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## Articles

### **IMPLICATIONS OF THE UK COMPANIES ACT 2006 FOR INSTITUTIONAL INVESTORS AND THE MARKET FOR CORPORATE SOCIAL RESPONSIBILITY**

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#### I. INTRODUCTION

Much is expected of the modern corporation. Shareholders seeking to maximize their return on investment pay close attention to reported earnings and stock price appreciation.<sup>1</sup> Unanticipated negative movements in these variables can give rise to shareholder agitation, amplified by hedge funds and activist pension funds.<sup>2</sup> Although this is characteristic of the Anglo-American ‘market for corporate control,’ these types of pressures

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1. See John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 13 (2005) (“CFOs state that earnings are the most important financial metric to external constituents.”).

2. See TESSA HEBB, *NO SMALL CHANGE: PENSION FUNDS AND CORPORATE ENGAGEMENT 1-2* (2008) (discussing the role of pension funds and institutional investors).

have also 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.<sup>3</sup> The European Union (hereinafter "EU") has sought to modernize member states' 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.

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.<sup>4</sup> 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 regarding the long-term welfare of beneficiaries, short-term shareholder value is balanced against the long-term growth and development of whole economies.<sup>5</sup> In these cases, fiduciaries are self-conscious about the time horizon over which they reap value from investment; even if not intended, the largest of institutional investors have a stake in the long-term structure and performance of global markets.<sup>6</sup>

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.<sup>7</sup> For much of continental Europe, the corporation is

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3. See Rob Bauer et al., *The Emerging Market for European Corporate Governance: The Relationship Between Governance and Capital Expenditures, 1997-2005*, 8 J. ECON. GEOGRAPHY 441, 463 (2008) ("[P]ortfolio investors are able to exert pressure on the managers of large [European] firms to act in ways consistent with shareholder value rather than stakeholder value . . .").

4. See Gordon L. Clark & Tessa Hebb, *Why Should They Care? The Role of Institutional Investors for Corporate Global Responsibility*, 37 ENVTL. PLAN. 2015, 2028 (2005) (showing how institutional investors may encourage companies to adopt higher environmental standards).

5. See Benjamin J. Richardson, *Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?*, 22 BANKING & FIN. L. REV. 145, 145-69 (2007) (examining and questioning the existence of the apparent dichotomy between fiduciary responsibility and socially responsible investment).

6. See JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC* 52-58 (2000) (discussing the emergence of fiduciary capitalism as institutional investors take large ownership interests in equity markets).

7. See, e.g., Gordon L. Clark et al., *Social and Environmental Shareholder Activism in the Public Spotlight: US Corporate Annual Meetings, Campaign Strategies, and Environmental Performance, 2001-04*, 40 ENV'T & PLAN. 1370, 1371 (2008) (observing that "the business of business is business").

foremost a social institution and is treated as such in corporate law.<sup>8</sup> 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 goes well beyond managing investor expectations, a fact-of-life recognized as such by non-governmental organizations (hereinafter “NGOs”) and community groups at the interface between media and markets.<sup>9</sup> Mobilizing public confidence in corporate responsibility while remaining duty-bound by statutory obligations to shareholder value is a challenging task.<sup>10</sup>

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.<sup>11</sup> These expectations can be important, given that the debate about the relative value of national models of corporate governance in global financial markets will have 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).<sup>12</sup> The genesis of the UK Companies Act 2006 (hereinafter “the Companies Act”) is linked to Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 (hereinafter “the EU Modernization Directive”), as well as deeply-entrenched domestic conceptions of the proper responsibilities of corporate

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8. See KLAUS J HOPT, *Common Principles of Corporate Governance in Europe?*, in *CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY* § 3.1 (Joseph A McCahery et al. eds., 2002) (describing the public interesting German corporations).

9. See Pratima Bansal & Iain Clelland, *Talking Trash: Legitimacy, Impression Management, and Unsystematic Risk in the Context of the Natural Environment*, 47 *ACAD. MGMT. J.* 93, 101 (2004) (arguing that managers can increase a firm’s environmental legitimacy by “minimiz[ing] negative media reports”).

10. See Doreen McBarnet, *Corporate Social Responsibility Beyond Law, Through Law, For Law: The New Corporate Accountability*, in *THE NEW CORPORATE ACCOUNTABILITY: CORPORATE SOCIAL RESPONSIBILITY AND THE LAW* 9 (Doreen McBarnet et al. eds., 2007) (describing the broad range of issues encompassed by corporate social responsibility).

11. See Christine Parker, *Meta-regulation: Legal Accountability for Corporate Social Responsibility*, in *THE NEW CORPORATE ACCOUNTABILITY*, *supra* note 10, at 236-7 (arguing for the meta-regulatory potential of law).

12. See RONALD J. GILSON, *Globalizing Corporate Governance: Convergence of Form or Function*, in *CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE* 129-130 (Jeffrey N. Gordon & Mark J. Roe eds., 2004) (discussing the relative value of national models of corporate governance).

officers.<sup>13</sup> 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 modernization project, amplified by the UK Labor government (hereinafter “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 with regard to the proper roles and responsibilities of corporate officers rather than an expression of conventional corporate social responsibility (hereinafter “CSR”) discourse.<sup>14</sup> By conventional 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 with regard to 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’ 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.

Indeed the current global credit crisis, which has its origins in widespread defaults on subprime mortgage loans in the United States, is an example where the lack of transparency in financial markets resulted in asymmetric information and the mis-pricing of the real risk behind traded mortgage-backed derivatives.<sup>15</sup> Whatever the nature and scope of disclosure, care should be taken not to exaggerate the commitment of institutional investors to disclosure regulation for ethical reasons as opposed to an interest in the more accurate determination of asset pricing.

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13. See The Companies Act, 2006, c. 46 (Eng.); EUR. PARL. & COUNCIL, 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 conversations with Cynthia A. Williams and industry sources that the UK Government was unaware of the EU Modernization 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.

14. See MICHAEL C. JENSEN, *A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS* (2000).

15. See James L. Bicksler, *The Subprime Mortgage Debacle and Its Linkages to Corporate Governance*, 5 INT’L J. DISCLOSURE AND GOVERNANCE, 295, 295-96 (2008).

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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 because it fitted well into information-dependent theories of financial market performance.<sup>16</sup> Equally, the Government was able to use this template to tame more radical amendments for disclosure on environmental footprints 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 we suggest that many of the largest private pension funds will not because of conflicts of interest inherent in these types of institutions.

## II. DEVELOPMENT OF THE MODERN ANGLO-AMERICAN CORPORATION AND FINANCE SECTOR

### A. *Modern Capitalism*

In his treatment of post-war economic structure and performance, Shonfield marveled at the rate of growth in U.K. employment and income over the previous twenty years.<sup>17</sup> By his account, the chronic instability and poor performance of the U.K. economy through the inter-war years had been solved by the existence of built-in economic stabilizers and Keynesian control over the business cycle.<sup>18</sup> 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 judicious use of national planning (especially regarding 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

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16. See WILLIAM J. WILHELM, JR. & JOSEPH D. DOWNING, INFORMATION MARKETS: WHAT BUSINESSES CAN LEARN FROM FINANCIAL INNOVATION 11-16 (2001) (presenting an information-based analysis of financial markets).

17. ANDREW SHONFIELD, MODERN CAPITALISM: THE CHANGING BALANCE OF PUBLIC AND PRIVATE POWER 4 (1965).

18. *Id.* at 17.

next wave of innovation.<sup>19</sup>

Shonfield's treatise was matched in the U.S. by Galbraith's *The New Industrial State*.<sup>20</sup> 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 labor resources and the consequent growth of private pension systems.<sup>21</sup> 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*."<sup>22</sup>

Shonfield and Galbraith wrote of a mode of accumulation at its peak. Through the 1970s, the U.K. 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 U.S. industry was not to face these competitive pressures until the 1980s, by the early 1990s Jensen argued that the U.S. industrial corporation had proven unable to respond effectively to growing market competition because of management entrenchment and an imperfect market for corporate control.<sup>23</sup> Coming out of the 1980s, the U.K. economy had entered a new phase of accumulation where real incomes were now driven by employment in service industries and London's pivotal role in the emerging global financial industry.<sup>24</sup> By the end of the 1990s, the U.S. economy had also been transformed, albeit with greater income disparity and the remarkable persistence of a number of enormous industrial firms that refused to die.<sup>25</sup>

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19. *Id.* at 363.

20. JOHN KENNETH GALBRAITH, *THE NEW INDUSTRIAL STATE* (1967).

21. Gordon L. Clark, *Re-writing Pension Fund Capitalism 1: The Modern Corporation and Pension Benefit Systems in a World of Perpetual Motion* (Oxford Univ. Sch. Geography & Env., Working Paper No. 05-08, 2005).

22. SHONFIELD, *supra* note 17, at 376-77.

23. Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 850-62 (1993).

24. See GORDON L. CLARK, *EUROPEAN PENSIONS & GLOBAL FINANCE* 170-92 (2003) (explaining London's prominent role in the world's financial services industries).

25. See Ashby H. Monk, *The Knot of Contracts: The Corporate Geography of Legacy Costs*, 84 ECON. GEOGRAPHY 221, 228-29 (2008) (arguing that a modern economy is uncompetitive if its labor force consists largely of unskilled workers, but that many American firms resist change because of anticipated transition costs, both to the firm and to

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Our point in rehearsing the recent history of the U.K. and U.S. is to stress that, not so long ago, the modern corporation was a power in the land. It dominated domestic markets, controlled its financial destiny, and 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 often negotiate their shares of revenue (retained earnings and wages) 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.<sup>26</sup> First, the liberalization of product markets through the European Economic Community (followed by the EU) effectively pitted U.K. industry against its nearest-neighbours. Notwithstanding the costs of competition, British firms resisted competition in part because of much lower rates of productivity growth and technological innovation compared to robust European national champions. Slow rates of growth turned into profound economic crisis. These competitive forces found in the momentum associated with twenty-first global economic integration, now threaten continental Europe. Second, as industry in the UK failed under the weight of this resistance, the nation-state came to realize 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.<sup>27</sup> 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).

The fledgling financial services industry fueled the transformation of British industry, the economy and society. 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” liberalized 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 followed by the acceleration of global financial integration from the mid-1990s. Third, pension funds and

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individuals).

26. Luigi Zingales, *In Search of New Foundations*, 55 J. FIN. 1623, 1642-43 (2000).

27. See Kevin Campbell & Douglas Vick, *Disclosure Law and the Market for Corporate Social Responsibility*, in *THE NEW CORPORATE ACCOUNTABILITY*, *supra* note 10, at 243-44 (analyzing the expansion of corporate social responsibility accountability fostered by the United Kingdom's new legal disclosure strategy).

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 cozy 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.<sup>28</sup> Given the goal of maximizing 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 capitalization. Automated trading systems cued to changes in stock market pricing and linked to stock market indices dominate daily trading volume.<sup>29</sup>

The modern corporation has become the traded object of global financial markets and, in some cases, deliberately so.<sup>30</sup> 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 logic of global financial market integration.<sup>31</sup>

### B. *Institutional Investors, Markets, and Disclosure*

We have suggested that the growth of retirement savings in institutions held at arms-length from the immediate interests of sponsoring companies altered the balance of power in financial markets in favor of

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28. See Gordon L. Clark & Tessa Hebb, *Pension Fund Corporate Engagement: The Fifth Stage of Capitalism*, 59 INDUS. REL. 142, 142 (2004) (arguing that pension funds aggregate the disbursed ownership of beneficiaries and can therefore act as unified entities with a single voice to engage companies).

29. See E. PHILIP DAVIS & BENN STEIL, INSTITUTIONAL INVESTORS 347 (2001) (describing automation in institutional trading).

30. See GORDON L. CLARK & DARIUSZ WOJICK, THE GEOGRAPHY OF FINANCE: CORPORATE GOVERNANCE IN THE GLOBAL MARKETPLACE 133 (2007) (researching the demand for cross-listing of publicly listed firms).

31. See Susan Strange, *The Future of Global Capitalism; Or, Will Divergence Persist Forever?*, in POLITICAL ECONOMY OF MODERN CAPITALISM: MAPPING CONVERGENCE AND DIVERGENCE 182, 184-85 (Colin Crouch & Wolfgang Streeck eds., 1997) (introducing analysis of whether more integration of world markets lends itself to greater convergence of world economy).



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.”<sup>32</sup> This develops Robert Clark’s 1981 account of the historical evolution of management theories over two centuries.<sup>33</sup> 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.<sup>34</sup> This conceptual and analytical revolution has arguably remade the structure and performance of global financial markets in its image.<sup>35</sup>

As is well-appreciated, even in crisis the vast majority of pension funds, mutual funds insurance companies, and endowments abide by the principles of modern portfolio theory (hereinafter “MPT”).<sup>36</sup> In brief, these principles are as follows: (1) there is a correlation 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 investing—picking winning stocks over losing stocks—is not a viable long-term investment strategy. MPT provides a rationale for holding large swaths of whole markets and 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.<sup>37</sup>

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32. See Clark & Hebb, *supra* note 28, at 143.

33. See Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561, 562 (1981) (arguing that the history of capitalism is composed of four stages, each of which presented problems demanding a specific legal framework to address them).

34. See MICHAEL J. CLOWES, *THE MONEY FLOOD: HOW PENSION FUNDS REVOLUTIONIZED INVESTING* 1-18 (2000).

35. See generally DONALD MACKENZIE, *AN ENGINE, NOT A CAMERA: HOW FINANCIAL MODELS SHAPE MARKETS* (2006) (describing modern portfolio theory).

36. See JOHN Y. CAMPBELL & LUIS M. VICEIRA, *STRATEGIC ASSET ALLOCATION: PORTFOLIO CHOICE FOR LONG TERM INVESTORS* 222-24 (2002) (providing an analysis of how an individual investor would best allocate wealth into broad asset classes over a lifetime under a number of different variables).

37. See BOB LITTERMAN & GOLDMAN SACHS ASSET MANAGEMENT QUANTITATIVE RESOURCES GROUP, *MODERN INVESTMENT MANAGEMENT: AN EQUILIBRIUM APPROACH* 25-26 (2003). This is not, of course, the full story. Recent research in the U.K. and the U.S. 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

Systematic out-sourcing of investment management from all but the largest of pension funds has accompanied the revolution in financial markets (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). Specialized 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.<sup>38</sup>

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. Recognizing this fact, pension fund trustees have been left with the responsibility for overall investment strategy, informed, of course, by modern portfolio theory.<sup>39</sup> 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. In recent years, the story has been complicated by a loss of confidence in the efficient markets hypothesis, which underpins the third MPT principle noted above, the rise and fall 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 global credit crisis has also undercut the credibility of less-than-transparent risk transfer devices such as collateralized debt obligations (for example, mortgages). It is apparent that only the best-governed funds and institutions focused on risk management and return

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declines as the net inflow of assets to “winning” mutual funds dampens the capacity of those entities to sustain their distinctive strategies. See, e.g., Aneel Keswani & David Stolin, *Which Money is Smart? Mutual Fund Buys and Sells of Individual and Institutional Investors*, 63 J. FIN. 85, 85 (2008) (employing a British data set of monthly fund inflows and outflows differentiated between individual and institutional investors to argue for a robust “smart money” effect in the United Kingdom).

38. See CLARK, *supra* note 24, at 180.

39. See Gordon L. Clark & Roger Urwin, *Best-Practice Pension Fund Governance*, 9 J. ASSET MGMT. 2, 6-7 (2008) (“Well-governed trustee boards tend to allocate . . . available time and resources to issues like investment strategy and management that may affect the long-term integrity of the institution and payment of pension benefits.”).

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 outperform asset-specific benchmarks.<sup>40</sup>

What should be emphasized 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 collateralized 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 behavior, it serves as a normative claim on the proper value of quoted prices.<sup>41</sup> As such, it is not surprising that enormous attention is paid by institutional investors (acting on behalf of their pension fund 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 mispricing 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 subprime credit crisis). In this respect, the scope of "disclosure" of market-relevant information by traded companies and related entities has become the litmus test of financial regulation.<sup>42</sup>

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 U.S.) and the treatment of insider and outsider shareholders as regards the timely disclosure of market information (as in much of continental Europe).<sup>43</sup> 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.<sup>44</sup> Apparent differences between countries'

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40. See Josh Lerner et al., *Smart Institutions, Foolish Choices: The Limited Partner Performance Puzzle*, 62 J. FIN. 731, 742 (2007) (documenting large heterogeneity in the performance of investor classes).

41. See Gur Huberman, *Behavioural Finance and Markets*, in COGNITIVE PROCESSES AND ECONOMIC BEHAVIOUR 1-15 (Nicola Dimitri et al. eds., 2003).

42. See Tessa Hebb, *The Economic Inefficiency of Secrecy: Pension Fund Investors' Corporate Transparency Concerns*, 63 J. BUS. ETHICS 385, 391 (2006) (reporting a shift to "corporate governance campaigns aimed at raising information within the firm").

43. See John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1780-81 (2002) (discussing the fuller disclosure requirements of a U.S. stock exchange.). For the European comparison see *supra* note 31.

44. See Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1149 (1997) (showing that civil law countries have "the weakest investor protections and

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.<sup>45</sup> 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."<sup>46</sup>

In this context, the election of the UK Labor government in 1997 and the booming securities markets in the run-up to 9/11 seemed to offer a chance for social activists to mobilize the power of institutional investors. As part of a larger debate over the prospects for a U.K. stakeholder society and the lessons to be learned about CSR from continental European social democracies, the Labor government was lobbied to make good on the promise to affect socially responsible investment.<sup>47</sup> 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 realization of investments"; and (b) "their policy (if any) in relation to the exercise of the rights (including voting rights) attached to investments."<sup>48</sup> For all the critical comment that has accompanied this regulation, there are three reasons why its impact has proven to be rather limited.<sup>49</sup> Most

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least developed capital markets"). 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 favor of U.S. standards of corporate governance. See, e.g., Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 843-850 (2005) (analyzing the costs of management entrenchment in the U.S. and the improper limits imposed on institutional investors in exercising their "ownership" rights).

45. See Tessa Hebb & Dariusz Wójcik, *Global Standards and Emerging Markets: The Institutional Investment Value Chain and CalPERS' Investment Strategy*, 37 ENV'T & PLAN. 1955, 1971 (2005) (arguing for greater convergence to global standards when key actors in the investment value chain demand levels of corporate and social behavior greater than those consistent with a country's current regulatory framework).

46. HAWLEY & WILLIAMS, *supra* note 6, at 22.

47. See WILL HUTTON, *THE STATE WE'RE IN* (1997) (discussing the prospects for a UK stakeholder society).

48. The Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc.) Amendment Regulations 1999, 1999, S.I. 1849, cl. 2(4)(b) (U.K.).

49. See John M. Conley & Cynthia A. Williams, *Engage, Embed, and Embellish: Theory Versus Practice in the Corporate Social Responsibility Movement*, 31 J. CORP. L. 1, 35-37 (2005) (describing three groups into which beneficiaries who support socially responsible investing divide themselves).

obviously, the change in regulation pre-supposed corporate disclosure on these issues whereas the nature and scope of corporate disclosure were not directly affected. In any event, though hardly recognized 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.<sup>50</sup> 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 U.K. Social Investment Forum for amendment to the Financial Services and Markets Act 2000 to include the provision of environmental investment and related lending products within the Financial Services Authority's mandate.<sup>51</sup>

### III. THE EMERGENCE OF MANDATORY REPORTING REQUIREMENTS OF NON-FINANCIAL INFORMATION

#### A. *The 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.<sup>52</sup> The Strategy set 2005 as the deadline by which the European Commission's Financial Services Action Plan ("FSAP") of 1999 would be implemented.<sup>53</sup> The motivating purpose of the FSAP was to "enhance the comparability of financial statements prepared by Community companies

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50. The global finance industry's lack of responsiveness to social concerns, indeed social welfare, is one of the topics explored in JOHN C. BOGLE, *THE BATTLE FOR THE SOUL OF CAPITALISM* (2005).

51. U.K. Social Investment Forum, "UK Social Investment Forum Tells MPs of Need to Include Environment in Framework for Financial Services Regulator" (Press Release, April 19, 1999), at [www.uksif.org/press/welcome/frameset.shtml](http://www.uksif.org/press/welcome/frameset.shtml); Financial Services and Markets Act, 2000. If limited in scope, the U.K. "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." Fjärde AP-fonden (Fourth Swedish National Pension Fund), *A Presentation of Seden's New National Pension Funds* 4 (2001).

52. Presidency Conclusions, Lisbon European Council (March 23-24, 2000), available at [http://www.europarl.europa.eu/summits/lis1\\_en.htm](http://www.europarl.europa.eu/summits/lis1_en.htm).

53. *Commission Communication Implementing the Framework for Financial Markets: Action Plan*, COM (1999) 232 final (May 11, 1999), available at <http://europa.eu/scadplus/leg/en/lvb/l24210.htm>.

whose securities are admitted to trading on a regulated market.”<sup>54</sup> 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.<sup>55</sup> 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 business . . . together with the principal risks and uncertainties that it faces.”<sup>56</sup> 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.<sup>57</sup>

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 (“White Paper”).<sup>58</sup> The White Paper was framed around four strategic objectives: (1) to enhance shareholder engagement and a long-term investment culture; (2) to ensure better company regulation and a “think small first” approach; (3) to make it easier to set-up and run a company in the UK; and (4) to 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 key drivers of long-term company performance.”<sup>59</sup> Heightened disclosure standards were driven by a commitment to a more efficient market pricing of traded

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54. See EU Modernisation Directive, *supra* note 13 at cl. 1.

55. 2002 O.J. (L 243) 1.

56. EU Modernisation Directive, *supra* note 13 at art. 1 cl. 14(a) and art. 2 cl. 10(a).

57. *Id.*

58. Communication from the Commission to the Council and the European Parliament on Modernising Company Law and Enhancing Corporate Governance in the European Union—A Plan to Move Forward, COM (2003) 284 final (May 21, 2003), at 23; DEPARTMENT OF TRADE & INDUSTRY, COMPANY LAW REFORM, 2005, Cm. 6456, available at <http://www.berr.gov.uk/bbf/co-act-2006/white-paper/page22800.html>.

59. *White Paper* at 10.

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 White Paper on greater disclosure of financial and non-financial information came through in the 2005 amendments to the UK Companies Act 1985 (hereafter, OFR Regulations).<sup>60</sup> Among the items considered, these amendments established the requirement for an Operating and Financial Review (“OFR”) for quoted companies. One motivation behind these amendments was the incorporation into U.K. law of the new accounting requirements introduced under the EU Modernization Directive. There were, however, other important domestic considerations in the U.K.’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.”<sup>61</sup> The Department noted that sophisticated financial disclosure regime was needed to encourage capital market activity.<sup>62</sup> 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 best way to encourage shareholders and potential investors to exercise effective and responsible control in their investment decisions.<sup>63</sup> 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.<sup>64</sup>

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.<sup>65</sup> In addition, adopting the “fair review” standard from the EU Modernisation Directive would lead to “greater transparency and precision of company reporting on

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60. The Companies Act 1985 (Operating and Financial Review and Directors’ Report etc.) Regulations 2005, S.I. 2005/1011 [hereinafter “OFR Regulations”].

61. UK Department of Trade & Industry, Final Regulatory Impact Assessment on the Operating and Financial Review and Directors’ Report Regulations, *available at* <http://www.berr.gov.uk/files/file21361.pdf>.

62. *Id.* at ¶ 5.

63. *Id.* at ¶¶ 4, 9.

64. *Id.* at ¶ 8.

65. *See* Bauer, *supra* note 3 (noting that “the market for corporate control is increasingly important in promoting short -and medium-term shareholder value”).

performance on financial and non-financial matters.”<sup>66</sup> 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.<sup>67</sup> In this way, although the OFR demonstrated similarities to the EU 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 favor of the predominant concerns of Anglo-American shareholder capitalism.<sup>68</sup>

Indeed, the U.K.’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 U.K. position clear by emphasizing 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 a more fulsome, and more forward-looking review than that required under the [EU Modernisation] Directive.”<sup>69</sup> 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

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66. UK Department of Trade & Industry, *supra* note 61, at ¶ 13.

67. *Id.* at ¶ 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, e.g.*, Gordon L. Clark & James Salo, *Corporate Governance and Environmental Risk Management: A Quantitative Analysis of ‘New Paradigm’ Firms*, in PENSIONS AT WORK: SOCIALLY RESPONSIBLE INVESTMENT OF UNION-BASED PENSION FUNDS 129, (Jack Quarter et al. eds., 2008) (analyzing differing management styles in response to growing financial risk).

68. *See* Conley & Williams, *supra* note 49, at 35 (suggesting that the OFR represented a push away from stakeholder capitalism within the U.K., which is contrary to what we argue). Rather, we claim the OFR distinguished itself from what we define as conventional CSR because it was ultimately focused on shareholders’ financial interests.

69. UK Department of Trade & Industry, *supra* note 61 at ¶ 14.



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 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 main trends and factors which are likely to affect that company’s future development, performance and position.”<sup>70</sup> Additionally, OFR provisions gave substance to the EU Modernisation Directive’s requirement for non-financial reporting on “environmental and employee matters.”<sup>71</sup> Companies were to be required to include information about the environment including analyzing the impact of the company on the environment.<sup>72</sup> As well, companies were required to provide “information about social and community issues.”<sup>73</sup>

In November of 2005, however, the UK Chancellor abandoned the new OFR provisions less than six months after they were introduced without consultation with the Department of Trade and Industry, other Ministries, or relevant stakeholders.<sup>74</sup> 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 goldplated regulatory requirement that from April next year all quoted companies must publish an operating and financial review.”<sup>75</sup>

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 (“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.<sup>76</sup> 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:

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70. OFR Regulations, *supra* note 60 at § 1(d).

71. *Id.* at part 2, § 234ZZB, cl. 3(b).

72. *Id.* at part 9, § 4, cl. 1(a).

73. *Id.* at part 9, § 4, cl. 1(c).

74. 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.

75. *Chancellor Gives ONS Independence*, BBC NEWS, Nov. 28, 2006, available at <http://news.bbc.co.uk/1/hi/business/4477516.stm>; see also Cynthia A. Williams & John M. Conley, *Triumph or Tragedy? The Curious Path of Corporate Disclosure Reform in the U.K.*, 31 WM & MARY ENVTL. L. & POL’Y REV. 317, 327-361 (2007) (offering a more detailed discussion on the political story surrounding the UK Government’s policy reversal on the OFR.)

76. Company Law Reform Bill, 2005, H.L. Bill [34].

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[T]he Chancellor's statement abolishing the OFR simply did not earn him the brownie points from the business community that he anticipated . . . [i]nvesting 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.<sup>77</sup>

*B. Passage of the UK Companies Act 2006*

In the Reform Bill, the companies' obligation to report non-financial information as per the OFR was replaced by company directors' obligation to produce an annual business review.<sup>78</sup> 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.<sup>79</sup> 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.<sup>80</sup>

In debates 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-à-vis information disclosure, rather than a radical CSR model for the U.K. corporation.

In this respect, the Government's disclosure regime was consistent with Jensen's theory of the firm.<sup>81</sup> 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

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77. 677 PARL. DEB., H.L. (5th ser.) (2006) 194.

78. Reform Bill, *supra* note 76, at § 390, cl. 2.

79. *Id.* at § 390, cl. 4(b).

80. *Id.* at § 390, cl. 7.

81. *See* JENSEN, *supra* note 14, at 85-87.

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.<sup>82</sup> 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.<sup>83</sup> Jensen described the total costs which arise from this “unavoidable” tension between shareholders and directors as “agency costs.”<sup>84</sup> 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.”<sup>85</sup> In carrying out this duty, the new drafting of Section 172 stated that directors would:

[H]ave 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,

(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 . . .<sup>86</sup>

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, the 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 endeavor “to a more not quite pluralist society but rather a northern European model where there

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82. *Id.* at 86.

83. *Id.*

84. *Id.*

85. Companies Act 2006, c. 46, *supra* note 13, at § 172.

86. *Id.*

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are a group of stakeholders [that] are involved.”<sup>87</sup> 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.<sup>88</sup>

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.<sup>89</sup> 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 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 conventional 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.<sup>90</sup>

She distinguished this financial value-based argument from a purely environmental-based case for the disclosure regime saying “[a]s 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.”<sup>91</sup>

Also debated was the need for an auditor’s report to verify the validity

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87. 679 PARL. DEB., H.L. (5th ser.) (2006) 169.

88. *Id.*

89. *Id.* at 170.

90. 450 PARL. DEB., H.C. (6th ser.) (2006) 889.

91. *Id.* at 890.

of reported information. Baroness Thornton, 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.<sup>92</sup> Her concern was echoed by Baroness Miller who argued 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.<sup>93</sup> This concern was raised again later in the House of Commons where it was argued that much of the information presented by companies on environmental and social responsibility is public relations or “green-wash.”<sup>94</sup> The House of Commons’ focus on this issue indicated a specific intention to overcome the charge often made of conventional CSR discourse as an elaborate form of public relations.<sup>95</sup> The auditing of corporate reports was therefore central to making the information relevant to actual business performance rather than simply another avenue for marketing.<sup>96</sup>

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.”<sup>97</sup> 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.<sup>98</sup> 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.<sup>99</sup>

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 October 18, 2006 to require disclosure of “information about persons with whom the company has contractual or other arrangements which are

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92. 679 PARL. DEB., H.L. (5th ser.) (2006) 166.

93. *Id.* at 167.

94. *Id.*

95. See Conley & Williams, *supra* note 49, at 37-38.

96. See Margaret Blair et al., *The New Role for Assurance Services in Global Commerce*, 33 J. CORP. L 325, 326-327 (2008).

97. Companies Act 2006, § 496.

98. *Id.* at § 463.

99. *Id.* at § 418.

essential to the business of the company.”<sup>100</sup> 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.<sup>101</sup> Second, there 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.<sup>102</sup>

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.”<sup>103</sup> Secondly, the Government did not intend disclosure to be particularly detailed, but to be sufficiently high-leveled 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:

[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.<sup>104</sup>

It was not just the NGOs but also members within the business community who were concerned about the lack of a clear reporting

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100. *Id.* at § 417, cl. 5(c).

101. 686 PARL. DEB., H.L. (5th ser.) (2006) 465.

102. *Id.* at 471.

103. *Id.* at 468.

104. *Id.* at 459-60. 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.

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 them assess how the directors have performed their duty under section 172 (duty to promote the success of the company).”<sup>105</sup> Furthermore, for the reasons suggested above, the precise scope and scale of the business review was more rigorously worded than 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.<sup>106</sup>

#### IV. THE NEW ROLE OF CESR INFORMATION IN THE FINANCE SECTOR

##### A. *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 they have previously agreed to exceptions specific to a member state (as for the U.K. in selected areas of policy making). While the EU does lead the U.K. 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

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105. Companies Act 2006, § 417, cl. 2.

106. *Id.* at § 417, cl. 5.

Europe's largest traded companies. In fact, the EU Modernisation Directive came to the U.K. policy arena already committed to reinforcing U.K. global advantages in corporate governance and the "principles approach" over the "rules and regulation" approach to securities regulation.<sup>107</sup> In this context, the Companies Act can be seen as one element in 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.<sup>108</sup>

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 considered.<sup>109</sup> 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.<sup>110</sup> Equally, the Chancellor's political sensitivity to claims

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107. See Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L.J. 1, 1-2 (2008) (discussing the recent advantages realized by the U.K. with regard to international IPO's because of its "principles-based" approach to securities regulation).

108. See Coffee, *supra* note 43. Competition between financial centers 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, 218-19 (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 U.S. securities regulation and especially the U.S. preference for detailed rules and regulations over principles. See generally MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, *SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP* (2007). This issue has re-emerged with the debate over the proper U.S. regulatory response to the sub-prime credit crisis; for some, the crisis was the result of banks and financial institutions circumventing the rules regarding capital adequacy and the like. By some accounts, a principles approach would have dampened such behavior putting the onus on the institutions to show that their investment practices were consistent with the intentions of regulators.

109. Companies Act 2006, § 417, cl. 3.

110. 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 Labor 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 generally ANTHONY KING, *THE BRITISH*



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 favored in the U.K. 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 in the U.S. The U.S. financial reporting regulation has shied away from the U.K. 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.<sup>111</sup> In a 2003 U.S. Securities and Exchange Commission (“SEC”) report, the SEC considered amending this approach in favor of an *objectives oriented* standard approach.<sup>112</sup> The Report argued in favor of standards framed in terms of an accounting objective “at an appropriate level of specificity” with “an appropriate amount of implementation guidance.”<sup>113</sup> This debate remains unresolved in the U.S. Indeed, the reluctance of the SEC and Financial Accounting Standards Board to implement principles-based accounting standards may account for the lack of CESR reporting in the US, and will continue until clearer financial metrics are developed to analyze CESR information.

As a consequence, firms specializing 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

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CONSTITUTION (2007) (noting the recent history of British constitutional life).

111. See David Alexander, *Globalisation of Accounting Standards: A UK Perspective*, in GLOBALISATION OF ACCOUNTING STANDARDS 58-61 (Jayne M. Godfrey & Keryn Chalmers eds, 2007).

112. SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (2003).

113. *Id.* at Executive Summary.

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 directors' newfound disclosure obligations. Armed with CESR information, disclosure has become, an important element of corporations' reputation management programs in the media and elsewhere.<sup>114</sup>

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 standardized disclosure of market-sensitive information such that data are *comparable* between companies (especially those in the same industries and countries), *consistent* in definition and measurement over time, and *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 with regard to corporate characteristics and stock-price movements have become essential to investment practice, whatever the past significance attributed to the efficient markets hypothesis.<sup>115</sup> 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.<sup>116</sup>

Absent U.K. 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 ("IASB"). However, the IASB has lagged behind EU and U.K. legislation on developing standards and metrics for these types of issues.<sup>117</sup> Independent of government and based upon independent

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114. See Clark & Hebb, *supra* note 4, at 2023-24 (discussing the importance of disclosure in maintaining, or disrupting, a corporation's reputation).

115. See Gordon L. Clark et al., *Institutional Investors and the Language of Finance: The Global Metrics of Market Performance*, in GLOBALISATION OF ACCOUNTING STANDARDS, *supra* note 111, at 15 (discussing global harmonization of language used in global accounting standards).

116. Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107, 144-145 (2003).

117. Note, however, that the U.K. 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

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.<sup>118</sup>

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 growth. It would subsequently fall to governments to crystallize these market-based models in more traditional regulatory standards.<sup>119</sup>

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 specialized 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.<sup>120</sup> Mainstream rating companies have remained aloof from

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have not set industry standards.

118. See Alexander, *supra* note 111, at 60-61.

119. 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 House of Lords over the Climate Change Bill where a proposed amendment would provide "guidance" on company reporting as to greenhouse emissions.

120. There have been recent discussions in Europe and the U.S. on how to better regulate credit rating agencies and their methodologies. See Trade Union Advisory Comm. to the Org. for Econ. Cooperation and Dev., *Trade Union Advisory Committee, Financialisation and the "Sub-Prime" Financial Crisis—Issues for Future Regulation* (Sept. 5, 2007)

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the calibration of CCSR related issues, preferring, perhaps, to monitor the development of standards and data in this area before acquiring (at some time in the future) the market innovators.

We can distinguish between two generic approaches taken by intermediaries in the development of CCSR 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 CCSR 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 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 be above or below the relevant benchmark.<sup>121</sup>

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 CCSR 'liability' over a range of crucial variables relevant to corporations' long-term financial performance.<sup>122</sup> 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 stylized 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.

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(proposing issues that should be discussed with regard to the proper reaction by financial authorities).

121. James Salo, *Corporate Governance and Environmental Performance*, (Sch. of Geography & the Env't, Oxford Univ., Working Paper No. 05-11, 2005).

122. Abigail McWilliams & Donald Siegel, *Corporate Social Responsibility and Financial Performance: Correlation or Misspecification?*, 21 STRATEGIC MGMT. J. 603, 603-604 (2000).

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 *in the event* that regulation is implemented to price CESR externalities, rather than measuring a company’s exposure to financial costs in relation to 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.

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.<sup>123</sup> 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 judgment associated with qualitative scores, as well as the problems sometimes encountered when attempting to understand assessors’ judgments 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.<sup>124</sup> These intermediaries are also clearly distinct from social activists, whose agenda is differently focused on the roles and responsibilities of the firm, and can therefore be distinguished from conventional CSR discourse in which the social and environmental interests of external stakeholders are a more dominant concern.<sup>125</sup>

#### B. *A New Kind of Regulatory Strategy*

The U.K. 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

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123. See Benjamin J. Richardson, *Pensions Law Reform and Environmental Policy: A New Role for Institutional Investors* 4(5) J. INT’L. FIN. MARKETS 159, 167 (2002) (discussing socially responsible investment).

124. See, e.g., Trucost Methodology Overview, <http://www.trucost.com/howtrucostanalyses.html> (last visited Nov. 11, 2008) (discussing the Trucost assessment methodology, which is one of the most important intermediaries in the London market for environmental accounting).

125. See Conley & Williams, *supra* note 49, at 1 (discussing the empirical results of the “‘corporate social responsibility’ movement”).

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.<sup>126</sup> New governance theory argues that the CSR movement may more closely represent the latter. Under this characterization of the CSR movement, information disclosure is often used by corporations as a kind of public relations charade rather than a way of regulating corporate behavior.<sup>127</sup> New governance theory describes a “post-regulatory state” in which corporate behavior is transformed through interactions between various actors—other firms, NGOs, government, and actors. Therefore, compared to regulatory mechanisms like mandatory information disclosure, highly networked communities are more influential in changing corporate behavior.<sup>128</sup>

Reflexive law theorists, however, adopt a slightly different approach. They acknowledge the role of various stakeholders in actively changing corporate behavior but argue that verifiable and comprehensive information disclosure is crucial to catalyzing this change. They argue that reliable mandatory reporting on, for example, corporate environmental performance, is important for stakeholder activism to have any real influence.<sup>129</sup>

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.<sup>130</sup> The control mechanism of the regime is the mandatory disclosure requirement.<sup>131</sup> Although the absence of reporting standards weakens the

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126. See Karen Yeung, *Government By Publicity Management: Sunlight or Spin*, PUB. L. 360, 362 (2005) (discussing whether public communication management of government information really enhance transparency and accountability). 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, and methods of safe use, among other pieces of information. See Liz Fisher, *The Perfect Storm of REACH: Charting Regulatory Controversy In the Age of Information, Sustainable Development, and Globalization*, 11 J. RISK RES. 541, 541 (2008).

127. See Conley & Williams, *supra* note 49, at 23 (noting that the corporate social responsibility movement “may invite insincerity”).

128. Anne-Marie Slaughter, *Global Government Networks, Global Information Agencies, and Disaggregated Democracy*, 24 MICH J. INT’L L. 1041, 1057 (2003).

129. See Richardson, *supra* note 123, at 167 (discussing the importance of mandating reliable reporting in order for the information to be useful to investors).

130. See Yeung, *supra* note 126, at 362.

131. See ANTHONY OGUS, *REGULATION: LEGAL FORM AND ECONOMIC THEORY* 126-44 (1994) (describing mandatory information disclosures).

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.<sup>132</sup> Whereas the effectiveness of some mandatory disclosure regimes (for example, product labeling) 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 intermediaries are closely scrutinizing 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: 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.<sup>133</sup> This type of regulation is therefore different from 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 CSR credentials without any direct repercussions.<sup>134</sup>

It is important to emphasize, then, that the Companies Act appears to move beyond the conventional 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.<sup>135</sup> Ideally, market prices

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132. Gordon L. Clark, *London in the European Financial Services Industry: Locational Advantage and Product Complementarities*, 2 J. ECON GEOGRAPHY 433, 433 (2002).

133. See BRONWEN MORGAN & KAREN YEUNG, AN INTRODUCTION TO LAW AND REGULATION: TEXT AND MATERIALS 316-18 (2007).

134. See Conley & Williams, *supra* note 49, at 57 (noting that the corporate social responsibility movement is motivated by ethical concerns).

135. See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) (discussing the “theoretical and empirical literature on the efficient markets model,” which occurs when prices fully reflect available information).

respond to new information quickly and accurately once the information is disclosed. However, where markets have not been given the opportunity to price financially material information because it has not been made available, then financial markets are exposed to the savage shocks such as we have seen in the subprime-led global credit crisis, and what we may expect to see if the physical consequences of climate change take place as predicted.

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 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. Second, they have lacked a common metric to accurately analyze this information. Since financial markets have failed to price CESR information to date, the Government appears to be intervening to assist investors in pricing 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 a regulator of information disclosure on both environmental and social matters, as well as a protector of the integrity of the quoted stock price of traded securities.<sup>136</sup>

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.<sup>137</sup> The Government has implicitly acknowledged that CESR is an example of "expensive" information because CESR information has conventionally been of unreliable quality and difficult to measure in terms of financial materiality. The U.K.'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

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136. See John R. Graham et al., *Value Destruction and Financial Reporting Decisions*, 62 FIN. ANALYSTS J. 27, 27-28 (2006) (discussing other reporting factors which diminish the integrity of market pricing).

137. See Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in 1B HANDBOOK OF THE ECONOMICS OF FINANCE 1059-60 (George M. Constantinides et al., eds., 2003) (explaining that substantial costs are associated with the discovery and exploitation of mis-pricings, and that returns on such an investment may be almost impossible to predict).



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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.<sup>138</sup>

The approach under the Companies Act is characteristic of Anglo-American shareholder capitalism because it empowers small investors and "outsiders" who do not share the privileged "insider" relationships that stakeholders in continental Europe might enjoy with top-level management.<sup>139</sup> This approach also empowers small investors in relation to institutional investors, since the latter usually have superior data-processing technology and organizational capacity to digest and analyze this information.<sup>140</sup> This may be intentional, since institutional investors, who own seventy percent of all listed equities in the U.K., have been slow to respond to CESR issues. This may be, in part, explained by the paucity of quantifiable metrics to analyze 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 that 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 CESR. By pinning disclosure obligations on directors in conjunction with amendments to directors' duties discussed above, the Government is demonstrating a prescient understanding of corporate behavioral 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 behavior compared with other variables such as jurisdiction, size, or annual turnover.<sup>141</sup> In addition, managers and shareholders can exert greater

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138. This is another instance in which the disclosure regime under the Companies Act (2006) moves beyond conventional CSR drivers, where a company's CESR activities rarely include their "core" activities.

139. High levels of information transparency on CESR are also consistent with the EU's strategy of building 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 Modernization Directive as discussed are attempts to build greater harmonization of markets around transparent and well-informed markets.

140. See Qi Chen, *Discussion of Which Institutional Investors Trade Based on Private Information About Earnings and Returns?* 45 J. ACCT. RES. 323, 323 (2007) (discussing possible explanations, including varied power levels, for differences between institutions that trade on private information and those that do not).

141. NEIL GUNNINGHAM ET. AL, SHADES OF GREEN: BUSINESS, REGULATION, AND

change on firm-wide behaviors in the Anglo-American firm, compared with NGOs and the public.<sup>142</sup> 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.

## V. 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 contextual: 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 recognize, of course, that this is characteristic of Anglo-American economies wherein the financial sector has become virtually autonomous from the so-called "real" economy.<sup>143</sup> But it is increasingly the case for continental European economies, and especially their largest traded corporations that seek the benefits of global financial markets.<sup>144</sup>

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, realized. We noted the tension between these expectations, arguing that the Companies

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ENVIRONMENT 68 (2003).

142. Ruth V. Aguilera et al., *Putting the S Back in Corporate Social Responsibility: A Multilevel Theory of Social Change in Organizations*, 32 ACAD. MGMT. REV. 836, 836 (2007) (arguing that the varied motives of NGOs and corporations lead to variations in ways that each are effective in increasing corporate social responsibility).

143. See FRANKLIN ALLEN & DOUGLAS GALE, UNDERSTANDING FINANCIAL CRISIS 50 (2007).

144. See Rob Bauer et. al, *supra* note 3 at 461-65 (arguing that increasing adoption of shareholder-friendly Anglo-American corporate practices by continental companies will allow European corporate governance to substitute for government regulation).

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Act was conceived to enhance the global competitiveness of U.K.-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 U.K. Labor Government favored the former over the latter.

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.<sup>145</sup> 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.<sup>146</sup> 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 U.K. embraced the opportunity to re-write U.K. company law but with a particular flavor (captured in our recounting of the parliamentary debate over its passage through the House of Lords). The U.K. Government introduced the principle that company directors ought to disclose market-relevant information on the long-term prospects of the firm, including, 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.

In effect, the Government passed on the opportunity to embrace continental European social democracy. In doing so, it reinforced its

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145. See WILHELM & DOWNING, *supra* note 16, at 107, 137 (providing an analytic framework for examining the effects of evolving information technology on financial markets).

146. See Bauer et al., *supra* note 3, at 442.

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apparent commitment to the competitiveness of U.K. 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 in the absence of government reporting standards, financial intermediaries have sought to provide measures to the extent that financial agents require consistent, comparative and comprehensive metrics for assessing corporate value. There has been a remarkable burst of private investment in metric-making, some of which rely upon qualitative judgment, 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 centers of financial innovation.<sup>147</sup>

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 has 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 CCSR metrics remains cautious given the regulatory history in this area in the UK. We noted, for 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

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147. See CLARK, *supra* note 24, at 170-95 (identifying London as prominent in the world's financial services industries).

environmental matters.<sup>148</sup> 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, recognize the complex nature of the issues involved and the lack of widely-accepted decision-metrics relevant to investment strategy. Too often, consideration of CESR issues is 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 U.K., many funds are staffed by “secretaries” who 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. Alternatively, 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 U.K. 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 regulating corporate social and environmental responsibility. We have already witnessed the devastating effect which poor disclosure regulation can have of global capital markets in the form of the subprime global credit crisis. Let us hope that the strategy embedded in the UK

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148. See Emiko Caerlewy-Smith et al., *Agitation, Resistance, and Reconciliation with Respect to Socially Responsible Investment: The Attitudes of UK Pension Trustees and Oxford Undergraduates*, 38 ENV'T & PLANNING 1585, 1585 (2006) (illustrating an example of divergence between pension-fund managers’ policies and the expectations of a community they serve).

Companies Act will assist in mitigating similar shocks in the future.