IMPLICATIONS OF THE UK COMPANIES ACT 2006 FOR INSTITUTIONAL INVESTORS AND THE CORPORATE SOCIAL RESPONSIBILITY MOVEMENT

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Implications of the UK Companies Act 2006 for institutional investors and the corporate social responsibility movement

Gordon L. Clark¹ & Eric R. W. Knight².

Non-governmental organisations, activists, and the public-at-large hold large firms accountable on many issues including their environmental footprints and the social standards of their suppliers around the world. For those coming from European social democratic traditions, stakeholders have a legitimate voice in the affairs of the corporation especially in two-tiered governance regimes that separate supervision from management. Notwithstanding attempts to re-write their proper roles and responsibilities, the Anglo-American corporation is widely believed to be the medium for the accumulation of shareholder value.

Recently, however, a counter-argument has emerged suggesting that the UK Companies Act 2006 broke with this tradition to embrace the European model if not wholly then at least in terms of giving legitimate voice to social and environmental issues. We note that the UK Companies Act 2006 owes much to the EU Accounts Modernisation Directive but argue that the disclosure of social and environmental factors relevant to understanding the risks faced by the corporation owes more to the interests of institutional investors than community activism. We also suggest that there remain deep-seated divisions amongst institutional investors (especially different types of pension funds) that may have long-term consequences for UK disclosure policy and the power of markets to affect corporate social and environmental responsibility. We contrast the UK amendments with the current situation in the United States.

¹ Halford Mackinder Professor of Geography, Oxford University Centre for the Environment, Oxford University. This paper was presented at the Sloan Industry Conference 2008, Boston MA and the Financial Markets and Environmental Governance workshop at Oxford University. It is based upon the first-named author’s 2007 Nanovic Lecture on European Studies at Notre Dame University. It bears the imprint of continuing dialogue with Teresa Ghilarducci, Tessa Hebb and Cynthia Williams on the power of institutional investors. Thanks go to Notre Dame for the invitation to present the Nanovic Lecture, to Adam Dixon for research assistance on the themes developed herein, and to Tessa Hebb and Ashby Monk for comments on a first draft of this paper. None of the above should be held responsible for any errors or omissions.

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Introduction

Much is expected of the modern corporation. For shareholders seeking to maximise their return on investment, close attention is paid to reported earnings and stock price appreciation.\(^3\) Unanticipated negative movements in these variables can give rise to shareholder agitation, amplified by hedge funds and activist pension funds.\(^4\) Although this is characteristic of the Anglo-American ‘market for corporate control’, it is apparent that these types of pressures have been brought to bear on large continental European companies even though nation-state rules and regulations governing stakeholders’ relationships have been slow to embrace shareholder rights.\(^5\) It is significant that the European Union (hereafter, EU) has sought to ‘modernise’ member state corporate law responding, in part, to the reliance of member states on domiciled companies for long-term economic growth in the face of heightened global competition for market position and the integration of financial markets.

Shareholder interest in the rate of return aside, it should be acknowledged that community activists and some types of institutional investors have encouraged traded firms to respond to global challenges such as climate change and the welfare of employees and service providers in distant lands.\(^6\) For many activists, these issues are about ethics and moral responsibility given the enormous power of large corporations when compared to the majority of national governments. For some institutional investors, especially those with legal obligations as regards the long-term welfare of beneficiaries, short-term shareholder value is balanced against the long-term growth and development of whole economies.\(^7\) In these cases, fiduciaries are self-conscious about the time horizon over which they reap value from investment; even if not

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\(^7\) See Benjamin J. Richardson, *Do the fiduciary duties of pension funds hinder socially responsible investment?*, 22 BFLR 145 (2007).
intended, the largest of institutional investors have a stake in the long-term structure and performance of global markets.  

Whether corporations have any obligation other than making a profit - the limit of corporate social responsibility associated with Milton Friedman’s dictum proclaimed at the height of the cold-war - is subject to considerable debate.  For much of continental Europe, the corporation is foremost a social institution and is treated as such in corporate law. In many jurisdictions, the formal purpose of the corporation references the ‘social good’ albeit in a variety of guises, often stating an explicit commitment to community welfare and economic value. Even in the Anglo-American world, companies seeking social kudos often proclaim commitment to community norms and expectations; managing public expectations go well-beyond investor expectations, a fact-of-life recognised as such by non-governmental organisations (hereafter, NGOs) and community groups at the interface between media and markets. Mobilizing public confidence in corporate responsibility while remaining duty-bound by statutory obligations to shareholder value is a challenging task.

The issue of corporate responsibility has four distinct dimensions: social expectations, investor expectations (short-term and long-term), governmental expectations (statute and regulations), and theoretical-cum-academic expectations. We should take care not to discount the significance of any of these expectations, least of all the theoretical or ‘in-principle’ expectations of the academic community. These expectations can

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13 See Christine Parker, Meta-regulation: legal accountability for corporate social responsibility in id at 207.
be important given debate about the relative value of national models of corporate governance in global financial markets, with far-reaching consequences for the nature and scope of standards adopted by supra-national legislative entities such as the EU and the International Accounting Standards Board (IASB). The genesis of the UK Companies Act 2006 (hereafter, the Companies Act) is linked to Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 (hereafter, the EU Modernisation Directive) as well as deeply-entrenched domestic conceptions of the proper responsibilities of corporate officers. Understanding corporate responsibility as embedded in the Companies Act requires an appreciation of the interests of those stakeholders who sought to influence the conception and implementation of the Act.

Our paper has three goals. First, we show that the Companies Act is, in part, an expression of the EU modernisation project, amplified by the UK Labor government (hereafter, the Government) to further the global status of the UK as a leading standard-setting jurisdiction. Second, we suggest that the Companies Act can be seen as an expression of conventional microeconomic theoretical expectations as regards the proper roles and responsibilities of corporate officers rather than an expression of “traditional” corporate social responsibility (hereafter, CSR) discourse. By traditional CSR discourse we mean a theory of the firm in which the firm has a responsibility to external stakeholders (whether social, environmental, ethical or otherwise). Third, we argue that the disclosure requirements of the Companies Act are entirely consistent with Anglo-American investor expectations as regards the premium on the free-flow of market-sensitive data. While disclosure requirements seem to match the expectations of many social activists, especially regarding firms’

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14 See JEFFREY N. GORDON & MARK J. ROE (EDS.), CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (2004) (discussing the relative value of national models of corporate governance).
15 See The Companies Act 2006. See. Directive 2003/51/EC of the European Parliament and of the Council, June 18 2003, amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings. This Directive was passed by both Parliament and the Council as required under the co-decision procedure. We understand from Cynthia A. Williams in conversation with industry sources that the UK Government was unaware of the EU Modernisation Directive during its company law reform process, but added language to incorporate the EU process when they belatedly recognized that a parallel process was going on in Europe. However, we have not been able to verify this was the case.
long-term environmental liabilities, the motivating logic of such disclosure has more to do with the market pricing of corporate value than expansion of the scope of corporate social responsibility. Whatever the nature and scope of disclosure, care should be taken not to exaggerate the commitment of institutional investors to these issues. In conclusion, we distinguish between the demand and supply of disclosure and the interests of public and private pension funds.

In these ways, we challenge those who argue that the Companies Act is a major step forward in defining the nature and scope of corporate responsibility. We concede that it is important, but argue that its importance is to be found in its commitment to improving information disclosure relevant to market pricing. By our assessment, the Government was able to marry-together otherwise competing expectations of social activists and investors in a model of disclosure that is quite innovative (if judged against information-dependent theories of financial market performance). Equally, the Government was able to use this template to tame more radical amendments for disclosure on environmental foot-prints and global supplier-network conditions. Whether the form of disclosure on these issues will be effective depends, in part, on the degree to which institutional investors are willing to act on the information. Some may. But it is suggested that many of the largest private pension funds will not because of conflicts of interest inherent in these types of institutions.

Development of the modern Anglo-American corporation and finance sector

Modern capitalism

In his treatment of post-war economic structure and performance, Shonfield marvelled at the rate of growth in UK employment and income over the previous twenty years. By his account, the chronic instability and poor performance of the UK economy through the inter-war years had been solved by “the existence of in-built economic stabilisers” and Keynesian “control over the business cycle”. Some forty years ago, Shonfield argued that the conflict over consumption and investment, which had bedevilled the first half of the twentieth century, would be resolved through the

19 Id. at 17.
judicious use of national planning (especially as regards education and training), economic management, the welfare state, and the regulation of the large enterprises that dominated the economy. As for long-term growth, Shonfield suggested that many enterprises were of sufficient economic size to mobilize the internal resources necessary to invest in the next wave of innovation.

Shonfield’s treatise was matched in the US by Galbraith’s *The New Industrial State*. Both writers were transfixed by the emerging ‘partnership’ between the nation-state and the modern corporation, suggesting that the bureaucratic management of markets and incomes were to their mutual advantage. Elsewhere, Clark develops these claims about the symbiosis between the nation-state and the corporation for Anglo-American economies in the years leading up to about 1973 emphasizing their implications for the management of labour resources and the consequent growth of private pension systems. The “golden era of growth” was dominated by large industrial corporations, relatively high levels of unionization, and growing real incomes. It was also an era in which corporations held their assets as physical plant and equipment, market incumbency being the basis for long-term investment. Shonfield concluded that the “modern private enterprise” viewed itself as a “permanent institution”.

As the record shows, Shonfield and Galbraith wrote of a mode of accumulation at its peak. Through the 1970s, the UK experienced high levels of unemployment, slowing growth in real income, and rapid de-industrialization as private institutions faced the full force of international competition for market share. While US industry was not to face these competitive pressures until the 1980s, by the early 1990s Jensen argued that the US industrial corporation had proven unable to respond effectively to growing market competition because of management entrenchment and an imperfect market

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21 See Gordon L. Clark, Re-writing pension fund capitalism I: the modern corporation and pension benefit systems in a world of perpetual motion, OXFORD UNIVERSITY WORK PAPERS IN EMPLOYMENT, WORK AND FINANCE 05-08 (2005), available at http://www.geog.ox.ac.uk/research/transformations/wpapers/.
23 See ANDREW SHONFIELD, supra note 17 at 376.
for corporate control.\textsuperscript{24} Coming out of the 1980s, the UK economy had entered a new phase of accumulation where real incomes were now driven by employment in service industries and the pivotal place of London in the emerging global financial industry.\textsuperscript{25} By the end of the 1990s, the US economy had also been transformed albeit with greater income disparity and the remarkable persistence of a number of enormous industrial firms that had refused to die.\textsuperscript{26}

Our point in rehearsing the recent history of the UK and the US is to stress that, not so long ago, the modern corporation was a power in the land. It dominated domestic markets, it controlled its financial destiny, and it was an equal partner with the nation-state in fostering the growth and development of its home-market. The modern corporation and its associated unions could negotiate their shares of revenue (retained earnings and wages) often to their mutual benefit leaving the residual to be paid as dividends to shareholders.

Three forces conspired to undercut the power of the modern corporation.\textsuperscript{27} First, the liberalisation of product markets through the European Economic Community and then the EU effectively pitted UK industry, characterised by lower productivity growth and technological innovation, against robust European national champions. British firms resisted competition, turning slow rates of change into profound economic crisis. These types of competitive forces, found in the momentum associated with twenty-first century economic globalization, now threaten continental Europe. Second, as UK industry failed under the weight of resistance, the nation-state came to realise that the post-war ‘partnership’ could no longer be relied upon to deliver employment and rising living standards. This political calculus effectively discounted hide-bound class alliances, replacing the partnership with a more distant relationship such that the corporation was increasingly seen as a means to an end.\textsuperscript{28}

\textsuperscript{25} See GORDON L. CLARK, EUROPEAN PENSIONS AND GLOBAL FINANCE (2003).
\textsuperscript{26} See Ashby H. Monk, \textit{The knot of contracts: the corporate geography of legacy costs}, 84 ECON GEOGR 221 (2008).
\textsuperscript{27} See Luigi Zingales, \textit{In search of new foundations}, 55 J FINANC 1623 (2000).
\textsuperscript{28} See Kevin Campbell & Douglas Vick, \textit{Disclosure law and the market for corporate control} in supra note 10 at 241.
The nation-state invigorated the market for corporate control so as to sustain the growth of national income (if not the interests of corporate-elites).

Fuelling the transformation of British industry was the fledgling financial services industry. Underpinned by the reserves of established banks and insurance companies, the assets of public and private funded pension systems created in the aftermath of the Second World War flooded into London. Thatcher’s ‘big bang’ liberalised London’s markets, providing domestic savings with a global platform for portfolio investment around the world. Intended or not, the ‘big bang’ combined with burgeoning market liquidity gave the London market a significant ‘first-mover’ advantage over continental rivals, reinforced by the in-flow from American investment houses and then by the acceleration of global financial integration from the mid-1990s. Pension funds and institutional investors swamped the internal resources of corporations driving a wedge between the generation of earned income and the financing of corporate strategy and investment. As foreign banks came to London for a global and European location, the cosy alliances of the past were fractured.

Unlike much of continental Europe, the Anglo-American financial sector has grown separately from industry and the state. Because of the trust institution, the application of fiduciary duty as the governing ethic and the legal separation of asset management from pension plan sponsors’ treasuries it is arguable that plan sponsors being the origin of pension assets are also, paradoxically, the object of financial institutions’ investment strategies.29 Given the goal of maximising the portfolio risk-adjusted rate of return, the average traded firm has been forced into a corner: being just one stock in large diversified portfolios, it is neither held nor traded on its particular merits nor is its management necessarily held to account for poor performance. It is all about the short-term pricing of stocks given the flow of information about actual and expected earnings and market capitalisation. Automated trading systems cued to changes in stock market pricing and linked to stock market indices dominate daily trading volume.30

The modern corporation has become the traded object of global financial markets and, in some cases, deliberately so.\textsuperscript{31} Not surprisingly, the demand for information on its structure and performance has come to dominate debate over the proper substance of company law pitting national traditions against the argued inexorable logic of global financial market integration.\textsuperscript{32}

**Institutional investors, markets, and disclosure**

We have suggested that the growth of retirement savings in institutions at arms-length from the immediate interests of sponsoring companies altered the balance of power in financial markets in favour of third-party investors. Elsewhere, the nature and significance of this transformation for the structure of Anglo-American financial markets is described in detail and is referred to by Clark and Hebb as the “fifth stage of capitalism”.\textsuperscript{33} This develops Robert Clark’s 1981 account of the historical evolution of management theories over two centuries.\textsuperscript{34} As pension and retirement savings accumulated over the second half of the twentieth century, a revolution was taking place in the investment of those assets, accentuating the growing separation between traded companies and institutional investors and their market intermediaries.\textsuperscript{35} This revolution was conceptual and analytical and has arguably remade the structure and performance of global financial markets in its image.\textsuperscript{36}

As is well-appreciated, the vast majority of pension funds, mutual funds insurance companies, and endowments abide by the principles of modern portfolio theory (hereafter, MPT).\textsuperscript{37} In brief, these principles are as follows: (1) there is a correlation


\textsuperscript{32} See Susan Strange, The future of global capitalism: or, will divergence persist forever? in COLIN CROUCH & WOLFGANG STRECK (EDS.), POLITICAL ECONOMY OF MODERN CAPITALISM: MAPPING CONVERGENCE AND DIVERGENCE (1997) at 182.


\textsuperscript{34} See Robert C. Clark, The four stages of capitalism: reflections on investment management treatises, 94 HARV L REV 561 (1981).


\textsuperscript{36} See DONALD MACKENZIE, AN ENGINE, NOT A CAMERA: HOW FINANCIAL MODELS SHAPE MARKETS (2006).

\textsuperscript{37} See JOHN Y. CAMPBELL & LUIS M. VICEIRA, STRATEGIC ASSET ALLOCATION: PORTFOLIO CHOICE FOR LONG-TERM INVESTORS (2002).
between risk and return such that investment can be assessed in accordance with expected risk-adjusted rates of return; (2) investment strategy is about managing portfolio risk such that any particular investment and its associated risk and return characteristics should be judged against investors’ overall objectives; and (3) markets are so efficient that active investment—picking winning stocks over losing stocks—is not a viable long-term investment strategy. In combination, MPT provides a rationale for holding large swaths of whole markets, treating particular stocks as components in a comprehensive strategy of investment management. Given the costs of active management and the unlikely prospect of being able to formulate a consistent winning strategy, passive portfolio investment is the operative strategy.  

Accompanying the revolution in financial markets has been the systematic outsourcing of investment management from all but the largest of pension funds (note that mutual funds and insurance companies have, by their very nature, tended to internally manage pension and retirement savings). There are significant economies of scale in managing the flow of assets from contributors to funds to managers and in return to funds and their beneficiaries (witness the market dominance of custodial firms like State Street Bank of Boston). Likewise, there are economies of scale in executing planned trading strategies that vary by asset class and market segment. Just as importantly, while many investment banks offer a full range of investment management services, these firms often claim a stronger reputation in one asset class over others (for example, PIMCO in bonds but not in equities). Specialised knowledge and expertise are a continuing source of competitive advantage notwithstanding the claims made by bulge-bracket firms for the cost-advantages of complementary products.

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38 See BOB LITTERMAN & GOLMAN SACHS ASSET MANAGEMENT QUANTITATIVE RESEARCH GROUP, MODERN INVESTMENT MANAGEMENT: AN EQUILIBRIUM APPROACH (2003). This is not, of course, the full story. Recent research in the UK and the US on the persistence of ‘winning’ traders suggests that a small set of market players are able to produce out-performance in a systematic manner by virtue of their buying (but not selling) strategies. This is apparently the case for individuals as well as institutions (although the latter are likely to dominate the former); it is also widely believed that out-performance declines as the net inflow of assets to ‘winning’ mutual funds dampens the capacity of those entities to sustain their distinctive strategies - see, for example, Aneel Keswani & David Stolin, Which money is smart? Mutual fund buys and sells of individuals and institutions, 63 J FINANC 85 (2008).

39 See GORDON L. CLARK, supra note 24.
Just as importantly, the accumulated size, complexity, and time-sensitivity of global financial markets have effectively disenfranchised pension fund trustees from direct operational responsibility for investment management. Recognising this fact of life, pension fund trustees have been left with the responsibility for overall investment strategy informed, of course, by modern portfolio theory. Only rarely, and mostly in public pension funds, do trustees seek to influence the trajectory of particular stocks.

This story about the structure and control of investment management has been told a number of times (as noted above). In recent years, it has been complicated by a loss of confidence in the efficient markets hypothesis which underpins the third principle listed above of the MPT, the rise of hedge funds and alternative asset classes like infrastructure, and the search for alpha (a premium on active investment) over beta (the performance of whole markets). The sub prime credit crisis has also undercut the credibility of less-than-transparent risk transfer devices such as collateralised debt obligations (for example, mortgages). It is apparent that only the best-governed funds and institutions, focused on risk management and return volatility, have been effective investors in these arenas. For all the publicity garnered by endowments’ high compound annual rates of return, the average public and private pension fund has not been engaged in the frontiers of financial innovation nor has it been able to systematically out-perform asset-specific benchmarks.

What should be emphasised at this juncture is the degree to which institutional investors rely upon the veracity of market prices and the response of financial agents to those prices. The efficient pricing of stocks and bonds, let alone the more exotic financial instruments such as collateralised debt obligations is at the very heart of MPT. Even if the efficient markets hypothesis is not a full account of the anomalies and biases in market pricing and human behaviour, it serves as a normative claim on the proper value of quoted prices. As such, it is not surprising that enormous attention is paid by institutional investors (acting on behalf of their pension fund.

41 See TESSA HEBB, supra note 2.
clients) and governments (acting on behalf of the welfare of many millions of beneficiaries) to the informational content of market prices. In the end, the mis-pricing and systematic distortion of asset values represents a significant welfare cost to society and, more immediately, a constraint on the performance of investment managers (as apparent in the sub prime credit crisis). In this respect, the scope of “disclosure” by traded companies and related entities of market-relevant information has become the litmus test of financial regulation.\(^4^4\)

As the record shows, however, no country has an unblemished record in these matters, particularly in relation to the auditing of declared corporate assets and liabilities (witness the Enron and WorldCom scandals in the USA) and the treatment of insider and outsider shareholders as regards the timely disclosure of market information (as in much of continental Europe).\(^4^5\) La Porta et al. demonstrate the existence of very different national traditions as regards corporate disclosure policies and the variable significance attributed to global portfolio investors over entrenched domestic interests.\(^4^6\) Apparent differences between countries’ disclosure regimes have prompted some of the world’s largest pension funds to agitate for ‘reform’ either directly through the lobbying of governments or through the leverage applied by the differential investment of their own assets by company and country.\(^4^7\) As such, some of the world’s largest pension funds have been identified as important innovators in their own right, assuming the responsibilities and obligations of “universal owners”.\(^4^8\)

In this context, the election of the UK Labour government in 1997 and booming securities markets in the run-up to 9/11 seemed to offer a chance for social activists to

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\(^{4^5}\) For an account of the situation in the USA see John C. Coffee, *Racing towards the top? The impact of cross-listing and stock market competition on international corporate governance*, 102 COL L REV 1757 (2002). For the European comparison see supra note 30.

\(^{4^6}\) See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Legal determinants of external finance*, 52 J FINANC 1131 (1997). While the problems of management entrenchment and the influence of insiders over outsiders are often discussed with reference to continental Europe, it is apparent that some analysts of corporate governance would dispute the presumption in favour of US standards of corporate governance. See, for example, Lucian Bebchuk, *The case for increasing shareholder power*, 118 HARV L REV 833 (2005) on the costs of management entrenchment in the US and the improper limits imposed on institutional investors in exercising their ‘ownership’ rights.


\(^{4^8}\) See JAMES P. HAMLEY & ANDREW T. WILLIAMS, supra note 6.
mobilize the power of institutional investors. Being part of a larger debate over the prospects for a UK stakeholder society and the lessons to be learnt about CSR from continental European social democracies, the Labour government was lobbied to make good on the promise to affect socially responsible investment.\(^49\) In 1999 the Government issued changes in regulations—the Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc) Amendment Regulations—under the Pensions Act 1995 wherein trustees of occupational (and thereafter local government pension funds) were required to disclose in a written statement of investment principles the following:

(a) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and

(b) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments.\(^50\)

For all the critical comment that has accompanied this regulation, there are three reasons why its impact has proven rather limited.\(^51\) Most obviously, the change in regulation pre-supposed corporate disclosure on these issues whereas the nature and scope of corporate disclosure was not directly affected. In any event, though hardly recognised at the time, the effects of the change in regulation were to fall largely on fund managers rather than on pension funds. Fund managers were reluctant to engage with the issues unless directly required by their clients.\(^52\) In this respect, the regulation did not require institutional investors to take social, environmental or ethical considerations into account in their investment decisions. The Government also rejected a proposal by the UK Social Investment Forum for amendment to the Financial Services and Markets Act 2000 to include the provision of environmental


\(^50\) Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc) Amendment Regulations 1999 at cl. 2(4).


\(^52\) The lack of responsiveness of the global finance industry to social concerns, indeed social welfare, is one of the topics explored in JOHN C. BOGLE, THE BATTLE FOR THE SOUL OF CAPITALISM (2005).
investment and related lending products within the Financial Services Authority’s mandate.\textsuperscript{53}

The emergence of mandatory reporting requirements of non-financial information

The \textit{EU Modernisation Directive}

The EU Modernisation Directive was a product of the Lisbon Strategy of 2000 which sought to build competitive and efficient European financial markets.\textsuperscript{54} The Strategy set 2005 as the deadline by which the European Commission’s Financial Services Action Plan (hereafter, FSAP) of 1999 would be implemented.\textsuperscript{55} The motivating purpose of the FSAP was to “enhance the comparability of financial statements prepared by Community companies whose securities are admitted to trading on a regulated market”.\textsuperscript{56} Regulations which emerged from the FSAP included Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 which introduced the requirement that European listed companies prepare consolidated accounts in accordance with International Accounting Standards from 2005 onwards.\textsuperscript{57} The EU Modernisation Directive sought to ensure that annual and consolidated reporting for EU companies was in line with best practice, including the reporting of financial and non-financial information.

The EU Modernisation Directive was ambitious in its scope, amending both annual reporting under Directive 78/660/EC and consolidated annual reporting under Directive 83/349/EEC. It instituted a system of reporting whereby companies must provide “at least a fair review of the development and performance of the company’s

\textsuperscript{53} Financial Services and Markets Act 2000. If limited in scope, the UK ‘reform’ did spark legislative initiatives in continental Europe and Australia for fund managers to actively consider social, environmental and ethical concerns in their investment decisions. Sweden introduced the toughest provisions regarding social and environmental disclosure. Regulatory reforms in January 2001 required Sweden’s five largest state-run pensions, to incorporate environmental and ethical considerations in their investment strategies as well as report to the Government on the implementation of this policy: “investments activities shall take environmental and ethical considerations into account without lowering the overall objective of a high return”.


\textsuperscript{56} See EU Modernisation Directive, supra note 15 at recitals clause 1.

business …together with the principal risks and uncertainties that it faces”.

Although this did not explicitly refer to environmental, social or governance factors of firms, the Directive provided that “where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters” shall be reported.

The EU strategic plan subsequent to the Lisbon Strategy, the Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union launched by the European Commission in May 2003, was one of the points of reference for the UK’s 2005 White Paper on Company Law Reform (hereafter, White Paper).

The White Paper was framed around four strategic objectives. These were to enhance shareholder engagement and a long-term investment culture, ensure better company regulation and a “think small first” approach, make it easier to set-up and run a company in the UK, and provide greater flexibility for corporate reforms in the future. The White Paper described disclosure reforms as “a further major step forward in improving company reporting and transparency and in promoting effective dialogue on the drivers of long-term performance”.

Heightened disclosure standards were driven by a commitment to a more efficient market pricing of traded companies, implying that stock prices ought to be determined by long-term value.

Unresolved was whether non-financial disclosure had separate status or was dependent upon a demonstrable link to stock market pricing. The initial legislative effects of the EU Modernisation Directive and the UK White Paper as regards greater disclosure of financial and non-financial information came through in the 2005 amendments to the UK Companies Act 1985 (hereafter, OFR Regulations).

Among the items considered, these amendments established the requirement for an Operating and Financial Review (hereafter, OFR) for quoted companies. One motivation behind

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58 EU Modernisation direction, supra note 15 at article 1 cl. 14(a) and article 2 cl. 10(a).
59 Id.
61 White Paper, id. at 12.
these amendments was the incorporation into UK law of the new accounting requirements introduced under the EU Modernisation Directive. There were, however, other important domestic considerations in the UK’s purpose and intended effects of these reforms.

The domestic considerations behind the OFR reforms can be elucidated from the Department of Trade and Industry’s “Final Regulatory Impact Assessment on the Operating and Financial Review and Directors’ Report Regulations”.

Therein it was noted that there was a need for a sophisticated financial disclosure regime to encourage capital market activity. The key purpose and intended effect of the OFR was to improve shareholder engagement (as opposed to stakeholder engagement), and it was argued that clear, meaningful, and reliable information about the main drivers of a company’s performance was the way forward in encouraging shareholders and potential investors to exercise effective and responsible control in their investment decisions.

It was also argued that where market asymmetries of information were overcome, investors would be more able to invest in capital markets with reduced adverse selection and therefore lower liquidity risks.

Improved transparency through greater access to data on quoted companies should place shareholders in a better position to effectively protect their interests and control directors’ overreach. In addition, adopting the “fair review” standard from the EU Modernisation Directive would lead to “reporting on performance on financial and non-financial matters”.

Environmental disclosures were to be elements of non-financial “matters”, acknowledging the pressure on businesses to account for the increasingly important intangible asset value of a firm based on its brand image and reputation.

In this way, although the OFR demonstrated similarities to the EU

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64 Id. at paragraph 5.
65 Id. at paragraph 4 and 9.
66 Id. at paragraph 8.
67 See Rob Bauer, Robin Braun, & Gordon L. Clark, supra note 3.
68 UK Department of Trade & Industry, supra note 63 at paragraph 13.
69 Id. at paragraph 18. The significance of intangible assets for the modern corporation clearly varies by sector, and the history of a corporation. Methods of discriminating between corporations as regards their sensitivity to reputation have been developed, in part, based upon proprietary databases. See, for example, Gordon L. Clark & James Salo, Corporate governance and environmental risk management:
Modernisation Directive by requiring reporting on non-financial matters, the OFR’s broader focus on shareholders’ interests and the proper pricing of a company’s future financial performance distinguished the OFR from continental European notions of stakeholder capitalism in favour of the predominant concerns of Anglo-American shareholder capitalism.\(^70\)

Indeed, the UK’s particular concern for shareholders’ interests may explain the more rigorous disclosure provisions in the OFR compared with the EU Modernisation Directive. The EU Modernisation Directive applied to large and medium-sized companies without distinguishing between quoted and non-quoted companies, and framed its reporting provisions on financial and non-financial information generally without specific reference to the kind of information which would need to be disclosed nor the intended recipients of this information. However, the Government made the UK position clear by emphasising that the requirement to disclose non-financial information was directed at the interests of shareholders rather than stakeholders: “The Government believes that the shareholder base of quoted companies – typically large and diverse – has different and additional needs to that of private companies, hence the requirement to prepare more fulsome, and more forward-looking review than that required under the [EU Modernisation] Directive”.\(^71\)

In this sense, the UK’s OFR was largely motivated by a conviction that environmental and social information had a clear link to stock market pricing and future financial performance.

Although the reasons for the OFR’s broad disclosure of non-financial information including where appropriate corporate environmental and social responsibility (hereafter, CESR) were grounded in conventional theories of the firm, they also satisfied NGO interests in corporate social responsibility. As discussed, these provisions directly incorporated the requirements for “fair review” reporting of a

\[^{70}\text{We would therefore argue against the claim that the OFR represented a push towards stakeholder capitalism within the UK as John. M. Conley & Cynthia A. Williams, supra note 51 suggest. Rather, the OFR distinguished itself from what we define as traditional CSR because it was ultimately focussed on shareholders’ financial interests.}\]

\[^{71}\text{UK Department of Trade & Industry, supra note 63 at paragraph 14.}\]
company’s development, performance, or position as set out in the EU Modernisation Directive. However, they went further by requiring companies to report on “the future trends and factors underlying the development, performance and position” of the company in the next financial year.\(^\text{72}\) Additionally, OFR provisions gave substance to the EU Modernisation Directive’s requirement for non-financial reporting on “environmental and employee matters”.\(^\text{73}\) Companies were to be required to include information about the environment including analysing the impact of the company on the environment.\(^\text{74}\) As well, companies were required to provide “information about social and community issues”.\(^\text{75}\)

In November 2005, however, the UK Chancellor abandoned the new OFR provisions less than 6 months after they were introduced without consultation with the Department of Trade and Industry, other Ministries, or relevant stakeholders.\(^\text{76}\) The publicly stated reason for abandoning these provisions was the administrative costs associated with reporting. The then Chancellor (and now Prime Minister) Gordon Brown said: "I understand the concerns about the extra administrative cost of the gold-plated regulatory requirement that from April next year all quoted companies must publish an operating and financial review”.\(^\text{77}\)

The policy reversal was not met with universal acclaim by the business community. In any event, as we note below, these provisions reappeared in a weaker form in the Company Law Reform Bill (hereafter, Reform Bill) which was debated in the House of Lords and the House of Commons through 2006 before its passage as the UK Companies Act 2006.\(^\text{78}\) Lord Sharman during the Second Reading on the Reform Bill in the House of Lords assessed the political and business communities’ positions on disclosure in the following terms: “the Chancellor’s statement abolishing the OFR

\(^{72}\) OFR Regulations, supra note 62 at § 1(d).

\(^{73}\) Id. at § 6 cl. 1.

\(^{74}\) Id. at § 4 cl. 1(a).

\(^{75}\) Id. at § 4 cl. 1(c).

\(^{76}\) For example, in anticipation of the adoption of the OPR, the UK Accounting Standards Board had published an Exposure Draft in 2005 canvassing the likely scope of expected disclosure as well as various measures needed to implement the policy. See BBC NEWS, “Chancellor gives ONS independent,” dated 28 November 2006, available at http://news.bbc.co.uk/1/hi/business/4477516.stm. For a more detailed discussion on the political story surrounding the UK Government’s policy reversal on the OFR see Cynthia A. Williams & John M. Conley, Triumph or tragedy? The curious path of corporate disclosure reform in the UK, 31 WM. & MARY ENVTL L & POL’Y REV 317 (2007).

\(^{77}\) Company Law Reform Bill, House of Lords, 1 November 2005.
simply did not earn him the brownie points from the business community that he anticipated….investing bodies like the notion of an OFR and the issues that have given rise to concern did not involve whether there should be an OFR, but involved some of the data that were to be required”. 79

**Passage of the UK Companies Act 2006**

In the Reform Bill, the obligation on companies to report on non-financial information as per the OFR was replaced by an obligation on company directors to produce an annual business review. 80 The Bill abandoned substantial provisions which had appeared in the OFR. First, the Reform Bill dropped the requirement for forward-looking reporting on the main trends and factors likely to affect the company’s future. Second, although the business review would be required to include information on environmental and employee matters where appropriate, “social and community” issues were omitted. 81 Furthermore, environmental matters no longer explicitly included the impact of the business on the environment, and the requirement to disclose a company’s environmental impact assessment policies and the success of their implementation was abandoned. Finally, whereas the OFR and the EU Modernisation Directive required businesses to report in a manner consistent with their size and complexity, the Reform Bill exempted businesses qualifying as “medium-sized” from reporting non-financial information. 82

In debate through the House of Commons and House of Lords, however, the Government was pressured to reinstate many of the OFR provisions which had been removed in the business review section of the Reform Bill. Although there was lobbying from both the NGO and business communities, the key reforms which made it into the Bill were based on mainstream microeconomic theories of the firm and efficient markets *vis-a-vis* information disclosure, rather than a radical CSR model for the UK corporation.

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79 Second Reading, House of Lords, 11 January 2006 at 194.
80 Reform Bill, *supra* note 78 at § 390, cl. 2.
81 *Id.* at § 390, cl. 4(b).
82 *Id.* at § 390, cl. 7.
In this respect, the Government’s disclosure regime was consistent with Jensen’s theory of the firm.\textsuperscript{83} An implicit assumption permeating debate in the House of Commons and House of Lords was that information related to environmental and social matters is crucial for markets to accurately evaluate the market prices of firms. Jensen argued that the firm is a product of the relationship between principals (shareholders) and agents (management), and that shareholders and managers do not have the same interests. Consequently, resources (both pecuniary and non-pecuniary) are expended by both parties to maximize their private interests. Shareholders commit “monitoring expenditures” in order to oversee directors’ actions and seek to limit activities that harm their interests.\textsuperscript{84} Directors, on the other hand, give shareholders appropriate incentives in the contracting relationship to deflect suspicion and pay shareholders “bonding costs” to guarantee that shareholders will not hinder their activities.\textsuperscript{85} Jensen described the total costs which arise from this “unavoidable” tension between shareholders and directors as “agency costs”.\textsuperscript{86} Agency costs can be positive and even desirable so long as the benefits to the firm’s yield exceed the downside costs.

In the final version of the Reform Bill, disclosure was deemed necessary in order to give effect to the newly codified directors’ duty to act in a way which is “most likely to promote the success of the company for the benefit of its members as a whole”.\textsuperscript{87} In carrying out this duty, the new drafting of section 172 stated that directors would:

have regard (amongst other matters) to:

(a) the likely consequences of any decision in the long term;

[...]

(c) the need to foster the company’s business relationships with suppliers, customers and others,

\textsuperscript{83} See MICHAEL JENSEN, supra note 16.
\textsuperscript{84} Id. at 86.
\textsuperscript{85} Id.
\textsuperscript{86} Id.
\textsuperscript{87} Companies Act 2006, supra note 15 at § 172.
(d) the impact of the company’s operation on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct; [...] \(^{88}\)

In effect, this provision identified CESR matters as issues to which directors would need to turn their mind to in carrying out their duties for the benefit of the company. This is very different from CSR where the company is motivated by responsibilities towards external stakeholders.

In the Grand Committee stage in the House of Lords and throughout the passage of the Bill at issue was whether the duty to promote the success of the company was a new duty which therefore required a change in implementation arrangements to support this duty or whether it simply made no difference. Lord Sharman’s view was that a new duty would be formed to push the Anglo-Saxon model of corporate endeavour “to a more not quite pluralist society but rather a northern European model where a group of stakeholders are involved”. \(^{89}\) This was contested by Lord Hodgson who argued that the Bill simply codified common law duties and therefore made no substantive difference to the existing legal position.

Lord Sainsbury, Under-Secretary of State for the Department of Trade and Industry, sought to clarify the Government’s position. Although he acknowledged that the Reform Bill would codify common law duties, he contended that it would make a substantive difference by identifying specific factors which are relevant to the success of the company. \(^{90}\) In this way, the codification of directors’ duties could be regarded as a monitoring cost imposed on directors so that shareholders and prospective shareholders could better assess the risk/return profile of UK firms. The significance of newly codified directors’ duties, then, was not that they materially changed the relevance of CESR considerations in terms of the success of the company. Rather it was that they explicitly acknowledged what had previously been taken to be the

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\(^{88}\) Id.

\(^{89}\) Grand Committee, House of Lords, 1 March 2006 at 169.

\(^{90}\) Id. at 170.
implicit: the importance of CESR factors in protecting shareholders’ interests and the
long-term success of the company.

In the House of Commons, a company’s environmental and ethical performance was
interpreted as a financial value issue by the Conservatives, rather than as a purely
environmental or traditional CSR issue. Justine Greening MP argued that:

[A]t the heart of any successful company is an in-depth understanding
of what its customers want and value. Perhaps more than at any time
in the past, customers place a value not just on what they are
purchasing from companies, but on the way in which companies have
carried out their business in order to provide those products or
services. Companies can therefore be at the forefront of the push to
tackle environmental and ethical issues.\(^91\)

She distinguished this financial value-based argument from a purely environmental-
based case for the disclosure regime saying “as the Minister said, company law is not
the best vehicle for addressing wider social and environmental concerns. We can
address those objectives, as some Government Members have said, through domestic
legislation, health and safety measures and environmental protection, on which
progress has been made”.\(^92\)

A second issue debated was the need for an auditor’s report to verify the validity of
reported information. Baroness Thorton in the Grand Committee stage of the House
of Lords identified quality assurance of the information as an issue which was raised
from public consultations on the OFR regulations but which was not addressed in the
Reform Bill.\(^93\) Her concern was that unaudited information would result in the
provisions becoming a “marketing bandwagon” for companies to promote their
alleged “ethical”, “sustainable”, or “fair trade” products and services.\(^94\) This concern
was echoed later in the House of Commons where it was argued that much of the
information presented by companies on environmental and social responsibility is

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\(^91\) Debate, House of Commons, 18 October 2006 at 889.
\(^92\) Id. at 890.
\(^93\) Grand Committee, House of Lords, 1 March 2006 at 166.
\(^94\) Id. at 167.
public relations or “green-wash”. The House of Commons’ focus on this issue indicated a specific intention to overcome the charge often made of traditional CSR discourse as an elaborate form of public relations. The auditing of corporate reports was therefore central to making the information relevant to actual business performance rather than simply another avenue for marketing.

In the final version of the Companies Act, the provisions regarding the auditing of disclosed information remained weak. The only explicit obligation on the auditor is with respect to the directors’ report more generally, which includes the business review. At section 496 of the Companies Act, the auditor “must state in his report on the company’s annual accounts whether in his opinion the information given in the directors’ report for the financial year for which the accounts are prepared is consistent with those accounts”. There is no requirement to verify the validity of the non-financial information itself. This reflects the Government’s eagerness to avoid a “prescriptive” or rules-based approach to reporting. The provisions which do apply to the quality of reporting hold directors liable for loss to the company suffered as a result of any untrue or misleading statements in the directors’ report. Personal liability also attaches to directors if they fail to disclose relevant information to the company’s auditor or if they fail to take all relevant steps to do so.

A related issue which attracted attention in the House of Lords was a late amendment to the Reform Bill suggested by the House of Commons on 18 October 2006 to require disclosure of “information about persons with whom the company has contractual or other arrangements which are essential to the business of the company”. This is particularly relevant to companies’ supply chains. There were two substantive objections to this amendment debated by the House of Lords. First, it was thought by Baroness Cohen that disclosure of this information would be detrimental to business because of its commercially sensitive nature. Second, there

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95 Id.
96 See John, M. Conley & Cynthia A. Williams, supra note 49.
97 See Margaret Blair, Cynthia A. Williams, Li-Wen Lin, The new role for assurance services in global commerce, 33 J Corp L 2 (2008).
98 Companies Act 2006, s496.
99 Id. at § 463.
100 Id. at § 418.
101 Id. at § 417, cl. 5(c).
102 Considering of Commons Amendments, House of Lords, 3 November 2006, citing Baroness Cohen.
was a concern expressed by Baroness Noakes that the obligation would be too onerous, since it was unclear how much detail companies would need to provide so as to comply with the provision.\textsuperscript{103}

The Government made two clarifications in response to these concerns. The first was to provide an exception to reporting on supply chain issues where “disclosure would, in the opinion of the directors, be seriously prejudicial to that person and contrary to the public interest”.\textsuperscript{104} Secondly, the Government did not intend disclosure to be particularly detailed, but to be sufficiently high-levelled so as to give an impression of the principal risks and opportunities facing the company.

While these clarifications were sufficient to win support for the amendment, they also highlighted the absence of rules and regulations which could serve as benchmarks for the quality and quantity of required disclosure. The omission of such standards reflected the Government’s concern not to impose costly reporting obligations on companies, and to leave much of the nature of reporting to directors’ discretion. But as Lord Razzall commented in the final Consideration of Commons Amendments in the House of Lords on November 2006:

\begin{quote}
[W]e support the NGOs in believing that the Government…ought to give some indication of what the standard reporting practice should be, which they have the power to do by regulation. The whole purpose of this is not only to obtain the disclosure of information itself, but also to provide a measure by which a number of ethical investors, or those who wish to invest within an ethical framework, can obtain comparisons between different companies. It would be difficult for those ethical comparisons to be made without some element of standard reporting practice which I feel can come only from the Government.\textsuperscript{105}
\end{quote}

\textsuperscript{103} \textit{Id} citing Baroness Noakes.  
\textsuperscript{104} \textit{Id} citing Lord Sainsbury of Turville.  
\textsuperscript{105} \textit{Id.} citing Lord Razzall. This echoed the principal purpose of the EU Modernisation Directive which was to generate a common reporting standard so as to allow comparison between European traded companies on financial and non-financial measures.
It was not just the NGOs but also members within the business community who were concerned about the lack of a clear reporting standard.

Ultimately, the disclosure regime promulgated under the final Companies Act 2006 incorporated elements of the EU Modernisation Directive. Nonetheless, there were significant differences in form and substance. In section 417(2) of the Act directors, not the company, are required to compile a business review “to inform members of the company and help assess how the directors have performed their duty under section 172 (duty to promote the success of the company)”.

Furthermore, for the reasons suggested above, the precise scope and scale of the business review was more rigorously worded that the EU Modernisation Directive, as follows:

[T]he business review must, to the extent necessary for the understanding of the development, performance or position of the company’s business, include:

(a) the main trends and factors likely to affect the future development, performance and position of the company’s business; and

(b) information about (i) environmental matters (including the impact of the company’s business on the environment), (ii) the company’s employees, and (iii) social and community issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies; and

(c) subject to subsection (11), information about persons with whom the company has contractual or other arrangements which are essential to the business of the company.

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107 Id. at § 417, cl. 5.
The new role of corporate environmental and social governance (CESR) information in the finance sector

Disclosure standards and financial intermediation

As is the case in many areas of European policy making, member states are required to adhere to EU Directives unless there are previously agreed exceptions specific to a member state (as for the UK in selected areas of policy making). While the EU does lead the UK in a variety of policy areas, especially as regards employment rights and conditions and environmental policy, it is arguable that the roots of the EU Modernisation Directive in the Lisbon Strategy (2000) and the commitment to pan-European integration of financial markets reflected the interest of the Government (and the city of London in particular) in a growing market for financial services as well as the unfettered flow of portfolio investment to Europe’s largest traded companies. In fact, the EU Modernisation Directive came to the UK policy arena already committed to reinforcing UK global advantages in corporate governance and the “principles approach” over the “rules and regulation” approach to securities regulation.108 In this context, the Companies Act can be seen as elements of a concerted campaign by the Government to reinforce the dominance of London in European financial markets, and the advantages enjoyed by London over New York in international financial market transactions.109

As noted above, the Companies Act left company directors responsible for disclosing relevant information for business reviews of the long-term prospects of their firms. In doing so, the Act relied on a principles-based standard of accounting based on “a fair review of the company’s businesses” while referencing the crucial issues to be

109 See John C. Coffee, supra note 44. Competition between financial centres for global position is a vital ingredient in debate over nation-state financial regulation. See Dariusz Wójcik, Geography and the future of stock exchanges: between real and virtual space, 38 GROWTH CHANGE 200 (2007). In their assessments of the declining significance of Wall Street in relation to London both the Committee on Capital Markets Regulation (2007) and the Bloomberg and Schumer report suggested that one cause of this decline was to be found in the costs of US securities regulation and especially the US preference for detailed rules and regulations over principles. See MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK’S AND THE US’ GLOBAL FINANCIAL SERVICES LEADERSHIP, CITY OF NEW YORK (2007). This issue has re-emerged with the debate over the proper US regulatory response to the sub-prime credit crisis; for some, the crisis was the result of banks and financial institutions circumventing the rules as regards capital adequacy and the like. By some accounts a principles approach would have dampened such behaviour putting the onus on the institutions to show that their investment practices were consistent with the intentions of regulators.
considered.\textsuperscript{110} As such, it did not provide an explicit definition of the nature and scope of proper reporting on those issues. For some commentators, Parliament had neither the time nor the expertise to define the nature and scope of the implied reporting ‘standards’ introduced through the legislation. Observers of the legislative campaign in the House of Lords suggest that the Commons’ deliberations on the Bill were at best perfunctory, at worst uninformed.\textsuperscript{111} Equally, the Chancellor’s political sensitivity to claims about the costs of over-burdening corporate reporting narrowed the nature and scope of mandated reporting. As a consequence and notwithstanding attention to the environment and employee circumstances in debate over passage of the Reform Bill, company directors were deemed responsible for determining the weight and significance (if any) to be attributed to these issues. It could be argued, moreover, that the Government pulled back from providing explicit rules on CESR disclosure requirements in a manner consistent with the principles-based approach to accounting favoured in the UK and EU. Indeed, in the absence of a principles-based approach it is likely that there would be no information disclosure on CESR risks and long-term uncertainties facing a company, as is the case the US. The US financial reporting regulation has shied away from the UK principles-based approach to accounting standards and a fair review override in preference to rule-based accounting which provides explicit guidance on what companies are required to report.\textsuperscript{112} In a 2003 US Securities and Exchange Commission (hereafter, SEC) report, the SEC considered amending this approach in favour of an \textit{objectives-oriented} standard approach.\textsuperscript{113} The Report argued in favour of standards framed in terms of an accounting objective “at an appropriate level of specificity” with “an appropriate amount of implementation guidance”.\textsuperscript{114} This debate remains unresolved in the US. Indeed, the reluctance of the US SEC and Financial Accounting Standards Board to

\begin{flushleft}
\textsuperscript{110} Companies Act 2006, \textit{supra} note 15 § 417 cl. 3.

\textsuperscript{111} There is a certain irony in the capacity and willingness of the House of Lords to engage in the substantive issues of legislation (compared to their colleagues in the Commons). Since being elected in 1997, the Labour Government has sought to establish the primacy of the lower House by reforming the Lords. However, by excluding hereditary peers and by the appointment process, the Lords has become a chamber more than able to challenge the government of the day. See \textsc{Anthony King}, \textsc{The British Constitution} (2007) (on the recent history of British constitutional life).

\textsuperscript{112} See \textsc{David Alexander}, \textit{Globalisation of accounting standards: a UK perspective} in \textsc{Jayne M. Godfrey} \& \textsc{Keryn Chalmers}, \textsc{Globalization of Accounting Standards} (2007) at 15.


\textsuperscript{114} \textit{Id.} at Executive Summary.
\end{flushleft}
implement accounting standards which are principles-based may account for the lack of CESR reporting in the US, and that this will continue until clearer financial metrics are developed to analyse CESR information.

As a consequence, firms specialising in legal services, accounting and audit functions, and directors’ training and compliance have entered the market to provide advice on reporting according to the Companies Act and its provisions. Service companies have relied, in part, upon professional bodies to supply guidelines on compliance in the absence of detailed Government rules and regulations and legal precedents that might provide authoritative interpretations. Similarly, a range of NGOs have come to the burgeoning market for corporate advice and third-party certification, moving from public opinion with respect to the proper scope of CESR to providing fee-based advisory services. Not surprisingly, the larger advisory companies have employed CESR specialists from the NGO sector and universities just as many of the larger FTSE-listed corporations have come to employ in-house CESR specialists with responsibility to build the information databases consistent with director’s new found disclosure obligations. Armed with CESR information, disclosure has become, amongst other things, an important element of corporations’ reputation management programmes in the media and elsewhere.\footnote{See Gordon L. Clark & Tessa Hebb, supra note 4.}

Notwithstanding the boost to fee-based advisory services brought by the disclosure requirements of the Companies Act, it would seem that directors’ compliance with the Act may remain specific to each company until ‘best-practice’ standards of reporting are established. By contrast, institutional investors demand standardised disclosure of market-sensitive information such that data are\textit{ comparable} between companies (especially those in the same industries and countries),\textit{ consistent} in definition and measurement over time, and\textit{ comprehensive} in nature and scope. Further, with the importance of real-time data providers such as Bloomberg, Reuters, and Thomson it is also apparent that institutional investors demand immediate access to this type of data directly from trading desks. Data-mining and the stress-testing of causal relationships as regards corporate characteristics and stock-price movements have become essential to investment practice whatever the past significance attributed to the efficient
markets hypothesis. See, for example, the success of the Gompers et al. test and its variants on the significance of companies’ quality of corporate governance for stock value.

Absent UK government rules and regulations governing the disclosure of market-sensitive data on the long-term prospects of companies, market intermediaries have sought to supply standards and data. One of the most important providers of disclosure standards with respect to corporate balance sheets and the related data that flows through global financial markets is the London-based International Accounting Standards Board (hereafter, IASB). However, the IASB has lagged EU and UK legislation on developing standards and metrics for these types of issues. Independent of government and based upon ‘independent’ expertise, the IASB is responsible for formulating and articulating corporate reporting standards consistent with the effective flow of market-sensitive information to global financial markets. Presumably, if the IASB were to introduce related standards it would neither allow directors’ discretion as to the significance attributed to such standards, nor would it allow directors the option to select ‘relevant’ data or information. The IASB, like other accounting standard boards around the world, mandates both the use of promulgated standards and the nature and scope of information to be disclosed.

In the space provided by the Companies Act, and the lack of engagement on these issues by the accounting standards boards, intermediaries have come to market with their own ‘standards’ and products to match. As such, the absence of standard-setting by the Government on this issue is arguably a deliberate experiment in market-volunteerism. It is an attempt to let market agents digest the large volume of financial and non-financial information entering the marketplace so that it might pre-empt what CESR issues are regarded as important drivers for long-term sustainable economic

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118 Note, however, that the UK Accounting Standards Board (2006) has sought to influence the reporting of items subject to the “business review” sections of the Companies Act with a set of recommendations reflecting what they contend to be “best-practice”. Lacking statutory force, as was to be the case through the OFR, these recommendations have not set industry standards.
119 See David Alexander, *supra* note 63.
growth. It would subsequently fall to governments to crystallize these market-based models in more traditional regulatory standards.\textsuperscript{120}

Historically, of course, agencies like Standard & Poor’s, Moody’s, and Fitch have provided company-specific single-score alphanumeric credit ratings to the market allowing investors to evaluate in a comparable, consistent and comprehensive manner the market value of proffered debt. These companies use similar methods of assessment to come to their scores, matched by some of the more recent market entrants that offer specialised ratings on, for example, the nature and quality of corporate governance. As is well-appreciated, however, the mainstream ratings companies have not fared well in the aftermath of the 1990s tech-bubble and the more recent subprime global credit crisis. Their methods of assessment and calibration of underlying credit risks have been subject to harsh criticism.\textsuperscript{121} Mainstream rating companies have remained aloof from the calibration of CESR related issues preferring, perhaps, to monitor the development of standards and data in this area before acquiring (some time in the future) the market innovators.

We can distinguish between two generic approaches taken by intermediaries in the development of CESR standards and performance data. There are, as noted above, firms that begin with a comprehensive array of variables designed to capture the crucial issues relevant to CESR factors. Beginning with company annual reports and websites, these firms interview companies to augment their initial assessments. From there they develop qualitative scores to indicate corporate responsiveness to the issues as well as their actual performance benchmarked against industry and country averages. The resulting scores across a number of indicators relevant to institutional investors rely upon directors’ disclosure and the evaluation of collected data. In effect, these types of intermediaries seek to capture current performance against relevant standards and supply to the market their assessments of companies’ likely future

\textsuperscript{120} Presumably the Government will introduce such a standard once the metrics are clearer, and the private sector has ‘test-run’ what the standard needs to include (so that investment companies can build their metrics in common agreement). See, for example, recent debate (early 2008) in the Lords over the Climate Change Bill where a proposed amendment would provide “guidance” on company reporting as to greenhouse emissions.

\textsuperscript{121} There have been recent discussions in Europe and the US on how to better regulate credit rating agencies and their methodologies. See TRADE UNION ADVISORY COMMITTEE, FINANCIALISATION AND THE SUB-PRIME FINANCIAL CRISIS: ISSUES FOR FUTURE REGULATION (2007).
performance. For example, when assessing companies’ environmental performance, ratings firms must determine the relevant issues, the indicator variables, and the extent to which the assessed companies could be said to above or below the relevant benchmark.\textsuperscript{122}

Instead of relying upon corporate disclosure and the willingness of corporations to be interviewed and assessed, a new generation of intermediaries have sought to develop quantitative estimates of corporate CESR ‘liability’ over a range of crucial variables relevant to corporations’ long-term financial performance.\textsuperscript{123} Here, the intention is plain: to avoid the complications and costs involved in site-visits and qualitative ratings by building comprehensive and consistent databases on individual firms benchmarked against industry averages. Intermediaries rely heavily upon the public disclosure by corporations of their liabilities, augmented by stylised models of whole industries. In effect, these models seek to map the nature and scope of industry-specific systems of production and distribution being a means of referencing firms according to their relative performance. Based on this procedure, industry analysts can build stories of likely long-term environmental performance, innovation, and technological change. Analysts can identify firms that might be included, for example, in ‘best-in-class’ sectorally-diverse investment portfolios.

Reference to corporate CESR ‘liabilities’ here should be qualified by the fact that, in most cases, these quantitative metrics are measuring a company’s exposure to financial costs \textit{in the event} that regulation is implemented to price CESR externalities, rather than existing regulated liabilities or costs. In the context of emerging legal regimes to price carbon and other environmental outputs from industry, these quantitative metrics are helpful in anticipating firms’ future cash flow risks should markets and regulations apply more exacting pricing regimes. However, since these projections are long-term, they are inevitably subject to uncertainty about both the future regulatory landscape as well as the future CESR performance of the firm.

\textsuperscript{122} James Salo, \textit{Corporate governance and environmental performance}, COMPETITON AND CHANGE (forthcoming).

\textsuperscript{123} Abagail McWilliams & Donald Siegel, \textit{Corporate social responsibility and financial performance: correlation or misspecification?}, 21 STRATEGIC MANAGE J 603 (2000).
Nevertheless, these quantitative estimates of companies’ actual and disclosed liabilities, and their expected rates of change over time, can be very important for analysts seeking to build predictive models of stock price movements.\textsuperscript{124} Equally, quantitative estimates allow for rapid and systematic data sorting and comparison. For example, a single carbon-estimate may be sufficient for investment analysts to rank-order traded firms by industry, by country, and by market indices. By stripping out the judgement associated with qualitative scores, as well as the problems sometimes encountered when attempting to understand assessors’ judgements and benchmarks, these types of intermediaries supply to the market data in much the same form that analysts encounter in their day-to-day trading.\textsuperscript{125} These intermediaries are also clearly distinct from social activists whose agenda is differently focussed on the roles and responsibilities of the firm, and can therefore be distinguished from traditional CSR discourse in which the social and environmental interests of external stakeholders are a more dominant concern.\textsuperscript{126}

\textbf{A new kind of regulatory strategy}

The UK government’s willingness to stand back and let financial intermediaries compete for the development of tools which adequately price the market value of CESR information is not only a uniquely shareholder-oriented approach to CESR, but also represents a unique type of regulatory strategy. Information-based regulatory strategies are not new to the field of corporate social responsibility. However, it is widely contested whether information-based strategies are truly ‘regulatory’ in the command and control sense, or closer to a form of new governance in which firms (or other market actors) are merely ‘influenced’ but are ultimately free to act of their own accord.\textsuperscript{127} New governance theory argues that the CSR movement may more closely represent the latter. Under this characterisation of the CSR movement, information

\textsuperscript{124} See Benjamin J. Richardson, \textit{Pension law reform and environmental policy: A new role for institutional investors?} 5 JIFMA 159 (2002).
\textsuperscript{125} See, for example, the assessment methodology of Trucost one of the most important intermediaries in the London market for environmental accounting, \textit{available at www.trucost.com}.
\textsuperscript{126} See John. M. Conley & Cynthia A. Williams, \textit{supra} note 49.
\textsuperscript{127} See Karen Yeung, \textit{Government by publicity management: sunlight or spin}, PUBLIC LAW 360 (2005). A recent interesting example of this debate is the EU REACH regulation on chemicals production and trade. In this case, the disclosure of information has been a pre-condition to the existence of the market because chemicals producers are prevented from entering the market until they have disclosed the information on the chemicals’ properties, risks, methods of safe use, among other pieces of information. See Liz Fisher, \textit{The perfect storm of REACH: charting regulatory controversy in the age of information, sustainable development, and globalization}, 11 J RISK RES 1 (2008).
Disclosure is often used by corporations as a kind of public relations charade rather than a way of regulating corporate behaviour. New governance theory describes a “post-regulatory state” in which corporate behaviour is transformed through interactions between various actors – other firms, NGOs, government actors. Highly networked communities are therefore most influential in changing corporate behaviour compared with regulatory mechanisms like mandatory information disclosure.

Reflexive law theorists, however, adopt a slightly different approach. They acknowledge the role of various stakeholders in actively changing corporate behaviour but argue that verifiable and comprehensive information disclosure is crucial to catalysing this change. They argue that reliable mandatory reporting on, for example, corporate environmental performance, is important for stakeholder activism to have any real influence.

We argue that the corporate disclosure regime within the Companies Act is best described as a hybrid policy instrument which combines both command and control regulation and market-based mechanisms. The control mechanism of the regime is the mandatory disclosure requirement. Although the absence of reporting standards weakens the substance of the ‘command’ directed towards firms, the competition amongst financial intermediaries in London to interpret the disclosed data distinguishes the Companies Act from other disclosure regimes with weaker enforcement mechanisms. Whereas the effectiveness of some mandatory disclosure regimes (for example, product labelling) are limited by the ability of informed consumers to accurately interpret the disclosed information, the Government has sought to leverage the power of London’s finance sector and market-price incentives to guarantee the quantity and quality of information to be disclosed. In this way, the market acts as an effective ‘enforcer’ of the disclosure provisions because financial

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128 See John, M. Conley & Cynthia A. Williams, supra note 49.
130 See Benjamin J. Richardson, supra note 73.
131 See Karen Yeung, supra note 76.
intermediaries are closely scrutinising information and putting pressure on firms to make the information reliable and relevant.

The market-based mechanism used in the disclosure provisions is also unusual because the intention behind the provisions, as we have discussed, is to enhance shareholders’ understanding of the business risks facing quoted stocks and improve competitive market pricing of these stocks. In terms of regulatory theory, this logic relies on consensual regulatory theory: that is, a form of regulation which encourages participants to cooperate with each other. In this case, the company, investors, and financial consultants are brought into close contact on the issue of CESR information and are encouraged to agree on what information is relevant to the long-term financial prospects of a particular company. This type of regulation is therefore different to CSR disclosure regimes where the incentive to provide information is usually ethical rather than financial, and where some firms may be prone to exaggerate their CESR credentials without any direct repercussions.

It is important to emphasise, then, that the Companies Act appears to move beyond the traditional characteristics of the CSR movement and integrates CESR information within a theory of efficient market operation rather than simply ethical and social responsibility. Unlike the CSR movement where the role of all stakeholders is prominent, the Government has given prominence to investors while simultaneously satisfying the interests of the NGOs and social activists. The goal of financial markets under the efficient market hypothesis is for quoted stock prices to fully reflect all the information available on the firm. Ideally, market prices respond to new information quickly and accurately once the information is disclosed.

The Government’s disclosure regime is an attempt to encourage financial intermediaries to price this information accurately and efficiently. The regime negotiates a complex balance. On the one hand, it explicitly acknowledges that CESR information is financially material and that it needs to be priced in order for

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134 See BRONWEN MORGAN & KAREN YEUNG, AN INTRODUCTION TO LAW AND REGULATION: TEXT AND MATERIALS (2007).
135 See John. M. Conley & Cynthia A. Williams, supra note 49
markets to be informationally efficient. On the other hand, it acknowledges that to date the efficient markets hypothesis has failed for two reasons. First, investors have not had access to reliable CESR information and, secondly, they have lacked a common metric to accurately analyse this information. Since financial markets have failed to price CESR information to date, the Government appears to be intervening to assist investors on how they should price CESR risks over the long term. By developing a complex regulatory regime which gives financial intermediaries an incentive to fill this gap, the Government acts as both a regulator of information disclosure on environmental and social matters, as well as protecting the integrity of the quoted stock price of traded securities.\(^{137}\)

The disclosure regime also addresses the assumption under the efficient markets hypothesis that sharp-eyed arbitrageurs are able to rapidly move prices after the announcement of market-sensitive information. Although this may be true for some types of information (for example, mergers and acquisitions, dividend announcements, and so forth), arbitrage opportunities are limited in instances where information is expensive to acquire, verify, and process.\(^{138}\) The Government has implicitly acknowledged that CESR is an example of ‘expensive’ information because CSR information has traditionally been of unreliable quality and difficult to measure in terms of financial materiality. The UK’s disclosure provisions are an attempt to overcome this hurdle because the onus is on directors to interpret what information is ‘essential’ to the business and to report on trends and factors which are likely to affect the future development, performance and position of the business. In this way, the CESR information which is to be disclosed under the Companies Act is intended to be crucial to a firm’s business operations.\(^{139}\)

The approach under the Companies Act is characteristic of Anglo-American shareholder capitalism because it empowers small investors and ‘outsiders’ who do

\(^{137}\) See John R. Graham, Value destruction and financial reporting decisions, 62 FINC ANAL J 27 (2006) (discussion of other reporting factors which diminish the integrity of market pricing).


\(^{139}\) This is another instance in which the disclosure regime under the Companies Act (2006) moves beyond traditional CSR drivers, where a company’s CSR activities rarely include their “core” activities.
not share the privileged ‘insider’ relationships which stakeholders in continental Europe might enjoy with top level management. This approach also empowers small investors in relation to institutional investors, since the latter usually have superior data-processing technology and organisational capacity to digest and analyse this information. This may not be unintentional since institutional investors who own seventy percent of all listed equities in the UK have been slow to respond to CESR issues. This may be, in part, explained by the paucity of quantifiable metrics to analyse CESR data which has meant that institutional investors have been cautious of CESR information. It remains to be seen whether financial intermediaries will be able to develop metrics which are sufficiently rigorous for institutional investors to change their tune on this issue.

Finally, it should be noted that the Companies Act disclosure regime should be distinguished from other information-based policies because it places the obligation to report on directors (through the annual business review), rather than on the company at large, as is common in public relations-driven CSR. By pinning disclosure obligations on directors in conjunction with amendments to directors’ duties discussed above the Government is demonstrating a prescient understanding of corporate behavioural change. In agreement with reflexive legal theorists, Gunningham et al have argued that the attitudes and style of top-level management are highly correlated with firms’ environmental behaviour compared with other variables such as jurisdiction, size or annual turnover. In addition, managers and shareholders can exert greater change on firm-wide behaviours in the Anglo-American firm, compared with NGOs and the public. In this respect, the Government’s decision to place the business review reporting obligation on directors may be an effective way to engage high level managers and directors within the firm.

140 High levels of information transparency on CESR are also consistent with the EU’s strategy towards more integrated and competitive capital markets across Europe. Under a closed market structure a premium is placed on special relationships between ‘insiders’ and the firm. These relationships facilitate the flow of private information which is fully digested before being released to the market. However, the fair review accounting principles of the EU Modernisation Directive as discussed are attempts to build greater harmonisation of markets around transparent and well-informed markets.
141 See Qi Chen, Discussion of which institutional investors trade based on private information about earnings and returns? 45 J ACCOUNTING RES 323 (2007).
Implications and conclusions

The premise of this paper is that the modern corporation is both the object of investment for the global financial sector and the source of value for society. As the object of investment, the modern corporation is subject to the theories and practices of the investment industry being, more often than not, just one element amongst many in market-based portfolios. Its ‘value’, in this respect, is relative: that is, it is priced against market information concerning its expected value relying upon common metrics and comparative market performance. As such, the modern corporation has no intrinsic value—whether investors hold or do not hold a corporation in their stock portfolios depends upon their overall desired risk-adjusted rate of return. We recognise, of course, that this is characteristic of Anglo-American economies wherein the financial sector has become virtually autonomous from the so-called ‘real’ economy. But it is increasingly the case for continental European economies, and especially their largest traded corporations that seek the benefits of global financial markets.

At another level, the modern corporation is the principal source of value for society. Obviously, it provides employment and earned income as well as tax revenue for governments. In many countries, its share of national income has grown dramatically over the past fifty years so much so that the ‘partnership’ between the state and the corporation, so important for post-war politics and policy, has been heavily discounted. For many, this is the ‘normal’ state of affairs. But this has meant that the modern corporation carries two rather different sets of expectations: as the means of generating income for distribution through society, and as the medium through which social expectations are to be, in part, realised. We noted the tension between these expectations, arguing that the Companies Act was conceived to enhance the global competitiveness of UK-listed corporations given EU and domestic debate over the proper purpose of the corporation with respect to social and environmental standards. When pressed to explain its preference, the UK Labour Government favoured the former over the latter.

144 See FRANKLIN Allen & DOUGALS GALE, UNDERSTANDING FINANCIAL CRISIS (2007).
145 See Rob Bauer, Robin Braun, & Gordon L. Clark, supra note 3.
Nonetheless, it is apparent that the Government, market analysts, and social activists have joined together in an uneasy alliance to promote greater disclosure of information to a broad array of constituents. The disclosure movement has been driven by financial market agents concerned to better price, on a comparative basis, one company over others. This claim for the disclosure of market-sensitive information has proven extremely powerful, buttressed by theories of market efficiency and related notions of market equitability wherein ‘insiders’ and ‘outsiders’ are deemed deserving of access to the same information.\textsuperscript{146} If it appears as an unassailable economic good, the disclosure movement is also a means to an end wherein the autonomy of corporate executives is brought to account on the assumption that disclosure can discipline hubris and a penchant for empire-building (Bauer et al. 2008). For continental Europe, of course, the disclosure movement is part of a larger process whereby hitherto sheltered national champions have been integrated into the global financial community.

For the EU, concerned about the social responsibility of the modern corporation, the interest of financial agents in disclosure has been an opportunity to articulate a broad range of items for disclosure while advocating standards by which the quantity and quality of information are to be judged. The EU Modernisation Directive sought to combine both in a way that would meet the interests of the social partners or stakeholders in an expansive definition of corporate responsibility. The UK embraced the opportunity to re-write UK company law but with a particular flavour (captured in our recounting of the parliamentary debate over its passage through the House of Lords). Here, the Government introduced the principle that company directors ought to disclosure market-relevant information on the long-term prospects of the firm, including \textit{where relevant} reference to social and environmental matters. This was hardly a ringing endorsement of corporate social responsibility; the Government sought at every opportunity to narrow the scope of such a requirement to that which would be appropriate for market valuation of company prospects.

\textsuperscript{146} See WILLIAM J. WILHELM & JOSEPH D. DOWNING, \textit{supra} note 15.
In effect, the Government passed on the opportunity to embrace continental European social democracy. In doing so, it reinforced its apparent commitment to the competitiveness of UK financial markets and especially London’s place in the global competition for incorporation, cross-listing, and international financial transactions. The Government’s reluctance to set reporting standards on certain matters including social and environmental issues has prompted rapid growth in market-based solutions to these questions. We have argued that, to the extent that financial agents require consistent, comparative and comprehensive metrics for assessing corporate value, in the absence of government reporting standards financial intermediaries have sought to provide these types of measures. There has been a remarkable burst of private investment in metric-making, some of which rely upon qualitative judgement, others of which are entirely quantitative in the manner made popular by the real-time data streams that flow across the trading desks of major financial institutions. Once again, metric-making has advantaged London as one of just a few truly global centres of financial innovation.147

Not surprisingly, metric-making has brought into being remarkable coalitions of interest and institutions linking the NGO community with banks, venture capital partnerships and pension funds. If stymied by the Chancellor’s repudiation of the OFR, through the Companies Act, the NGO community have found a willing audience in segments of the financial industry (if not always the corporate sector). But at this juncture we emphasized that metric-making is a supply-side activity—it is all about articulating standards and measures of measurement for the investment industry on the assumption that the demand for such metrics will follow the lead provided by statute. Whether this will actually occur remains to be seen. The Government has embarked on a remarkable experiment in reflexive ‘regulation’ eschewing political leadership in the hope that the social expectations of activists will be taken up through the interests of financial agents in pricing the value of major companies.

However, the interest of pension funds and institutional investors in CESR metrics remains cautious given the regulatory history in this area in the UK. We noted, for

147 See GORDON L. CLARK, supra note 24.
example, that the UK Labor government’s 1999 disclosure ‘policy’ on ‘ethical’ pension fund investment was still-born; it failed at a rudimentary level to encourage pension funds and their service providers to engage in the issues. By contrast, the relevant provisions of the Companies Act concerning the long-term prospects of firms are likely to have far more important affects than the change in regulations to the Pensions Act 1995. In any event, recent research has indicated that many pension funds and their trustees have not made real efforts to match their investment policies to community expectations as regards social and environmental matters. In part, reluctance to engage CESR issues can be explained by a narrow interpretation of fiduciary duty that excludes reference to anything other than the risk-adjusted rate of return. Equally, we have also shown that many trustees, especially those that are experienced, recognise the complex nature of the issues involved and the lack of widely-accepted decision-metrics relevant to investment strategy. Too often, CESR issues considered are event-specific, undercutting the strong interest of pension fund trustees in a well-governed investment strategy.

In any event, many private sector pension funds are opposed to these types of interventions in all but the most obvious cases. This is for two reasons. First, private sector pension fund boards typically include senior executives whose principal concerns are their own status and promotion in the company (most important) and the solvency of the fund in relation to corporate revenue and growth (very important). In the UK, it is also the case that many funds are staffed by ‘secretaries’ that are company employees; deliberation over investment strategy is often truncated and reliant upon consultants. In effect, private pension funds have neither the interest nor the capacity to engage with the issues. At best, pension fund boards are likely to follow the lead on social and environmental matters provided by highly reputable investment houses whose investment products integrate these matters into the expected pricing of offered portfolios. At the margin, a demonstrated link between risk and return and environmental liabilities and management capacity may attract the interest of boards; at the margin, unless held by government to account for such decisions, pension boards may simply ignore the issues.

By our interpretation, the UK Companies Act 2006 provides a political recipe for reconciling two competing interests in the value of the modern corporation. Where the Government might have required certain reporting standards and where it might have introduced mandatory disclosure on significant social and environmental concerns, the Government sought to enhance the competitiveness of London’s financial markets in relation to Frankfurt and Wall Street. In this respect, the Government underwrote the prospects for market-intermediation rather than directly regulate corporate social and environmental responsibility.