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# Changing the Rules of the Game:

# Can Voicing for Social Responsibility Influence Market Behavior Toward Greater Inclusiveness in Economic Development?

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A Thesis

Presented to

the Faculty of Arts, Humanities and Social Sciences

University of Denver

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In Partial Fulfillment

of the Requirements for the Degree

Master of Arts

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by

Eileen M. Hoffmann

November 2019

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Title: Changing the Rules of the Game: Can Voicing for Social Responsibility Influence Market Behavior Toward Greater Inclusiveness in Economic Development?
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Degree Date: November 2019

**Abstract**

This thesis examines social responsibility within a capitalist economy by investigating socially responsible investing and, tangentially, corporate social responsibility. These concepts have been at the heart of economic and legal debates for hundreds of years, with no clearly defined consensus regarding how to account for multi-stakeholder welfare inside the market system. This point is brought to life by analyzing two dominant twentieth-century economic periods, 1945-1975/79 and post-1980, through the deliberations of Keynesian economics and Milton Friedman.

This thesis postulates that since the 2008 global financial crisis, a new (i.e. third) economic period is taking shape, ushered in by both the ill-effects of late twentieth-century policies and changing societal norms regarding for what and to whom a capitalist economy can and should be responsible. By utilizing the concept of 'voice,' as developed in the writings of economist Albert O. Hirschman, greater inclusiveness in economic development is being considered inside the market system through suggested qualitative parameters beyond the current quantitative measurement criteria of GDP. This thesis thus claims that the rules of the game are changing, with shareholders having both economic and legal precedent to influence, through voice, market behavior toward multi-stakeholder concerns.

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# 1. Introduction: A Case for Change

## *1.1 Corporate Social Responsibility (CSR)*

Corporate behavior has been allowed to go unchecked, particularly since the 1980s, with unconstrained free market principles dominating economic and legal theory and policies. What has emerged are highly uneven forms of growth worldwide, sharpened class divides, and mounting ecological crises. These problems permeate the brand of capitalism that the United States has adopted, and they hinder the progress of truly unprejudiced globalization. Worldwide leaders, pursuing such a narrow mission of economic growth, as measured within the quantitative parameters of GDP, without equal influence of any countervailing objective, have allowed for deregulated corporate activities to become a de facto controller of contemporary life. While, in that process, numerous social norms, morals, and obligations to humanity - and the planet that humanity inhabits - have been relinquished.

Many have argued, as Milton Friedman[1] did, that to expect a corporation to be accountable for any responsibility other than legally making money is simply not feasible, as someone ultimately pays the price for its socially responsible actions.

[1] In a seminal article, published in *The New York Times Magazine*, Friedman wrote that the doctrine of social responsibility was fundamentally subversive in a free society, stating that “there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud” (Friedman 1962, 1970).

Perhaps corporate altruism is impossible. There exists throughout history a tension philosophically between economic and social good. But that tension also requires the economic ecosystem to work harder to unite these two seemingly incompatible interests. This notion is particularly relevant given that the list of corporate malfeasances keeps growing longer the more that time passes since the embrace of a free market economic model across much of the globe.

For instance, in just the first two decades of the twenty-first century, there have been large-scale multinational corporate scandals, spanning numerous industries, resulting from deregulation and a lack of corporate oversight that have allowed unethical behavior or negligence to go unchecked until substantial economic, environmental, and social damage ensued. A few notable examples of corporate malfeasance include; (i.) Enron Corporation's accounting fraud of its energy business in 2001, leading to thousands of employee layoffs, its share price falling from over $90 to under a dollar, and the company filing Chapter 11 bankruptcy (this also led to Arthur Anderson surrendering its CPA license)[2]. (ii.) The 2010 British Petroleum (BP) Deepwater Horizon oil rig explosion in the Gulf of Mexico, causing four million barrels of oil to spill into the ocean - the worst accidental oil spill of all time – costing the lives of 11 people and devastating the local ecosystem, marine, and wildlife. BP reported approximately $44 billion in costs toward clean-up and compensation to localities, its share price was cut in half, and dividend payments were suspended[3]. (iii.) Volkswagen's emissions scandal in 2015 whereby the company was fitting cars with false emissions controls in order to

[2] (Thomas, 2002).

[3] (Bomey, 2016; EPA).

underestimate – by up to 40 times the allowable limit - the level of nitrogen dioxide its cars were emitting, effecting up to eleven million cars, costing approximately $30 billion in remedies, and resulting in the company's share price falling by a third[4]. (iv.) Valeant Pharmaceuticals drug price scandal in 2015 which included excessive drug price increases to consumers, lack of investment in research and development, and order book size inflation – all to report higher profits. Valeant's share price fell by more than 80 percent and the company changed its name to Bausch Health Companies[5]. (v.) Facebook's 2018 scandal surrounding the harvesting of tens of millions of users' data by Cambridge Analytica, a massive breach of consumer privacy. Facebook's CEO has been called to testify in front of the U.S. Congress on more than one occasion, the company has been fined billions of dollars by the Federal Trade Commission (FTC) and by European regulators, and it continues to face growing criticism surrounding user privacy concerns and irresponsible, if not unethical, business tactics.

Last, but certainly not least, the global financial crisis of 2008, a decisive, free-market breakdown instigated by a failure on the part of market participants to identify the systemic liquidity risk of opaque financial instruments, resulting in the collapse of both Bear Stearns and Lehman Brothers, two of the oldest investment banking firms in the United States. The negative spillover effects of the global financial crisis resulted in an

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[4] (Hotten, 2015).

[5] (Gandel, 2015).

estimated $5.4 trillion decline in the market value of global pension funds (OECD, October 2009)[6].

Understanding the linkages between unlimited free markets, deregulation, and corporate irresponsibility is important because often times the same behaviors that are not only allowed but encouraged within the current capitalist system, and that lead to malfeasance in extreme cases, also cause mounting externalities, which are spillover effects that impact third parties as a consequence of a firm's economic activity, in the course of legal business activity. To this end, since the 1980s, corporations have largely been legally free to pursue profit maximization without regard to external factors such as natural capital preservation nor equality in the development of social capital. Moreover, deregulation has allowed many multinational corporations to side-step proper taxation, antitrust issues, and consumer privacy concerns.

Davis (1973) thus argues that corporate social responsibility starts where the law ends. A firm is not being socially responsible if it simply follows the requirements of the law, because that is what any good citizen would do. A profit maximizing firm under the rules of classical economics would do as much. Social responsibility goes further and accepts social obligations beyond the bare requirements of the law (Davis, 1973, p. 313). Viewed in this light, Friedman's theory on social responsibility can be critiqued as only identifying corporate behavior within its legal and economic legitimacy and not in the realm of social obligation (Sethi, 1979, p. 65).

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[6] Systemic market risk that has developed within the global pension fund system is addressed in detail in Chapter 3.

Yet, norms in a social system often emerge out of voluntary consensus regarding what is socially acceptable behavior. Legislation tends to follow, not lead, the voluntary recasting of societal expectations. As such, Sethi (1975, 1978) defines social responsibility as bringing corporate behavior up to a level compatible with prevailing social norms, values, and expectations. This definition contemporaneously includes a firm's obligation to respond to externalities created by market action. Building on this notion, there is considerable consensus that nearly all stakeholders, including shareholders, are oriented toward corporations that are not just profitable but have social strategies that make positive contributions toward addressing externalities, such as wealth inequality and environmental protections, by considering such issues in corporate objectives (Husted & Allen, 2011). The framework of corporate social responsibility throughout this thesis follows the definition of Davis (1973) such that a corporation has an "obligation to evaluate in its decision-making process the effects of its decisions on the external social system in a manner that will accomplish social benefits along with the traditional economic gains which the firm seeks" (p. 312).

### *1.2 Global Externalities*

#### *1.2.i Environmental Externalities*

According to the United Nations Environment Programme - Finance Initiative (UNEP FI), the value of global annual environmental external costs is high and increasing. Based on research compiled from the UNEP FI, the costs of externalities such as greenhouse gas (GHG) emissions, over-use of water, pollution, and unsustainable resource use amounted to $6.6 trillion in 2008, representing eleven percent of global

GDP. Approximately one third of this total, or $2.2 trillion, was attributable to the largest 3,000 public companies (Stern Review on the Economics of Climate Change, 2006; Intergovernmental Panel on Climate Change Scenario A2, 2007). The costs of addressing the accumulating effects of these externalities will rise if business continues as usual. Under a scenario of low per capita economic growth, rising population levels, and gradual technological advancement, the value of annual environmental externalities is estimated to reach $28.6 trillion in 2050, or eighteen percent of global GDP, mainly from a projected increase in GHG emissions from $4.5 trillion in 2008 to $21 trillion in 2050, as outlined in Figure 1 below.

| Environmental impact | *External costs in 2008 (US$ billions)* | *External cost relative to global GDP in 2008* | *Projected external costs in 2050 (US$ billions)* | *Projected external cost relative to global GDP in 2050* |
|---|---|---|---|---|
| Greenhouse gas (GHG) emissions | 4,530 | 7.54% | 20,809 | 12.93% |
| Water abstraction | 1,226 | 2.04% | 4,702 | 2.92% |
| Pollution (SOx, NOx, PM, VOCs, mercury) | 546 | 0.91% | 1,926 | 1.20% |
| General waste* | 197 | 0.33% | 635 | 0.39% |
| Natural resources | | | | |
| *Fish* | 54 | 0.09% | 287 | 0.18% |
| *Timber* | 42 | 0.07% | 256 | 0.16% |
| Other ecosystem services, pollutants and waste | Not available (NA) | NA | NA | NA |
| **Total** | **6,596** | **10.97%** | **28,615** | **17.78%** |

*The estimate for general waste only includes data on OECD countries, as there is no consensus on global waste figures.

Figure 1: Annual Environmental Costs for the Global Economy in 2008 and Projections for 2050. Source: UNEP FI, 2011.

Figure 1 demonstrates that the current global economic system is generating environmentally damaging outputs that are depleting and jeopardizing the earth's ecological foundations upon which future generations depend. Infinite growth on a finite

planet is impossible (Hahnel, 2011). While this fact has been acknowledged in economic history, it has not been tested in practice until the past half century. Accordingly, it is widely understood that the current trajectory of global economic growth does not properly accommodate for the external environmental damages it creates.

*1.2.ii Wealth Inequality*

Based on data compiled by The World Bank, increases in global wealth over the past several decades have been unevenly divided, with low-income countries accounting for less than one percent of global wealth in 2014 (Figure 2), a figure that matched their share of wealth in 1995. Yet, the global population share of low-income countries grew from six percent to eight percent over that same time period, resulting in an expanding gap in the ratio of wealth per capita between high-income OECD and low-income countries to 52:1 from 47:1 in 2014 as compared to 1995, respectively.

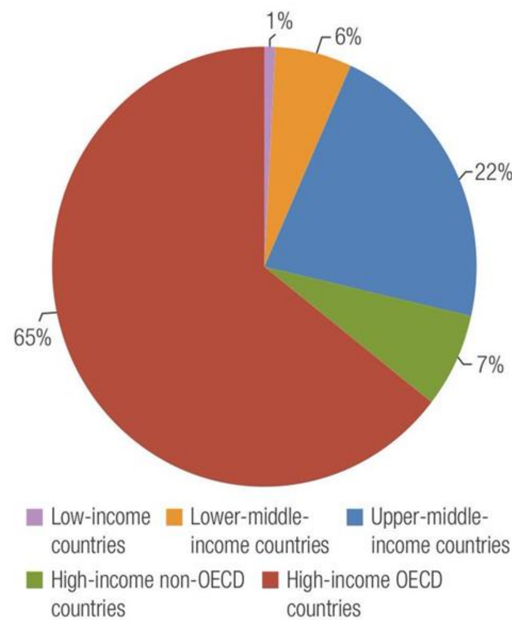


Figure 2: Distribution of Global Wealth by Income Group, 2014.
Source: The World Bank.

The World Bank highlights that nearly two-thirds of countries that have remained as low-income since 1995 are classified as resource rich (i.e. rich in fossil fuel energy and minerals that are considered nonrenewable), or fragile and conflict states, or both. As such, The World Bank advises that strong institutions and good governance are needed in these countries to ensure that the national income generated from nonrenewable resources (or "rent" as it is often referred given that extraction of nonrenewable resources is finite and, thus, temporary) is re-invested in a broader range of developmental projects in order to reduce fossil-fuel dependency in low-income countries. Multinational corporations can provide necessary investment to help accomplish this task (World Bank Group, 2018) and, simultaneously, address a key financing need of the UN 2030 Sustainable Agenda.

Figure 3 highlights that there have been diverging income trajectories within developed nations as well since the 1980s, particularly in the U.S., with the national income share of the top one percent doubling since this time period while the share of the bottom 50 percent has decreased steadily.

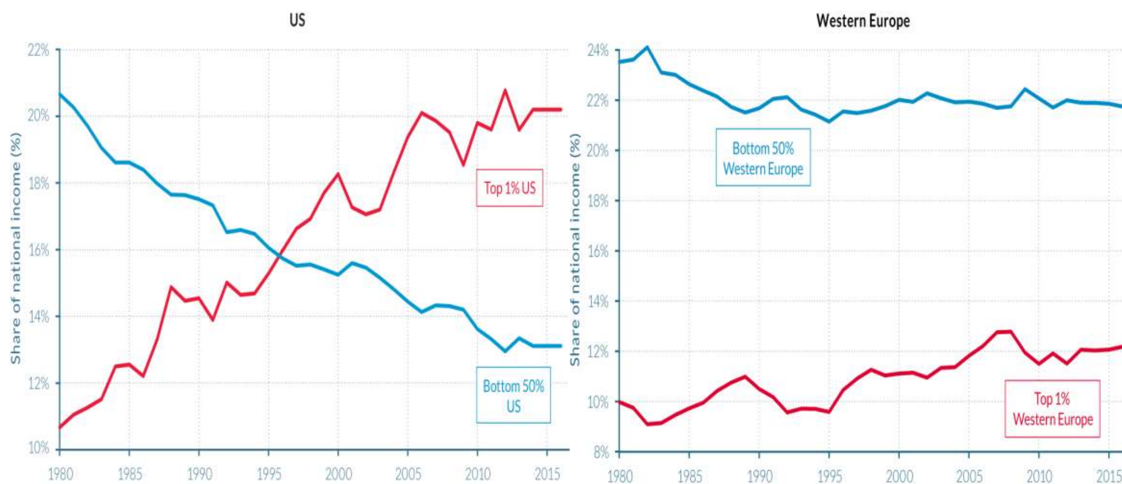


Figure 3: Top 1% versus Bottom 50% National Income Shares, U.S. and Western Europe, 1980-2016. Source: World Inequality Report 2018.WID.world.

Figures 1-3 help to quantify the global inequities in wealth and lack of environmental protections that are externalities of global concern which should be considered within corporate activities. Because of such externalities, leaders of the socially responsible investing movement, such as Lydenberg (2002)[7], argue that there is a need for the economic system to move from its current model toward one where real structural reform happens and economic solutions to environmental and social problems are provided. Hence, this thesis posits that society is at a pivotal juncture where many of the economic and legal policies that were established in the late twentieth-century must be reconsidered, and corporate activity must incorporate the totality of its external impacts so that its business objectives can facilitate greater inclusiveness in economic development.

### *1.3 Socially Responsible Investing (SRI)*

Who can be the arbiter of change? Socially responsible investing is a broad field that is not exclusively connected with corporate social responsibility nor is it strictly an implementation of corporate social responsibility (Kurtz, 2008). This said, Kurtz (2008) indicates that all social investors do include in their investment decision processes some combination of ethical, religious, social and/or environmental concerns, over and above consideration of financial risk and return (p. 250). Moreover, socially responsible investing includes broad-based efforts to establish standards for corporate behavior and,

[7] Lydenberg is a co-founder of KLD Research & Analytics, Inc., a leading authority on social research for institutional investors, and also co-founded the first SRI index, the Domini 400 Social Index. Lydenberg has worked with the Council on Economic Priorities as director of corporate accountability research and is the author of relevant CSR/SRI books such as *Corporations and the Public Interest* (Berrett-Koehler, 2005), and *Investing for Good* (Harper Collins, 1993).

in turn, to evaluate corporations against these standards (Kuhn & Deetz, 2008). These efforts include those of both the United Nations and of non-financial reporting organizations, discussed at length in chapter four of this thesis.

Establishing standards of corporate behavior under non-financial categories such as social, environmental, and governance (ESG) concerns is often viewed as a way for shareholders to exert greater ownership influence by utilizing their right to vote (or refusing to vote) their proxies on these such issues at annual corporate shareholder meetings. Thus, Kuhn et al. (2008) note that the integration of non-financial criteria by socially responsible investors is often viewed as a form of shareholder activism. Socially responsible investors appreciate the interrelation between non-financial ESG metrics, or externalities, and long-term economic development. Importantly, SRI adheres to the realization that shareholders represent just one constituent within the vast number of stakeholders that corporations are reliant upon to successfully execute a business strategy. This realization inherently links the interests of shareholders to the long-term maximization of stakeholder, rather than shareholder, value.

This reasoning is particularly relevant in light of the concept of 'universal ownership.' The universal ownership argument puts forward that because large institutional investors (whether professing to be socially responsible or not) hold such a diverse and broad cross section of industries and corporate activities within an investment portfolio, they can be said to be invested in the universe, or the economy, as a whole. Therefore, even though one firm may externalize costs, these same costs are likely being internalized by another firm either owned within the same portfolio or within an

institutional investor's broader holdings. This dynamic leads to a misallocation of idiosyncratic, or stock-specific, risk in portfolio construction.

Therefore, as universal owners, the externalities that corporate business practices inflict onto third parties cause their investment portfolios, in aggregate, to have internalized externalities that are not properly accounted for. These unaccounted-for externalities create inconsistencies in the process of estimating a portfolio's risk and return profile under the normative method of portfolio construction, that of modern portfolio theory (discussed in chapter three), as investors cannot effectively diversify away idiosyncratic risk. Instead, higher stock-level correlations and greater systematic risk, or volatility, are now inherent within most institutionally managed portfolios.

Deregulation and global integration of multinational corporations has also led to concentrated economic power such that industry-sector effects have replaced country-specific effects in explaining global stock returns (Baca, Garbe, & Weiss, 2019). These factors have led to elevated levels of systemic risk in the global market system associated with corporate activities. Hence, Hawley and Williams (2000) contend that there is an economic interest of a universal owner to voice for greater transparency and proper allocation of a corporation's all-in costs and to advocate for the minimization of global negative externalities (such as environmental damage) and the maximization of global positive externalities (such as wealth equality) across all industry sectors.

These contexts suggest that institutional investors do play an important authoritative role over corporate accountability, particularly as it relates to engagement with corporate officers and to the rights of shareholders to vote and to elect boards of directors. Additionally, institutional investors have an outsized influence on the market

value of corporate shares. For example, in the aforementioned cases of corporate scandals, institutional investors sold these stocks and the market value of these securities declined often well before either the law or the government could indict corporate wrongdoers. Thus, financial markets can and do exact a form of justice on corporate irresponsibility, but this type of justice does not necessarily change corporate behavior. Therefore, this thesis draws on the idea of 'voice,' as developed by economist Albert Hirschman[8], whereby socially responsible investors voice their desires for broader consideration of stakeholder value within the investment decision-making process.

*1.3.i Debunking Shareholder Primacy in Favor of Stakeholder Theory*

Berle and Means (1932) famously set out two contradictory lines of thought with regard to whom the public corporation served (Bratton, 2019). The first line of thought resonated comfortably with the shareholder-centered corporate legal theory of shareholder primacy (Bratton, 2019, p. 2), which Friedman espoused and has subsequently dominated the capitalist economic system since the 1980s[9]. Shareholder

[8] "There are two main types of activist reactions to discontent with organizations to which one belongs or with which one does business: either to *voice* one's complaints, while continuing as a member or customer [shareholder], in the hope of improving matters; or to *exit* from the organization, to take one's business elsewhere [sell the stock]." (Hirschman, 1978, p. 90). Hirschman's concept of exit, voice, and loyalty is discussed in further detail in Section 1.4.

[9] Shareholder primacy law originated in the 1911 case, *Dodge v. Ford Motor Co*. The Michigan Supreme Court rejected Henry Ford's desire to sacrifice profits to the benefit of employees and consumers and ruled, "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end" (Millon, 1991, p. 230). Shareholder primacy was curtailed in the aftermath of the 1929 stock market crash, with the Securities Act of 1933 and Securities Exchange Act of 1934 requiring federal disclosure by corporations to demonstrate "ultimate fairness" in their actions, and state and federal law significantly restricted corporate self-dealing. It re-emerged after the 1973-1974 bear market, during which the DJIA lost nearly half its value. This event gave academics and economists, such as Friedman, a receptive audience for the renewed view that separation of ownership and control was a moral hazard that caused agency costs (i.e. management's wasteful spending or even pillaging from the firm to their own benefit), restrained if management's duty was to serve shareholders (Stout, 2013, pp. 1172-1176).

primacy teaches that, in the wake of separation of ownership and control, the efforts of officers and directors (i.e. agents) should be directed toward working on behalf of the shareholders (i.e. principals) who voted these directors into their roles and who's capital corporate officers managed. This principal-agent relationship was thought to be a straightforward and effective way in which to curb corporate power, or potentially unaccountable and self-serving behavior of corporate managers, also called moral hazard[10]. It was reasoned that moral hazard could be suppressed if managers were accountable to shareholders for their actions, as their actions could be easily quantified and measured in terms of corporate profitability.

Berle and Means' (1932) second line of thought resonated well with stakeholder theory, which views the separation of ownership and control as an implicit responsibility to the public[11]. This view was favorable given that public corporations were (and still are) owned by thousands of shareholders, none of whom own more than a fraction of corporate shares outstanding and many of whom are passive owners (Stout, 2013).

Under this backdrop, stakeholder theory is increasingly justifiable today given that large institutional investors collectively own 73 percent of stock issued by Fortune 1,000 companies, yet these corporate shares are owned or managed within diversified investment vehicles across a multitude of asset classes, industry sectors, and geographies,

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[10] Friedman's concern with moral hazard is discussed further in Section 2.3.i.b.

[11] "Neither the claims of ownership nor those of control can stand against the paramount interests of the community…It is conceivable – indeed it seems almost essential if the corporate system is to survive – that the 'control' of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity" (Berle & Means, 1932, p. 64).

with passively managed index funds owning more than one fifth of this total[12]. In aggregate, the business activities of Fortune 1,000 companies account for over two-thirds of U.S. GDP (Fortune, 2019). This universal and passive ownership structure of such a large percentage of U.S. GDP lends further support to the stakeholder theory approach as outlined in Berle and Means' (1932) second line of reasoning.

Furthermore, the aforementioned cases of corporate malfeasance provide evidence that this dispersed free-market ownership of corporate shares has not alleviated management moral hazard concern (Bratton, 2019, p. 7). Instead, the return of shareholder primacy in the mid-late 1970s led to changes in compensation law that encourage corporate officers and directors to adopt short-term profit-enhancing strategies to maintain a high share price[13], even going so far as engaging in fraud (Stout, 2013, p. 1180). Moreover, Stout (2013) argues that shareholder primacy has favored speculative investment strategies such as hedge funds (which are largely unregulated) as well as corporate takeover specialists. These investors are not shareholders, but activists who pressure boards of directors to make business decisions that are often harmful to other stakeholders, such as requiring employee lay-offs, pay cuts, expense cutting, selling assets, and taking on debt – all under the guise of unlocking shareholder value. Despite this focus on share price performance, market returns in the post-1980 economic period

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[12] (Bebchuk & Hirst, 2019). The index sector is dominated by three U.S.-based index fund managers, Blackrock, State Street Global Advisors, and Vanguard. This statistic refers to these three behemoths.

[13] Congress amended the tax code in 1993 to require that top executives' pay at public corporations be tied to objective performance metrics in order to be a deductible expense. Shareholder primacy suggested the obvious metric should be stock price, thus the concepts of equity-based compensation and pay-for-performance, nonexistent prior to the 1980s, were developed. These developments resulted in CEO pay to average employee pay rising from 140:1 in 1991 to 500:1 in 2003 (Stout, 2013, p. 1176).

trailed the previous economic period[14]. Thus, an argument can be made that shareholder primacy has come at the expense of not just external stakeholders but also millions of individual investors whose retirement and other savings are entrusted to pension and retirement benefit funds and other asset managers whose attempt to manage assets with a long-term view has been significantly challenged.

Pension funds, in particular, hold the largest ownership position in Fortune 1,000 companies at 30 percent. Additionally, across all OECD countries, the average ratio of pension assets to GDP was 67 percent in 2010 (Hawley, Johnson, & Waitzer, 2011)[15]. These statistics highlight the critical role of pension funds as universal asset owners, who act as trustees to not only ensure current pension fund payments but also to ensure the sustainability of the pension system itself, which requires an adherence to long-term responsible investment practices (Sievanen, Sumelius, Islam, & Sell, 2012). Moreover, the fiduciary duty of most institutional investors, and in particular trustees of pension and employee benefit funds, requires them to act with prudence and loyalty when making investment decisions such that they consistently attend to both the short-and-long-term interests of their clients and beneficiaries, respectively. In doing so, Lydenberg (2007) maintains that trustees and other fiduciaries have a duty to invest in assets that assure an opportunity for a high quality of life, both from a financial return and a social return

[14] The annual return for the DJIA (trough to trough) between the 1932 bottom of the Great Depression and the 1973-1974 bear market was 6.4% while the annual return from 1973-1974 to the 2008-2009 global financial crisis was 5.0% (https://www.macrotrends.net/1319/dow-jones-100-year-historical-chart).

[15] In countries such as the Netherlands, Switzerland, and Iceland, total pension assets exceed national GDP, whereas in the United Kingdom and Australia, the ratio is in excess of 80 percent. In the U.S., total retirement assets were $16 trillion in 2009 (state and federal pension plans accounted for $6.2 trillion), representing over 110 percent of GDP, with mutual funds managing $4.1 trillion, or 25 percent of the total (Brady, Holden, & Short, May 2010).

perspective.  This thesis asserts that this duty includes an implicit recognition of the universal owner argument and the ill-effects caused by the excessive profit-orientation of shareholder primacy.

The third chapter of this thesis is dedicated to the rules of the game of asset management, such as fiduciary duty, the prudent man rule, and modern portfolio theory. These aspects of investing transcend both SRI and CSR.  As way of introduction, stakeholder theorists argue that changes in trust law, which occurred in the 1990s and considerably relaxed the rules governing investment practices, have exposed beneficiaries to inappropriate levels of liquidity and systemic market risk.  These regulatory changes help to explain the large losses experienced by global pension funds during the 2008 global financial crisis, as outlined previously.

*1.3.i.a  Pros and Cons of the Stakeholder v. Shareholder Theory Debate*

Socially responsible investing proposes a solution to instances wherein the social welfare theorem of modern economic theory does not hold; that is, when the profit-maximizing behavior of corporations does not necessarily imply social-welfare maximizing outcomes (Renneboog, Horst, & Zhang, 2008).  Renneboog et al. (2008) suggest that SRI supports stakeholder theory such that sound social and environmental corporate behavior and good corporate governance are criteria for investment in addition to profit maximization.  To this end, business investment is not expected to continue until its marginal return exceeds its cost of capital, but rather up until aggregate societal welfare is maximized (p. 1730).

However, Jenson (2001) contends that stakeholder theory increases agency costs and weakens the internal control systems of firms, since social performance measures are subjective. Critics also point out that in a competitive market, if a corporation pursues social and environmental goals at the expense of profits, it may not survive. Stakeholder theory also does not delineate how to distribute welfare equitably between multi-stakeholders (Renneboog et al., 2008).

Shareholder theory advises that because shareholders are the suppliers of capital and accept residual financial risk with no contractual guarantee of a fixed payment from a firm's activities, shareholders should receive the residual profits (Reinhardt, Stavins, & Vietor, 2008). Reinhardt et al. (2008) further reason that if businesses internalize externalities, they will produce less output at higher costs and higher prices which will, in turn, negatively impact not only financial returns to shareholders but also the real economy and employment. A counter to these arguments is found in the idea that because shareholder value is measured in the form of maximizing future residual cash flows it can only, by very definition of the term residual, be considered as a control variable for other goals and purposes of the firm and cannot mean that it is the first principle nor the first purpose of the firm (Koslowski, 2000, p. 138).

### *1.3.ii Mainstreaming of Socially Responsible Investing*

As illustrated in the preceding section, the debate over stakeholder v. shareholder theory is contentious and represents a hurdle to wider adoption of social responsibility inside a capitalist market system. Nonetheless, despite this ongoing debate, the fact remains that the SRI approach is gaining traction. For instance, from a high-level, the

United Nations Principles for Responsible Investment (UN PRI), discussed in chapter four, has been adopted by 2,300-plus investor signatories representing approximately $60 trillion of institutionally managed assets globally (PRI , 2019). More specifically, in the U.S., Morningstar (2018) reported that new capital flows into sustainable investment funds totaled $6.4 billion in 2017, up 10% from $5.8 billion in 2016, expanding the total assets managed under sustainable investment mandates to $100 billion. Furthermore, the formation of new U.S.-based socially responsible investment funds rose to over one-hundred annually in each year between 2015-2017, up from only fifteen funds launched annually during the 1970-1990 time-frame. According to The Forum for Sustainable and Responsible Investment (US SIF), there were 1,002 socially responsible investment funds operating in the United States at the end of 2016, versus just 55 in 1995 (Figure 4).

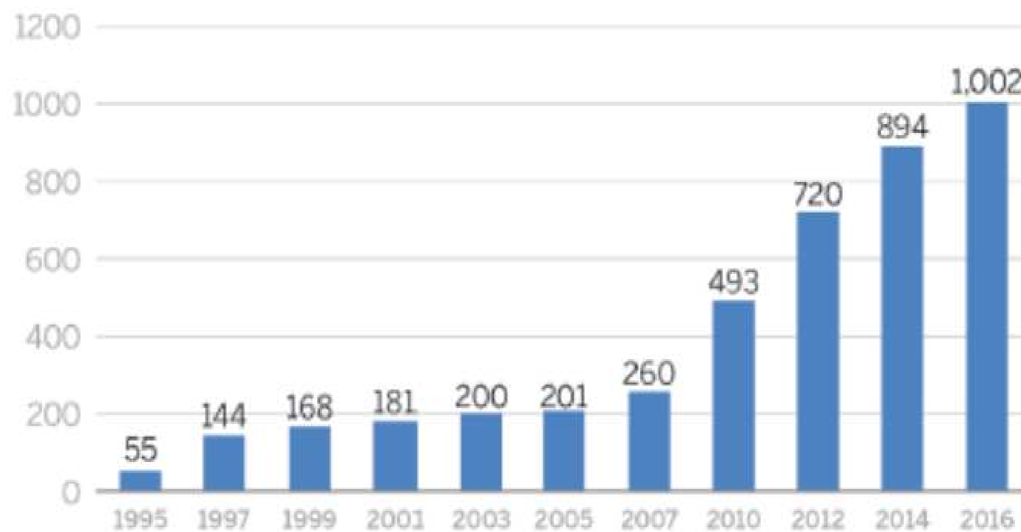


Figure 4: Growth of Socially Responsible Investment Funds in the U.S.
Source: The Forum for Sustainable and Responsible Investment.

This recent mainstreaming of socially responsible investing implies that there can perhaps be a voluntary, free-market mechanism through which social change can be

organized to achieve desired results. Conventional asset managers and their leaders have recently embraced societal concerns regarding sustainability and have become vocal supporters for some form of broader accountability for natural and social well-being within investment objectives.

For instance, Larry Fink - Chairman and CEO of $6 trillion BlackRock, the world's largest investment firm – asked in his 2019 annual letter to CEOs, *Purpose & Profit*, for these individuals to address social and economic issues and to not equate purpose with "the sole pursuit of profits but with the animating force for achieving them." Fink (2019) articulated his view that purpose and profits are inextricably linked, with this linkage growing in strength as "the public holds companies to more exacting standards." Ray Dalio - Co-Chairman and Co-Chief Investment Officer of $150 billion Bridgewater Associates, one of the world's largest hedge funds – penned an online memo in April 2019, *Why and How Capitalism Needs to be Reformed*. In this memo, Dalio (2019) supported the capitalist economic system but accepted that it has created polarizing social injustices to such an extent that the system cannot continue to remain passively indifferent. Dalio's proposed reforms included: (1) creating private-public partnerships between corporations, governments, and philanthropists that would jointly evaluate and invest in development and technological projects based on both social and economic criteria, with clear performance objectives to monitor results, and; (2) improving the measurability of all-in costs of corporate productivity. These proposals mirror the mission of the UN 2030 Sustainable Agenda.

Importantly, and possibly most relevantly, socially responsible investing is an ideal that resonates with both the Millennial generation and Generation Z. This is

important because the largest generational wealth transfer in U.S. history is approaching, with baby boomers estimated to pass down $30-plus trillion in assets over the next several decades (Accenture, 2016). Moreover, Accenture (2013) forecasts that Millennials, who have proven to be highly engaged social activists, will soon represent an estimated one trillion in annual spending, while Generation Z are true digital natives who have a worldview that is both environmentally and inclusively based.

Lydenberg (2007) proposes that these generations do not base the societal value of a corporation solely on its stock price. This simplified connection is not only a narrow expression of corporate value but a precarious one, as the aforementioned string of corporate scandals, triggered by the pursuit of profit maximization, has shown. Socially responsible investing and the universal ownership argument provide these younger generations with a more robust means of assessing the range of values that a contemporary corporation generates for society (Lydenberg, 2007, p. 476).

### *1.4 A Proposed Option - Albert O. Hirschman: Exit, Voice & Loyalty*

Albert Hirschman was a notable development economist. His book, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States* (1970), outlined a contention with the way that the field of economics placed such virtue on competition, which he correlated with exit, while disregarding the possible contributions of voice. Moreover, Hirschman discussed the unfortunate notion that competition was considered a more efficient process than one that allowed for the redress of grievances – particularly given the unequal ability of certain income and class levels to exercise their right to exit in undesirable situations.

Because of these concerns, Hirschman contended that economic reasoning was often incomplete and in certain instances there was a need to address the failure of some actors to live up to the behavior that society required of them. He applied this critique of incomplete economic reasoning to that of the typical way in which shareholders react to poor corporate behavior, as Hirschman (1970) wrote:

> The relation between corporate management and stockholders is a case in point. When the management of a corporation deteriorates, the first reaction of the best-informed stockholders is to look around for the stock of better-managed companies. In thus orienting themselves toward exit, rather than toward voice, investors are said to follow the Wall Street rule that "if you do not like the management you should sell your stock."…this rule "results in perpetuating bad management and bad policies" (p. 46).

As Hirschman stated, a common method to address corporate misconduct is indeed exit and a typical response by investors who are dissatisfied with corporate activity of any kind - financial, managerial, social, environmental, or governance related. Shareholders sell stocks all the time, but it is an option that neglects any opportunity to effect change within an organization for the better. Exit also is not always possible, and it eliminates a shareholder's right to vote on important issues and to elect boards of directors. Voice is another option, supported by loyalty, and accomplished through the rational engagement, assessment, and expectation that a corporation can and will adjust its business objectives to better serve multi-stakeholder welfare.

### *1.5 Thesis Claim*

The socially responsible investing movement is a global voice of shareholders expressing a desire for market participants to consider long-term sustainable economic

development in the investment decision-making process. This thesis claims that shareholders who endeavor, through voice, to influence market behavior toward a viable model for the future where economic development is achieved without compromising sustainability of the environment nor producing unfair wealth inequalities in societies, have both economic and legal precedent to do so. Furthermore, by utilizing voice, as opposed to exit, shareholders are exercising their rights and fiduciary duties to assist in the regulation of market behavior. Against this backdrop, this thesis presents an argument that the rules of the game are changing, with stockholders in a unique position to advocate for greater global reconciliation between economic, environmental, and social welfare through responsible investment approaches that can influence market behavior toward multi-stakeholder concerns.

This claim is investigated through the analysis of two distinct economic periods that dominated the twentieth century, (1) Keynesian economics of 1945-1975/79 and, (2) the post-1980 economic period as characterized by Milton Friedman. In order to fully appreciate the twentieth-century debate of Keynes v. Friedman, chapter two of this thesis delves into relevant economic history of Adam Smith, laissez-faire economics, and corporate legal developments of the nineteenth-century. This historical background is contextually important as it serves as a foundation and a necessary recollection of what the "economic order used to be and what made it come apart" (Lemann, 2019). Thus, it sets the stage for the conclusion of this thesis, which puts forth unconventional economic theories on the basis that a new (i.e. third) economic period is currently being formed in response to the failures of twentieth-century theory and policies.

This third economic period, which began in earnest after the global financial crisis of 2008, is being developed in real time. It represents a dramatic shift in how society at large is restructuring the global economic system based, in part, on the ill-effects of strict adherence to shareholder primacy that developed in the late twentieth-century. In fact, a recent article in *The Wall Street Journal* labeled the post-1980 economic period a "shareholder revolution" (Lemann, 2019) that led to corporate boards acquiescing to the idea that corporate governance implied a sole duty to attend to the creation of shareholder value at any cost. The consequences of this narrow-mindedness have included global economic insecurity, political unrest, social dislocations, and corporate antitrust issues. Encouragingly, the dawn of a new economic age has also manifested itself in response to these unintended negative consequences.

While there is no way of knowing exactly what new economic theory and policies might be enacted during this emerging economic period, this thesis presents important contributions to new and useful ways of thinking about what might happen in the future and assists in shaping novel economic thought processes and paradigms.

## 2. How Did We Get Here? The Rocky Relationship Between Business and Society - Relevant Economic and Legal History

A desire to create positive social change in the corporate world in not a new phenomenon. Corporate social responsibility scholars have long argued that companies have ethical and moral obligations to society that, while not required, are expected (Carroll, 2004). Yet, the relationship between corporate business activities and societal outcomes has been a rocky one throughout the history of economic and legal theory and policies, which this chapter outlines in detail.

This chapter begins with the relevant historical writings of Adam Smith, touches on laissez-faire economics, and proceeds with an analysis of two meaningful nineteenth century legal concepts, corporate personhood and limited liability. The review of these historical periods is crucial in order to gain a deeper understanding of a main aspect of this thesis, which is to outline the two dominant economic periods of the twentieth-century, described herein as Keynes v. Friedman. These historic contexts form the basis for the rise of a third proposed economic period, post the 2008 global financial crisis, which is only just evolving and upon which this chapter concludes.

### *2.1 The Misconceptions of Adam Smith*

Smith was first and foremost a moral philosopher and while his most famous book, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), has

primarily been used to describe the free market economic system, it also contained important moral teachings that have implications for corporate social responsibility. Smith was particularly reliant on the tenets of morality, liberty, and justice in his economic writings on the fairness in exchange (Brown & Forster, 2012). *The Wealth of Nations* is "pervaded by a concern with justice and injustice, with the conflict between private and public interest…ideals of justice, liberty and the public interest provide [its] essential framework" (Billet, 1976, p. 295). Already in its title, *The Wealth of Nations*, Smith intimated that wealth is a universal goal, not the wealth of a singular nation, and even less so the wealth of a few individuals. In fact, Coker (1990) explains that "even though Smith's economic man acts in his own self-interest, he never fails to recognize that his behavior should have consequences for others which are beneficial" (p. 141). As it relates to social responsibility, Smith acknowledged that self-interest must be tempered by virtue and justice (James & Rassekh, 2000), but what is meant by self-interest?

The Smithian concept that the pursuit of self-interested behavior within exchange unknowingly benefits society represents one of the most influential doctrines in economics and is a foundational pillar of the free market system. As such, an accurate and complete consideration of this Smithian doctrine is paramount to analyzing Friedman's limited tolerance for corporate social responsibility, as Friedman took Smith's advocacy of self-interested behavior and assigned it an outsized role in corporate profit-seeking behavior.

This thesis posits that morality, fairness in exchange, and the laws of justice each constitute important underlying elements within the pursuit of self-interest laid out in Smith's 'invisible hand' of market forces. To this end, there is a moral dictum

throughout *The Wealth of Nations*, and not simply a mechanistic approach to Smith's free market economic system, even though it may not be readily apparent within his infamous invisible hand passage, as Smith (1776) wrote:

> …every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it…he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.
>
> I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it (Bk. IV, Ch. II, p. 456).

For instance, with respect to the laws of justice, Smith (1776) specified:

> The obvious and simple system of natural liberty establishes itself of its own accord. Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man (Bk. IV, Ch. IX, p. 687).

For Smith, the laws of justice were a necessary element to a viable free market system wherein natural liberty could flourish. In the absence of this element, self-interested behavior could easily turn into harm or neglect of other parties which, in modern economic terms, can be considered negative externalities. Smith (1776) explicitly stated as much, "to hurt in any degree the interest of any one order of citizens, for no other purpose but to promote that of some other, is evidently contrary to that justice and equality of treatment which the sovereign owes to all the different orders of his subjects" (Bk. IV, Ch. VIII, p. 654).

Wright (2005) proposes that Smith equated justice with a moral regard for dealing with others, as adjudicated by an unbiased spectator in addition to laws and the courts; with morality and fairness in exchange two key factors in producing the positive spill-over effects of private markets onto society that Smith suggested (pp. 52-53). Smith's invisible hand of market forces can generate positive externalities for society only when understanding these subtler defining characteristics of self-interested behavior.

The relation of this foregoing argument to corporate social responsibility is such that, for self-interested corporate behavior to promote societal welfare, it must not benefit one group at the expense of another as these actions would violate the laws of justice (James et al., 2000). This reasoning helps to explain why externalities can no longer remain unaccounted-for within the global market system, as modern corporate activities are a zero-sum game with market efficiencies achieved by one corporation coming at the expense of inefficiencies incurred by another.

Deregulation has intensified these violations of the laws of justice in the post-1980 period. Relaxed legal constraints have escalated the damage inflicted onto larger parts of societies given that corporate behavior has become increasingly disassociated from the moral, just, and fair aspects of economic exchange. In fact, a parallel can be drawn between Smith's distaste for the mercantile system of his era with that of today's modern exploitation of low-income country labor, as Smith (1776) wrote:

> …but our spinners are poor people, women commonly scattered about in all different parts of the country, without support or protection. It is not by the sale of their work, but by that of the complete work of the weavers, that our great manufacturers make their profits…

> It is the industry which is carried on for the benefit of the rich and powerful that is principally encouraged by our mercantile system. That which is carried on for the benefit of the poor and indigent is too often either neglected or oppressed (Bk. IV, Ch. VIII, p. 644).

This thesis puts forth that much of the market failures of the past half century, such as the oft-misguided profit-seeking behavior and corporate malfeasances outlined in chapter one, can be construed to have violated the underlying tenets of Smith's invisible hand theory; with morality, fairness in exchange, and the laws of justice seeming to have dissipated alongside deregulation.

This is not to say that Smith believed, in practice, that the invisible hand of market forces would not create inequalities nor negative externalities. Smith recognized that economic order, when left to its natural course, was marked by serious conflicts between private interests and the interests of the general public (Viner, 1927, p. 217). "Wherever there is great property, there is great inequality. For every rich man, there must be at least five hundred poor, and the affluence of the few supposes the indigence of the many" (Smith, 1776, pp. 709-710, Bk. V). Yet, while Smith believed this division of labor promoted prosperity (White, 2012, p. 211), a complete understanding of *The Wealth of Nations* should not be construed as a basis that favored an anti-corporate social responsibility perspective such as Friedman's. Smith's opposition to the royal charter monopolies of his own time and his distrust of concentrated economic power suggests that he would have a negative view of the modern corporation. *The Wealth of Nations* is thus helpful in explaining how capitalist profits result from systematic exploitation of its factors of production (including human, natural, and financial capital) and in grasping the causes of contemporary social and environmental injustices (Scott, 2007).

*2.1.i Laissez-Faire and Adam Smith*

It is a prevailing position amongst a large majority of economists that classical economic theory supports a laissez-faire, noninterventionist approach that is traceable to Adam Smith, with this position often found in the writings of Friedman. Not surprisingly, since the 1980s, a free market, laissez-faire system has hence dominated economic priorities with the purview that this ideology is 'correct' economic theory and policy. Laissez-faire economics espouses unfettered competition, whereby the role of the government is to ensure that no market participant uses force or fraud to restrain such competition, hence the adage laissez-faire, or the 'let it alone' principle (Benedict, 1985). To this end, laissez-faire implies no government intervention in the workings of a market economy as, once it is up and running, a smoothly operating equilibrium exists where natural tendencies, left to themselves, generate optimal outcomes[16] (Henry, 2008, p. 210).

Yet, Adam Smith did not use the words laissez-faire even once in *The Wealth of Nations*. While Smith did agree with many laissez-faire principles - such as there being a natural order in the economic affairs of individuals, firms, and society that worked best with minimal governmental interference - he also saw an important role for government, albeit limited, within the market system for the benefit of society, including in instances where there were "violations of the laws of the markets" (Henry, 2008, p. 211). To this end, Viner (1927) paints a more balanced view of Smith and not of a "doctrinaire advocate of laissez-faire." While Smith "devoted more effort to his case for individual

[16] Friedman believed in this laissez-faire approach to government in a free market system, with government "essential as both a forum for determining the 'rules of the game' and as an umpire to interpret and enforce the rules decided on." Yet, he opposed social welfare programs and other interventions in market relations on the grounds of economic inefficiency (Friedman, 1962).

freedom than to exploring the possibilities of service through government" he recognized that self-interest and competition were, on occasion, "treacherous to the public interest they were supposed to serve, and he was prepared to have government exercise some measure of control over them where the need could be shown and the competence of government for the task demonstrated" (Viner, 1927, pp. 231-232).

Specifically, Smith endorsed government oversight in three areas; national defense, civil justice, and providing for public works. In these three cases, Smith favored the role of government in instances that he thought would facilitate 'the wealth of nations' which included defending it through military support, protecting property rights and intellectual property, and providing infrastructure, public education, and health care, to name but a few examples. In fact, Forman (2017) suggests that Smith plausibly allowed for a broad scope of legislation to model society under these three categories.

Smith also advocated for a just distribution of wealth, with poverty counter to the natural liberty that he believed was essential to a well-functioning economic system. "His sympathy with the humble and the lowly, with the farmer and the laborer, was made plain for all to see. It was in the interests of the general masses that [Smith] wished above all to promote" (Viner, 1927, p. 232). This sympathy was evident in Smith (1776):

> Servants, labourers and workmen of different kinds, make up the far greater part of every great political society. But what improves the circumstances of the greater part can never be regarded as an inconveniency to the whole. No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable.
>
> It is but equity, besides, that they who feed, cloath and lodge the whole body of people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, cloathed and lodged (Bk. I, Ch. VIII, p. 96).

*2.2 Legal Developments in the Nineteenth Century and the Gilded Age*

Laissez-faire economics were promoted during the early nineteenth century. The last few decades of this century, which are often referred to as the Gilded Age, recognized the limitations of laissez-faire policies. The Gilded Age took place approximately a century after Smith wrote *The Wealth of Nations*, during the first decades of the Second Industrial Revolution of 1870-1914, after the Civil War and prior to WWI. It was described as such because rapid economic growth served as a 'gilded' mask to hide rampant social welfare problems that occurred as a result of industrialized corporate activities, which involved corruption and worker exploitation in business practices (Mintz & McNeil, 2018). This period reflected a large-scale shift in the use of the corporation to conduct business for private gain[17], the emergence of law regarding corporate personhood and limited liability, and an acknowledgement that laissez-faire theories did not effectively organize large-scale economic activity.

*2.2.i Corporate Personhood*

The nature and law surrounding corporate personhood is central to the concept of corporate responsibility, with this law having the potential to be a significant contributor to the longstanding quest for more responsible corporate conduct (Johnson, 2012). It was born out of an 1886 Supreme Court ruling, in the case of *County of Santa Clara v.*

[17] Prior to and during the first half of the nineteenth century, the purpose of a business enterprise was to carry out public-serving functions that were in the interest of public welfare (Johnson, 2012, p. 1145). Most public business projects were related to economic development such as building bridges and turnpikes, operating water works, and establishing banks and/or insurance companies. Corporate status was utilized so that states could unite a group of individuals in order to make a project possible and to ensure that the project would continue in the event that some members no longer participated (Blair, 2013, p. 800).

*Southern Pacific Railroad*, that granted the corporation ‘personhood,’ or legal rights similar to natural persons, by allowing that a railroad corporation could not have a special tax invoked on its property due to its fourteenth amendment right which barred discrimination on the basis of its corporate identity (Torres-Spelliscy, 2018). This decision created a privileged norm for corporations by legally enforcing the idea that corporations were created-persons under the fourteenth amendment, and therefore worthy of constitutional protection.

This ruling took place during the early phase of the advent of the transnational corporation. Thus, corporations were granted this legal right in part to facilitate trans-continental business operations (Federman, 2003). Importantly, Federman (2003) recognizes that another reason the Supreme Court created corporate personhood was to embed, within the hitherto vague meaning of ‘person’ in the 1868 passage of the fourteenth amendment, a constitutional kind of legal ‘person’ it found suitable to offer legal redress.

Corporate personhood served as a way to accommodate for changing social patterns of that time period - including industrialization, advances in corporate structures, worker exploitation, the emancipation of slaves, immigration, and population growth - by allowing corporations access to the federal courts. The federal courts could, in turn, influence corporate interests in particular directions as federal law supplanted state law as related to corporate behavior (Federman, 2003, pp. 169-170). Henceforth, American capitalism evolved under the auspices of constitutionally protected corporate rights.

*2.2.ii Limited Liability*

United States limited liability laws also took shape during the nineteenth century, with New York state passing the first limited liability law for manufacturing companies in 1811. The origins of limited liability are complex, and in part reflect the growing class divides of this time[18], including the upward standing of the middle-and-upper-class who had accumulated wealth through 'managerial capitalism' brought on by industrialized corporate development, as referenced by Chandler (1977). These newly emerging class levels brought forth the idea of the "rentier" investor, as individuals desired profitable investment alternatives to government debt and land in addition to investments that carried less risk than the unlimited liability partnerships characteristic of this period. Rentier investors did not want to be viewed as industrial capitalists, but simply as passive investors who were owners of income rights (Ireland, 2010). As such, limited liability held that a shareholders' capital risk was equal solely to the amount originally invested in

[18] The origins of limited liability can be traced back to sixteenth and seventeenth century Europe with the emergence of commercial chartered corporations and with permanent joint stock companies. Limited liability also came to be associated with broader economic and social changes in the nineteenth century. Economist John Stuart Mill appeared before a Parliamentary Committee in 1850 to discuss the advantages of limited liability in allowing for the working class to have a greater degree of "fair play" at a time of growing discontentment between the class divides of capital owners and laborers. "I am quite aware from what I have heard stated by members of the working classes, and by persons active and anxious for the improvement of their condition, that they feel very great difficulty in establishing proper control over one another, and over the managers; and they ascribe to that the failure" of partnership laws (77, [840]). "An alteration of the law in regard to the responsibility of the partners would be of great importance to those [working class] associations." The value of limited liability, "as it relates to the working class, would not be so much to facilitate the investment of their savings, not so much to enable the poor to lend to those who are rich, as to enable the rich to lend to those who are poor" (78 [847]). "The advantages which the possession of large capital gives, which are very great, and which are growing greater and greater inasmuch as it is the tendency of business more and more to be conducted on a large scale; these advantages are at present…to a degree a monopoly in the hands of the rich, and it is natural that the poor should desire to obtain those same advantages by association. I do not speak of political or social considerations, but in a purely economical sense" (79 [852]) (British Parliament, House of Commons, Select Committee, 1850, pp. 77-79).

a corporation. From a legal perspective, limited liability was based on the fact that a corporation was a separate entity with it alone responsible for its debts (Kempin, 1960).

Limited liability was a contentious concept, with those opposed claiming it would result in corporate irresponsibility, excessive speculation, overtrading of corporate shares, and higher incidences of bankruptcy. Notwithstanding these contentions, by the end of the nineteenth century, limited liability became one of the defining characteristics of the corporate form given the overriding need for an efficient way to aggregate capital and account for it within a business structure[19].

### *2.2.iii New Market Powers*

The legal privileges of corporate personhood and limited liability aided in the creation of a new concentration of power in market economies (Meeropol, 2004). Chandler (1977) suggests that one of the new market powers was that of the "visible hand" of corporate management taking the place of Smith's invisible hand of market forces in organizing the flow of goods and allocating both capital and workers for future production and distribution. In this regard, "the corporation became the most powerful institution in the American economy and its managers the most influential group of economic decision makers," which Chandler entitled managerial capitalism (Chandler, 1977). The other new market power involved stockholders and the large-scale investment activities conducted on the New York Stock Exchange, which were often speculative, passive, and indifferent toward a corporation's effects on society.

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[19] The legal recognition of corporate personhood provided a mechanism for partitioning assets and protecting them from creditors (or heirs) of a corporation, as well as protecting investors from creditors. As such, the legal standing of corporations as separate entities eventually led courts to absolve shareholders of liability for corporate debts, post the full pay-in of capital (Blair, 2013, pp. 794-795).

These two market powers still exist today and form the basis of American capitalism, and the laws of corporate personhood and limited liability are still contentious. "Corporate personhood permits corporate appeals to justice that result in human injustice" (Ritz, 2007, p. 190). "Before limited liability, shareholders risked going bust. Now quite passive investors could afford to risk capital. The Crash of 1929 made the public aware for the first time that…[investing in corporate shares] had serious flaws" (The Economist, 1999).

Yet, over the years, voices have been raised by scholars and legal theorists that paint these two legal concepts as friends, not foes, of corporate social responsibility. For instance, the historical emergence of corporate personhood, coupled with limited liability, gives legal recognition to the public corporation as being a distinct corporate person whose property and affairs, while being in hands of its directors and managers and not its stockholders nor other stakeholders, cannot thus be equated with the interests of either its managers or its investors, each of whose interests might be at odds with those of the other and with broader social interests (Johnson, 2012, p. 1143). As such, while corporate personhood and limited liability may have given the corporation constitutional power with which to generate negative externalities onto society, it also created a legal-social actor with the potential to advance societal expectations extending beyond the particular goals of capital providers, directors, and managers.

### *2.3 The Twentieth Century*

Economic and legal interpretations of corporate personhood and limited liability are important components of the shareholder primacy debate, discussed in chapter one,

that developed in the twentieth century. For instance, in the well-known 1932 Berle-Dodd debate on whom the corporation should serve, Dodd contended that as corporate persons with widely dispersed share ownership, corporations conduct business within society, which is governed not just by law but by ethical standards and public opinion toward social obligations and, as such, the duties of its managers are pluralistic. Hence, the modern corporation has a social service as well as a profit-making function (Dodd, 1932, p. 1148)[20].

This viewpoint advances the corporation as a legal counterparty to *all* contracts that it enters into with its various stakeholders, including managers, employees, customers, suppliers, and investors (Blair, 2013, p. 797)[21]. In this context, the laws of corporate personhood and limited liability can be interpreted as serving both sides of the corporate responsibility coin, as they allow corporations the legal bandwidth to serve in both socially responsible and profit-seeking ways.

These perspectives support a key objective of this thesis, which is to reframe Friedman's view on corporate social responsibility as being overly concerned with the role of officers and directors as related solely to the principal-agent relationship with

[20] In addition to economic responsibilities owed to shareholders, managers have social responsibilities because of "the fact that business is permitted and encouraged by the law primarily because it is of service to the community rather than because it is a source of profit to its owners" (Dodd, 1932, p. 1149).

[21] The paradox of shareholder primacy is that it is an assumed relationship based on corporate governance law that stipulates a set of shareholder rights as having the right to elect a corporation's board of directors and the right to receive the earnings of a corporation in the form of a dividend. The legal duties for corporate officers and directors include acting as fiduciaries in the management of corporate assets (Boatright, 1994, pp. 396-397). While these legal rights and duties have been interpreted as synonymous with maximizing shareholder value, there has always been the latent possibility that the duty of the corporation might be interpreted as a duty to consider the welfare of the enterprise as a whole, including all of its constituents (Millon, 1991, pp. 240-242).

shareholders. Thus, this thesis posits that Friedman (i.e., the post-1980 period) did not properly address, neither in rhetoric nor in policies, the broader purpose of a corporation as a legal-social actor. In fact, shareholders and other stakeholders stand to benefit by appealing to corporate personhood and limited liability in the area of corporate social responsibility given the enormous privilege granted to corporations in shaping not just economic activity but also socially desirable outcomes (Ritz, 2007, pp. 190, 198).

### *2.3.i Keynes v. Friedman*

Two opposing views of a capitalist economy emerged throughout the twentieth century which have occupied a key position in both economic policies and theory since this time period. It is from the diverging viewpoints of Keynes v. Friedman that the modern debate of both CSR and SRI can perhaps best be brought to life. Both economists espoused complex theories which, as with the field of economics itself, contain contradictions and subcurrents that cannot be fully presented within the context of this thesis. The purpose of this section is to outline the over-arching differences of Keynes v. Friedman to better understand the important tenets that separate these two schools of thought, with particular attention given to the role of government in a capitalist economy and the economic policies of these two time periods.

The first view is that of Keynesian economics, which grew in popularity after the market failure of the stock market crash of 1929 and the subsequent devastations of the Great Depression of the 1930s. Keynes focused on the shortcomings of capitalism, particularly with respect to periodic episodes of massive unemployment of capital and labor which, in his view, were evidence of an *in*efficient economic system.

The second view, advocated by Friedman, emphasized the efficiency of the market economy. Disequilibrium situations, such as economic and social devastations, were attributable to temporary aberrations of market forces that would correct themselves and restore equilibrium. In the extreme, this latter view went one step further by denying the very existence of a problem, with unemployment in the 1930s being rationalized by workers "choosing" to take more "leisure" time.

This extreme approach was profoundly irresponsible to Keynes. To the extent that governments followed the non-interventionalist policies often advocated in laissez-faire economics, Greenwald and Stiglitz (1987) note that Keynes believed this was tantamount to not only condemning those individuals who could not obtain gainful employment but also condoning the host of social and economic consequences which followed from that unemployment[22].

*2.3.i.a 1945-1975/79 - Keynesian Economics*

Keynes was always critical of laissez-faire in his writings and offered harsh critiques of its justifications for economic inequalities and rejections of programs for workers and the poor. Keynes believed that the state had a responsibility in attaining certain important political, economic, and social objectives (Dostaler, 1998, p. 321). These responsibilities were particularly evident to Keynes in light of the harsh realities of the 1930s, which demonstrated that the market system by itself could neither allocate resources efficiently nor ensure macroeconomic stability (Hetzel, 2007, p. 3). Even prior

[22] Unemployment was just one manifestation of a much wider set of market failures that Keynes acknowledged within a market economy. Keynes believed that rather than deny the existence of such failures, it was better to confront them, with one avenue being that of limited government intervention to correct maladies so that the economy could again operate in an efficient manner (Greenwald et al., 1987).

to this time period, Keynes had written extensively about the necessity for market intervention on the basis that private and social interests did not often intersect. These thoughts are expressed in Keynes (Laissez-Faire, 1926):

> It is not true that individuals possess a prescriptive 'natural liberty' in their economic activities…The world is not so governed from above that private and social interest always coincide. It is not so managed here below that in practice they coincide. It is not a correct deduction from the principles of economics that enlightened self-interest always operates in the public interest. Nor is it true that self-interest generally is enlightened; more often individuals acting separately to promote their own ends are too ignorant or too weak to attain even these.

Furthermore, in *Liberalism and Labour* (1926), Keynes stated that "the political problem of mankind is to combine three things: Economic Efficiency, Social Justice, and Individual Liberty." He strove to reconcile these three principles within *The General Theory* (1936), by advancing fiscal policies as a means to pursue full employment and price stability, in addition to government-sponsored welfare programs.

Conversely, social justice does not appear in Friedman's economic theories. Instead, Friedman strove for political and economic freedom, in addition to individual liberty as specifically related to laissez-faire principles (Friedman, 1962, p. 165). These differing objectives are important nuances that guided Keynes v. Friedman's vastly different policy approaches. For Keynes, achieving social justice necessitated government action to correct for the inevitable inequalities of trying to achieve economic efficiency. Whereas, for Friedman, government intervention inhibited economic efficiency and the individual liberty that was achieved through free market forces (Dostaler, 1998, p. 322).

This last point is prevalent in Friedman (1948), *A Monetary and Fiscal Framework for Economic Stability*, which was penned and presented as an outline that highlighted Friedman's three long-run economic objectives:  political freedom, economic efficiency, and substantial equality of economic power (p. 246).  This paper was published early in Friedman's career, and shortly after Keynes death, in response to the Keynesian welfare-state capitalism policies that had been adopted in most Western economies by this time.  In this paper, Friedman (1948) stated:

> First, there is and can be no simple, reasonably objective, rule to determine the optimum share of activity that should be assigned to government – short of complete socialization – even if stability were the only objective.  But changes in the share assigned government are themselves likely to be destabilizing, both directly and through their adverse effects on anticipations.  Second, the share of activity assigned government is likely to have far more important consequences for other objectives – particularly political freedom and economic efficiency – than for stability (p. 252).

Importantly, Keynes was a proponent of the free market economic system and capitalism.  This said, his great contributions to the free market model were to recognize the need to curb and guide free market forces that often gave way to speculation and abuses and to reconcile the social inefficiencies of the market system through the use of government intervention (Greenwald et al., 1987, p. 2).  Keynes' view of capitalism was inextricably linked to his position that government involvement was the only practical means by which to safeguard the very capitalist economic system from destroying itself (Keynes, 1936, p. 380).  Yet, Keynes (Laissez-Faire, 1926) outlined  boundaries to his interventionalist approach by declaring, "the important thing for government is not to do

things which individuals are doing already, and to do them a little better or a little worse; but to do those things which at the present are not done at all."

In terms of corporate social responsibility, Keynes, interestingly, likened large corporations to social institutions, with this view arguably shaped by the public-serving orientation of British enterprises of his time period (Laissez-Faire, 1926). Therefore, Keynes viewed the separation of ownership and control as an implicit responsibility to the public, as he wrote (Laissez-Faire, 1926):

> A point arrives in the growth of a big institution…at which the owners of capital, i.e. the shareholders, are almost entirely dissociated from the management, with the result that the direct personal interest of the latter in the making of great profit becomes quite secondary. When this stage is reached, the general stability and reputation of the institution are more considered by the management than the maximum of profit for the shareholders. The shareholders must be satisfied by conventionally adequate dividends; but once this is secured, the direct interest of the management often consists in avoiding criticism from the public and from the customers of the concern.

Keynes (1936) also recognized that the pursuit of corporate profitability did not necessarily lead to beneficial societal outcomes, as he expressed "there is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable" (p. 157).

These Keynesian theories provide important contextualization into the post-war reconstruction policies implemented throughout 1945-1975/79. Policies of this time period aimed to provide synergies across socioeconomic objectives, which included support of free market enterprise tempered by state-induced stimulus programs in the form of government spending, income redistribution, pro-labor legislation, progressive taxation, industry regulation, and a social welfare programs such as food subsidies

(Carchedi & Michael, 2013, p. 94). The policy goals of this era were predicated on economic stability over economic growth - much to Friedman's discontent[23].

Notably, Keynes crafted the Bretton Woods Agreement in 1944 with Harry Dexter White, chief international economist at the U.S. Treasury. The Bretton Woods Agreement was a multilateral effort to provide for postwar economic reconstruction with two prevailing institutions established, the International Monetary Fund (IMF) and the World Bank. The United Nations was also born out of this period. In the U.S., New Deal social welfare programs were undertaken – many of which were politically contentious but still exist today - such as the Social Security Act of 1935[24].

In summary, Keynesian economics - based on economic stability and government stimulus - coincided with a period of economic prosperity for several decades, dubbed the Golden Age of Capitalism, with the period of 1948-1965 achieving the highest economic growth in American history (Carchedi et al., p. 87).

*2.3.i.b 1980 – 2008 – Milton Friedman*

Until the 1970s, the economics profession greeted Friedman's theories with hostility as he challenged the prevailing intellectual mainstream of Keynesian orthodoxy, which included a consensus view that wage and price controls could regulate inflation and offset the pricing power of large corporations (which were thought to be evidence of

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[23] "Since the Great Depression of the 1930s, economists now tend…to act and talk as if any improvement, however slight, in control of the cycle justified any sacrifice, however large, in the long-run efficiency, or prospects for growth, of the economic system" (Friedman, 1948, p. 245).

[24] Friedman believed that there was no validity to this social security program as it compelled people to effectually "spend a specified fraction of their income on the purchase of a retirement annuity and to buy the annuity from a publicly operated enterprise" (Friedman, 1962, p. 37).

monopoly power that had displaced the competitive market pricing system). Friedman, conversely, continued to argue throughout the 1950s and 1960s that markets worked efficiently to allocate resources and maintain macroeconomic equilibrium and that government policies inhibited the market system maximum latitude to work properly (Hetzel, 2007, pp. 2-3). Emphasizing this point, Friedman (1967) wrote:

> To Keynes the reformer, with his emphasis on short-run problems – it was he, after all, who said, 'in the long-run we are all dead,' with his confidence in civil servants to control and regulate…with his belief that we had seen 'the end of laissez-faire,' as he entitled a famous article, the solution was to substitute government intervention for market adjustment, to replace where necessary private investment by government spending (pp. 88-89).

It was not until the economic crisis of stagflation in the 1970s[25] that Keynesian policies began to wane, and Friedman's theories began to receive support. Until this point, output, employment, and economic stability were being buttressed by public expenditures and government regulation, which Friedman fundamentally opposed. Friedman believed that the economy, in the long-run, was essentially stable and over time it adjusted to the level of output and employment determined by the rate of growth in underlying determinants such as technology, the capital stock, and labor. Fiscal policy was an outside force which disturbed this natural process and created instability.

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[25] President Nixon's 1971 decision to abandon the Bretton Woods gold standard followed by the 1973 collapse of the Bretton Woods fixed exchange rate system caused two rounds of dollar depreciation, which spurred inflation. Additionally, the early 1970s experienced a series of exogenous shocks including; the lapse of price and wage controls in 1974, a speculative boom in nonfuel mineral prices, a sharp rise in agricultural prices beginning in 1973 caused in part by crop shortages in the U.S. and in part by strong foreign demand due to crop failure abroad, and the 1973 OPEC oil embargo, which quadrupled oil prices between 1973-1974 (Solow, 1980, pp. 250-253; Stout, 2013, pp. 1172-1173).

One of Friedman's greatest contributions to the field of economics was his monetary framework which attributed the behavior of prices to central bank policies that determined money creation. Friedman's quantity theory of money found that monetary policy, not fiscal policy as advocated by Keynes, influenced inflation (Hetzel, 2007, p. 11). Reinforcing this point, Friedman (1952) wrote, "if you want to control prices and incomes…in about as clear tones as empirical evidence ever speaks, control the stock of money per unit of output" (p. 170).

Friedman's view that the price level varied to achieve macroeconomic stability countered the Keynesian consensus that viewed the price level as being influenced by interventionist strategies. This fundamental difference in views about the equilibrating role of the price level carried over to the world of exchange rates, as Friedman argued that the price level was not institutionally determined but rather was a function of a varying price system that cleared the market for the quantity of money (Hetzel, 2007, pp. 12-13). Friedman's position favored a combination of flexible exchange rates and monetary rule. This position was, ultimately, instrumental to the collapse of the Bretton Woods fixed exchange rate system in the early 1970s.

As Friedman championed monetary policy and the doctrine of laissez-faire (heretofore demonstrated as an inaccurate portrayal of Adam Smith), the Civil Rights movement had culminated with the passage of the Civil Rights Act of 1964, a landmark U.S. labor law that banned segregation and employment discrimination. Other legislation soon followed that protected the environment and supported voter, educational, and workplace diversity. Against this backdrop, the idea of corporate social responsibility began to take a more prominent role within two of the largest philanthropic foundations

in the United States - The Ford and Rockefeller Foundations. These Foundations began to review their investment portfolios from the perspective of corporate social responsibility as did two Ivy League schools, Yale University and Cornell University. This newfound focus on corporate social objectives prompted the development of the first socially responsible investment mandates at mutual fund companies (Moskowitz, 1972). Publications such as *The Wall Street Journal* and *The New York Times* began to highlight companies with strong corporate social responsibility, or absence thereof, in articles, opinion pieces, and exposés.

Perhaps the most famous of these articles was Friedman's seminal essay, *The Social Responsibility of Business is to Increase its Profits* (1970), which appeared in *The New York Times Magazine*. The title was admittedly more provocative than its actual content, nonetheless, Friedman (1970) made exacting points regarding shareholder primacy by stating that a corporation's obligation was toward profit maximization on behalf of shareholders as opposed to social responsibility, as he wrote:

> In a free-enterprise…a corporate executive is an employee of the owners of the business. He has a direct responsibility to his employers. That responsibility is to conduct business in accordance with their desires, which generally will be to make as much money as possible while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom.
>
> Insofar as [the corporate executives] actions in accord with his 'social responsibility' reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money.[26]

[26] See footnote 1 (Friedman, 1962, 1970).

A concern with moral hazard ran strongly throughout this essay, as Friedman (1970) further stated, "I share Adam Smith's skepticism about the benefits that can be expected from 'those who affected to trade for the public good,'" alluding to government inefficiencies and abuses of power, which Friedman called "the iron fist of Government bureaucrats." Moral hazard was a key issue that Friedman (1962) consistently used when advocating for shareholder primacy. "If businessmen do have a social responsibility other than making maximum profits for stockholders, how are they to know what it is? Can [businessmen] decide what the social interest is?" "The corporation is an instrument of the stockholders who own it" (pp. 113-114).

Friedman's (1970) advocacy of the efficiency of free markets to curb moral hazard was also, in retrospect, myopic, "the great virtue of private competitive enterprise – it forces people to be responsible for their own actions and makes it difficult for them to 'exploit' other people for either selfish or unselfish purposes." "They can do good – but only at their own expense." For these reasons, this thesis posits that Friedman took the principal-agent relationship to an extreme and the moral hazard problem was not eliminated, it was offloaded onto society via externalities.

Due to a lack of acceptance of the corporation as a legal-social actor, Friedman saw the social movements of the 1960s and the corporate response to charitable causes as resembling that of a "corporate-state,"[27] which furthered his skepticism of expanding the responsibility of corporations beyond making money for its shareholders. He was

[27] The corporation has become a "social institution that is a law unto itself, with irresponsible executives who do not serve the interests of their stockholders." The direction of policy that permits corporations to make contributions for charitable purposes, is a step "in the direction of creating a true divorce between ownership and control and...toward the corporate state" (Friedman, 1962, p. 114).

primarily concerned with the economic outcomes of business decisions and believed the greatest good would occur for all if businesses stuck to decisions based on maximizing shareholder value.

In terms of the rising socially responsible investment movement, Friedman (1970) argued that while shareholders could very well voice their desires for corporate objectives other than profit maximization, the consequences would have negative implications, such as; lower potential returns to shareholders, higher prices to customers, and lower wages to employees. Yet, in practice, deregulation has produced many similarly negative results. Additionally, the universal ownership suggests that the modern-day institutional investor would not stand to benefit from this limited viewpoint on corporate social responsibility. As, insofar as corporate executive actions in accord with their social *ir*responsibility increase costs incurred by other corporations, the executives are spending the money of other corporations that are most likely owned by the same institutional investors who's interests the socially irresponsible executives are supposed to serve.

From a personal perspective, Friedman's book *Free to Choose* (1980), co-authored by his wife Rose, contained similar dissonant theories regarding environmental and other social concerns and their impact on economic outcomes:

> A long line of economists, philosophers, reformers and social critics have said…if you leave it to the market, the outcome may affect…the air we breathe, the water we drink, the safety of the food we eat.
>
> …all the movements – the consumer movement, the ecology movement, the back-to-the-land movement, the hippie movement, the ecology movement, the organic-food movement, the protect-the-wilderness movement, the zero-population growth movement, the 'small is beautiful' movement, the antinuclear movement – have had one thing in common. All have been antigrowth (pp. 187-188, 191).

Friedman was an influential advisor to President Ronald Reagan (while he was both running for office and during his Presidency). Thus, new economic policies were developed to address stagflation once Reagan took office in 1980 and characterized much of the post-1980 economic period. Many of these policies still exist today and included; targeting the money supply to manage inflation, slowing government spending, flexible instead of pegged exchange rates, easing or eliminating price controls and other regulations, reducing marginal tax rates, lessening support for social programs, deregulating and privatizing many industries, and redefining economic objectives toward growth with corporate profit-maximization as a main attribute.

### *2.4 Post 2008 – Voices for Change: A New Era of Economic Development*

The intent of this chapter thus far has been to outline how a knowledge of the past might usefully inform a strategy for the future. To this end, many of the economic priorities of the post-1980 period played a causal role in the corporate scandals and global externality issues outlined in chapter one and are now in need of addressing. Encouragingly, in the aftermath, there has been a newly emerging school of economic thought which recognizes that a capitalist economy subsists within social and environmental conditions and that free markets do not exist in isolation from regulations nor public institutions (Jacobs & Mazzucato, 2016). Hence, voices inside the market system calling for change are growing stronger. These voices understand the negative linkages between the quest for corporate profit maximization and the significant economic costs generated in the form of harmful environmental, social, and governance

externalities. Recent market failures have revealed that unlimited markets and minimal government regulation do not per se lead to increased economic efficiency.

In fact, the concept of allocational efficiency - which supports deregulation, unrestrained free markets, loose monetary policy, and corporate profit-maximization – has proven, in practice, to bear little resemblance to "rationally acting actors producing optimal efficiency" (Beckert, 2002, p. 8). As such, a renewed interest in socioeconomics has recently emerged with new economic approaches that take into consideration the significance of non-market constraints found in social, environmental, and governance factors. Without these constraints, Beckert (2002) indicates that no rational strategy for efficiencies of any kind can be achieved in a market economy, as the pursuit of one type of efficiency can and often does conflict with other types of efficiencies. Such is the case between allocational efficiency and social efficiency, with the latter referring to the ability of the market system to contribute to identified social objectives[28]. Social efficiency is an important component of long-term economic stability as it assesses not only the undesirable side effects of economic development but, importantly, how an economic system performs according to both established and newly developed social criteria. Regulation that mandates compliance to these social criteria evolves out of informal responses to changing norms of acceptable behavior (Platteau, 2000).

Seen in this way, the voices calling for change in this new economic era, discussed in chapter four, can be appreciated for amending the misguided policy choices

[28] "At the core of economics is the concept of efficiency, with allocational efficiency related to explanations of economic growth and to the theory of the firm. Empirical evidence suggests that [social efficiency] in a capitalist economy cannot be gained to a significant extent through allocational efficiency" (Leibenstein, 1966, pp. 392-395).

that were established in the post-1980 economic period of deregulation. In fact, while not widely acknowledged, since the 1980s there have been a proliferation of state statutes authorizing management to consider shareholder as well as non-shareholder interests in formulating corporate policies (Millon, 1991).

Complimenting this view, Blair and Stout (1999) suggest that an economic model for the future should view the public corporation "not as a nexus of implicit and explicit contracts but, rather, as a nexus of firm-specific investments governed by a board of directors whose job it is to act as 'disinterested' trustees for the corporation itself." By taking this stance, board members would be "rightfully charged with faithfully representing the interests of not just shareholders, but of all stakeholders" (pp. 285-287), and in balancing competing concepts of efficiency. This approach is counter to the principal-agent model endorsed by Friedman, yet it is more consistent with Keynesian theory and policies as well as with the law itself (Stout, 2002)[29].

Shareholders, in turn, can more effectually utilize the certain limited circumstances where they do enjoy special rights not granted to other stakeholders, such as voting rights and the right to elect board members. Institutional investors in particular, as universal owners with significant ownership of corporate shares, should recognize that

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[29] "Milton Friedman is a Nobel Prize-winning economist, but he is obviously not a lawyer. A lawyer would know that shareholders do not, in fact, own the corporation. Rather, they own a type of corporate security called 'stock.' As owners of stock, shareholders' rights are quite limited…[they] do not have the right to exercise control over the corporation's assets, the corporation's board of director's hold that right. Similarly, shareholders do not have any right to help themselves to the firm's earnings; the only time they can receive any payment directly from the corporation's coffers is when they receive a dividend, which occurs only when the directors decide to declare one. As a legal matter, shareholders accordingly enjoy neither direct control over the firm's assets nor direct access to them…Shareholder ownership gets even more muddied with publicly held companies that have issued debt, as the economic structure of the firm is altered. Thus, from both a legal and economic perspective, the claim that shareholders own the public corporation simply is empirically incorrect" (Stout, 2002, pp. 1191-1192). These ideas are reinforced in Keynes (Laissez-Faire, 1926).

these specific rights grant shareholders a unique way in which to represent the interests of an entire coalition that comprise the firm and to take corrective action, as opposed to simply selling the stock, if corporate behavior injures not just shareholders, but all stakeholders (Blair et al., 1999, p. 289). This viewpoint is consistent with the Hirschmanian concept of shareholder voice.

This chapter established economic and legal merit for a main argument put forth in this thesis, which is that the rules of the game are changing, with stockholders in a unique position to voice for greater global reconciliation between economic, environmental, and social welfare through responsible investment approaches that can influence market behavior toward multi-stakeholder concerns.

The next chapter attends to the rules of the game that govern asset management, such as fiduciary duty, the prudent man rule, and the normative method of portfolio construction entitled modern portfolio theory. Legislation was enacted in the post-1980 economic period that allowed for greater flexibility within the ethical interpretation of these three governing standards of investment management. This thesis asserts that these more permissive rules have added systemic market risk and instability to the global market system and, therefore, are also in need of change.

## 3. The Rules of the Game (of Asset Management)

The responsibility of a corporation is to "make as much money as possible while conforming to [shareholder] basic rules…both those embodied in law and those embodied in ethical custom" (Friedman, 1970). Friedman's statement begs the question, what are the rules of law and ethical custom in asset management? Thus far in this thesis, three key rules of the game - corporate personhood, limited liability, and shareholder primacy – have been analyzed through the lens of economic and legal history to determine if it is within these respective purviews for both corporations and shareholders to adopt a socially responsible, stakeholder theory approach in their respective business and investment objectives.

This chapter attends to the rules of the game as they relate to fiduciary duty and the prudent man rule that govern institutional investors on behalf of their constituents, i.e. workers and individuals whom have entrusted their retirement savings and other portions of their wealth to professional asset managers. Moreover, established norms of investment portfolio construction, known as modern portfolio theory, are also discussed in relation to fiduciary duty and the prudent man rule, as the interrelation between these important investment frameworks is often used for political purposes.

As articulated in chapter one, responsible investment is not just an implementation of CSR, it is a broader subject that also includes the determination of

the types of investment vehicles that are appropriate to invest in. This thesis maintains that responsible investing involves the necessity of institutional investors to uphold higher standards of law and ethical custom above what changes to these governing principles currently allows.

### *3.1 Fiduciary Duty – Evolutions of a Laissez-Faire Investment Approach*

Fiduciary duty is a significant aspect of managing assets. As outlined in chapter one, a large percentage of global wealth is entrusted to institutional investors, in particular trustees of pension and employee benefit funds, whom are considered universal owners. These institutional investors have a fiduciary duty to invest assets with both 'prudence' and 'loyalty'[30]. While alterations in trust law in the 1990s relaxed the investment standards attached to these words, their definitive meaning remains the same.

Prudence means to act with good judgement in the use of reason and to use caution with respect to risk. Loyalty means allegiance and faithfulness owed by a pledge to someone or something. Taken together, most institutional investors take a pledge to act with loyalty, prudence, and care when making investment decisions and to be concerned with the financial safety of their clients' and beneficiaries assets while balancing long-term objectives with short-term needs. Thus, it is important to understand how fiduciary duty evolved in the United States throughout the twentieth century and to

[30] The legal responsibilities of trustees of pension and employee benefit funds include the fiduciary duty of *loyalty* and duty of *prudence*, with fiduciaries legally held to stricter standards than the 'morals' of the market or corporate governance law that stipulates a set of shareholder rights and legal duties for corporate officers and directors, both of which have limited liability attached. Fiduciaries can be personally liable for breaches of duty (Hawley et al., 2011; Hutchinson, 1976; Youngdahl, 2012).

highlight how permissive governance with respect to fiduciary duty has been another cause of fragility within the global economic system in the post-1980 economic period.

Fiduciary duty and its prudent man rule underwent a sea change in U.S. law in the 1992 *Restatement [Third] of the Law of Trusts*. This change is notably relevant because of its linkage to the 1974 enactment of ERISA (Employee Retirement Income Security Act). ERISA was the first comprehensive attempt in the U.S. to establish federal fiduciary standards and to regulate the conduct of persons managing the assets within private pension and employee benefit plans. Prior to ERISA, it had become apparent from congressional findings that abuses existed in administering these plans including misappropriation of plan assets and investments in high risk ventures (Hutchinson, 1976). Within ERISA, much of the emphasis is on the procedures which should be followed in properly managing assets or selecting and monitoring investment managers, with proper fiduciary conduct tied to ERISA's prudent man rule, which states:

> A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries - with the care, skill, prudence, and diligence under the circumstances then prevailing that of a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so (Hutchinson, 1976, pp. 15, 16, 57).

Based on ERISA's wording, fiduciaries are further governed by the American Law Institute's (ALI) book of legal precedents, the *Restatement of the Law of Trusts*, which offers a definitional guide to investment decisions. The *Restatement of the Law of Trusts* underwent three important evolutions during the twentieth century as related to fiduciary duty, in 1937, 1959, and 1992, respectively.

The 1959 *Restatement [Second] of Trusts* instructed that a trustee "make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived" [31] (Halbach, 2000). Moreover, the 1959 *Restatement [Second] of Trusts* stated that "the trustee is under a duty to the beneficiary to distribute the risk of loss by a reasonable diversification of investments, unless under the circumstances it is prudent not to do so" (Hutchinson, 1976).

In 1992, the *Restatement [Third] of Trusts* considerably changed the standards of permissible types of investments within pension and employee benefit plans[32] and stated that the trustee's duty was to apply a "prudent investor" standard that "requires the exercise of reasonable care, skill, and caution…to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust" (Halbach, 2000). The 1992 revisions were adopted in 1994 under a new Uniform Prudent Investor Act (UPIA)[33], in which all categoric restrictions of types of investment were removed and a

[31] The 1937 *Restatement of the Law of Trusts* stated, "in making investments not only is the trustee under a duty to use due care and skill, but he must use the caution of a prudent man…with a view to the safety of the principal and to the securing of an income reasonable in amount and payable with regularity. It should be the policy of the trustee so to invest the trust property as to preserve its value, while making it reasonably productive of income, rather than so to invest it as to jeopardize its preservation in the hope of increasing its value or increasing the income. It is not the duty of the trustee to invest only in the very safest and most conservative securities available [such as U.S. government bonds]…by the use of care, skill and caution, an investment can ordinarily be made which will yield a higher income as to which there is no reason to anticipate a loss of principal" (Butler, 1937, pp. 233-234).

[32] The *Restatement [Second] of Trusts* explicitly described improper investments as including speculative securities, stocks on margin, and untried enterprises. The *Restatement [Third] of Trusts* incorporated modern portfolio theory investment practices and allowed investments in start-ups, junk bonds, and derivatives. Since 1992, the investment portfolios of most large pension and public employee benefit funds hold all types of these speculative securities (Youngdahl, 2011, pp. 122-123).

[33] As of 2008, all but five states had adopted some form of the UPIA (Youngdahl, 2012, p. 121).

fiduciary's central concern was defined as a trade-off between risk and return with diversification prescribed as integral to prudent investing (Hawley et al., 2011, pp. 6-7).

The 1994 UPIA conformed to the principles of modern portfolio theory (MPT), developed by economist Harry Markowitz (1952) but not widely adopted until after the recession and market downturn of 1973-1974. MPT was then considered revolutionary, particularly as Friedman's deregulation era was in political favor. MPT provides a framework to construct and select a portfolio based on two main criteria, (1) the expected performance of the investment and, (2) the risk appetite of the investor (Fabozzi, Gupta, & Markowitz, 2002). Accordingly, beginning in 1994, with fiduciary duty and the prudent "investor" rule tied to MPT, the new common standard of evaluating prudence has been through assessing the volatility, risk, and return of a portfolio and the new standard of fiduciary duty has equated to diversifying investments within a portfolio so as to minimize the risk of large losses (Youngdahl, 2012, p. 124).

Yet, the enormity of cross-country spillover effects experienced during the 2008 global financial crisis resulted in significant losses incurred by global pension funds, as outlined in chapter one. Thus, critics of MPT now recognize that wide adherence to MPT theories have generated high correlations to overall global market returns given that general market exposure, rather than investment selection, have become the primary driver of performance. Moreover, the techniques that MPT utilizes for controlling risk – diversification, securitization, and hedging – actually increase systemic risk and fragility within the aggregate economy in market downturns due to the opaque (i.e. imprudent) nature of many modern-day financial instruments, which trigger wide-spread defaults on leveraged debt and large losses in savings.

As such, economic theory that underpins MPT, which includes the assumptions that financial markets are efficient and investors are rational and risk averse, are now being viewed as illogical and far from perfect in practice. There is growing debate amongst fiduciary scholars regarding the negative consequences of current investment practices implemented under the auspices of these more flexible fiduciary standards. This concern is particularly noteworthy in light of the political nature surrounding pension and employee benefit funds, as described in the next section.

### *3.2 Politics Within the Pension and Employee Benefit Fund System*

When ERISA was first enacted, its premise was to ensure that the social and economic quality of life expectations of American workers were met, with the private pension system in a position to influence the level of savings, the operations of the capital markets, and the relative financial security of millions of Americans, which were considered three fundamental elements of national security (Garmager, 1976, p. 687).

Since 1994 and the adoption of UPIA, these premises are thought to have been violated with ERISA instead becoming a political battleground based on the high stakes surrounding the use of vast pools of capital that exist in pension and employee benefit funds. To this end, corporate influence over the Administration in power has attempted to impede whatever social issues deemed detrimental by labeling pension and employee benefit fund investments as activism under the guise of strict adherence to fiduciary duty (Youngdahl, 2012). Ironically, as this thesis has outlined, fiduciary duty standards are no longer strict with regard to what types of investment strategies a fiduciary may undertake. Notwithstanding this irony, corporate interference is accomplished through the

Department of Labor (DOL) issuing guidance to trustees as to the approach they may take in regard to investment activities that use anything other than MPT considerations[34].

For example, the flexing of political muscle being carried out by the current Administration consists of a 2019 executive order calling for the DOL to assess the energy sector investment and proxy trends of retirement funds subject to ERISA. This executive order was undertaken to support the current Administration's investment in domestic energy infrastructure which includes pro-fossil fuel policies such as rolling-back clean energy efforts and supporting the coal industry. These policies conflict with many ESG concerns and ignore federal reports that contain direct scientific warnings of climate change unless the use of fossil fuels is reduced.

This executive order came one year after guidance was issued by the DOL stating that ERISA plan fiduciaries "are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals." Furthermore, fiduciaries "must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision" (U.S. DOL EBSA, 2018). While a fiduciary is allowed to allocate funds into ESG-investments, criteria must be evaluated solely on an economic basis such that "the activity is likely to enhance the economic value in the plan's investment in that corporation after taking into account all the costs involved" (U.S. DOL EBSA, 2018).

[34] The DOL is the fiduciary-regulating agency of ERISA, whose retirement and welfare benefit plans covered 141 million U.S. workers and beneficiaries with a total of $7.6 trillion in assets at year-end 2018. The DOL first began issuing proclamations shortly after the 1994 enactment of UPIA during the Clinton Administration (Youngdahl, 2012).

The essence of these orders imply that fiduciaries must act within the principles of objective materiality with respect to ESG issues.

While the outcome of these recent political manifestations remains to be determined, Urwin and Woods (2009) argue, and this thesis has demonstrated, that there is significant merit in the allowance of socially responsible investing strategies under the permissive standards of the 1994 UPIA, despite the occasional DOL guidance to the contrary. An argument can also be made that SRI strategies offer a method of portfolio diversification as part of an overall investment strategy, which is in accordance with the 1992 *Restatement [Third] of Trusts*. Furthermore, as universal owners, trustees have a fiduciary duty to recognize long-term responsible investment approaches that support their mandate to assure the opportunity for a high-quality of life for their participants upon retirement (Lydenberg, 2007, p. 471).

### *3.3 Changing the Rules of the Game*

The post-1980 economic period encouraged leniency in fiduciary duty laws and the prudent man rule and exposed the instability of MPT as an investment approach. These more flexible standards have resulted in speculative investing, over-trading, market inefficiency, lower corporate governance, and the chasing of performance by institutional investors whom are concerned with short-term results and portfolio optimization as opposed to long-term investment decision-making (Hawley et al., 2011; Youngdahl, 2012). Supporting this view, the World Economic Forum (2011) linked investor short-termism to the adoption of permissive fiduciary duty regulatory frameworks given the ability and willingness of pension funds, whom are the world's largest long-term

investors, to accept potentially sizable losses now that prudence is considered synonymous with risk appetite (World Economic Forum, 2011, p. 10).

Employee benefit trusts are entities that primarily exist to service long-term obligations to beneficiaries (Youngdahl, 2012, p. 134). To this end, this thesis proposes that the fiduciary regulatory framework, particularly with regard to pension and employee benefit funds, must adapt its guidelines back toward a long-term, responsible investment approach[35], which includes: observing higher standards of permissible investment practices; recognizing externalities when making investment decisions and constructing portfolios, and; adhering to the universal ownership argument.

These assertions are particularly relevant in light of the current trend within the OECD toward seeking sustainable global pension systems that closely relate to responsible investment practices (OECD, 2009)[36]. Sustainable global pension systems can be established, in part, by moving away from strategies that encourage short-term

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[35] The current retirement crisis may be due to a single erroneous assumption made early in the academic development of modern portfolio theory - which is the basis of every pension fund's asset allocation strategy - the assumption that investors try to maximize wealth instead of minimize liabilities. A more appropriate model would assume that investors try to maximize surplus (assets minus liabilities), as this would take into consideration external costs, corporate debt, and other forms of financial leverage. This reasoning argues for central banks and academia to develop a new economic tool kit (Muralidhar, December 2014, *Adding liabilities as a reference point to MPT,* Pension & Investments).

[36] While it is beyond the scope of this thesis, the current retirement crisis includes the fact that most public and private pensions in the U.S. are underfunded. Loose monetary policy, which has been a hallmark of the post-1980 economic period, and its accompanying ultra-low interest rates, have pushed pensions into risker assets in order to compensate for the negligible return offered on U.S. Treasury Bills. In the 1950s and 1960s, pensions acted much like savings accounts, holding almost exclusively fixed income and cash assets, which worked when interest rates were in the 5-6% range. In the mid-1970s to 1980s, pension allocation to equities and other alternative assets rose to 20-25% and now stands at 75%, with alternative investments representing 20% of this ratio. Pension fund demand for corporate bonds has also driven a surge of debt-funded corporate buybacks. Hence, loose monetary policy has perversely lower relative wealth even though absolute wealth has increased (U.S. Board of Governors of the Federal Reserve System, *Financial Accounts of the United States, 1952 to 2012*, Pew Analysis of State Financial Reports; Merton and Muralidhar, April 2015, *Monetary policy: It's all relative*, Pension & Investments).

investment behavior and rewarding long-term investment practices that utilize social, environmental, and governance parameters as a path toward raising economic outcomes (Sievänen et al., 2012)[37].

The next chapter offers a discussion on the responsible investing criteria that the United Nations is providing as a countervail to the current "laissez-faire" fiduciary duty, prudent investor, and modern portfolio theory investment guidelines. Driven by the leadership efforts of the UN, there is greater awareness, accessibility, and cohesiveness of global responsible investment approaches being developed. Moreover, the UN is facilitating in the formation of a new and necessary governance structure which Sievänen et al. (2012) highlight as an important step toward greater adoption of responsible investment approaches within the global pension system.

[37] See Appendix A for a country case study on the responsible investment practices of Norway's sovereign wealth fund, Norwegian Government Pension Fund, the largest sovereign wealth fund in the world.

## 4. The Voices for Socially Responsible Investing

### *4.1 The United Nations*

The United Nations was founded in 1945, out of the ashes of WWII. Shortly thereafter, President Harry S. Truman's (1949) Inaugural Address stated:

> We will continue to give unfaltering support to the United Nations and related agencies, and we will continue to search for ways to strengthen their authority and increase their effectiveness. With the cooperation of business, private capital, and labor…new economic developments must be devised and controlled to benefit the peoples of the areas in which they are established. Guarantees to the investor must be balanced by guarantees in the interest of the people whose resources and whose labor go into these developments. Exploitation for foreign profit - has no place in our plans. All countries, including our own, will greatly benefit from a constructive program for the better use of the world's human and natural resources. This should be a cooperative enterprise in which all nations work together through the United Nations…for the achievement of peace, plenty, and freedom.

This quote is emblematic of the Keynesian theories outlined in chapter two, with international economic development post-WWII emphasizing more equitable policies along with leadership from the newly formed United Nations. It is also poignantly analogous to the newly emerging economic period, where there is call for the capitalist system to again devise new economic policies "for the better use of the world's human and natural resources." Through UN programs, business and private capital are being asked to work toward mitigating the negative global impacts of externalities that are causing systemic market instability and posing risk to future economic development.

Since the post-1980 deregulation period, the UN has set many development goals that address environmental protections, an area of global concern that this thesis established as an externality in chapter one. In 1987, the UN mandated the World Commission on Environment and Development, known as the Brundtland Commission, followed shortly thereafter by the World Summit on Environment and Development in 1992, known as the Rio Earth Summit. Both these gatherings were in response to an emerging recognition that the human economy was stressing the global environment with calls on all countries to integrate principles of sustainable development into national policies and programs (Moran, Wackernagel, Kitzes, Goldfinger, & Boutaud, 2008, pp. 470-471).

Yet, it was not until the 2000 Millennium Development Goals (MDGs) that the UN was able to establish unprecedented support by all members that put human development goals at the center of the global agenda with a shift away from growth as the central objective. The eight established MDGs – poverty, education, gender equality, child mortality, maternal health, HIV/AIDS and other diseases, environment, and global partnership – reflected an important endorsement of human well-being as central to economic development. Additionally, unlike other UN goals that were largely ignored by the Bretton Woods institutions, the multilateral organizations of the World Bank and the IMF gradually committed to include the MDGs within their policy frameworks (Fukuda-Parr, 2004, pp. 395, 398).

Over their fifteen-year policy life span, the MDGs generated new and innovative partnerships, raised public awareness, and showed the value of global goal-setting. By putting human well-being at the forefront, the MDGs helped to steer decision-making

between OECD and developing countries toward more critical needs. Their results included many social advancements in developing countries, such as; helping to lift more than one billion people out of extreme poverty, making inroads against hunger, combatting multiple life-threatening diseases, and establishing new thresholds around ecological limits (Kumar, Kumar, & Vivekadhish, 2016).

### *4.1.i The UN Sustainable Development Goals ( UN SDGs)*

While the MDGs achieved many successes, the frequency of market crises has intensified, as have the costs of global environmental externalities, and wealth equality between low-income and OECD countries remains stagnant, as outlined in Figures 1-3 in chapter one. Hence, the 2012 UN Rio +20 Summit in Brazil committed governments to creating a new set of sustainable development goals to be integrated into a follow-up to the MDGs upon their expiration in 2015, leading to formal adoption of the UN 2030 Agenda and its seventeen Sustainable Development Goals (SDGs)[38]. The SDGs build on experience acquired in pursuing the MDGs and pick up the unfinished agenda. Additionally, the SDGs address broader definitions of inclusiveness, focus more on environmental protections and, importantly, strengthen global partnerships through the mobilization of civil society organizations and the private sector (Kumar et al., 2016).

[38] Sustainable development is defined as "development that meets the needs of the present, without compromising the ability of future generations to meet their own needs" (UNCTAD, 2019). The seventeen SDGS are: 1.No Poverty 2. Reduced Inequalities 3.Zero Hunger 4. Sustainable Cities and Communities 5. Good Health and Well-Being 6. Responsible Production and Consumption 7. Quality Education 8. Climate Action 9. Gender Equality 10. Life Below Water 11. Clean Water and Sanitation 12. Life On Land 13. Affordable and Clean Energy 14. Peace, Justice and Strong Institutions 15. Decent Work and Economic Growth 16. Partnerships for the Goals 17. Industry, Innovation and Infrastructure. There is a final goal, number 17.1. Strengthen domestic resource mobilization.

*4.1.i.a An Emerging System of Governance that Advances Stakeholder Theory*

Furthering this preceding point, the post-1980 deregulatory period created significant challenges to the formation of global governance. Therefore, international cooperative associations between market and non-market participants have formed in order to advance and to fund the UN SDG agenda. These various coalitions of self-governing organizations share a recognition that the capacity to achieve multi-stakeholder welfare cannot not rest on the regulatory power of governments nor on unlimited free market forces. This new civil governance system combines resources, skills, and spheres of authority[39] that are better suited to address many of the non-financial SDG initiatives (Rosenau, 2007; Sievänen et al., 2012).

These collaborations are important because an essential financing mechanism for accomplishing the complex, multi-challenges of the SDGs - such as overcoming poverty and protecting the planet – are private-public partnerships (PPPs) (World Bank Group, et al., 2015). The objective of PPPs is to raise both public and private policy support and to channel funds effectively. Yet, Griggs (2013) suggests that the SDGs are simply not achievable without holistic changes to the economic playing field (pp. 306-307), and they require integrated measurement criteria given the enormous price tag that comes with funding their vast and ambitious targets[40]. To this end, Biermann et al. (2012) argue that

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[39] Spheres of authority consist of broad-gauged advocacy networks, transnational organizations, informal networks, NGOs, corporations, and financial institutions that all share like-minded 'citizenship' ideals not bound by law nor by border but rather by intentional and voluntary compliance toward achieving common goals (Rosenau, 2007).

[40] The UN 2030 Agenda has an annual global investment need of $5-7 trillion, which represents 7-10% of global GDP and 25-40% of annual global investment. Current annual investments of both the public and private sector total $1.4 trillion, with multilateral banks committing $400 billion of this total. At the current level of private sector participation, there is an annual funding shortfall of $1.6 trillion, over and above public-sector official development assistance (ODA), to meet just the SDG needs of developing

many of the SDG goals must be mainstreamed into global trade, investment, and finance so that policy adherence by global economic institutions is synchronized with market-based initiatives (p. 1307). This integration necessitates the advancement of stakeholder theory, as envisaged by the UN (Kumar et al., 2016).

Both the complexity and expense of the SDG agenda requires a novel approach to global governance, that of both a non-legally binding and a regulatory commitment to sustainability integration in economic development (Biermann, Kanie, & Kim, 2017). Reinforcing this opinion, Costanza et al. (2016) propose that this new approach to global governance be largely detached from the current international legal system and from top-down, regulatory, and strictly market-based solutions. Rather, it should also encompass a bottoms-up, grassroots, stakeholder-oriented solution with innovative problem-solving and evolving policy frameworks, institutions, and partnerships beyond what exist today.

*4.1.i.b A Countervail to Laissez-Faire Fiduciary Duty Rules*

As discussed in the prior chapter, there is a need within the construct of a sustainable global pension system to reestablish long-term investing norms in the governance standards of fiduciary duty. Lydenberg (2007) upholds that this need is supported by the fact that these institutional investors, as both universal owners and fiduciaries, have inherently long-term investment horizons and are often part of

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countries. Thus, business cannot continue as usual within the global market system as the public sector cannot finance the Agenda. Hence, a step-change level of private sector investment is required to fill the investment gap (UNCTAD, 2014, pp. 140-142). Overall, financing for the SDGs requires a complex mosaic of all sources of financing in a structured and interactive manner (Lajčák, 2018). Expert analysis is being undertaken to channel funds effectively. For instance, the SDGs have 169 targets v. the MDGs 21 targets; Kumar et al. (2016) cite the work by nobel laureates at Copenhagen Consensus that suggest the UN concentrate on the top 19 SDG targets, as it could get $20 to $40 in social benefits per dollar spent v. less than $10 if allocated evenly across all 169 targets.

government structures whose duty it is to enhance economic and social opportunities in order to improve quality of life metrics. These metrics include health, education, decent living standards, and environmental protections.

The investment case for funding the SDGs offers a potential compliment to these metrics and can help fiduciaries better evaluate investments that are aligned with these objectives. Moreover, the SDG investment case argues that it is an inefficient allocation of capital to invest in corporations that do not recognize social responsibility, as many ESG concerns have high external costs (UN PRI, 2017, p. 16). The SDGs provide concrete issues that these external costs are associated with. Thus, they act as talking-points for institutional investors to engage, through voice, more effectively with corporate officers and directors regarding the externalities that their business strategies either create or are subject too. Additionally, the SDG agenda provides a clearly defined framework within which to construct an investment portfolio that can both identify and address specific areas of industry, market, and global economic risks that are external to the requirements of corporate financial filings and quantitative GDP measurements yet ought to be considered as long-term liabilities.

Viewed in this way, the SDGs provide a countervail to the relaxed investment parameters of the 1994 UPIA and the speculative nature of MPT risk management techniques. By utilizing the SDGs as a tool to control risk, institutional investors, as fiduciaries, can gain a broader understanding of the potential long-term macro and micro risks that they are exposed to as universal owners. The SDGs support more informed investment decision-making and better identification of both idiosyncratic and market risk. This approach is in contrast to the current laissez-faire method of MPT, which

encourages indexing alongside hedging strategies under the guidance of diversifying investments within a portfolio so as to minimize the risk of large losses. As established in chapter three, MPT has led to high systemic risk, short-termism, and liquidity crises in downturns. Figure 5 provides a high-level overview of the SDG investment case, which outlines for fiduciaries various portfolio impacts related to sustainability:

**FIDUCIARY DUTY**
The SDGs are an articulation of the world's most pressing sustainability issues and as such act as the globally agreed sustainability framework. The SDGs can support investors in understanding the sustainability trends relevant to investment activity and their fiduciary duties.

| | RISKS | OPPORTUNITIES |
|---|---|---|
| MACRO | By the nature of their investments, asset owners that choose to hold a diversified portfolio, investing in a wide range of asset classes and geographies, will be exposed to the global challenges that the SDGs represent. Failure to achieve the SDGs will impact all countries and sectors to some degree, and as such create macro financial risks. | Achieving the SDGs will be a key driver of global economic growth, which any long-term investor will acknowledge as the main ultimate structural source of financial return. |
| MICRO | The challenges put forward by the SDGs reflect that there are very specific regulatory, ethical and operational risks which can be financially material across industries, companies, regions and countries. | Companies globally moving towards more sustainable business practices, products and services provide new investment opportunities. |

Figure 5: Fiduciary Duty: UN 2030 Agenda for Sustainable Development - Long-Term Portfolio Impact. Source: UN PRI, 2017.

### *4.1.ii The UN Principles for Responsible Investment (UN PRI)*

The UN PRI was launched at the New York Stock Exchange in 2006, with the support of seventeen founding investor signatories[41] comprised of large, global asset management institutions, religiously affiliated asset managers, state pension and employee retirement benefit funds, and sovereign wealth funds. A primary mission of

[41] Signatories have committed to; 1. incorporating, 2. disclosing, 3. promoting, 4. advancing, 5. implementing, and 6. reporting ESG factors in instances that are consistent with their fiduciary duties.

the UN PRI is to help institutional investors better understand the investment implications of the SDG agenda, as outlined in Figure 5, and to assist in the consideration of SDG targets within the investment decision-making process.

The mobilization of worldwide assets is critical to the funding success of the SDGs, as the global market system has, in principle, the financial resources to address the needs of the UN 2030 Agenda (World Bank Group, et al., 2015). However, market-based capital is largely absent from investing in both SDG issues and, importantly, developing countries. For instance, overall private flows currently amount to less than 20 percent of total financial flows to low-income countries (Lajčák, 2018, p. 2), where wealth inequality has been stagnant since 1995 (see Figure 2).

Consequently, part of the financing dilemma associated with the SDGs is how to remove blockages within the global investment chain that hinder private sector flows[42]. Some of these blockages include the necessity for public policy changes but some come from within the capital markets, most significantly from market regulators (UNCTAD, 2019). Until these obstacles are addressed, the significant uptake of the UN PRI, outlined in chapter one, signifies an important call to action by global institutional investors in support of the SDG agenda but does not yet represent actual investment in the SDGs.

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[42] ODA and domestic resource mobilization (DRM) remains essential to accelerating economic growth and lifting people out of extreme poverty in low-income countries given restrained private investment, hence SDG 17.1. However, financing from institutional investors can be done through (1) investment in inclusive and sustainable business models that reach under-served populations and by (2) supporting regulatory frameworks that promote inclusive growth. To assist, Multilateral Development Banks (MDBs) and the IMF are working with development partners to translate the SDGs into country level targets, policies, and programs. Proposed regulations include mandates that support an inclusive business environment and shift the allocation of investable funds to policy-based lending (World Bank Group, et al., 2015, pp. 2, 6).

While the ultimate challenge lies in matching the investment needs of the UN SDGs to the investment flows of the UN PRI; perhaps as relevantly, strong UN PRI adoption suggests that global voices within market forces recognize a fiduciary duty to balance short-term needs with long-term sustainability goals. With their vast reach and influential partnerships, Biermann et al. (2017) give credit to the UN SDGs and the PRI for increasing awareness of and accessibility to responsible investment approaches that take into consideration broader development goals above economic growth at any cost.

### *4.2 Non-Financial Reporting Organizations*

The eventual goal of the socially responsible investing movement is to eliminate the distinction between it and mainstream investment strategies as all market participants come to recognize the business risks of irresponsible behavior (Vogel, 2005, p. 65). There have been many efforts, in fact, throughout the post-1980 economic period by market and non-market participants alike to improve the integration of environmental, social, and governance factors into corporate and investor decision-making to further responsible investment behavior[43]. Non-financial reporting (i.e. sustainability or integrated reporting) is one such effort, and while it is only a part of a broader call for higher standards within the capitalist market system, it accomplishes a need for greater

[43] The 1992 Rio Earth Summit launched a wave of data gathering and publishing companies dedicated to standardizing and regulating environmental and sustainable development reports (Vukic et al., 2017). "It is becoming clear that communicating effectively with stakeholders on progress toward economic prosperity, environmental quality and social justice, i.e. the triple bottom line, will become a defining characteristic of corporate responsibility in the 21st century" (John Elkington, 1997, *Cannibals with Forks: the Triple Bottom Line of 21st Century Business*, New Society Publishers). Elkington's influential book, along with his consultancy, SustainAbility, supported the idea of managing, measuring, and reporting on stakeholder issues (Milne & Gray, 2013).

transparency and some form of assurance that corporate strategies consider externalities that impact multi-stakeholder welfare (Waddock, 2008, p. 33).

Currently, the capitalist market system is incapable of taking externalities into account because corporate financial statements have no way to recognize costs that are external to corporate business practices and no method to calculate the future liabilities that these externalities create. Thus, non-financial reporting is intended to offset the current market incentive structure that actually works counter to externality cause and effects, whereas a firm once rewarded with greater market returns if it externalized as many operating costs as possible would now be penalized. Seen in this way, non-financial reporting organizations help market and non-market participants to recognize a firm's social, environmental, and governance objectives and to take this information into account when engaging with corporations either through voicing, investing, and/or entering into any type of implicit or explicit contract with a firm.

There are a wide range of organizations that have developed non-financial reporting toolkits from which companies can chose when drafting multi-stakeholder reports. These reports are not legally binding but provide helpful information on ESG issues in a standardized format (Vukic, Vukovic, & Calace, 2017, pp. 19-20). The most widely used non-financial reporting frameworks include those of the Global Reporting Initiative (GRI), The OECD Guidelines for Multinational Corporations, the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB)[44]. As expressed earlier in this chapter, market and non-market participants have

[44] It is unnecessary to delve into the details of each non-financial reporting framework for the purposes of this thesis. However, worth noting is the inter-connectedness of these organizations. For instance, the GRI, an NGO based in the Netherlands, helped the UNEP FI develop its sustainability reporting framework

increasingly relied on informal standards to identify and assess global externality issues in the absence of formal governance. Hence, these non-financial reporting organizations are serving an important role within this new mode of civil regulation governing multi-stakeholder welfare.

Yet, these organizations have garnered considerable criticism as well. For instance, the quality of these reports is lacking given the voluntary and subjective nature of non-financial metrics which allows firms to choose what they want to disclose, leaving much of the information that they do report on considered either non-material and/or non-verifiable (Vogel, 2005, pp. 69-70). Milne & Gray (2013) argue that these organizations have become institutionalized such that, in this process, genuine concern for stakeholder welfare has been sidelined. Additionally, these reports rarely cover the social, environmental, and governance issues that need to be addressed in the context of responsible and sustainable business practices, such as; lobbying practices, pay disparities of CEOs to employees, and voluntary limits and constraints on production and output.

*4.2.i Multi-Stakeholder Welfare Should Not Boil Down to a Rating*

Much of this criticism surrounding non-financial reporting is justified and further exacerbated by the fact that highly nuanced corporate objectives and investment activity are attempted to be captured in a singular ESG rating. Environmental, social, and

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in the early-mid 2000s, alongside a working group that consisted of financial institutions, environmental, and social NGOs. The resulting collaborative report, *GRI Financial Services Sector Supplement*, envisioned to become the UNs sustainability reporting standards for the financial sector (UNEP FI, 2009). The GRI, in 2010, also forged an alliance with the OECD Guidelines for Multinational Enterprises. Recently, The SASB (founded in 2011 by Michael Bloomberg along with former SEC Chair Mary Schapiro) and the GRI committed to working together at the request of the G20 Task Force on Climate-related Financial Disclosures. This collaboration is intended to provide a comprehensive reporting mechanism so that global investment firms can better manage and price climate-related risk appropriately as a prerequisite to making underwriting, lending, and investment decisions.

governance concerns are not only subjective, but multi-dimensional, which can lead to confusion, biases, and value-judgements in the reporting of these metrics. Thus, there is a high probability that no one standardized method can encapsulate all relevant aspects of economic, social, environmental, and governance behaviors that a corporation may undertake to satisfy all stakeholders. Moreover, it is reasonable to assume that non-financial reporting agencies have profit-seeking and political agendas of their own.

Accordingly, this thesis suggests that it is implausible to compress these dynamics into a singular ESG rating that can effectually be used in portfolio construction. Furthermore, there exists a lack of cohesion and a disingenuousness to the rating system that has served to undermine the credibility of many ESG rating agencies. This has led to a weak form of sustainability being promoted inside the market system, when what is needed are sincere efforts to develop and adhere to investment strategies that genuinely target more inclusive economic development[45].

Supporting this assertion, the American Council for Capital Formation (ACCF)[46] report, *Ratings that Don't Rate: The Subjective World of ESG Rating Agencies* (Doyle,

[45] A literature review of empirical studies, in addition to market-based analysis, was undertaken as due diligence for this thesis that evaluated the performance characteristics of SRI strategies dating closely back to the origins of this asset class in the 1970s. Results were as follows: limitations of time-series event studies were such that deletion effects from an SRI index could have be related to a worsening financial, not ESG, profile - meaning that correlation does not imply causality (Becchetti, Ciciretti, & Hasan, 2009). Meta-analysis results found a non-statistically significant performance differential between SRI and conventional funds (Revelli & Viviani, 2015). Bull-and-bear-market regime studies suggest that strong co-movements of SRI indices to that of conventional indices calls into question just how different SRI indices are vis-à-vis their parent index (Managi, Okimoto, & Matsuda, 2012). Market-performance of SRI v. parent indices reveal nearly identical portfolio construction and performance characteristics. These findings offer an unclear answer as to whether CSR is reflected in SRI strategies. Revelli et al. (2015) argue that broad-based market products with sustainability and/or ESG taglines are "weak" versions of value-investing that do little more than check a box for asset managers while expanding their suite of product offerings. Thus, a relatively weak form of sustainability in the capital markets appears to exist.

[46] The ACCF is a non-profit, economic policy organization that claims nonpartisanship.

2018), found biases, lack of transparency, and disparities in accuracy within the data that non-financial rating agencies evaluated. Moreover, SustainAbility[47] published results of a global survey entitled, *Rate the Raters, Expert Views on ESG Ratings* (Wong, Brackley, & Petroy, 2019). The results indicate that non-financial rating agencies do not fully integrate sustainability principles into the analysis of corporate social responsibility and regard various ESG aspects inconsistently. This report concluded that the process for capturing sustainability data was inefficient and the ability to use ESG data in decision-making ineffective, with a suggestion that ratings be replaced with higher engagement between shareholders (i.e. voice) and corporate officers and directors (Wong et al., 2019).

### *4.3 What Now?*

A main argument laid out within this thesis was that the rules of the game are changing, with stockholders in a unique position to voice for greater global reconciliation between economic, environmental, and social welfare through responsible investment approaches that can influence market behavior toward multi-stakeholder concerns. This multi-fiduciary stakeholder perspective requires consideration of other constituencies' interests within corporate behavior (Green, 1993, p. 1419). How then can these considerations be measured if not by a singular ESG ratings nor through the reliance on non-financial reporting metrics disclosed within corporate filings?

This chapter determined that voices calling for socially responsibility, including the UN and certain non-financial reporting organizations, are serving to promote the awareness of externalities, universal ownership, and multi-stakeholder concerns. These

[47] See footnote 43 for a background on SustainAbility.

organizations are also important actors in an emerging system of civil global governance (Milne et al., 2013). However, these voices are ultimately inward-looking and have not, as of yet, influenced institutional investment practices in a statistically significant way.

A more radical approach toward how economic development is evaluated should be considered, with a recognition that there are natural limits to the scale of economic growth and that human-beings value more than just consumption and the accumulation of financial wealth. The final chapter of this thesis is dedicated to discussing unconventional economic theories that capture broader measurements of economic development, as both an alternative and a compliment to the market-oriented suggestions outlined thus far.

The alternative economic theories presented in chapter five share the common theme of emphasizing qualitative, rather than strictly quantitative, parameters within a broader vision of how GDP should be measured. Moreover, a focus on the long-term maximization of environmental sustainability, wealth equality, freedom from oppression, health, education, and human well-being are emphasized, as opposed to short-term corporate profit maximization.

The qualitative objectives discussed in the concluding chapter of this thesis are important avenues toward achieving unprejudiced global economic development. They are also consistent with the UN SDG agenda as well as the universal ownership argument presented in chapter one. Lastly, these proposed qualitative objectives can be interpreted as new and necessary pillars to the long-term efficiency and sustainability of the current market-based economic system.

## 5. Conclusion

Hirschman "enjoyed serendipity. He insisted that human history provides 'stories…which look more like tricks history has up its sleeve than like social-scientific regularities, not to speak of laws'" (Sunstein, 2015, p. vii). Expanding on this thought, in his 1967 book, *Development Projects Observed*, Hirschman originated a principle that he called the Hiding Hand, which he believed told a great deal about economic development. Hirschman (1967) described planners of economic and social development as tending to enter into a course of action because they often neglected "a set of possible and unsuspected threats" to the profitability and the eventual survival of a project. Planners did not simply overestimate the possibility of success and underestimate the cost of a project; they also underestimated the prospective reactions to a project's failure. "Once things begin to go wrong, people discover unexpected ways to set them right, hence the idea of a Hiding Hand" (Sunstein, 2015, p. viii). Flyvbjerg and Sunstein (2016) suggest that Hirschman's Hiding Hand, which beneficially concealed difficulties, also provided a remedy in the emergence of human creativity to solve unanticipated problems. "You have to do all these foolish things before you do the sensible things" said Hirschman in a field note annotation (Bianchi, 2011, p. 18). In this spirit, it is perhaps possible to use Hirschman's Hiding Hand principle to explain the failures of the post-1980 economic period and the rise of this newly emerging economic era.

The objectives of this emergent era are not fundamentally new to the discipline of economics. Rather, they represent a present-day attempt to navigate tensions between current ethical concerns and modern economic development. A centrist approach is needed. Thus, social responsibility must include both private and public commitments toward reducing global inequities. A new toolkit is also required, or a dose of human creativity as Hirschman's Hiding Hand suggests, that is not so rigid in its approach.

To this end, the World Bank report, *The Changing Wealth of Nations 2018: Building a Sustainable Future*, acknowledges that the annual income statement of a country – as summarized by its GDP or other similar quantitative measures – provides an incomplete picture of a country's economic health and potential for the future. This is especially true for resource-rich countries that can deplete their natural resources for short-term gains and increase GDP per capita at the sacrifice of long-term sustainability and future growth. As such, to more accurately assess a country's economic health, traditional measures of economic activity, such as GDP and GDP per capita, ought to be augmented with measures of a country's total asset base or wealth, as these two latter parameters better enable a country to generate future long-term income (pp. 25-26).

In this report, the World Bank (2018) further identifies that many aspects of wealth accounting currently exist within the System of National Accounts (SNA), which is a rich data source for various wealth measurements that assess national economic progress by governments, the private sector, international organizations, as well as many other global stakeholders. However, these wealth accounts have not been implemented in traditional measures of annual production and income, such as GDP, largely because twentieth-century macro-economic policies (shaped in the aftermath of WWII by Keynes

and continued by Friedman) focused on the short-term challenges of how to counteract market downturns, recessions, and depressions with produced capital. In this process, the long-term sustainability of natural and human capital were not given the same attention.

Yet, the Hiding Hand of twentieth century policies – which were admittedly born out of serious economic, social, political, and wartime crises – revealed the calamities that accompanied these policy actions, such as the enormity of external environmental damage and its unaccounted-for costs within GDP (see Figure 1) and the persistence of global wealth inequalities (see Figures 2-3). The true show of hands, as this thesis has postulated, was the gravity of the systemic risk within the market system that became evident in the aftermath of the 2008 global financial crisis. Since this event, there has been increasing public and private support for inclusion of broader measurements of economic progress, such as long-term human capital development and natural capital preservation. To use the Hirschmanian concept of exit, voice, and loyalty, the global economic system and the planet that it inhabits do not have the option of exit. Thus, voices calling for structural change are being heard. The concept of loyalty to this structural change, and what this structural change will entail, will be formulated in the course of this newly developing economic era. Importantly, the socially responsible investment decisions made by two key actors inside the market system - corporations and institutional investors – are critical to this loyalty.

Promisingly, the World Bank (2018) has constructed a new method to calculate a county's total wealth by summing up each component of sustainability: *Total wealth =*

*natural capital* + *produced capital* + *human capital* + *net foreign assets*[48]. The methodology used to calculate natural capital, for example, includes valuing the conservation and preservation of protected areas, important because approximately a third of the world's largest urban areas are supplied their drinking water from sources in or downstream from protected areas. Conservation and preservation are projected to save billions of dollars in supply and treatment costs as forests and wetlands naturally regulate the flow of water and remove contaminants (p. 218).

An example of the World Bank's (2018) new human capital accounting methodology involves support for public policies in education and health care through measurements tied to investments made by countries in their respective education and health care systems. However, data demonstrates that there is a weak relationship between expenditures and performance in these public policy arenas, which indicates that the quality of spending is more important than the quantity (p. 117).

With respect to carbon wealth versus carbon risk, the World Bank (2018) now measures the sum of the rental value of three underground fossil fuels, including petroleum, natural gas, and coal, based on the assumption that the world cannot consume more than 20 percent of existing fossil fuel reserves and still hold global surface temperatures to less than the internationally set 2° Celsius average warming target (p. 103). It also quantifies the long-term wealth risk for carbon-rich countries that rely on exporting fossil fuel resources and identifies that low-or-middle-income countries have

[48] For the first time, explicit estimations of human and natural capital are included in a bottoms-up, total wealth formula. This new formula is a significant departure from past estimates, where total wealth was estimated assuming that consumption was the return on total wealth. Thus, wealth was calculated back from consumption estimates (World Bank Group, 2018).

the largest carbon-wealth risk as they derive more than half of their revenues from oil, gas, and coal. The UN SDGs play a critical role in providing private sector financing, through both corporate long-term investment and direct investment from institutional investors, that will enable these countries to diversify their economies away from fossil fuel dependency (pp. 104, 111). For high-income countries such as Norway, with approximately five percent of its total assets in fossil fuels (p. 105), the investment approach within its sovereign wealth fund mitigates this concern by investing across geographies, industries, and asset classes; adhering to responsible investment practices; and making investments in renewable energy. These strategies support Norway's short-term pay-out requirements and help fund long-term, pension obligations of the state[49].

Other contemporary solutions to measuring well-being include parameters within the *World Happiness Report* (Helliwell, Layard, & Sachs, 2019), first developed in support of a 2012 UN meeting, "Wellbeing and Happiness: Defining a New Economic Paradigm." This annual report is based on emerging science that shows the quality - or happiness - of people's lives are connected to subjective measures, denoted as life evaluations. These life evaluations include how people view the quality of their governmental system, community engagement (either through helping others or from the generosity of fellow community members), positive and negative effects of technology usage, and addiction rates. From these and other life evaluations, six key variables are then aggregated to explain the happiness of a country: GDP per capita, social support, healthy life expectancy, freedom, generosity, and absence of corruption (Helliwell et al.,

[49] See Appendix A for a case study on responsible investment within Norway's sovereign wealth fund.

2019). Worth noting, the highest country rankings of happiness in 2016-2018 were the Nordic countries of Finland, Denmark, Norway, Iceland, and Sweden in addition to the Netherlands and Switzerland, with the U.S. ranking 19th. The lowest country happiness rankings included Afghanistan, Syria, India, Ukraine, Sri Lanka, Venezuela, and South Africa, all listed in the bottom third out of 156 countries polled, while China ranked 93rd.

Amartya Sen's 1999 book, *Development as Freedom*, opened with the statement that "development can be seen as a process of expanding the real freedoms that people enjoy." In this light, Sen (1999) suggested that traditional economic growth measurements of GDP, income, and technological advances should be viewed as important means to expanding freedoms but not as developmental ends. Equally important are determinants of freedom such as education and health care, in addition to political and civil rights, as well as the elimination of what Sen called "unfreedoms" that hinder development, such as; poverty, tyranny, poor economic opportunities, and repressive states. Sens' thoughts echo many of the initiatives in the UN SDG agenda and compliment the views of Moran et al. (2008) in that sustainable development represents a commitment to advancing human well-being with measurements and indicators that properly reflect changes in quality of life within countries.

In many respects, the socially responsible investment movement is similar to Thaler and Sunstein's 'Nudge theory,' the behavioral economic concept put forth in their influential book, *Nudge* (2008). Thaler et al. (2008) propose that positive reinforcement and indirect suggestions are ways to influence the behavior and decision-making of a group of individuals. Nudge theory supports the idea that the investment decisions made by market forces, including corporations and institutional investors, influence the choices

upon which society at large makes decisions about how they can and should live. So why not voice for these investment decisions to increase opportunities for people to make choices that will help them live longer, healthier, and happier lives?

*Nudge* (2008) is based on the assumption that the starting point, or intention, in a thought process can subtly influence situations. So why not, in the investment decision-making process, start with the intention of maximizing societal welfare instead of maximizing profits? Moreover, why not start with the assumption that these two interests are not mutually exclusive, but interdependent. This starting point will influence corporate behavior toward a greater awareness of activities that can be considered sustainable, which is analogous to a greater awareness of the long-term.

Without proper consideration to the long-term, there is a higher probability for more uncertainty within in the process of forecasting a corporation's future residual cash flows. As Keynes (1936) said, the future is uncertain. So why not, amid all the erroneous assumptions made in the course of estimating corporate profitability, include a long-term assumption regarding a company's willingness and ability to provide expansions to societal well-being that go beyond simply short-term financial outcomes?

The market mechanism is a powerful and important contributor to global economic progress (Sen, 1999, p. 6). Thus, it is only rational to use this mechanism as a starting point for global intentions that foster multi-stakeholder welfare as a path toward sustainable economic development and that recognize GDP growth does not necessarily equate to the ability of people to live long, healthy, happy, and free lives. Measurable outcomes will develop out of these realigned intentions, and these intentions will

ultimately form the basis of whether or not humanity – and the planet that humanity inhabits - follows a sustainable path (Moran et al., 2008).

Viewed in this context, the new and unconventional theories presented in this chapter are all rooted in qualitative measurement approaches to economic development. In many ways, they are indicative of a twenty-first century invisible hand, leading market participants toward more responsible and inclusive investment behavior with a recognition that externalities no longer exist and that all individuals, in the pursuit of self-interest, are universal owners of the global economic system.

There is no way of knowing what the future holds. Nonetheless, this thesis put forth important contributions to new and useful ways of thinking about how economic theory and policies might be shaped going forward. It thus concludes with the notion that the socially responsible investing movement is bringing to life the essence of what Keynes (1936) called 'animal spirits,' as he wrote:

> …a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits – of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.
>
> Enterprise only pretends to itself to be mainly actuated by the statements in its own prospectus, however candid and sincere. Thus, if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die; - though fears of loss may have a basis no more reasonable than hopes of profit had before (pp. 161-162).

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## Appendix A:  Case Study - Government Pension Fund of Norway

The Norwegian Ministry of Finance Report for the Government Pension Fund (the Fund) outlines Norway's responsible investment strategy as undertaken by Norges Bank, the central bank of Norway and also the Fund's manager (The Fund, 2019).  The Fund is the largest sovereign wealth fund in the world, comprised of over $1 trillion in assets, including 1.5 percent ownership of global shares.  Norges Bank has developed three main components of the Fund's responsible investment approach:  establishing principles, exercising ownership, and investing sustainably.

These three components aim to achieve multiple objectives, including; contributing to the development of standards that advance the long-term interests of the Fund, promoting well-functioning markets and good corporate governance, and influencing company practices over time through direct contact with companies.  The Fund (2019) summary states that dialogue (i.e. voice) is an important active ownership tool that broadens the understanding of companies while enabling Norges Bank to communicate its expectations with regard to good business practices, corporate governance, and adequate disclosure of sustainability and shareholder rights.  Norges Bank also issues company expectations through public documents on the following seven issues:  climate change, water management, human rights, children's rights, tax and transparency, anti-corruption, and ocean sustainability.  Moreover, Norges Bank collaborates with companies, investors, and other stakeholders to promote research that enhances the knowledge of good corporate governance and sustainability and how these concerns are linked to financial risk and return (p. 52).

International standards and principles that are emphasized by Norges Bank include the UN Global Compact, the G20/OECD Principles of Corporate Governance, and the OECD Guidelines for Multinational Enterprises. With regard to the UN SDGs, Norges Bank acknowledges that, as a long-term and global investor, the Fund has an inherent interest in sustainable development and achieving the SDGs, in both developed and developing countries, could contribute to the long-term return of the Fund through increased economic resilience (Norges Bank Investment Management, 2018).

Leading up to these reports, Norway's Ministry of Finance held an Investment Strategy Summit in 2013, gathering leaders of Norway, global asset owners and managers, and world experts on responsible investing. The purpose of the Summit was to develop an intellectual framework regarding environmental, social, and governance issues and to provide clarity on the outcomes of such investment approaches. At this Summit, Towner (2013) outlines two problems that were recognized as being relevant to the Fund as a long-term, institutional investor, uncertainty regarding the social cost of carbon dioxide in regulatory decision-making and the role that governments should take to limit use. The effects of environmental and social externalities were also discussed, with leaders arguing that because of the size of Norway's sovereign wealth fund, it was partly the Fund's responsibility, as a universal owner, to mitigate these externalities given that it's investment decisions have an impact on society (Towner, 2013).

This Summit determined that the method of exclusion (i.e.: exit) in asset selection was a relatively simple way of managing ESG-issue related risk, but it rarely solved underlying problems directly and it eliminated the Fund's shareholder rights (Towner, 2013). Other key issues of portfolio concern were the governance of human rights,

climate change, and water conservation and preservation. Proposed actions were such that, through international collaboration, the Fund's managers would continue to cultivate ways in which responsible investment could be achieved, with particular emphasis placed on mounting evidence that the reasoning of MPT may not hold if global investors derive utility from objectives other than profit-maximization (Towner, 2013). Summit participants gave indications that global asset owners and managers do care about ethical considerations and sustainable investments, even at the sacrifice of financial returns, with the Summit highlighting the importance of trying to reconcile the tension between non-financial concerns and maximizing expected risk-adjusted returns.

With respect to sustainable investing, Norway's Ministry of Finance announced in 2019 that it would increase the investment mandate within the Global Pension Fund Global (GPFG, Norway's oil fund) in renewable energy infrastructure projects. This mandate builds on an existing mandate for environment-related investment but now includes the permission of investing in unlisted (i.e. not publicly traded) projects in OECD countries. This decision marks the first time GPFG will be able to invest in unlisted infrastructure and answers calls to invest in unlisted renewables that began over a decade ago. Thus, the mandate for environment-related investments was increased to NOK120 billion, with a limit of holding two percent of GPFG assets in these types of investments to limit risk (Fixsen, 2019).

This decision was made in part to continue effort within the GPFG to diversify assets from oil and gas and to support global investment efforts in renewable energy (Fixsen, 2019). This mandate does not, as of yet, include investment in developing-country infrastructure. However, it provides the GPFG an opportunity to build

competence in managing assets in unlisted renewables which comprise most developing-country infrastructure investment opportunities. Fixsen (2019) highlighted that this change in strategy also acts to lower the GPFG's systemic risk associated with owning publicly traded securities.