Cambridge Law Journal, **67(2)**, July 2008, pp. 396–422
doi:10.1017/S000819730800038X *Printed in Great Britain*

ETHICAL INVESTMENTS: A CASE OF DISJOINTED THINKING

ROSY THORNTON*

I. INTRODUCTION

IN an era of globally available information, members of the public cannot help but be aware of the impact of different industries, and within them individual enterprises, upon their workforce, consumers and the environment. Those with money to invest in are increasingly conscious of how the selections they make when purchasing shares may have wide-reaching effects. Quite naturally, many are concerned to try to make responsible investment choices; the ethical investment industry has itself become a multi-million pound business.

Since 1984, when Friends Provident launched its Stewardship Fund, the first specifically "ethical" unit trust, the sector of the investment market targeted at investors seeking to ensure socially responsible uses for their money has grown exponentially. By the end of the 1980s there were 44 ethical retail funds operating in the United Kingdom; the number at the end of 2005 was 63, representing an estimated 440,000 individual investors and incorporating a total fund value of £6.1 billion[1]. Moreover, such unit trusts are only a small fraction of the overall "SRI" or socially responsible investment market; figures gathered in 2001 suggest that the £3.5 billion then held in ethical retail funds was dwarfed by £13 billion held in SRI assets by the churches, £25 billion by charities, £80 billion by pension funds and £103 billion by insurance companies[2]. Nor is SRI by any means a phenomenon restricted to the UK. A worldwide survey of major fund managers conducted in 2004 for Mercer Investment Consulting found that 73 per cent. of respondents believed that the incorporation of SRI indicators into investment analysis would become a mainstream part of fund management practice within a decade.[3]

* Fellow of Emmanuel College, Cambridge. Richard Nolan, Matthew Conaglen and Mike Gross kindly read and commented on the article in draft, but any errors are of course my own.

1 Market statistics collected and analysed by EIRIS (Ethical Investment Research Services): see http://www.eiris.org.

2 Russell Sparkes, *Socially Responsible Investment: A Global Revolution* (Chichester 2002).

3 Jane Ambachtsheer, *SRI: What do Investment Managers Think?* 21 March 2005: see http://www.merceric.com/srisurvey.

Individuals who serve as trustees, or who are employed by firms acting as corporate trustees, have consciences, too; they are no doubt affected by the same personal moral, social and political promptings as any private individual, whether the trust in question be a traditional family trust, a pension fund or a charity. Trustees, however, are not free, as ordinary citizens would be, to follow their conscience when investing the trust assets which are under their stewardship. The notion of ethical investment of trust funds, at least in legal theory, is an extremely restrictive concept.

II. Guiding Principles of Trustee Investment

The Trustee Act 2000 largely codified the default powers and duties of trustees (including their investment functions) across all sectors and types of trust, putting much into statute which had previously lain in the common law. The standard of care to be applied to a trustee when exercising his investment powers[4] is that found in section 1 of the Act, namely that:

> He must exercise such care and skill as is reasonable in the circumstances, having regard in particular –
> (a) to any special knowledge or experience that he has or holds himself out as having, and
> (b) if he acts as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

Section 3 liberalised[5] the range of investments in which, under the general law,[6] a trustee is permitted to invest, to the extent that he may now "make any kind of investment that he could make if he were absolutely entitled to the assets of the trust". Section 4 provides that trustees, when exercising their investment powers, must keep the portfolio under regular review[7] and must "have regard to the standard investment criteria";[8] these are the "suitability to the trust" both of the

4 Trustee Act 2000, sch. 1, para. 1.

5 The previous law, contained in the Trustee Investment Act 1961, restricted in particular the proportion of the fund which trustees were able to invest in ordinary equities; in the absence of wider express powers in the trust instrument, at least one-half of the fund had to be retained in "safe" investments such as gilt-edged securities and bank deposit accounts. For a summary see David Hayton, *Underhill and Hayton: Law Relating to Trusts and Trustees*, 15th ed., (London 1995), pp. 563–585. In fact, most express private trusts already included wider powers equivalent to the new law: see Law Commission, *Trustees' Powers and Duties* (Consultation Paper No. 146, 1997), para. 2.7.

6 In practice, despite the wide ambit of Trustee Act 2000, s. 3, many private trust instruments still contain express investment powers, whether to restrict the statutory power or to reinforce it: see Lord Millett (ed.), *The Encyclopaedia of Forms and Precedents*, 5th ed. (London 2005), vol. 40(1), paras. [3514] and [2616].

7 Section 4(2).

8 Section 4(3).

https://doi.org/10.1017/S000819730800038X Published online by Cambridge University Press

type of investment under consideration and of the specific asset in question[9], as well as "the need for diversification of investments … in so far as is appropriate to the circumstances of the trust".[10]

What the 2000 legislation apparently does not affect is the longstanding common law principle that a trustee, when investing trust funds, should take such "care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide";[11] this has traditionally been taken to mean that, unlike a person acting on his own account, a trustee must avoid investments "which are attended with hazard".[12] In other words, although the range of choice is now the same as for an individual investing on his own behalf, within that range the criteria applied by trustees when selecting the investment portfolio must remain more cautious.

Also unaffected by the Trustee Act is the basic principle guiding trustees when making any decision regarding the investment of the trust fund. This was classically set out by Sir Robert Megarry V.-C. in the leading case of *Cowan* v. *Scargill*.

> The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust…When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment… the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question…[13]

In other words - and subject to limited exceptions which will be considered in section V below - it is the maximisation of value and yield which should drive investment decisions. The corollary of this, as Sir Robert Megarry went on to point out, is that "trustees must put on one side their own personal interests and views".[14] They may hold strong personal opinions as to the immorality of a particular company, industry or sector, but if investments which they regard as unpalatable would be "more beneficial to the beneficiaries than other investments", they must not refrain from making them on those grounds. It may not be practicable, as Lord Murray recognised in the Scottish Court of Session in *Martin* v. *City of Edinburgh District*

[9] Section 4(3)(a).
[10] Section 4(3)(b), re-enacting section 6(1) of the Trustee Investments Act 1961.
[11] *Re Whiteley* (1886) 33 Ch. 347, 355. The Law Commission's intention, at least, was that "wider powers of investment…do not affect the general duties which the law imposes on trustees" (Law Com. No. 260, 1999, para. 2.30).
[12] *Learoyd* v. *Whiteley* (1887) 12 App. Cas. 727, 733. Risk, however, is now to be judged across the whole investment portfolio: see note 16 below.
[13] [1985] Ch. 270, 286–287.
[14] [1985] Ch. 270, 287.

Council, for a trustee to "divest himself of all personal preferences, of all political beliefs, of all moral, religious or other conscientiously held principles" – trustees are human beings, after all; but, whatever his own views, he must "none the less do his best to exercise fair and impartial judgment" in the best interests of the beneficiaries.[15]

Furthermore, firmly enshrined in the modern case law is the notion that the standard of care pertaining to trustee investment must be "capable of adaptation to current economic conditions and contemporary understanding of markets and investments"; in relation to the question of diversification, in particular, trustees are "to be judged by the standard of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation".[16] Any assets which are individually more hazardous may be offset by other, safer investments to form a portfolio which is balanced and which, when taken as a whole, seems best designed to further the financial needs of the particular trust.

The Trustee Act 2000, by unbinding trustees' hands and broadening the range of investments from which they are free to select, has enabled them to take full advantage of the lessons of portfolio theory.[17]

三、遊覽：投資組合理論

III. Excursus: Portfolio Theory

In reality, of course, whether a particular investment is going to be financially beneficial is not something which can be stated with certainty in advance. Risk and uncertainty are inherent in the nature of the exercise. Instead, through analysis of market factors, historic trends and other known data, fund managers are able to calculate indicators by which to judge the desirability of proposed investment strategies.[18]

For any individual asset, investors are able to take a measure of its likely performance, based on an average of possible outcomes weighted for their estimated probability. This is known as the "expected return". They are also able to come up with an indicator of the volatility of or risk attached to that asset, by averaging the dispersion of the possible outcomes from the mean, a measure known as "variance". However, investors do not consider individual assets in

[15] (1988) S.C.L.R. 90, 97.

[16] *Nestlé* v. *National Westminster Bank plc* [1988] (1996) 10(1) Trust Law International 113, 115, *per* Hoffmann J.

[17] The explanatory notes to the 2000 Act (available at http://www.opsi.gov.uk/acts/en2000/2000en29.htm) expressly note that the definition of the standard investment criteria in section 4(3) "accords with modern portfolio theory" (para. 25).

[18] See generally Edwin J. Elton, Martin J. Gruber, Stephen J. Brown and Williams N. Goetzmann, *Modern Portfolio Theory and Investment Analysis* (Chichester 2003), ch. 4. See also Isaac N. Legair, "Modern Portfolio Theory: A Primer" (2000) 14(2) Trust Law International 75.

isolation. By holding a combination of assets known as a portfolio they are able to spread, and thus minimise, the risk to which the fund is exposed. This can be demonstrated statistically, since the variance of a group of assets will tend to be less than the average of the variance of the individual assets themselves. The importance of diversification through the holding of a varied portfolio of investments has long been recognised and, in the case of trustee investors, as we have seen, is now enshrined in statute as part of the standard investment criteria.[19] As Lord Nicholls of Birkenhead has pointed out, the traditional prohibition upon selecting investments "attended with hazard"[20] must be read in the context of a strategy whereby risk is managed across a balanced portfolio, incorporating a prudent mixture of low and higher risk assets.[21] Diversification cannot, of course, eliminate all risk; it cannot remove 'systematic' or market risk but only 'non-systematic' or firm-specific risk.[22]

Some combinations of assets will be more effective than others in reducing the overall risk on the portfolio. To take a very simple example, if two assets are likely to perform well under opposite market conditions or at different times, then dividing the fund between these two would substantially reduce the degree of risk; on the other hand, dividing the fund between two investments which will tend to track each other and perform well under similar conditions would be less effective at reducing overall risk. To adopt Emma Ford's colourful example, "the risk in owning stock in an umbrella manufacturer is lower if the investor also owns stock in a suntan lotion manufacturer".[23] Investors judge the dependence or independence of assets for these purposes by means of a measure called "covariance", which is calculated by averaging the product of the deviations of each asset from its mean. Covariance indicates the extent to which assets tend to move together; if they are liable to perform well at similar times and under similar market conditions, the covariance will be positive; if they are liable to perform well at opposite times or under opposite conditions it will be negative. If their likely performance is completely unrelated, it will tend to be zero.

Using covariance to select a portfolio of assets which are, so far as possible, independent gives investors a highly effective way of reducing risk. In theory, if a portfolio contains a sufficient number of independent assets then, whatever the variance of the individual assets

19 See note 10 above.
20 See note 12 above.
21 "Trustees and their Broader Community: Where Duty, Morality and Ethics Converge" (1995) 9(3) Trust Law International 71, 76.
22 Zvi Bodie, Alex Kane and Alan Marcus, *Investments*, 6th ed. (Boston 2005), p. 224.
23 "Trustee Investment and Modern Portfolio Theory" (1996) 10(4) Trust Law International 102, 102.

within the portfolio, the average variance of the portfolio as a whole always approaches zero. In real life, unfortunately, things are not that simple. In most markets, assets tend not to perform independently, but to move up and down in an interrelated manner. Thus by increasing the number of assets in the investment portfolio and by ensuring that they are as independent as possible, the variance or risk can be minimised but never reduced entirely to zero. As the size of the portfolio increases, the addition of any new asset will have a smaller and smaller effect – though always, in theory, some effect – in terms of the reduction of overall risk.

When selecting a portfolio of investments, fund managers will typically either look for the lowest possible variance on the portfolio for a given expected return, or else for the highest possible expected return for a given acceptable level of variance or risk. For any given market or universe of assets, it is possible to plot what is known as the "efficient frontier", representing all the optimal combinations of variance with expected return.[24]

IV. Forms of Ethical Investment Strategy

The United Nations Environment Programme Finance Initiative (UNEPFI) identifies two mechanisms for incorporating ethical factors into the investment decision-making process. The first is termed "positive screening" and involves setting inclusive criteria which must be met before an investment can be included within the portfolio; the second, "negative screening" (sometimes termed ethical disinvestment) applies disqualifying criteria to exclude companies or sectors from the portfolio.[25] Whether SRI criteria are applied positively or negatively, in either case the policy in question may be 'socially dictated' or 'socially sensitive'. These terms, first coined by American commentators Hutchinson and Cole,[26] have been widely employed in the English literature[27]. A socially dictated policy is one which uses predetermined ethical considerations to limit or determine the selection of investment assets, such considerations taking precedence over commercial factors. A socially sensitive policy allows SRI factors to come into play only when choosing between investments which appear equivalently attractive according to normal financial criteria. *Prima facie* it appears

[24] See generally Bodie, Kane and Marcus (note 22 above), ch. 8.

[25] *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (UNEPFI Asset Management Working Group 2005), p. 25. Available at http://www.unepfi.org/publications/investment/index.html.

[26] J.D. Hutchinson and C.G. Cole, "Legal Standards Governing Investment of Pension Assets for Social and Political Goals" (1980) University of Pennsylvania Law Review 1340.

[27] See, for example, Peter Docking and Ian Pittaway, "Social Investment by English Pension Funds: Can It be Done?" (1990) Trust Law and Practice 25; Gerard McCormack, "Sexy But Not Sleazy: Trustee Investments and Ethical Considerations" (1998) 19(2) Company Lawyer 39.

that the former strategy, at least, if adopted by trustees, would offend against the principles enshrined in *Cowan*.

Another form of ethical policy which may be pursued by investors is what UNEPFI identifies as "shareholder engagement".[28] This involves investors attempting to influence the performance in ethical terms of companies in which they hold shares, through the use of shareholder voting rights and other forms of lobbying or influence. Although this form of SRI activity does not affect asset selection and is largely outside the ambit of this article, it should be noted that if trustee investors engage even in this type of pressurising activity, they may well be acting in breach of duty. Shares within the portfolio are held on behalf of the trust, and trustees ought not to exercise voting or other shareholder rights, which they hold in their fiduciary capacity, for purposes other than, or ways which may run contrary to, the financial best interests of the beneficiaries.

V. Ethical Decision-Making: The Exceptions to the Rule

With the economic theory in mind, as well as the practical forms which SRI may take, let us now return to the law. Although it is established that the paramount duty of trustees when exercising their investment function is to maximise financial advantage to the beneficiaries, the principle is not absolutely invariable. It may, of course, be that the trust instrument expressly instructs or empowers trustees to exclude from consideration certain assets or classes of assets, or to adhere to specified criteria of social responsibility when making investment decisions[29]. Moreover, there are a number of judicially recognised exceptions to the general rule: instances of situations when it is permissible for trustees to select investments on other than strictly financial grounds.

The first such instance was mentioned by Sir Robert Megarry V.-C. in *Cowan* v. *Scargill* and is wholly unexceptionable. If the trust in question is a small, family trust and all the beneficiaries are adults with full legal capacity, then if they strongly and unanimously take a particular view about particular industries, the trustees may follow the views of the beneficiaries and exclude such shares from the portfolio. As the Vice-Chancellor pointed out,

> The beneficiaries might well consider that it was far better to receive less than to receive more money from what they consider to be evil and tainted sources. "Benefit" is a word with a very

[28] See note 25 above, at pp. 25–26.
[29] "Trustees would be entitled, or even required, to take into account non-financial criteria… where the trust deed so provides": *per* Sir Donald Nicholls V.-C. in *Harries* v. *Church Commissioners for England* [1992] 1 W.L.R. 1241, 1247.

https://doi.org/10.1017/S000819730800038X Published online by Cambridge University Press

> wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit.[30]

He went on to state that such cases were likely to be very rare; he also refused to draw any analogy, in the case of the coal miners' pension trust in the case before him, to the majority views of a representative body of beneficiaries, namely the members of the mineworkers' union voting on investment policy at their annual conference. Furthermore, it should be emphasised that taking account of the beneficiaries' deeply held convictions is very different from allowing any influence for the trustees' own views. One way of rationalising this first exception might be to view it as an application of the consent principle based upon the rule in *Saunders* v. *Vautier*;[31] this would explain why it requires the unanimity of *sui iuris* beneficiaries, and why trustees' own wishes have no rôle to play here.

A second apparent exception may be drawn from the case of *Evans* v. *London Co-operative Society*.[32] There, Brightman J. ruled to be lawful a loan made by the Co-operative Society's pension fund to the Society at an interest rate below prevailing market rates. This has been held up by some commentators as allowing a limited form of "social" or community investment,[33] but in fact the exception appears to be a very narrow one. The beneficiaries of the pension fund were all employees of the Society and "dependent for their employment upon the financial health of the society", which, moreover, because of its co-operative structure, lacked the usual means of raising working capital available to commercial undertakings.[34] Viewed in this light, it will be seen that the loan was made not on any broad social or ethical ground but rather, entirely consistently with principle, in the interests of the beneficiaries' economic well-being.

Thirdly, there are two related exceptions to the rule which specifically concern charitable trusts. They derive from *Harries* v. *Church Commissioners for England*.[35] In that case, Sir Donald Nicholls V.-C. began by ruling that as far as general principle is concerned, charitable trusts are no different from any other trust, and that the maximisation of financial return is the paramount duty when trustees are making investment decisions. As he observed, "most charities need money; and the more of it there is available, the more the trustees can

[30] [1985] Ch. 270, 288.
[31] (1841) 4 Beav. 115. See also *Goulding* v. *James* [1997] 2 All E.R. 239, 247 *per* Mummery L.J.; *CPT Custodian Property Ltd.* v. *Commissioner of State Revenue* 2005 ATC 4925, 4933.
[32] 5 July 1976, unreported, but see full note in Robin Ellison, *Private Occupational Pension Schemes* (London 1979), p. 356.
[33] See, for example, Richard Nobles, *Pensions, Employment and the Law* (Oxford 1994), p. 184.
[34] *Ibid.*, at p. 365.
[35] [1992] 1 W.L.R. 1241.

seek to accomplish."[36] However, the Vice-Chancellor then went on to outline an exception: namely, "when the objects of the charity are such that investments of a particular type would conflict with the aims of the charity".[37] The examples which he offered were those of cancer charities refusing to invest in tobacco shares, trustees of temperance societies ruling out investment in breweries or distilleries and Quaker charities deciding not to invest in the arms trade.

In addition, Sir Donald Nicholls held that there may be cases, albeit in his view likely to be comparatively rare, where the trust's holdings of a particular asset might hamper the work of the trust, either by alienating potential donors or by deterring potential recipients of the charity's aid from being willing to take advantage of it.[38] The first of these two instances can be dismissed at once as not in fact being an exception to the usual principle at all; if donations are likely to be reduced by more than the expected return from the holding of the asset, then that is a straightforward matter to be fed into the equation for assessing the financial benefit of the investment. The other example is more relevant and may stand as a viable exception, although any deterrent effect upon potential service users is liable to be difficult to gauge, and unlikely to be sufficiently disruptive to outweigh hard economic arguments the other way in any but very occasional circumstances.

The fourth exception is not one of principle but appears to arise more or less entirely by default. It emerges from a close reading of the judgment of Sir Robert Megarry in *Cowan* v. *Scargill*. Although the proposition "that trustees could not be criticised for failing to make an investment for social or political reasons" is not one he was able to accept "in its full width", he did go on to concede that "if the investment in fact made is equally beneficial to the beneficiaries, then criticism would be difficult to sustain in practice, whatever the position in theory".[39] In other words, he seemed to be saying, if trustees are faced with a choice between two assets which are equally advantageous in financial terms, they would not be acting in breach of duty by making the selection according to their own ethical preferences. A "socially sensitive" SRI policy would not be unlawful. At first sight, this argument appears quite reasonable. If there is nothing to choose between the two investments, then following one's own moral views seems no more objectionable than the alternative, which would appear to be simply sticking in a pin.

36 *Ibid.*, at p. 1246.
37 *Ibid.*, at p. 1246.
38 *Ibid.*, at p. 1247. The question is begged as to what concrete evidence of this trustees are likely have; the danger may be that anecdotal evidence of donor disapproval will serve as an *ex post* rationalisation of the trustees' own preferences.
39 [1985] Ch. 270, 287.

There is, however, a fundamental objection to the fourth exception: namely, that it is based in unreality. Unless the investment powers in the particular trust instrument are most unusually restrictive, trustees are never likely to face the artificially constructed choice which Sir Robert Megarry postulates. In practice, they are not measuring one given asset against one given alternative, but (in the nature of modern portfolio investment) selecting a range of assets from amongst a very wide pool. Moreover, how plausible is it that two assets would ever be, in the Vice-Chancellor's words, ''equally beneficial''? Intuitively, we must assume that in the real world one asset is never going to have an exact twin in investment terms. But what about in the artificial statistical world created by economists and their assumptions? Here, where the complexities of the real market place must necessarily be reduced to a series of rough and ready assumptions, might not two potential investments appear on paper to be equally attractive? The answer again, however, would appear to be no. Not only is it extremely improbable that the complex measures used to estimate expected return and variance will produce two identical sets of values, but it must be remembered that these assets are not being considered in isolation but in relation to an existing portfolio. Therefore the trustees should be comparing not only the expected return and variance of the two assets themselves, but also the covariance between those assets and the rest of the holdings within the portfolio. When this factor is taken into account, it becomes inconceivable that there would be no legitimate investment ground upon which to distinguish between the two assets. The major flaw in the fourth ''exception'', therefore, is not so much that the trustees could be held to be at fault in making the choice posited by Sir Robert Megarry on moral grounds, but rather than the occurrence of such a choice is a practical impossibility.

Of course, trustees are not omniscient. They will only be held, in their selection of investments, to the standard of care set out in section 1 of the Trustee Act 2000,[40] either as reasonable professionals or as reasonable lay trustees. If the latter, however, they will be required to take expert advice;[41] and the duty must surely be for the trustees or their advisers to attempt, in the light of all the available data, to distinguish between assets on economic grounds, according to the best of their abilities, rather than simply throwing up their hands and calling them much of a muchness.

Furthermore, even if, with imperfect information and imperfect skill, trustees genuinely find themselves unable to draw a line between proposed investments, there is still no justification for allowing

[40] See section II above.
[41] Trustee Act 2000, s. 5.

selection on an ethical basis. The investments will not in fact, as we have seen, represent identical risks in every respect; there will still be ways, albeit unknown, in which the real future risks of the two assets differ. That being the case then, according to strict economic analysis, the optimal decision would not be to choose one above the other, whether on SRI grounds or the toss of a coin, but (administrative costs permitting) to split the sum available for investment between both the assets and hence spread the hidden risk. If all else appears equal, then diversify.

The fifth and final of the exceptions to the general rule is also not explicit but arises by clear implication from the judgment of Sir Donald Nicholls in the *Harries* case. The facts concerned the investment strategy adopted by the Church Commissioners, who were charitable trustees. Their present investment policy did incorporate a moral or ethical element, and indeed had done so ever since they were constituted in 1948; the claimants, led by Richard Harries, the Bishop of Oxford, sought declarations to the effect that the Commissioners were obliged to have regard to Christian principles when making investment decisions, and that a policy which still attached overriding importance to financial considerations was erroneous in law. Those declarations were refused. The Vice-Chancellor's decision was, in effect, to uphold the existing, broadly ethical investment policy but to rule impermissible the more rigidly constrained policy proposed by the claimants.

What is most interesting here is the ruling that the Commissioners' present approach, expressly termed by Sir Donald Nicholls an "ethical" investment policy, was compliant with the law. Their policy statement ruled out completely any shareholdings in companies whose main business was armaments, gambling, alcohol, tobacco or newspapers (this last on the basis of the possible appearance of political bias) as well as any company with more than a small part of its business in South Africa (this being the era of apartheid), as well as incorporating the general statement that "as responsible investors we… continue to take proper account of social, ethical and environmental issues"[42]. It was not merely a "socially sensitive" but, at least in part, a "socially dictated" strategy. Yet the Vice-Chancellor asserted, "I can see nothing in this statement of policy which is inconsistent with the general principles" of trustee investment law.[43]

It is important to note that this was not because the case came within the second exception outlined above, concerning investments

[42] [1992] 1 W.L.R. 1241, 1249.

[43] *Ibid.*, at p. 1250. And see later (also at p. 1250): "In my view this self-constraint by the Commissioners is not one which in practice has led to any error of law on their part, nor is it likely to do so."

which conflict with the purposes of the charity. Although the Commissioners argued that there was a body of opinion within the membership of the Church of England which was opposed to the industries in question, Sir Donald Nicholls pointed out that many others would take a contrary view; as he dryly observed, "to say that not all members of the Church of England eschew gambling, alcohol or tobacco would be an understatement".[44]

The contention of the Church Commissioners, with which the Vice-Chancellor implicitly concurred, was that their existing policy, although it narrowed the range of potential investments they might make, did not unduly restrict their ability to pursue a financially viable investment strategy. Most crucially, it did not do so "because there… remained open to the Commissioners an adequate width of alternative investments".[45] In other words, even a predetermined, socially dictated SRI strategy, based upon negative screening, was not unlawful provided that it left available to the trustees a sufficient range of choice. The judgment even gives us the figures. The Commissioners' existing policy - which was upheld as lawful - excluded approximately 13 per cent., by value, of listed United Kingdom companies.

This is the point where the fifth exception runs contrary to portfolio theory. The notion that it is possible to rule out from consideration a significant section of the economy in this way without damage to the expected financial return upon and level of risk to the trust portfolio is clearly flawed.

It can be demonstrated statistically that whenever the universe of assets from which investments are to be selected is narrowed, the graph will change and the efficient frontier will move.[46] The effect is likely to be very considerable when ruling out as much as 13 per cent. of the UK securities market, but in theory it can be shown that the exclusion of any asset or asset class from the range of available investment choices will have a negative impact upon outcomes. Writing extrajudicially, Lord Nicholls (as he now is) has argued that "the inclusion or exclusion of particular investments or types of investment will often be possible without incurring the risk of a lower rate of return or reducing the desirable spread of investments",[47] but economic theory suggests this to be misguided; any restriction adopted on ethical or other grounds will necessarily have an effect, however small, upon efficiency.

44 *Ibid.*, at p. 1250.
45 *Ibid.*, at p. 1250.
46 "Any constraint carries a price tag in the sense that an efficient frontier constructed subject to extra constraints will offer a reward-to-variability ratio inferior to that of a less constrained one" (Bodie, Kane and Marcus, note 22 above, p. 246). See also Frank K. Reilly, *Investment Analysis and Portfolio Management*, 3rd ed., (Chicago 1989), pp. 288–289.
47 (1995) 9(3) Trust Law International 71, 75.

Moreover in the *Harries* case what was excluded from the universe was not a random selection of assets, but whole industry blocks. The same is likely to be true of most SRI strategies; by their nature, ethical approaches are likely to rule out all shares in umbrellas and none in suntan lotion (or vice versa). By ruling out sets of shares likely to perform similarly at similar times and under similar market conditions, the effect is likely to be a remaining universe which is not only numerically narrower but also appreciably less varied and with a tendency to higher covariance, reducing the trustees' ability to spread and reduce risk to the portfolio. The concept of excluding any sector of the market and yet retaining a "sufficient" range of investment selection is flawed, flying as it does in the face both of portfolio theory and of the guiding principle of the beneficiaries' best (as opposed to "good enough") financial interests.

VI. Talking Down *Cowan* v. *Scargill*

There has been a tendency in recent years for those pushing for greater social responsibility in trustee investment to seek to undermine the influence of the case law, and especially the importance of the paramount principle of financial best interests as set out in the *Cowan* case. The most sustained attack on its authority came in a report in October 2005, commissioned for UNEPFI and produced by Freshfields Bruckhaus Deringer, which argued for a legal framework for integrating ethical issues into institutional investment worldwide.[48] In analysing current UK law, the report's authors lay out in some detail their reasons for contending that *Cowan* v. *Scargill* is of dubious reliability.[49]

Reliance is placed, for instance, on the fact that Sir Robert Megarry himself, commenting in an extrajudicial capacity, has stated that he did not consider himself to be making new law when he decided the case[50] and was surprised by the attention his judgment received.[51] However, it may be simply that his statement was not novel, because he was doing no more than enunciating the principles which necessarily flow from the nature of a trust: a trustee must act in the best interests of the beneficiaries and in accordance with the purpose of the trust which, in the case of almost all non-charitable trusts[52], is the protection of property and the furnishing of financial benefits.

48 See note 25 above.
49 *Ibid.*, at pp. 89 and 101.
50 "Investing Pension Funds: The Mineworkers' Case" in T.G. Youdan, *Equity, Fiduciaries and Trusts* (Zurich 1989), p. 115.
51 Given the date of the case, and the public prominence of Arthur Scargill and the mineworkers' union at the time, such surprise seems unwarranted.
52 The specific situation of charitable trusts will be considered in section IX below.

The UNEPFI report also suggests that much of what Megarry said in the case was *obiter* and is therefore not binding. However, the issue in *Cowan* was whether the NUM trustees were acting in breach of duty by refusing to agree to a proposed investment plan unless it excluded oil and gas shares. Thus the duties of trustees when selecting investments, and the legality of negative screening, were squarely raised for consideration, and it is difficult to see how any of the main points of the judgment can be regarded as *obiter dicta*. The report makes much of the fact that arguments before the court were inadequate, with NUM-appointed trustee Arthur Scargill choosing to represent himself, and a number of points not being fully considered, such as the fact that the particular pension fund was set up under a nationalisation scheme. What the authors do not go on to elaborate is how, if at all, these matters could possibly have affected the fundamental findings in the case as to the nature of trustees' investment duties, which appear, by their very nature, not to be specific to any particular trust.

Least persuasive of all is the argument that *Cowan* is no longer good law because it "was decided 21 years ago, before legal acknowledgment of modern portfolio theory"[53]. As we have seen, portfolio theory, very far from supporting the case for a wider role for SRI policies, points if anything in the opposite direction. Not only does it provide a mechanism for pursuit of the beneficiaries' financial best interests as required by *Cowan*, but it even casts doubt upon the rationality of those limited forms of screening on ethical grounds which are upheld, expressly or by implication, in *Cowan* and *Harries*.

VII. Disjointed Thinking: SRI Rhetoric and Legal Theory

Given the present state of the case law - and even if the exceptions in *Cowan* and *Harries* are accepted on their own terms - a serious mismatch may be identified between the rhetoric of the major players in the SRI sector and the legal theory of trustee investment.

The Ethical Investment Research Services (EIRIS) Foundation (itself a charity which supports and advises upon ethical investment) states in its guidance briefing for charities that "research shows that ethical or socially responsible investment can be consistent with good financial performance" and that "investing according to ethical criteria may make little difference to overall financial performance".[54] Under the law as it currently stands, these assertions seem to misunderstand the nature of the trustees' investment duty. It is well established that there is no duty to obtain a particular level of financial

[53] See note 25 above, at p. 89.
[54] *EIRIS Services for Charities* (available at http://www.eiris.org), p. 1.

return; as Hoffmann J. expressed it in *Nestlé* v. *National Westminster Bank plc*[55] "a trustee exercising investment powers is not under a duty to achieve results". The flipside of this proposition must be that the fact that a particular level of return happens to be achieved does not mean that the duty has been properly discharged.[56] Megarry V.-C. pointed out in the *Cowan* case that evidence of other funds having performed "well enough" without the categories of investments which trustees are seeking to exclude "misses the point".[57] Trustees must pursue the optimal policy, judged in the light of the information available to them; they must seek to do the best they possibly can for their beneficiaries.

In the Scottish case of *Martin*, a local authority, as trustee of its public and charitable funds, was held to have acted in breach of trust by pursuing a policy of disinvestment in companies with interests in South Africa under the *apartheid* regime. The declarator was granted despite the fact that the policy, far from leading to any measurable diminution in the value of the funds, had actually been financially beneficial.[58] This was because trustees must not "fetter their investment discretion by any *ab ante* decision", nor act "for reasons extraneous to the trust purposes".[59] Breach of trust lay not in the financial outturn of the particular choice of investments but in the process of selection. This position is supported by economic theory. Whether an investment will turn out to be beneficial *ex post* cannot be known in advance; all that trustee investors can do is make the best possible assessment of risk, based on the *ex ante* evidence available, and many variables beyond their control will also have an impact upon eventual performance.

Normally, breach of duty will occur whenever a decision is based upon improper or immaterial considerations. However, in *Cowan* Sir Robert Megarry did make one allowance.

> If trustees make a decision upon wholly wrong grounds, and yet it subsequently appears, from matters which they did not express or did not refer to, that there are in fact good and sufficient reasons for supporting their decision, then I do not think that they would incur any liability for having decided the matter on erroneous grounds; for the decision itself was right.[60]

The exclusion from consideration of a sector of possible investments, albeit for illegitimate political or ethical reasons, might in fact be

[55] (1996) 10(1) Trust Law International 113, 113.
[56] It may, however, mean that financial liability will not ensue: see section VIII below.
[57] [1985] Ch. 270, 294–295.
[58] (1988) S.C.L.R. 90, 93. There is no reason to suppose that English law is any different in this respect.
[59] *Ibid.*, at p. 97.
[60] [1985] Ch. 270, 294.

justifiable separately on objective, economic grounds; in such a case, the Vice-Chancellor seems to say, there would be no breach of trust. However, it is still the decision itself, and its properness or otherwise according to financial criteria, which constitutes the breach, and not the performance of the chosen shares over the months or years which follow. If the selection of investments runs contrary to the best financial indicators available at the time, it is still a breach of trust whether loss ensues or not.[61]

Hence, at least as the law presently stands, it is of scant relevance to arguments about the viability of SRI policies, to cite figures showing the adequate or even strong performance of the sector. Gerard McCormack, for example, produced statistics to support his assertion that "ethical investment funds perform quite respectably" and that "they are not the best performers but neither are they the worst".[62] However, it is difficult to see what value such information has for trustee investors. Certainly, the factors which make particular shares a good bet in portfolio management terms are many and complex, and the process of assessing them is necessarily an inexact one; certainly, the historical performance of an enterprise or sector is a major component of any judgment made. But it is only one such component. Even if ethical unit trusts had outperformed their mainstream equivalents consistently over recent years (which is very far from being the case), that would not mean that trustees would be justified in choosing to invest in them, without first making their best attempt at weighing all the other available pointers and indices, in order to decide whether such a strategy would be in the beneficiaries' financial interests.

Of course, it may be that for a particular reason, SRI considerations coincide with best estimates of economic performance. It might well have been that the widespread boycott of South African goods in the 1980s meant that shares in companies with interests there were a poor financial risk, or that the proliferation today of worldwide policies against cigarette smoking might make the tobacco industry a bad investment in economic terms.[63] When viewed in the context of the long time horizons of a pension trust, it is possible that adherence or otherwise to environmental standards may well affect a company's long-term results; Howard Pearce of the Environment Agency Pension Fund, for instance, has argued that "environmental issues like climate

[61] This despite Staughton L.J. appearing to suggest otherwise in *Nestlé* v. *National Westminster Bank plc* [1993] 1 W.L.R. 1260, 1276: see discussion in section VIII below.

[62] (1998) 19(2) Company Lawyer 39, 48–49.

[63] In fact, increasing cigarette sales in less developed countries have meant that the recent experience is quite the opposite: over the four years to June 2007 equities in the tobacco sector generated an average total return of 17.3 per cent. *per annum* compared with 10.5 per cent. across the whole FTSE All-World Index (see http://www.ftseall-world.com).

change have growing economic impact and will increasingly affect the financial performance and sustainability of companies".[64] In such cases, however, decisions are not being made on ethical grounds at all but merely on financial ones, in line with current legal principle. As Mr. Pearce went on to say, "responsible investment strategy is grounded on fund managers' investment decision-making processes that include environmental issues for fundamental economic and financial reasons, rather than any moral or ethical reasons."

The EIRIS briefing also asserts that "charities are turning to ethical investment… to deliver a positive message to both staff and the public".[65] This appears to fly in the face of the of clear statement of Nicholls V.-C. in *Harries* that "trustees cannot properly use assets held as an investment for other, viz., non-investment purposes… They must not use property held by them for investment purposes as a means for making moral statements".[66] The document also advises charities in the most general of terms, "Your supporters and beneficiaries are your stakeholders. Their views should be taken into account".[67] As we have seen, this is inconsistent with the case law, which allows the views of donors or service users to become relevant only in so far as a particular investment is actually likely to deter them from giving money or from coming forward for charitable assistance.[68] There may be some attraction in the argument that charitable trusts, because of their unique public and philanthropic position, ought to be subject to more flexible rules than other trusts as far as ethical investment of their funds is concerned. Perhaps charities should be allowed to set a moral example of public-spirited behaviour, where private trustees must simply pursue financial gain. According to Richard Nobles, "charity would, in most people's opinion, represent one area of social life in which the pursuit of values other than profit… must dominate";[69] he argues that since charitable trustees are empowered to give away their funds for socially beneficial purposes, it is illogical that investment should be subject to stricter, more commercial considerations.[70] However, as explained above, this is not the present state of the law, as propounded by the Vice-Chancellor in *Harries*. Charity property held for "functional purposes" and that held for investment were

[64] *Responsible Investment in Focus: How Leading Public Pension Funds are Meeting the Challenge* (UNEPFI Asset Management Working Group and UK Social Investment Forum 2007), p. 4. Available at http://www.unepfi.org/publications/investment/index.html.

[65] See note 54 above, at p. 3.

[66] [1992] 1 W.L.R. 1241, 1247.

[67] See note 54 above, at p. 2.

[68] See note 38 above.

[69] "Charities and Ethical Investment" (1992) 56 Conv. 115, 115.

[70] *Ibid.*, at p. 116.

firmly distinguished, the latter to be applied so as "to obtain therefrom the maximum return… consistent with commercial prudence".[71]

The rhetoric of human rights and of sustainable development, drawn from public international law instruments, has been prayed in aid by proponents of SRI. The Freshfields report for UNEPFI in 2005,[72] in addition to analysing the current legality of SRI under a range of domestic civil and common law jurisdictions, including the UK, considered the impact of international law, in particular the OECD Guidelines for Multinational Enterprises[73] and the UN Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights.[74] Whilst recognising that at present no international instrument creates "generally applicable international law obligations", the report does suggest that "international law is inching towards the possibility of horizontal effect and the acceptance of binding obligations on non-state actors".[75] However, even were international legal obligations accepted as falling upon enterprises themselves,[76] it is a very long step from there to suggesting that investors are subject to any correlative obligation to consider compliance on the part of those companies in which they seek to invest their funds. This is especially true in the case of trustee investors, who already fall under clear fiduciary obligations to the beneficiaries on whose behalf they act.

Claims, which might be argued to be misleading, have been made regarding statutory and other official recognition of the lawfulness of ethical investment of trust funds. EIRIS, for example, makes much in its materials of the change made to pensions regulations in 2000, requiring the trustees of occupational pension schemes to include in their statement of investment principles "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments"[77] and "their

71 [1992] 1 W.L.R. 1241, 1246. Nevertheless, a recent survey of charities conducted for the Assocation of Chartered Certified Accountants found that over half of respondents had a written ethical investment policy: Kreander, Beattie and McPhail, *UK Charity Ethical Investment – Policy, Practice and Disclosure* (ACCA Research Report No. 97, 2006), at p. 2. Available at http:/www.accaglobal.com/publicinterest/activities/research/reports/sustainable_and_transparent/rr_097.

72 See note 25 above.

73 Available at http://www.oecd.org/document/28/0,3343,en_2649_34889_2397532_1_1_1_1,00.html.

74 *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights*, U.N. Doc. E/CN.4/Sub.2/2003/12/Rev.2 (2003). Available at http://www1.umn.edu/humanrts/links/norms-Aug2003.html.

75 See note 25 above, at p. 34.

76 In this context it may be worth noting that since October 2007 company directors in the UK have been subject to a duty to promote the success of the company for the benefit of its members as a whole, and in doing so to have regard (amongst other matters) to "the impact of the company's operations on the community and the environment" and "the desirability of the company maintaining a reputation for high standards of business conduct" (Companies Act 2006, s. 172(1)(*d*) and (*e*)).

77 See now regulation 2(3)(*b*)(vi) of the Occupational Pension Schemes (Investment) Regulations 2005 (S.I. No. 3378/2005) issued under the Pensions Act 1995, section 35.

policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments".[78] This was heralded by EIRIS as a "major boost" to the field[79], and a sign of SRI practices becoming "entrenched".[80] Far from imposing any obligation to take into account ethical issues, however – the words "if at all" being significant - the amended regulations merely concern disclosure, and are designed to ensure transparency should trustees, within the very narrow confines permitted by the present case law, be taking SRI factors into account. It is true that the Green Paper which preceded the amendment stated the Government's view that "trustees should be able to consider moral, social and environmental issues in relation to their investments", but this was explicitly qualified as being "subject to the overriding requirements of trust law", and it is also notable that the statement is contained in a section headed "encouraging improvement in transparency and accountability".[81] There is clearly no intention to widen, beyond their current narrow ambit, the circumstances in which pension trustees may consider SRI factors. The provision is fundamentally about scrutiny; it is at least as likely to provide beneficiaries with information necessary for demonstrating a breach of trust as it is to persuade trustees into adopting an ethical investment strategy where they do not already have one.[82] Similarly, the Charity Commission takes the view that it is good "good practice" for charities to include in their annual report information regarding any ethical factors which they may take into account when investing their funds,[83] but the advice is directed at transparency rather than any specific encouragement of SRI policies.

Although the Trustee Act 2000 is conspicuously silent on the subject of ethical investment, the explanatory notes issued in conjunction with the legislation, when dealing with the question of "suitability" of investments under section 4(3)(*a*), state that this will include "any relevant ethical considerations as to the kind of investments which it is appropriate for the trust to make".[84] This is also relied upon by the SRI lobby as evidence of a liberalised attitude

[78] *Ibid.*, reg. 2(3)(*c*).
[79] *A Brief History of SRI/Ethical Investment* (available at http://www.eiris.org), p. 1.
[80] *What is the EIRIS Foundation?* (available at http://www.eiris.org), p. 1.
[81] *A New Contract for Welfare: Partnership in Pensions*, Cm. 4179 (Department of Social Security 1998), pp. 77–78.
[82] Nevertheless, the amendment does seem to be encouraging the adoption of SRI measures. In 2006 an estimated 11 per cent. of pension funds were making substantial use of negative screening policies, compared with only 2 per cent. in 2003 (Chris Gribben and Matthew Gitsham, *Will Pensions Funds Become More Responsible? A Survey of Trustees*, Just Pensions/Ashbridge Centre for Business and Society 2006, p. 3. Available at http://www.uksif.org/cmsfiles/uksif/ukpf2006-justpens.pdf).
[83] Investment of Charitable Funds: Detailed Guidance (Charity Commission 2003) at para. 93. Available at http://www.charity-commission.gov.uk/supportingcharities/cc14full.asp.
[84] See note 17 above, at para. 23.

on the part of the legislature; the EIRIS charities briefing, for example, claims that it may have "the greatest influence" over the ethical considerations which trustees apply.[85] However, again there is no evidence whatever of any attempt to alter the present position regarding the legality of ethical investment, something which would surely have required legislative change. The guidance notes would appear to refer only to those situations in which case law already recognises that SRI factors may apply. The word "relevant" is key, as is the phrase "appropriate for the trust". A particular investment would be inappropriate for a trust, for example, where it runs contrary to its charitable purposes;[86] it would not be inappropriate simply because the trustees take a moral stance against it.

VIII. *Nestlé* and *De Facto* Immunity

The current situation is therefore something of an anomaly. There exists a vibrant and growing SRI sector, where large amounts of private, institutional and charitable money are invested, by trustees as well as other investors, in assets which are screened positively or negatively on ethical grounds. Yet the practice is of doubtful legality, and is certainly suboptimal in terms of portfolio theory, narrowing as it does the universe of shares available for investment and therefore affecting the efficient frontier, to the detriment of the financial interests of the beneficiaries.

It may be instructive to question why the mismatch between the practice and the legal and economic theory has been allowed to continue for so long without further challenge in the courts. *Cowan* and *Harries* are, after all, both first instance decisions; the legality of ethical investment has never been considered by the higher courts, nor been litigated at all for fifteen years. The answer may lie in a fudge. Since the judgment of the Court of Appeal in *Nestlé* v. *National Westminster Bank plc*[87] it is clear that, due to the risk and uncertainty inherent in the making of investment choices, it will be very difficult in practice for aggrieved beneficiaries to prove loss arising from breach of their trustees' duties in this respect.[88] In that case, a family trust fund managed by the National Westminster Bank and its predecessor, was mismanaged to the extent that its value had fallen to only £269,203; had it maintained its original real terms value, it would have been worth approximately one million pounds. However, it being impossible for the beneficiary to prove that alternative investments would

[85] See note 54 above, at p. 2.
[86] See note 37 above.
[87] [1993] 1 W.L.R. 1260.
[88] Difficult, but not wholly impossible: see, for example, the New Zealand case of *Re Mulligan* [1998] 1 N.Z.L.R. 481.

necessarily have performed any better had the trustees exercised their powers properly in every respect, her action for equitable compensation failed.

The three judgments in *Nestlé* are far from being models of clarity. Staughton L.J., whilst finding on the facts that the trustee bank's misunderstanding of its investment powers and its failure to conduct periodic reviews of the portfolio had been symptomatic of "incompetence or idleness", said that these things "were not, without more, breaches of trust".[89] This seems a difficult stance to defend, given that in *Cowan*, *Harries* and *Martin*, the breach of duty was clearly held to lie in the factors applied when proposing or implementing an investment strategy and not necessarily in any loss being sustained by the fund.[90] The position of Leggatt L.J., in the context of this action for a monetary remedy, was the pragmatic one that "a breach of duty will not be actionable… if it does not cause loss". He went on to say that the claimant "will therefore fail who cannot prove a loss… caused by breach of duty."[91] This conceptual separation of breach from resultant loss (both of which are necessary if an action to surcharge the trustees is to be successful) clearly implies that a breach of trust may exist independently of loss, albeit that it will not give rise to any financial liability. His final conclusion was that the bank had not been shown "to have committed any breach of trust *resulting in loss*"[92] rather than that there was no breach at all. Dillon L.J.'s standpoint was similar. He appeared to accept that breaches of duty had occurred, ruling that "the bank should have appreciated the true scope of its powers of investment and should have reviewed the investments…with that in mind";[93] his reason for disallowing the beneficiary's claim was her failure to discharge the onus of proving loss arising from these breaches of duty.[94] Similarly to Leggatt L.J., he ended his judgment with the finding that there was no "breach of trust *which has caused loss*".[95]

From these somewhat opaque statements of Leggatt and Dillon L.JJ. it seems possible to draw the conclusion that an investment decision which is taken on erroneous grounds may amount to a breach of trust;[96] but while trustees may be opening themselves to the

89 *Ibid.*, at p. 1275–1276.
90 *Cowan*, *Harries* and *Martin* are, of course, first instance decisions and *Martin* a Scottish case of persuasive authority only. *Harries* and *Martin* post-date *Nestlé*, but Staughton L.J. made no reference whatever to *Cowan* v. *Scargill* in his judgment.
91 [1993] 1 W.L.R. 1260,1283.
92 *Ibid.*, at p. 1285 (italics added).
93 Ibid., at p. 1266.
94 Ibid., at p. 1269.
95 Ibid., at p. 1274 (italics added).
96 Instances of trustee SRI policies are likely to be easier to establish as breaches of duty even than the inadvertent or negligent misconduct of the bank in *Nestlé*, since decisions to limit the range of investment choice on ethical grounds are typically open, deliberate and reasoned.

possibility of a declaration that their strategy is unlawful,[97] an action for injunctive relief or an application to replace them as trustees, they stand very little practical risk of exposure to claims for compensation for resultant loss, even should their ethical portfolio underperform. It is simply very unlikely that beneficiaries will be able show that trustees would have chosen any differently, or chosen shares which performed any better, had they followed the proper criteria for selection.

The problem is a mismatch in thinking between law and economics: the law traditionally requires proof of factual causation on a case by case basis, whereas economists deal in probabilities. For a given level of fund manager expertise, any shift in the efficient frontier by restriction of the range of asset choice will reduce the *expected* return – but not necessarily the actual return in any given case. As we have seen,[98] economic theory supports the position that breach of trust should reside in the decision-making process, and not in a particular outcome or in the demonstrable, linear link between that outcome and earlier failures of process. The law – at least as far as financial liability is concerned – seems not to have taken this lesson fully on board.

The insusceptibility of proof of loss is what lies behind David Hayton's widely cited statement that, in spite of the paramount duty to pursue financial gain,

> [T]here is still much scope for trustees quietly to take into account the moral, social and political views of beneficiaries and of themselves, since it will in practice be difficult to prove that at the time a particular investment was made it was not as equally financial meritorious as certain other possible investments.[99]

However, to have an area of law which affects the investment of billions of pounds worth of trust funds left in a state where trustees are encouraged to act as they wish, irrespective of possible breach of duty, whilst "quietly" keeping their heads down, seems very far from desirable.

IX. Reform and the Obstacles to it

What, then, might be done to end the mismatch and bring law and practice into alignment? If Parliament were motivated to do so, how might it be possible to create a legal framework within which trustees were entitled, or even obliged, to take account of SRI factors, within the constraints of portfolio theory and without undermining the overriding duty to act in the best interests of the beneficiaries?

[97] This was the form of action in all three reported British cases on SRI.
[98] See section VII above.
[99] David Hayton, Paul Matthews and Charles Mitchell, *Underhill and Hayton's Law of Trusts and Trustees* (17th ed., London 2006), para 53.64.

One of the criticisms most frequently levelled at ethical investment policies is the subjectivity of their content. Lord Nicholls himself has conceded that permitting trustees to exercise investment powers for ethical purposes "would mean moving the boundary of the law into adjacent moral territory where right-thinking people differ widely in their views"[100]. "The nature of the problem," as Michael Harbottle comments, "is in part caught up with the difficulty of defining what is meant by 'ethics' in the first place".[101] One trustee might consider vivisection to be immoral, for instance, and refuse to invest in companies which engage in animal experimentation, while another might applaud any activity which advances medical science. Some may be opposed to nuclear power on grounds of safety or of its potential links to the arms industry; others may actively prefer it to other forms of power generation because of its lower impact in carbon emissions. While some trustees might place prime importance upon the recognition of trade unions in the workplace, or the presence of women in the boardroom, others might regard such matters as insignificant and focus instead on the enterprise's purchasing policy in developing countries, or its record of charitable giving. The range of possible considerations which might be raised as falling within the ambit of SRI is enormous. It has been estimated that ethical grounds of some kind could be found for excluding as many as half of all companies in the FTSE 100 share index.[102]

Richard Nobles has argued that although in the case of family trusts and pension schemes departure from the criterion of best financial interests would leave "no standard by which to control the trustees' investment policies other than the purely subjective one of whether they agree with the morals or politics of the trustees", the same is not true of charitable trusts. He contends that charitable trusts, by existing to further a charitable purpose, do provide their own non-financial criteria by which investment policy may be assessed[103]. If by this he means merely that a charity with a narrowly defined charitable aim may refuse to invest in enterprises conflicting with that aim, then Nobles is doing no more than restating what Sir Donald Nicholls said in *Harries*[104]. If, on the other hand, the claim is intended to be more extensive, if it is intended to suggest that the philanthropic aspect of charitable trusts somehow equips their trustees to make investment decisions based on the broader public benefit, then it is more controversial. Not only does this approach fly directly in the

[100] (1995) 9(3) Trust Law International 71, 74.
[101] *Investing Charity Funds* (Bristol 1995), p. 149.
[102] Gary Watt, *Trusts and Equity* (2nd ed., Oxford 2006), p. 436.
[103] (1992) 56 Conv. 115 at 117–118.
[104] See note 37 above.

https://doi.org/10.1017/S000819730800038X Published online by Cambridge University Press

face of the *Harries* judgment, but it is hard to see from where the content for such a generalised charitable approach to investment would derive. Take the case of a general grant-making (as opposed to service-delivering) charity: it is difficult to envisage what nature of investments would be contrary to such a trust's charitable purposes. There is, it is true, a detailed body of jurisprudence on the meaning of "public benefit" in the context of charities law, but the definition is tailored specifically towards identifying those purposes which fall within the definition of charity, and not at the very different and much wider question of whether companies are sufficiently socially responsible to be candidates for the investment of charitable funds. Nothing in the case law on charitable trusts would appear to disclose any workable or objectively defined criteria for determining what constitutes an 'ethical' investment.

Any change in the law expressly to permit consideration by trustees of SRI factors would surely need to address this difficulty of definition. Of course, there are many indices already in existence against which companies' ethical standards and performance might be judged. These include, for example, international criteria such as the OECD Guidelines and UN Norms cited by UNEPFI[105], as well as UNEPFI's own developing guidelines and the core labour standards of the International Labour Organisation (ILO). Within the UK, FTSE4Good, which maintains a series of benchmark indices for would-be ethical investors, has also developed its own set of corporate responsibility criteria,[106] which are kept under constant review. However, what is abundantly clear is that there is no consensus even within the SRI community about the exact content of any list of ethical criteria. The European Commission, in a Green Paper on promoting corporate social responsibility, specifically noted the "many specialised screening agencies… using… different tools and metrics" and hence "a need for more convergence between indicators developed by companies and the criteria used by analysts to assess a company's social and environmental performance".[107] What is considered to be "ethical" in investment terms is inherently subjective, imprecise and continually changing with altered societal perspectives: a difficult basis on which to found legal reform.

One way round the problem of lack of an external consensus on what is "ethical" might be to base reform upon the wishes of the

[105] See note 25 above, at p. 33–34.
[106] *FTSE4Good Index Series: Inclusion Criteria* (FTSE 2006). Available at http://www.ftse.com/Indices/FTSE4Good_Index_Series/Downloads/FTSE4Good_Inclusion_Criteria_Brochure_Feb_06.pdf.
[107] *Promoting a European Framework for Corporate Social Responsibility*, COM (2001) 366 final, 18 July 2001, para. 88. Available at http://ec.europa.eu/employment_social/soc-dial/csr/greenpaper_en.pdf.

particular beneficiaries. It is already the case, as noted above, that the unanimous views of all the beneficiaries, being of full age and capacity, may and perhaps even should be taken into account by trustee investors as part of their consideration of the beneficiaries' wider "benefit".[108] Gary Watt[109] has suggested that trustees might be placed under a statutory duty to consult with their beneficiaries and to consider their views, using as a precedent the provisions of section 11 of the Trusts of Land and Appointment of Trustees Act 1996, which requires consultation with beneficiaries when exercising certain specified functions of the trustees. Of course, in the case of large pension trusts such as that in *Cowan* v. *Scargill*, unanimity amongst the body of beneficiaries is a practical impossibility. If the model of trusts of land were followed, trustees might be placed under an obligation to give effect, as far as consistent with the general interest of the trust, to a simple majority of the beneficiaries. Watt's less radial version would be merely to create an obligation to "consider" the beneficiaries' wishes; he further suggests that a three-quarters majority might be an appropriate requirement before a particular SRI policy be adopted.[110]

One objection to Watt's approach is that investment of trust funds is a highly specialised activity. The trustees are experts, or if not they will be employing experts to advise them.[111] Any change in the law obliging trustees to consult beneficiaries on investment matters would presumably have to come with a duty to inform them as to the likely effects of any SRI decision.[112] Even this, however, would furnish little by way of effective safeguard. The exclusion of an asset or class of assets from consideration for the portfolio will not have a predictable outcome. The beneficiaries will not be told, disinvest from tobacco shares and it will cost you five, or ten, or fifty pounds a year. It will be a question not of altered facts but of altered risks – indeed, of making an alteration to a complex web of interconnected risks, where the impact of one apparently small exclusion is extremely difficult to forecast with any degree of confidence. The same uncertainty which at present makes it difficult for beneficiaries to bring home against trustees financial liability for the mismanagement of their investments

108 See note 30 above.
109 *Op. cit.*, at p. 437.
110 This would certainly require a change in the law, since it was established in *Cowan* that a majority vote of the mineworkers' union did not justify the trustees' proposed investment strategy; deference to the wishes of a majority of beneficiaries could not be justified by analogy to the consent principle derived from *Saunders* v. *Vautier* (see note 31 above), at least as far as an *ex ante* or *ex post* release from liability is concerned. An inter-generational objection also arises: three-quarters of the current beneficiaries of the scheme would be taking decisions affecting future members.
111 Trustee Act 2000, s. 5.
112 Full information is normally a prerequisite of any beneficiary consent: see, for example, *Boardman* v. *Phipps* [1967] 2 A.C. 46, 101 *per* Lord Cohen.

would also make it very difficult to show failure to provide adequate information, if not indeed render any consultation process unworkable. It is hard to avoid coming back round to the conclusion that investment is a complex task, better conducted by experts than by a large group of untutored lay people.

The key problem with any approach giving weight to the wishes of a majority of beneficiaries, however, is that the rights of the minority will be overridden. Why should one beneficiary have to suffer the risk of financial disadvantage (inherent in any narrowing of the investment universe) because a majority of the others espouse a particular moral view? Such a scenario offends against one of the fundamental duties of trusteeship, namely that of maintaining an even hand between beneficiaries.[113] In the case of a large institutional trust such as a pension scheme, there is also a danger that treating beneficiaries *en bloc* and simply following the preferences of the majority may mask socio-economic heterogeneity within the group. It is possible that those beneficiaries who are vocal and active, and who vote in favour of an SRI strategy, may be cushioned by other assets and not be those for whom the security of every penny of their pension is most crucial. There will always be some people who are better able than others to afford to take a moral or political stand. To do so with their own money is unobjectionable; for the law to allow them to do so with others' money would be less easy to defend.

Charitable trusts raise problems of a different kind. An approach based upon the views of the beneficiaries could have no application to charitable funds, which are held for purposes and which have no beneficial owners. There would appear to be no justification for taking into account, as an approximate equivalent, the wishes of current service users, in the context of trusts which are perpetual, and which exist for the public benefit and not for the private benefit of those who happen, at a particular time, to be the recipients of the charity's benevolence.

The alternative to legislative reform – or a self-help approach to be pursued alongside it - would be for settlers to make greater use of explicit SRI provisions when establishing a trust. A socially sensitive or even socially dictated investment strategy, involving either positive or negative screening, can readily be written into a trust instrument, and will enable trustees to implement an ethical policy without legal or practical difficulty, provided that its terms are defined with sufficient clarity. Of course this is not a comprehensive solution; it offers little assistance in respect of informally created trusts or those, both private and charitable, which are already in existence. But it does have many

113 See, for example, *Lloyd's Bank plc* v. *Duker* [1987] 1 W.L.R. 1324.

advantages – as well as being consistent with the way in which trusts have always efficiently evolved. In particular, the beneficiaries, at least in the case of a private trust, will not be able to complain that trustees are acting against their financial interests, since their interests are by definition limited to what they are defined to be in the trust instrument.[114] In practice, however, express ethical investment clauses frequently give a very large discretion to trustees.[115] It is within a settlor's competence to delegate to trustees the decision as to what is to be treated as "ethical" but, as we have seen, ethics are a highly subjective concept. Settlors choosing this path must recognise that what they are doing is giving trustees free rein to use the trust fund to further their own social and political opinions, at the expense of financially optimal decision-making.

Express settlor stipulation apart, there remains the fundamental question of whether trusts and trust law are the appropriate vehicle for seeking social changes of the kind which SRI policies are designed to bring about. Ethical investment is a way of bringing political pressure to bear on private companies which are engaging in activities, from weapons manufacture to animal testing, which are not in themselves unlawful. However desirable it may be that industry should adopt better labour relations or reduce its carbon footprint, the issue is whether socially directed investment by trustees is a legitimate mechanism for achieving it. Individuals in a democracy are free to lobby for legislation to effect social change; they are also free to use their own money to exert influence on enterprise. They are not, and should not be, free to use other people's money to the same ends. Trusts exist for quite specific purposes: to safeguard the property of the beneficiaries or, in the case of charities, to further defined charitable aims. Trustees are bound by well-developed fiduciary duties which guide them in their administration of the trust property, in accordance with those paramount purposes. If a trust is to protect the interests of beneficiaries - of *all* beneficiaries - then their property should not be used to forward the views, however socially desirable, of either the trustees or the majority of their fellow beneficiaries.

[114] "The notion of what amounts to equitable property rights under a trust is… flexible and is itself responsive to the bargain or undertaking on which a particular trust is founded… (E)quity does not contradict the intentions of the settlor: it only gives proprietary effect to his or her intentions as ascertained from all the terms used to establish a trust or settlement, including administrative powers and other such managerial provisions" (Richard Nolan, "Understanding the Limits of Equitable Property" (2006) 1 Journal of Equity 18, 36).

[115] See, for example, *The Encyclopaedia of Forms and Precedents* (note 6 above), vol. 40(1), para. [3515]: "To select only those investments which the {Trustees} in their absolute discretion consider to be ethically acceptable".