FOSTERING NASCENT RECOGNITION FOR HUMAN RIGHTS WITHIN ESG

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Introduction

Growing interest and participation in sustainable finance and investment activities from all segments of business and industry presents an important opportunity to advance human rights. Traditionally, the word "sustainability" would often conjure thoughts linked specifically to environmental issues (e.g. air/water/soil pollution); in this regard, the idiom "cannot see the forest for trees" comes to mind.[1] As the practice of sustainability and its associated movements evolved, so too have myopic perceptions of sustainability as limited to traditional environmental issues. Incorporation of related macro issues into the sustainability dialogue stemming from reckless business investment activities, development practices, and consequent environmental degradation resulting in human rights violations became a necessity. However, human rights issues seem to be addressed as secondary or solely linked-with environmental concerns and not so much as separate explicit issues to be considered. This article intends to reflect on and suggest ways to more explicitly incorporate human rights considerations associated with business investment activities into the Environmental, Social, and Governance ("ESG") metrics often employed to rate sustainable investment and financing decisions of companies; particular emphasis is placed on emerging trends in Norway's divestment decisions based in human rights violations and, to a lesser extent, recent policy changes taken by CalPERS.

I. Origin and Evolution of ESG Sustainable Finance

A. Sustainability, Business, and Finance

The United Nations Global Compact (the "UNGC") debut in early 2000 precipitated integration of sustainable finance on a global multilateral level.[2] Eight years prior to the UNGC, in 1992, the UN Environment Programme Finance Initiative (the "UNEP:FI") laid the groundwork for private sector banking, insurance, and investment involvement in sustainable finance.[3] Outside of the UN system, the Coalition for Environmentally Responsible Economies ("CERES") contemporaneously launched a set of sustainability reporting guidelines for companies.[4] Gradually, the idea of sustainable finance cooperation between the private sector, multilateral intergovernmental organizations, and public interest groups concretely manifested through the launch of the United Nations Principles for Responsible Investment ("UNPRI") in 2006.[5]

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[1]Dictionary of Cultural Literacy, 3rd Ed., Houghton Mifflin Company, 2005. http://dictionary.reference.com/browse/can't see the forest for the trees (last visited May 19th, 2017).

[2] United Nations, *United Nations Global Compact Annual Review – Anniversary Edition*, June 2010, at 9 *available at* https://www.unglobalcompact.org/docs/news_events/8.1/UNGC_Annual_Review_2010.pdf.

[3] United Nations Environmental Programme Finance Initiative, About, (May 19th, 2017). http://www.unepfi.org/about/

[4] Global Reporting Initiative, What is GRI? – History, https://www.globalreporting.org/information/about-gri/Pages/default.aspx (last visited May 19th, 2017).

[5] United Nations, Press Release, *United Nations Secretary-General Launches "Principles for Responsible Investment" Backed by World's Largest Investors*, Apr. 27, 2006 *available at* http://2xjmlj8428u1a2k5o34l1m71.wpengine.netdna-cdn.com/wp-content/uploads/un-unepfi-gc_press_20060427.pdf.

During this period of growth and recognition for sustainable finance and investment, numerous parallel multilateral sustainability initiatives took hold as well. Along with the UNGC in 2000 came the Millennium Development Goals ("MDGs") targeting various key problem areas associated with sustainability, poverty reduction, and development.[6] Additionally, the UN Financing for Development Office ("UNFFD") formed in 2003 to assist with the coordination and implementation of numerous finance and sustainability initiatives.[7] The UNFFD currently oversees the sustainable development and finance related commitments made in the "Doha Declaration on Financing for Development" in 2008.[8] With the transition from the MDGs to the Sustainable Development Goals ("SDGs") underway, the UNFFD's role in sustainable finance and investment became even more significant.[9] These multilateral developments in sustainable finance and investment activities occurring in the 2000s found their origins in criticisms of early finance debates.

B. From MPT and EMH to ESG

In the early 1950s Harry Markowitz developed a new investment theory, Modern Portfolio Theory ("MPT"), which emphasizes maximizing returns while minimizing risk through diversification of investments.[10] Nearly two decades later, Eugene Fama built upon Markowitz' concepts adding neoclassical economic ideals of rationality in developing the Efficient Market Hypothesis ("EMH").[11] Critics of MPT with respect to sustainable finance and investment emerged en masse following the financial crisis. One particular commentator argues that contemporary investment theory should measure investment success by more than whether or not they 'make money' for investors.[12] More specifically, Lydenberg argues that the definition of financial market success and investment success should include a greater purpose-driven goal oriented toward just and sustainable societies.[13]

Another post-2009 financial crisis commentator coming from a joint scholar and investment practitioner background criticized MPT and short-termism.[14] Youngdahl's work emerged as an outcome of the author's experience as a lawyer for employee retirement funds and

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[6] United Nations, General Assembly, *United Nations Millennium Declaration*, Sept. 18, 2000, G.A. Res. A/RES/55/2 *available at* http://www.un.org/millennium/declaration/ares552e.pdf.

[7] United Nations, General Assembly, *Ensuring effective secretariat support for sustained follow-up to the outcome of the International Conference on Financing for Development*, Mar. 5, 2003, G.A. Res. A/RES/57/273, *available at* http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/57/273&Lang=E.

[8] United Nations, Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus, *Doha Declaration on Financing for Development: outcome document of the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus*, Dec. 9, 2008, A/CONF.212/L.1/Rev.1*, *available at* http://daccess-dds-ny.un.org/doc/UNDOC/LTD/N08/630/55/PDF/N0863055.pdf?OpenElement.

[9] United Nations, General Assembly, *Organization of the United Nations summit for the adoption of the post-2015 development agenda*, Dec. 16, 2014, A/69/L.43*, *available at* http://www.un.org/ga/search/view_doc.asp?symbol=A/69/L.43&Lang=E.

[10] *See* Markowitz, H., *Portfolio Selection*, 7(1) J. FIN. 77 (1952).

[11] *See* Fama, E.F., *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25(2) J. FIN. 383-417 (1970).

[12] *See generally* Lydenberg, S., *Beyond Risk: Notes Toward a Responsible Investment Theory in* CORPORATE GOVERNANCE FAILURES, Hawley, Kamath and Williams eds., University of Pennsylvania Press (2011).

[13] *Id.*

[14] *See generally* Youngdahl, J., *Practitioners' Note: The Time Has Come For a Sustainable Theory of Fiduciary Duty in Investment*, 29 HOFSTRA LAB. & EMP. L.J. 115 (2011).

scholar-fellow with Harvard's 'Initiative for Responsible Investment.'[15] Thus, the primary focus is on fiduciary duty issues within an ERISA context and the tensions created by the Department of Labor's ("DOL") legal guidance (DOL guidance for sustainable investment activities will be discussed in greater detail in last part of the next section) for trustees interested in sustainable investment activities. Youngdahl, similar to other post-2009 financial crisis commentators, criticized MPT in light of the fiduciary conflicts it creates, but particularly for sustainable investment.[16] The overall thrust of Youngdahl's propositions are that ESG integration within fiduciary obligations and modified variations of MPT to promote sustainable investment counter short-termism by providing a more comprehensive investment picture.[17] Moreover, such integration between ESG and fiduciary obligations within modified versions of MPT have gained significant ground in Europe (as highlighted in the Freshfields Report[18] and discussed in the next section of this article).[19]

II. Integrating Human Rights Into ESG

A. ESG and Human Rights Background

The Global Reporting Initiative (the "GRI") began in Boston, Massachusetts in 1997 as an offshoot of earlier works by the non-profit organizations known as the "Coalition for Environmentally Responsible Economies" ("CERES") and the Tellus Institute.[20] The most current iteration of the GRI Guidelines is known as "G4" and is part of an on-going process to refine the process and approach to sustainability reporting. G4 Guidelines adopt a flexible approach to sustainability reporting that allows firms to adopt what are known as "core" or "comprehensive" options to demonstrate reporting compliance with the Guidelines.[21] The "core" option represents essentially the bare minimum for a compliant sustainability report by providing background for how an organization communicates ESG issues and impacts.[22] In addition to this background requirement, a organization must discuss its management approach and report a

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[15] *Id*.; for information regarding The Harvard Kennedy School's Initiative for Responsible Investment *see* Hauser Center, http://hausercenter.org/iri/.

[16] *Id.*

[17] *Id*.

[18] Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment*, October 2005, *available at* http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf; *see also* United Nations Environment Programme: Finance Initiative, *Fiduciary responsibility: Legal aspects of integrating environmental, social and governance issues into institutional investment*, July 2009, *available at* http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf [continuing the work of the initial 2005 Freshfields report]; *see also* United Nations Environment Programme: Finance Initiative, *Fiduciary Duty in the 21st Century*, September 2015, *available at* https://www.unpri.org/download_report/6131 [the most current iteration of Freshfields combined with a comprehensive update on UNEP:FI activities related to ESG].

[19] *See* Youngdahl, *supra* note 14.

[20] The Global Reporting Initiative, "What is GRI?: History" (May 19th, 2017) https://www.globalreporting.org/information/about-gri/gri-history/Pages/GRI's%20history.aspx.

[21] The Global Reporting Initiative, *An Introduction to G4: The Next Generation of Sustainability Reporting*, 2015, *available at* https://www.globalreporting.org/resourcelibrary/GRI-An-introduction-to-G4.pdf [hereinafter "GRI4"].

[22] *Id*. at 6.

minimum of one indicator associated with all of the organization's "Material Aspects."[23] Material Aspects are defined as "issues that are significant to a business' economic, environmental and social [EES] impacts and that substantively influence the assessments and decisions of its stakeholders."[24]

All of the Big Four Accounting Firms[25] are involved in the GRI, with Deloitte even providing certification training for sustainability reporting.[26] While this is commendable for the firms to get involved, their motives and methods of engaging with integrated and sustainability reporting has set off alarms among some commentators concerned with treatment and consideration of the Social metric aspects. One scholar who has studied the GRI extensively, Galit Safarty, notes some of the major shortfalls of over-reliance on quantitative measures as the sole measure for sustainability practices.[27] Further, Safarty emphasizes some of the problems that emerge from converting public values to numbers to comport with the notation "that what gets measured gets done."[28] The most important aspect of Safarty's work, however, is found in the discussion regarding the role and current involvement of the Big Four in the GRI.

By providing third party assurance for sustainability reporting within an accounting context, the Big Four have the ability to either do a lot of good or cause tremendous setbacks for the sustainable finance movement. As Safarty points out, one major area for concern involves the interpretation of legal norms, particularly those linked with international human rights law and environmental law, by accountants (not lawyers).[29] Related to this (and an issue not uncommon for the Big Four) are concerns for conflicts of interest in providing third party assurance on sustainability reporting.[30]

In order to enhance the legitimacy for accounting firm sustainability reporting there should be clear conflict of interest rules in place to address the concerns of possibly weakened indicators. Further, accountants should be interpreting and applying environmental and international human rights law in the sustainability reporting context. If the Big Four want to continue to offer services in the area of sustainability reporting they should employ lawyers for legal interpretation or somehow demonstrate comprehensive understanding and ability of their accountants to interpret and apply such legal standards and norms traditionally outside the scope of the general knowledge base of accountants. More on the relationship between GRI and other reporting initiatives as related to human rights within an ESG context is discussed later in Section III (A). Sustainability reporting is just one component in addressing the lack of explicit and separate human rights considerations in ESG. One of the leaders in ESG investment, the Norwegian government, uses a model that could provide a good starting point for others in explicit and consistent human rights integration.

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[23] *Id.*

[24] *Id*. at 4.

[25] Deloitte, PriceWaterhouseCoopers, Ernst&Young, and KPMG.

[26] Deloitte Global, "Global Reporting Initiative Certified Training Courses" (May 19th, 2017) http://www2.deloitte.com/us/en/pages/risk/events/gri-certified-training-courses.html.

[27] Sarfaty, G. A., *Regulating Through Numbers: A Case Study of Corporate Sustainability Reporting*, 53 VA. J. INT'L L. 575 (2013).

[28] *Id*.

[29] *See* Safarty, *supra* note 27.

[30] *Id*.

B. Norway's Government Pension Fund Global and Council of Ethics

When it comes to sovereign wealth funds, no country can top Norway's Government Pension Fund Global's ("GPFG") success of investment performance tied into ESG compliance, and more recently specific human rights considerations. At the close of 2014, the GPFG returned 7.6% or 544 billion kroner.[31] At the start of 2014, the GPFG reached a point where the fund could theoretically provide one million crowns to every living individual in Norway at that time…a little more than just a "rainy day fund."[32] Aside from its amazing financial performance, the GPFG is also a leader in moving sustainable finance considerations to the forefront of discussions on sustainable investment fund performance. So, what makes Norway's GPFG different from other sustainable investment funds in terms of human rights considerations?

The GPFG built its foundation for sustainable investment activities upon a core comprised of the UN Global Compact, OECD Principles of Corporate Governance, and OECD Guidelines for Multinational Enterprises.[33] Through a combination of applying these core international standards with their own, constantly evolving, sustainable investment practices, and by pursuing shareholder engagement, the managers of the GPFG carry out investment decisions. Sometimes the end result is divestment or a decision not to invest at all due to negative assessments of environmental and social (E and S metrics). In 2014, the GPFG divested from forty-nine companies that failed to meet the fund's standards.[34]

The fund focuses on long-term returns to safeguard the wealth of the Norwegian people now and well into the future. This attention to long-term concerns places the sustainable investment activities and decision-making for investment choices very much in alignment. Through a system of governance via a Council of Ethics established by the Ministry of Finance and the Norges Bank Executive Board (overseen by a Supervisory Council), the GPFG has managed to successfully lead the way in sustainable investment, but most importantly, in specifically integrating human rights into the social metric for the ESG assessment.[35] An aspect that is quite unique to the GPFG governance structure in comparison to other sovereign wealth funds and sustainable investment oriented funds is a fairly powerful and relevant Council of Ethics.

When the UN Guiding Principles on Business and Human Rights were introduced in 2011, the GPFG Executive Board signed on to the investor statement supporting it.[36] In 2014, the GPFG supported four shareholder proposals requesting comprehensive reports on identification and analysis of human rights risks both through direct company operations and indirectly through the companies' supply chains.[37] The imposition of Norway's GPFG ethics guidelines began in 2004 and since then have adapted to growing concerns that come with a more expansive definition of sustainable finance and investment.[38]

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[31] Norges Bank, Investment Management, "Positive Results for All Asset Classes", Press Release, March 13, 2015, *available at* http://www.nbim.no/en/transparency/news-list/2015/positive-results-for-all-asset-classes/.

[32] Alister Doyle, *All Norwegians Become Crown Millionaires, in Oil Saving Landmark*, Jan. 8th, 2014, REUTERS, *available at* http://www.reuters.com/article/2014/01/08/us-norway-millionaires-idUSBREA0710U20140108.

[33]Norges Bank, *Responsible Investment 2014* at 7, February 2015 *available at* http://www.nbim.no/globalassets/reports/2014/2014-responsible-investment.pdf [hereinafter GPFG 2014].

[34] *Id*.

[35] *Id.*, at 15.

[36] *Id*. at 17.

[37] *Id.* at 32.

[38] Halvorssen, A. M. and Eldredge, C., *Investing in Sustainability: Ethics Guidelines and the Norwegian Sovereign Wealth Fund,* 42 DENV. J. INT'L L. & POL'Y 389 (2014).

Part of the success of the GPFG, argue Halvorssen and Eldredge, can be attributed the active ownership mechanism and active exclusion or black-listing of firms that engage in unethical and unsustainable behavior.[39] With respect to the S metric, the GPFG is definitively a leader by considering human rights violations beyond the scope of simply labor rights issues (e.g. inclusive of "political terror").[40] In 2014, twenty-four (or approximately 18%) of the 135 company reports produced by the GPFG addressed human rights concerns beyond labor rights aspects of human rights.[41] The exclusion and/or divestment of companies by recommendation of the Council of Ethics resulted in sixty companies being excluded from the fund by the close of 2014.[42] Of the sixty companies excluded, three were specifically for human rights violations, two for violations of "other fundamental ethical norms", and three for "serious violations of the rights of individuals in situations of war or conflict" which arguably falls within the category of humanitarian law violations.[43] The human rights and humanitarian violations combined comprise approximately 28.5% of the conduct based exclusions from investment by the GPFG in 2014.

The GPFG model of exclusion for ethical violations inclusive of human rights considerations (defined broadly and inclusive of humanitarian issues) is fairly unique in approaching the Social metric for ESG analysis. Norway has inspired quite a bit of scholarly comment on and practical duplication of their evolving ethical exclusion approach. One such commentator, Ghahramani, proposes use of three models of sovereign-driven portfolio investment in relation to government pursuit of CSR and international law compliance linkages to sustainable investment (e.g. human rights violations).[44] The model exemplified by Norway's GPFG approach of "ethics-based legislative exclusion" plays an active role integrating human rights into the "S" consideration of ESG metrics.[45]

The companies currently excluded from Norway's GPFG for human rights or humanitarian violations include: Wal-Mart Stores, Inc., Wal-Mart de Mexico SA de CV, Zuari Agro Chemicals Ltd. for "serious or systematic human rights violations" and Africa Israel Investments, Danya Cebus and Shikun & Binui Ltd for "[s]erious violations of the rights of individuals in situations of war or conflict."[46] In addition, two companies, Potash Corporation of Saskatchewan and Elbit Systems Ltd. were also excluded from the GPFG, but for "serious violations of fundamental ethical norms."[47] The recommendations of the GPFG Council of Ethics that resulted in each company's exclusion from the fund provide insight into the thought process for human rights assessment linked to sustainable investment and finance decision-making. To maintain consistency with the GPFG's separation between "human rights" and "humanitarian" exclusions, the recommendations for each set companies will be addressed separately as well. However, the two "ethical norms" company exclusions will be addressed in their substantively

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[39] *Id.*

[40] *See* GPFG 2014, *supra* note 33, at 46.

[41] *Id*. at 48.

[42] *Id*. at 75.

[43] *Id*.

[44] Ghahramani, S., *Sovereigns, Socially Responsible Investing, and the Enforcement of International Law Through Portfolio Investment and Shareholder Activism: The Three Models*, 35 U. PA. J. INT'L L. 1073 (2014).

[45] *Id.*

[46] Runar Malkenes and Tor Martin Bærum, "Company Exclusions: Responsible Investments", April 9th 2014, NORWEGIAN MINISTRY OF FINANCE, *available at* https://www.regjeringen.no/en/topics/the-economy/the-government-pension-fund/internt-bruk/companies-excluded-from-the-investment-u/id447122/.

[47] *Id*.

relevant legal groupings (Elbit Systems Ltd. – humanitarian and Potash Corporation- human rights).

1. <u>GPFG Ethics Divestment Decisions – Human Rights Cases</u>

Wal-Mart Stores (and Wal-Mart de Mexico SA de CV) were the first companies to be excluded from the GPFG for human rights violations.[48] In the decision to exclude Wal-Mart from the fund, the GPFG Council of Ethics directly references internationally recognized human rights norms as well as legally binding international human rights treaty law.[49] In addition to citations to the International Covenant on Civil and Political Rights ("ICCPR"), the International Covenant on Economic, Social and Cultural Rights ("ICESCR"), and the Convention on the Elimination of All Forms of Discrimination Against Women ("CEDAW"), the GPFG Council of Ethics decision references a U.S. Supreme Court case, *Wal-Mart Stores, Inc. v. Dukes*, involving gender discrimination against women.[50]

Much in alignment with the Guiding Principles on Business and Human Rights, the GPFG Council of Ethics addressed Wal-Mart's corporate complicity in human rights violations as part of their divestment decision. Generally, the Council noted "conditions falling far short of the standards Wal-Mart itself requires of its suppliers and complicity in violations of ILO labour standards and human rights standards" and cross-referenced Wal-Mart Stores, Inc. *Standards for Suppliers: Internal Code of Conduct* [2004 version] to underscore the reasoning behind the divestment decision.[51] Specific violations range from active prevention of unionization (citing internal company documents such as "Wal-Mart: A Manager's Tool Box to Remaining Union Free") to slavery in violation of ICCPR Article 8 paragraph 3 and ICCPR Article 9.[52] Moreover, the Council referred to working conditions at textile factories in Wal-Mart's supply chain throughout the world as "abysmal" and rife with systematic abuse of employees/captured laborers (including children in violation of ILO Convention 182 and the UN Convention on the Rights of the Child).[53]

Five years after the Wal-Mart divestment decision, the Council reviewed a second company for human rights violations that led to divestment. Although officially divested under the GPFG category "Other particularly serious violations of fundamental ethical norms", the Potash Corporation of Saskatchewan decision involves implicit human rights allegations. The Potash decision involved phosphate resource extraction in the Western Sahara resulting in exploitation that does not give proper consideration to the local population.[54] The primary human rights issue addressed by the Council was self-determination given Morocco's lack of sovereignty over the Western Sahara.[55] The case implicitly addressed self-determination in a

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[48] *See* Runar Malkenes and Tor Martin Bærum, *supra* note 46.

[49] Gro Nystuen et. al., Petroleum Fund Council on Ethics, *Recommendation of 15 November 2005: Wal-Mart Stores Inc.*, Nov. 6, 2006, NORWEGIAN MINISTRY OF FINANCE, *available at* https://www.regjeringen.no/en/dokumenter/Recommendation-of-15-November-2005/id450120/ [unofficial English translation].

[50] *Id.*; *See also* Wal-*Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011).

[51] *See* Gro Nystuen et. al., *supra* note 49.

[52] *Id*.

[53] *Id*.

[54] Petroleum Fund Council on Ethics, *Recommendation of 15 November 2010: Potash Corporation of Saskatchewan & FMC Corporation*, Nov. 15, 2010, NORWEGIAN MINISTRY OF FINANCE, *available at* https://www.regjeringen.no/globalassets/upload/fin/etikk/2011/rec_phospahte.pdf [unofficial English translation].

[55] *Id*.

political autonomy sense and in an economic sense through the right to prevent resource exploitation, both of which are covered as recognized legal rights in the ICCPR and ICESCR respectively.[56]

The most recent divestment from the GPFG for human rights concerns occurred with Zuari Agro Chemical, Ltd. in 2013. The importance of the Zuari case to enhancing the presence and importance of human rights in determinative sustainable investment and finance decisions, particularly in lending teeth to the S-metric, cannot be underscored enough. In the very beginning of the decision, the Council states a clear line of demarcation on the responsibility of companies to comply with international human rights law despite the direct legal obligations being tied to States themselves and then derived from the international human rights conventions they are party to.[57] Most importantly, in the Zuari decision, the Council adopts an aggressive position on company accountability to international human rights law regardless of a company's home country legal recognition of such rights by stating:

> it is sufficient to establish that the company in question is acting in a manner that links it to serious or systematic violations of internationally recognised human rights. This applies regardless of whether the state where the violations are taking place has ratified the conventions against which the circumstances are assessed.[58]

The primary concern of the Council in the Zuari case involved the use of child labor, particularly children under the age of ten.[59] With Zuari Agro Chemical, the Council estimated that approximately 20% of the child laborers were under the age of 10 and children overall comprise approximately 30% of Zuari's agricultural labor.[60] After concluding that Zuari demonstrates no intention to remedy their human rights abuses, the Council recommended the exclusion of Zuari Agro Chemicals from any investments by the GPFG.[61]

Two of the three Council decisions (and three of the four companies, since Wal-Mart and Wal-Mart de Mexico were addressed jointly) based on human rights abuses involved severe and on-going abuse of children as a primary motivating factor for divestment by the GPFG. The third case adopted a broader view through indirect incorporation of human rights law via divestment due to violations of self-determination resulting from indigenous resource exploitation. In order to build a complete picture of human rights related divestment, the Council decisions for divestment associated with direct (human rights violations of individuals in conflict zones) humanitarian violations must also be considered. The companies excluded for these humanitarian violations were all involved in business activities in the territories of the West Bank and East Jerusalem.

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[56] Articles 1 and 27 in the ICCPR address human rights associated with political self-determination and Article 1 in the ICESCR; *see also* United Nations, *Self-Determination Integral to Basic Human Rights, Fundamental Freedoms, Third Committee Told as It Concludes General Discussion*, Sixty-Eigth General Assembly, GA/SHC/4085, Nov. 5, 2013, *available at* http://www.un.org/press/en/2013/gashc4085.doc.htm.

[57] Petroleum Fund Council on Ethics, *Recommendation on the exclusion of Zuari Agro Chemicals Ltd. from the Government Pension Fund Global's investment universe*, April 18, 2013, NORWEGIAN MINISTRY OF FINANCE, *available at* https://www.regjeringen.no/contentassets/f65ed42d67ee49d29ee8d238ff53d61d/zuari_eng.pdf [unofficial English translation][henceforth "Zuari Ethics Decision"].

[58] *Id.* at 2.

[59] *Id*. at 6-7.

[60] *Id*. at 9.

[61] *Id*. at 10.

2. <u>GPFG Ethics Divestment Decisions – Conflict/War Human Rights Violations Cases</u>

The first decision of the Council on non-munitions related humanitarian violations involved the company, Elbit Systems Ltd., which supplied the surveillance system for the West Bank territories, thus participating and perpetuating human rights violations against the occupants of the West Bank.[62] In 2012, three years following the initial Elbit decision, the Council expanded on reasoning behind Elbit in its decision to exclude Shikun & Binui Ltd. from the GPFG as well for similar reasons. The Shikun & Binui decision involved violations of the Geneva Conventions and associated human rights due to the Shikun's on-going participation in illegal settlement construction[63] in the occupied territories on the West Bank and in East Jerusalem.[64] The final two companies excluded within this group were Danya Cebus Ltd. and Africa Israel Investments Ltd. in 2014. The Council chose to exclude these companies from the GPFG for on-going (with no intention to stop) involvement in the construction of illegal settlements in East Jerusalem.[65]

These eight companies excluded from the GPFG for human rights violations (either direct human rights or within the context of humanitarian) provide insight and perspective on ways to include human rights considerations in sustainable investment and finance decisions. Given the extensive legal analysis conducted in the Council's decisions to exclude these companies, it may be possible to construct a stronger and easily transferrable framework for integration into the S-metric in ESG considerations. However, reliance on the GPFG decisions alone will not be adequate if the goal is to build a robust and comprehensive human rights measurement tool for S-metric areas in ESG analysis.

In February of 2016, Norges Bank Investment Management (the "NBIM"), which manages the GPFG, formalized their human rights considerations with the adoption of an explicit human rights policy.[66] The NBIM explicitly stated: "Companies have a responsibility to respect human rights, including in their own operations, as well as in supply chains and other business relationships. The expectations are based on international standards like the UN Guiding Principles on Business and Human Rights and the OECD's guidelines and principles."[67] The NBIM formal expectations document outlines four primary categories of expectations towards

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[62] Petroleum Fund Council on Ethics, *Recommendation on the exclusion of the company Elbit Systems Ltd*, Sept. 3, 2009, NORWEGIAN MINISTRY OF FINANCE, *available at* https://www.regjeringen.no/en/dokumenter/the-council-on-ethics-recommends-that-th/id575451/ [unofficial English translation].

[63] In a 2004 advisory opinion, the International Court of Justice found the construction of the settlements to be illegal under international humanitarian law; *see* International Court of Justice, *Legal Consequences of the Construction of a Wall in the Occupied Palestinian Territory*, July 4, 2004, *available at* http://www.icj-cij.org/docket/files/131/1671.pdf.

[64] Petroleum Fund Council on Ethics, *Recommendation for exclusion of Shikun & Binui Ltd. from the Government Pension Fund Global (GPFG)*, Dec. 21, 2011, NORWEGIAN MINISTRY OF FINANCE, *available at* https://www.regjeringen.no/contentassets/f65ed42d67ee49d29ee8d238ff53d61d/shikun_binui_eng.pdf [unofficial English translation].

[65] Petroleum Fund Council on Ethics, *Recommendation to exclude the companies Africa Israel Investments Ltd. and Danya Cebus Ltd. from the investment universe of the Government Pension Fund Global*, Nov. 1, 2013, NORWEGIAN MINISTRY OF FINANCE, *available at* https://www.regjeringen.no/contentassets/f65ed42d67ee49d29ee8d238ff53d61d/africa_israel_nov_2013.pdf [unofficial English translation].

[66] Norges Bank Investment Management, Human Rights Expectation Document, Feb. 4, 2016, https://www.nbim.no/en/transparency/news-list/2016/human-rights-expectation-document/.

[67] *Id*.

companies in relation to human rights.[68] It will be interesting to review the cases that emerge under the new expectations adopted in 2016.

On a much smaller scale, human rights violations are being considered (legislatively speaking) in American sustainable investment activities through state statutes (e.g. California) prohibiting investment in companies that do business with sovereigns or their SOE-affiliates with large human rights violations; Ghahramani refers to this model as "nation-centric legislative exclusion."[69] The last model, "extra-legislative activism", most commonly used by CalPERS, specifically employs the use of ESG in conjunction with legislated requirements. CalPERS provides a decent consideration of human rights within the "social" component of ESG with its "Emerging Equity Market Principles" [EEMP].[70]

C. CalPERS' EEMP

The California health and retirement benefits administrator, CalPERS, is the largest public fund of its kind in the United States.[71] Three years after Norway's GPFG adopted its ethical guidelines for sustainable investment activities, CalPERS adopted its "Emerging Equity Market Principles" ("EEMP"). The first principle of "political stability" includes considerations for human and economic rights.[72] Tensions caused by lagging interpretations of American fiduciary duties for institutional investors (e.g. CalPERS) and slow U.S. Department of Labor guidance on the related fiduciary issues for sustainable investment activities have held CalPERS back from achieving GPFG-level integration of human rights considerations in the S metric and from comprehensive sustainable investment engagement.

Many of the fiduciary legal problems faced by pension funds who wish to engage in sustainable investment activities extensively stem from Modern Portfolio Theory ("MPT"). In 2009, Johnson and de Graaf analyzed traditional concepts of legal fiduciary standards and duties emerging from MPT, particularly as related to pension funds and 'herding' behavior of investment activity.[73] Johnson and de Graaf refer to the current practice of fiduciary obligations in light of market changes as a "Lemming Fiduciary Standard" due to a failure to truly evaluate current practices based on what was once considered more of a "prudent expert fiduciary standard."[74] They further argue that this results in obsessive focus on short-term results which consequently violates the fiduciary duty of impartiality, particularly for pension funds that "manage assets to meet liabilities over several generations."[75] This last component is particularly important in comparing human rights integration into ESG analysis by Norway's GPFG and CalPERS.

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[68] Norges Bank Investment Management, *Human Rights Expectations Towards Companies*, at 3-4, 2016, *available at* https://www.nbim.no/contentassets/3258fe10181544cc8e02566c7237fa5f/human-rights-expectations-document2.pdf.

[69] *See* Ghahramani, *supra* note 44.

[70] *Id*.

[71] CalPERS, "About CalPERS" (May 19th, 2017) http://www.calpers.ca.gov/index.jsp?bc=/about/home.xml.

[72] CalPERS, *Emerging Equity Market Principles*, *available at* https://www.calpers.ca.gov/eip-docs/investments/policies/inv-asset-classes/equity/ext-equity/emerging-eqty-market-prinicples.pdf.

[73] Johnson, K. L. & Jan de Graaf, F., *Modernizing Pension Fund Legal Standards for the Twenty-First Century*, ROTMAN INT'L J. OF PENSION MGMT. (2009).

[74] *Id*.

[75] *Id*.

Some commentators argue that rather than seek a complete overhaul of American legal fiduciary duty standards, beneficiary participation enhancement within fund governance is a better approach.[76] Richardson advocates for this slightly different approach to ESG and fiduciary duties/obligations for fund governance. Unlike other commentators, Richardson suggests limited reform to fiduciary duties with stronger emphasis on strengthening beneficiary participation and voice within overall fund governance.[77] Richardson argues this can be achieved through the creation of legal requirements obligating representation of beneficiaries on fund boards or explicitly requiring that fund boards actively consult with beneficiaries.[78] The examples provided in his article for variations on these suggestions include: Ontario's former South African Trust Investments Act of 1988 and the Connecticut Retirement Plans and Trust Funds.[79]

A bit of a variation on this approach suggested by Jackson links issues of corporate law with shareholder primacy as contributing to the very short-termism problems pointed out by others, such as Johnson and de Graaf.[80] Jackson's work provides a comprehensive legal-historical overview of corporate governance in the U.S., U.K., and Germany and the evolution towards not just stakeholder theory, but viewing the stakeholder as shareholder models.[81] Specifically, Jackson discusses how aspects of corporate law combined with shareholder primacy contribute to short-termism at the expense of other stakeholder interests.[82] Thus, through the application of capital lock-in theory, stakeholder interests can be incorporated into the general theory of corporate governance deferring to a board of directors (which allegedly represents a "neutral mediating hierarch") with strong fiduciary obligations.[83] This assertion is supported by the fact that "no modern [American] court has struck down a decision by a board of directors because it favored stakeholder interests at the expense of shareholder interests."[84]

In March of 2015, CalPERS adopted a more stringent global governance policy.[85] The thirteenth Global Governance Principle in CalPERS new global governance policy explicitly charges CalPERS with a policy of "eliminating human rights violations."[86] To achieve this, the relevant CalPERS governance principle states that companies should be in compliance with Global Sullivan Principles or the United Nations Global Compact Principles.[87] Given the relative recency of CalPERS new global governance policy adoption, it will be a matter of time before an outcomes assessment similar to the human rights case analysis of Norway's GPFG can be conducted. Ultimately, CalPERS is constrained by U.S. legal standards, which have slowly been evolving to better accommodate ESG oriented investment activities.

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[76] Richardson, B. J., *Fiduciary Relationships for Socially Responsible Investing: A Multinational Perspective*, 48 AM. BUS. L.J. 597 (2011).

[77] *Id*.

[78] *Id*.

[79] *See* Richardson, *supra* note 76.

[80] Jackson, K. V., *Towards a Stakeholder-Shareholder Theory of Corporate Governance: A Comparative Analysis*, 7 HASTINGS BUS. L.J. 309 (2011).

[81] *Id*.

[82] *Id*.

[83] *Id*.

[84] *See* Jackson, *supra* note 80.

[85] CalPERS, *Statement of Investment Policy for Global Governance*, March 16, 2015, *available at* https://www.calpers.ca.gov/eip-docs/investments/policies/global-governance.pdf.

[86] *Id*. at 12.

[87] *Id*.

III. Legal and Accounting Considerations and ESG Human Rights

A. Contingent Liabilities and Human Rights Reporting

It is important to take into account discussion of contingent liability treatment when considering how to approach re-defining or enhancing current attributes of what defines the human rights aspects of the "S" in ESG. This is particularly so given potential application of contingent liability treatment to help enhance a measureable approach to incorporate actions taken by companies that may violate justiciable human rights into the "S". Difficulties arise when considering the multiple definitions and treatments of what constitutes a contingent liability from a loss perspective, particularly in relation to U.S. GAAP and IFRS Accounting Standards. Inconsistencies in reporting hampers progress in ESG advancement.

Under U.S. financial accounting standards, a loss contingency can range from probable to remote with the three specific categorical terms of "probably", "reasonably possible", and "remote" used to define the range of a contingent loss.[88] Further, two additional conditions are required for an estimated loss from a loss contingency to be reported on financial statements: 1) "it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements" and 2) "the amount of the loss can be reasonably estimated."[89] The rules are designed to both bar accrual of losses in relation to future periods (the probability aspect) and to ensure integrity of financial statements by having a loss be reasonably estimable.[90] The treatment of business risks is an important component of ASC 450-20 when exploring relationships between business activities and accountability for human rights violations within the context of expanding understanding of the Social metric in ESG.

U.S. financial accounting standards state "general or unspecified business risks do not meet the conditions for accrual in paragraph 450-20-25-2, and no accrual for loss shall be made."[91] As recognition of business obligations, both legally binding and investor expected, to respect not only the environment, but also human rights grows, so too will the prospect for loss contingencies that may have previously not met the conditions for accrual. Two of the most relevant loss contingencies for ESG assessment purposes are litigation and environmental liabilities.[92] Since the purpose of this article is to focus on the "S" in ESG, environmental liabilities will be only be discussed in so far as they relate to litigation associated with human rights violations tied to environmental liabilities. Before delving into the relevant jurisprudence to loss contingencies and contingent liabilities, contingency treatment differences under U.S. GAAP and IFRS must be discussed.

The IFRS equivalent to U.S. GAAP ASC 450-20 is found in IAS 37 which differs in several ways from ASC 450-20. A relevant difference between the two provisions involves how they define probability of incurring a contingent loss. More specifically, GAAP requires a greater degree of certainty ("likely") while IFRS applies a lesser degree of certainty ("more

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[88] Financial Accounting Standards Board, ASC 450 – Contingencies, -20 "Loss Contingencies", *available at* https://asc.fasb.org/section&trid=2127173.

[89] *Id*. at 450-20-25 (the phrase "date of financial statements" is further defined as "the end of the most recent accounting period for which financial statements are being presented").

[90] *Id*. at 450-20-25-3 to 25-5.

[91] ASC 450-20-25-8, "Business Risks."

[92] *See generally* Jonathan Schiff, Allen Schiff, and Hannah Rozen, *Accounting for Contingencies: Disclosure of Future Business Risks*, 13(3) MGMT. ACCT. Q. 1 (2012), *available at* http://www.imanet.org/docs/default-source/maq/maq_spring_2012_schiff-pdf.pdf?sfvrsn=0.

likely than not").[93] Another major difference between the two standards involves the disclosure requirements of contingencies, with IFRS providing a disclosure exception if the company would be seriously prejudiced by disclosure.[94] This last aspect, the disclosure exception provided for by IFRS, can provide a detrimental 'out' when evaluating a company's sustainable business practices using ESG metrics. Inclusion of contingent liabilities and associated discussions of materiality specifically for human rights abuses within existing reporting frameworks, such as the GRI and the UNGP reporting framework, will further the goal of recognizing human rights within ESG.

B. U.S. Uncertainty, ERISA Fiduciary Guidance, and Human Rights

ESG investment activities in the U.S. are regulated by the Employee Retirement Income Security Act (ERISA) with interpretative guidance from the U.S. Department of Labor. The state of uncertainty on exactly what is and is not acceptable in ESG investment activities is best demonstrated by the wording in U.S. Department of Labor's Interpretative Bulletin 2015-01:

> The Department believes that in the seven years since its publication, IB 2008-01 has unduly discouraged fiduciaries from considering ETIs and ESG factors. In particular, the Department is concerned that the 2008 guidance may be dissuading fiduciaries from (1) pursuing investment strategies that consider environmental, social, and governance factors, even where they are used solely to evaluate the economic benefits of investments and identify economically superior investments, and (2) investing in ETIs even where economically equivalent. Some fiduciaries believe the 2008 guidance sets a higher but unclear standard of compliance for fiduciaries when they are considering ESG factors or ETI investments.[95]

The bulletin goes on to make it clear that ERISA does not prohibit considering ESG factors, using ESG metric tools, nor is there a presumption that additional documentation will be required to justify ESG based investment decisions.[96] Yet, the matter of proper compliance to successfully engage in ESG investment activities still looms large presenting an uncertain path forward, particularly for the less popular of ESG activities – explicit and separate human rights based investments.

To this end, in acknowledgement of the uncertainty surrounding existing U.S. legal guidelines, a few multilateral efforts are underway. The United States is one country that has an active group within the UNEP:FI working on fiduciary duty issues in U.S. law within an ESG context.[97] Moreover, the UNPRI released a report earlier in 2016 containing two legal opinions from Groom Law Group and the law firm Morgan Lewis on ESG and ERISA.[98] As U.S. legal

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[93] *Id*. at 3.

[94] *Id*.

[95] United States Department of Labor, Interpretative Bulletin 2015-01, Oct. 26, 2015, *available at* http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=28547&AgencyId=8&DocumentType=1.

[96] *Id*.

[97] *See* United Nations Environment Programme: Finance Initiative, *Fiduciary Duty in the 21st Century: US Roadmap*, 2016, *available at* https://www.unpri.org/download_report/24188.

[98] *See* United Nations Principles for Responsible Investment, *Addressing ESG Factors Under ERISA*, Feb. 25, 2016, *available at* https://www.unpri.org/download_report/25250.

guidance and interpretation continues to develop, perhaps looking to international partners, such as Norway, could help formulate more concrete guidelines. In addition to these sources, other opportunities for collaboration may exist through partnerships with multilateral lending institutions.

In November of 2014, Vinod Thomas, Independent Evaluation Director General for the Asian Development Bank ("ADB"), made a significant statement on ADB (and implicitly all development bank) safeguard policies in support of sustainable finance. More specifically, Thomas said: "Safeguards are needed because public and private investors do not automatically mitigate the damages that spill over from their actions. Meeting the **safeguards cannot be aspirational or a goal to be considered down the road, but rather a regulation that is legally binding** [emphasis added]."[99] Thomas' statement regarding the strength of force for social safeguards in development bank investment activities bodes well for future enforcement considerations of human rights violations within the context of ESG.

IV. Conclusion

The potential for expanding human rights considerations within ESG analysis continues to grow with the emergence of explicit discussions of human rights as considerations not only integrated with, but more importantly, also apart from the environmental ("E") and governance ("G") factors in ESG. The examination of several sources, with particular emphasis on Norway's GPFG show promise in expanding opportunities for further integration of human rights within ESG. Given the recency of many of these changes, future research will involve reviewing outcomes from the GPFG's new and explicit human rights policies and how related human rights divestment decisions in the future joined with application of CalPERS new global governance policy will help shape the future of human rights considerations in ESG. Lastly, closer attention to the use of integrated reporting by global accounting firms with respect to such firms' interpretations of what constitutes reportable human rights violations will also need continued analysis in light of a quickly changing landscape for human rights in ESG.

[99] Santos, L. A., *ADB Leads Push for Requirements-Based Safeguards*, DEVEX, Nov. 12, 2014, https://www.devex.com/news/adb-leads-push-for-requirements-based-safeguards-84815 (last visited Feb. 13th, 2017).