest companies reported. *Id.* at 22. Of those reporting, 78% of worldwide companies and 82% of the largest 240 companies refer to the GRI reporting guidelines. *Id.* at 12. The companies surveyed were the largest 100 companies in each of 41 countries. *Id.* at 21. The increases in reporting are driven in part by growing numbers of mandatory reporting policies, both government and stock exchange. *See* KPMG, United Nations Environment Programme, Global Reporting Initiative and Unit for Corporate Governance in Africa, *Carrots and Sticks, Sustainability Reporting Policies Worldwide* (2013) (reporting on mandatory and voluntary reporting policies in 45 countries); Initiative for Responsible Investment, *Corporate Social Responsibility Disclosure Efforts By National Governments and Stock Exchanges* (The Hauser Inst. for Civil Soc'y, Working Paper, 2014) (updated quarterly) (collecting information about disclosure initiatives of regulatory authorities and stock exchanges around the world).

339. As the EY and GRI report concluded: "Once reporting has become standardized and easy to compare, there is little doubt that performance indicators on sustainability issues will become as important for business as financial performance." EY & GRI, *supra* note 316, at 4.

340. *The KPMG Survey on Corporate Responsibility Reporting 2013*, *supra* note 338, at 10 ("CR reporting is the means by which a business can understand both its exposure to the risks of these [environmental and social] changes and its potential to profit from the new commercial opportunities.").

341. EY & GRI, *supra* note 316, at 7.

as a means of improving companies' responses to ESG issues. Allen White, co-founder of GRI, claims: "Sustainability reporting has gone from the extraordinary, to the ordinary, to the expected."[342]

Firms that assist companies with preparing financial statements now actively market their ability to assist with integrated reporting.[343] For example, the website of Ernst & Young (now EY) includes information on integrated reporting and sustainable reporting and states: "Integrated reporting has been created to better articulate the broader range of metrics that contribute to long-term value . . . ."[344] EY explains that in order to create sustainable value, organizations must be able to adapt to "challenges and opportunities in their environments" and must demonstrate the ability to manage their intangible assets effectively.[345] Thus, investors will benefit from the information provided, and companies will benefit because by engaging in sustainability reporting a company will be better able to develop "a sustainable strategy (that is, a coherent plan to balance long term viability—for the benefit of both shareholders and society—with demands for short term competitiveness and profitability.)"[346]

V. CAN THE FIDUCIARIES OF A UNIVERSITY ENDOWMENT USE ESG INVESTING?

This article has reported on substantial empirical findings that ESG factors, if properly included with conventional financial analysis as part of an overall investment policy, will not necessarily adversely affect fund performance and may improve returns on a risk-adjusted basis. With those results in mind, the article returns to the question of the fiduciary duties of those who manage university endowments. Can an endowment's investment policy include ESG investing as a strategy? To answer that question this section returns to the fiduciary duties of loyalty and care,

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342. *Id.* at 21. As founder of GRI Mr. White has reason to promote sustainability reporting, and as an accounting firm seeking new business, so does EY.

343. A report by GRI found that the number of U.S. firms publishing externally assured GRI-based GRI reports rose from 10% in 2011 to 16% in 2013. *Trends in External Assurance of Sustainability Reports*, GRI at 4–5 (July 2014), http://www.ga-institute.com/fileadmin/user_upload/Reports/GRI_Trends-in-External-Assurance-of-Sustainability-Reports_July-2014.pdf. Globally, 45% of GRI reports were externally assured in 2013. *Id.*

344. Integrated Reporting: Tips for Organizations, *supra* note 327. EY, in association with the Global Reporting Initiative, produced a report titled: *Sustainability Reporting – The Time is Now*, *supra* note 316 (assessing the status of sustainability reporting and concluding that it has moved into the mainstream).

345. *See id.*

346. KRZUS, BALLOU & HEITGER, *supra* note 315 at 1.

specifically considering the issue of whether using ESG factors in investing could somehow be considered a breach of either of those duties.

A. Duty of Loyalty

The fiduciaries of a university have a duty of loyalty to act in the best interests of the university. Similarly, the fiduciaries of a separately managed university endowment have a duty of loyalty to the endowment, and therefore to the university it supports. A comment to UPIA suggests that a trustee might breach the duty of loyalty by engaging in SRI or ESG investing. An analysis of that Comment in the context of the current understanding of SRI explains why fiduciaries should not be concerned about a potential breach of the duty of loyalty.

The Comment to UPIA states:

> No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.[347]

This Comment made sense in the context of 1992 when the Uniform Law Commission promulgated UPIA. At that time, SRI was in its early stages and attention had focused on South African divestment screens. Little empirical evidence existed about returns on SRI funds, and the assumption was that restrictions on diversification would lead to lower returns.[348] John Langbein, the Reporter for UPIA and therefore the author, with the Drafting Committee of UPIA, of the Comments, had co-authored an article arguing that SRI as practiced at the time could breach the duty of loyalty.[349]

The UPIA Comment should not be read to preclude SRI as practiced today. The Comment's concerns focus on "sacrificing the interests of trust beneficiaries . . . by accepting below-market returns." The studies described in this article[350] have shown that below-market returns are not an inevitable consequence of ESG investing or SRI more generally, as was thought at the time Professor Langbein wrote the Comment. Thus, neither the Comment nor the earlier article by Professors Langbein and Posner should be of concern to a fiduciary considering ESG investing.

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347. UNIF. PRUDENT INVESTOR ACT § 5 cmt. (1994).
348. *See supra* Part IV.A.
349. Langbein & Posner, *supra* note 10.
350. *See supra* Part IV.C.

B. Duty of Care – Prudent Investor Standard

SRI has evolved from the 1980s when the early SRI strategies relied on negative screens. Over the years, SRI funds adopted best-in-class strategies and more recently ESG integration—the consideration of environmental, social, and governance factors as part of an overall investment strategy. The use of material extra-financial factors has become part of mainstream investment analysis, because investment managers understand that extra-financial factors provide a great deal of useful information about a company's opportunities and risks, especially as a long-term investment.[351] A growing number of studies have shown that SRI funds perform as well as or better than non-SRI funds, and ESG factors have been shown to enable analysts to identify value that might not be reflected in conventional financial reports.[352] Demand for better and more easily digestible information has led to the development of new reporting frameworks and the SASB standards for sustainability information.[353] Companies have found financial benefits in developing sustainability strategies.[354]

The use of ESG factors in investment decision making is sufficiently widespread[355] that ESG integration can now be considered within the scope of what a prudent investor can do. Thus, a decision to incorporate ESG investing in an investment policy is consistent with a fiduciary's duty to be a prudent investor. As investment strategies evolve, prudent fiduciaries

351. *See* HARVARD MGMT. COMPANY, http://www.hmc.harvard.edu/investment-management/sustainable_investment.html ("Aligned with our mission to provide strong long-term investment results to Harvard University, we include material ESG criteria in our investment analysis and decision-making processes.").

352. *See supra* Part IV.C. *See also Studies of Socially Responsible Investing*, SRISTUDIES.ORG, www.sristudies.org (covering academic studies on SRI through 2010-11).

353. *See supra* Part IV.E.

354. A publication of EY's Climate Change and Sustainability Services division describes sustainability reporting as a "best practice" of companies worldwide, and notes that 95% of the Global 250 issue sustainability reports. The publication lists benefits of sustainability reporting, including improved access to capital, increased efficiency, and waste reduction. Sustainability reporting can, in the view of the EY article, "prepare firms to avoid or mitigate environmental and social risks that might have material financial impacts on their business while delivering better business, social, environmental and financial value. . ." Of course the EY paper is written to encourage companies to use its services for GRI reporting. *The Value of Sustainability Reporting*, ERNST & YOUNG LLP, http://www.ey.com/US/en/Services/Specialty-Services/Climate-Change-and-Sustainability-Services/Value-of-sustainability-reporting (last visited May 28, 2015).

355. *See* Eccles et al., *supra* note 222.

will review their investment policies and consider whether revisions to include ESG investing are appropriate, based on current information.

C. Guidance from Department of Labor

The fiduciaries who manage retirement plans governed by the Employer Retirement Income Security Act (ERISA) must act as prudent investors for the plans under fiduciary standards.[356] Guidance issued by the Department of Labor (DOL) in October 2015 confirms that fiduciaries can consider ESG factors without breaching their fiduciary duties.[357] The DOL issued the guidance in response to concerns expressed about ESG investing by pension plans,[358] and the new guidance should provide comfort to any fiduciary worried about whether a prudent investor can engage in ESG investing strategies.

In 1994, the DOL issued Interpretive Bulletin 94-1 to clarify that the fiduciary of a retirement plan could consider collateral economic or social benefits of investments in making decisions for the plan, so long as the financial returns of the investments were comparable to the expected returns of other investments available to the plan.[359] This and subsequent guidance also emphasized that the economic interests of plan participants always take priority over policy interests.[360] Plan assets cannot be used "to promote social, environmental, or other public policy causes at the expense of the financial interests of the plan's participants and beneficiaries"[361] and fiduciaries cannot accept lower returns in order to promote policy interests.[362]

In 2008, the Department of Labor issued Interpretive Bulletin 2008-1, replacing IB 94-1.[363] The new bulletin said it did not change the basic legal principles of the earlier bulletin, but it stated that consideration of "collateral, non-economic factors" should be rare and well documented.[364]

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356. 29 U.S.C. § 1104(a)(1)(B) (2012) (restating the prudent person rule).

357. U.S. Dep't of Labor, I.B. 2015-1. After listing various terms associated with investing for extra-financial purposes, including SRI and ESG investing, the 2015 guidance explains that it will use the term economically targeted investments (ETIs).

358. *Id.*

359. I.B. 1994-1, 59 FR 32606 (Jun. 23, 1994). The 2015 Bulletin explains that I.B. 1994-1 was issued "to correct a popular misperception at the time that investments in ETIs are incompatible with ERISA's fiduciary obligations." I.B. 2015-1.

360. I.B. 2015-1.

361. *Id.*

362. *Id.*

363. I.B. 2008-1, 73 Fed. Reg. 61,734 (Oct. 17, 2008) (codified at 29 C.F.R. § 2509.08-01 (2016)).

364. *Id*.

This statement led to concern that fiduciaries could not consider ESG factors, even if they improved financial returns.[365]

To address the confusion caused by IB 2008-1, the DOL has removed it and reinstated IB 94-1. The new guidance explains:

> Environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices.[366]

The new guidance reflects the growing understanding of the role of ESG factors in an integrated investment strategy. Indeed, the guidance notes, "fiduciaries should appropriately consider factors that potentially influence risk and return."[367] Rather than discouraging consideration of ESG factors, the DOL wants to make clear that fiduciaries *should* consider these factors, when appropriate. The new guidance should reassure all fiduciaries, including those who serve university endowments.

D. Conclusion

In 2015 the Supreme Court confirmed that "a trustee has a continuing duty—separate and apart from the duty to exercise prudence in selecting investments at the outset—to monitor, and remove imprudent, trust investments."[368] The case reminds fiduciaries of university endowments to review and reconsider their investment policies periodically.[369] As they do so, fiduciaries must comply with the prudent investor standard and the duty of loyalty and must act with care and prudence on behalf of the endowments.

In a complex, constantly changing world having as much information as possible about risks and opportunities in investments should contribute to better investment performance. The DOL Bulletin reflects this view, suggesting that adding extra-financial factors to a robust financial analysis may reduce risks and improve financial results. The financial institutions described in Part IV.D have reached this conclusion as well.

As this article has explained, the prudent investor standard has evolved to include consideration of ESG factors. ESG investing cannot be

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365. I.B. 2015-1.
366. *Id*.
367. *Id.*
368. Tibble v. Edison Int'l, 135 S Ct. 1823 (2015).
369. *See* Jay Youngdahl, *US Supreme Court Clears Way for Actions Against Fiduciaries Who Do Not Monitor Their Investments*, RESPONSIBLE-INVESTOR.COM (June 8, 2015), https://www.responsible-investor.com/home/article/youngdahl_tibble/.

considered a breach of the duties of loyalty or care, so long as the factors are considered as part of an overall investment strategy with appropriate levels of risk and return. Thus, a fiduciary following the prudent investor standard can permit and encourage the use of ESG factors in investment decision making.[370]

370. The Freshfields report concluded that, in the U.S. context, "there appears to be a consensus that, so long as ESG considerations are assessed within the context of a prudent investment plan, ESG considerations can (and, where they affect estimates of value, risk and return, should) form part of the investment decision-making process." ASSET MANAGEMENT WORKING GROUP OF THE UNEP FINANCE INITIATIVE, *A Legal Framework for the Integration of Environmental, Social, and Governance Issues into Institutional Investment* 114 (2005). Germany requires the use of these criteria as part of the managers' fiduciary duty. *Global CSR Disclosure Requirements*, INITIATIVE FOR RESPONSIBLE INVESTMENT, http://hausercenter.org/iri/about/global-csr-disclosure-requirements (last visited May 25, 2015).