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INSTITUTIONAL INVESTORS AND RESPONSIBLE INVESTING: A NEW ZEALAND PERSPECTIVE

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Abstract

Responsible investors are primarily concerned with the environmental, social and governance (ESG) impacts of their investments. In many countries, responsible investment now reflects best practice for institutional investors. New Zealand is no exception to this trend. Responsible investment strategies are applied to billions of dollars of professionally managed assets in New Zealand. Institutional investors are integrating ESG factors into their investment decision making, divesting from unethical investments, and actively engaging with their investee companies on ESG issues. However, the use of these responsible investment strategies by institutional investors is widely unregulated. This lack of regulation can lead to "ESG washing" and a failure to adopt best practice methodology. This research paper will analyse how responsible investment strategies are regulated internationally and assess whether New Zealand should adopt any of the hard or soft law mechanisms commonly used overseas.

Keywords
Institutional investor, responsible investment, ESG, stewardship code

Word count
The text of this paper (excluding abstract, table of contents, footnotes, and bibliography) comprises exactly 13,708 words.

I Introduction

In the last two decades, the rise of responsible investment has taken the international financial markets by storm. Responsible investors are primarily concerned with the environmental, social and governance (ESG) impacts of their investments. Responsible investment has evolved from being on the side-line to at the forefront of decision making for investors. COVID-19, and its impact on the financial markets, has placed further emphasis on the need for sustainable and resilient finance. New Zealand is no exception to this trend. Responsible investment strategies are applied to billions of dollars of professionally managed assets in New Zealand.

In many countries, responsible investment now reflects best practice for institutional investors. The "institutionalisation of ownership" of listed companies is the concentration of capital in the hands of institutional intermediaries called upon to invest capital professionally on behalf of clients or beneficiaries.[1] Institutional investors include pension and superannuation funds, investment companies, mutual funds and unit trusts, insurance companies, banks and charitable foundations.[2] Institutional investors also include fund managers who professionally manage investments on behalf of other institutional investors.[3] Institutional investors are the largest holders of shares in public companies globally.[4] In 2018, it was estimated that 75% of global shares were held by institutional investors.[5] Furthermore, the companies that institutional investors are investing in can hold more power and wealth than many small nation states. As of 2016, of the world's 100 economic revenue collectors, only 29 were states and 71 were corporates.[6] Therefore, institutional investors hold the power to support a transition to a sustainable economy through the application of responsible investment strategies.

Institutional investors are integrating ESG factors into their investment decision making, divesting from unethical investments, and actively engaging with their investee companies

[1] Pedro Matos "ESG and Responsible Investing Around the World: A Critical Review" (2020) <https://www.cfainstitute.org/-/media/documents/book/rf-lit-review/2020/rflr-esg-and-responsible-institutional-investing.ashx> at 14.

[2] Aik Win Tan and Trish Keeper "Institutional Investors and Corporate Governance: A New Zealand Perspective" (2008) <https://www.wgtn.ac.nz/cagtr/working-papers/wp-65.pdf>.

[3] Aik Win Tan, above n 2.

[4] Pedro Matos, above n 1, at 13.

[5] Global Sustainable Investment Alliance "2018 Global Sustainable Investment Review" (2018) The Forum of Sustainable and Responsible Investment <https://www.ussif.org/files/GSIR_Review2018F.pdf> at 12.

[6] Milan Babic, Jan Fichtner & Eelke M. Heemskerk "States versus Corporations: Rethinking the Power of Business in International Politics" (2017) The International Spectator, 52(4) 20-43.

on ESG issues. However, the use of these responsible investment strategies by institutional investors is widely unregulated. This lack of regulation can lead to “ESG washing” whereby institutional investors use responsible investment as a marketing tool rather than a tool to create credible change. This research paper will analyse how responsible investment strategies are regulated internationally and will assess whether New Zealand should adopt any of the hard or soft law mechanisms commonly used overseas.

Chapter II of this essay will briefly discuss the history of the responsible investment movement and provide a definition of responsible investment that will act as the foundation for the remainder of the essay. Chapter II will critically evaluate the purpose of responsible investment and outline key reasons why institutional investors are choosing to, or should, invest responsibly. Chapter III will then discuss responsible investment in the New Zealand legal framework. Chapters IV-VI will discuss the three most common responsible investment strategies used in New Zealand: ESG integration, negative screening, and active ownership. Each chapter will describe a strategy and then critically evaluate the limitations of that strategy. By international standards, New Zealand is behind on legal developments that regulate how institutional investors implement these strategies. Chapter VII will discuss the international regulatory response to the use of responsible investment strategies. In particular, it will analyse the uptake and effectiveness of three instruments: codified fiduciary duties, ESG disclosure requirements, and stewardship codes. Chapter VII will consider which jurisdictions have adopted these policies and their effectiveness. Chapter VII will then conclude whether the policy should be, or likely will be adopted in New Zealand in the future. Ultimately, this research essay will conclude that New Zealand would benefit from adopting all three regulatory responses. However, this essay will that a stewardship code is the only regulation likely to be developed in the near future.

II Responsible Investing

A History

Responsible investing can be traced back hundreds of years to faith-based investing whereby members of the church were prohibited from investing in the slave trade.[7] However, it wasn't until the 1900's that the responsible investment movement was prominent. In the 1960's socially minded investors were concerned with addressing race and gender equality issues.[8] In the 1970's socially minded investors created demand for funds which avoided direct investment in Agent Orange, a controversial weapon used by the United States Department of Defence during the Vietnam War.[9] Broad exclusions of 'sin stocks' such as alcohol, tobacco, weapons, gambling and pornography can be traced back to the 1980's.[10] By the late 1990's responsible investment also focused on the environment following environmental disasters of the 1980's such as Bhopal, Chernobyl and Exxon Valdez.[11] Furthermore, the late 1990's saw an increase in global awareness of global warming and the depletion of the ozone layer.[12] By the 2000's responsible investing was heavily influenced by climate change and sustainability concerns.[13]

The modern era of responsible investing (2009 – present) was a response to the 2008 Global Financial Crisis. In the last decade there has been a rapid rise of responsible investment: what was once a niche practice, is now considered mainstream. Modern day responsible investing goes far beyond just excluding unethical investments and aims to create risk adjusted portfolios for investors.[14] As of 2018, global responsible investment was estimated to have reached $USD 30.7 trillion.[15] Some estimates say it will continue to rise to over $USD 50 trillion in the next two decades.[16]

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[7] Mark Camilleri "The Market for Socially Responsible Investing: A Review of the Developments" (2020) 16 Social Responsibility Journal at 4.

[8] At 4.

[9] Blaine Townsend "From SRI to ESG: The Origins of Socially Responsible and Sustainable Investing" (2020) The Journal of Impact and ESG Investing 1(1) at 3.

[10] At 5.

[11] Mark Camilerri, above n 7, at 5.

[12] At 5.

[13] Blaine Townsend, above n 9, at 6.

[14] Sara Bernow, Bryce Klempner, and Clarisse Magnin "From 'why' to 'why not': Sustainable investing as the new normal" (2017) <https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal#>.

[15] Global Sustainable Investment Alliance, above n 5.

[16] Global Sustainable Investment Alliance, above n 5.

B Definition

Responsible investing is also known as ethical investing or sustainable investing. Responsible investing takes a holistic approach to investing. Responsible investors recognise that companies have an impact on people and the planet. Responsible investors seek to encourage investment in companies that minimise negative impacts and stimulate positive impacts. Investors do this by considering, alongside financial return, the impact of their investment decisions on ESG factors.

To invest responsibly, institutional investors implement responsible investment strategies. For example, when building an investment portfolio institutional investors can use responsible investment strategies such as negative screening, positive screening, norms-based screening, ESG integration, sustainability themed investing and impact investing.[17] Alternatively, responsible investors can try and improve an investee companies ESG performance by using responsible investment strategies such as active ownership.[18] In Chapters IV–VI this essay will discuss in further detail the responsible investment strategies of ESG integration, negative screening and active ownership.

C Purpose

Aside from complying with regulatory requirements, there are several other reasons why institutional investors should invest responsibly. Firstly, it is now widely recognised that ESG risks influence investment return.[19] In 2015, the Global Research Institute conducted a study into the ESG-Corporate Financial-Performance Relationship.[20] The study examined literature published over the previous 50 years.[21] The study concluded that there is a "highly significant, positive, robust correlation" between ESG performance and corporate financial performance.[22] Therefore, financial performance of portfolios and ESG performance of portfolios can supplement each other.[23] This conclusion has been tested during the COVID-19 pandemic. There is emerging evidence that responsible investors

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[17] Global Sustainable Investment Alliance, above n 5, at 7.

[18] PRI Association "What is Responsible Investment?" (2020) <https://www.unpri.org/download?ac=10223> at 2.

[19] At 2.

[20] Global Research Institute "Digging Deeper into the ESG-Corporate-Financial-Performance-Relationship" (2020) https://download.dws.com/download?elib-assetguid=714aed4c2e83471787d1ca0f1b559006&wt_eid=2156623951900953270&wt_t=156624062435 at 3.

[21] At 3.

[22] At 3.

[23] At 3.

have endured the economic effects of COVID-19 better than those who have invested in companies with poor ESG performance. Of a globally representative selection of sustainable indices, 94% outperformed their parent benchmarks during the 2020 pandemic.[24]

Secondly, responsible investment supports the reallocation of capital to enable a transition to a sustainable economy.[25] A sustainable economy better aligns with the broader objectives of society. A sustainable economy protects the environment, protects the prosperity of people and basic human rights, and helps to address inequality.[26] This transition will require a significant reallocation of capital in a short amount of time.[27] Responsible investing helps with "greening finance" where investors consider the ESG impacts in investment decision making.[28] Responsible investing also helps with "financing green" whereby capital is invested into sustainable developments and solutions.[29] Further, a transition to a sustainable economy aligns with international commitments. Both the Paris Agreement and United Nations Sustainable Development Goals (SDGs) have ambitious targets for 2030, which has led the United Nations to call 2020-2030 the "decade of action".[30] Climate change is the highest priority issue facing responsible investors. It is no longer solely an environmental concern but presents a material financial risk.[31] In 2015, as part of the United Nations Framework Convention on Climate Change, 197 countries, including New Zealand, adopted the Paris Agreement.[32] The aim of the Paris Agreement is to keep global temperatures under two degrees above pre-industrial levels.[33] Governments alone will be unable to reach this goal, and therefore support from the

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[24] BlackRock "Sustainable investing: resilience amid uncertainty" (2020) <https://www.blackrock.com/corporate/literature/investor-education/sustainable-investing-resilience.pdf>.

[25] The Aotearoa Circle "Sustainable Finance Forum: Interim Report 2019" (2019) Sustainable Finance <https://static1.squarespace.com/static/5bb6cb19c2ff61422a0d7b17/t/5dd3b114d0279f0fb06e00f3/1574154539204/1013241_Sustainable+Finance+Report_FINAL_NEW+%28002%29.pdf >.

[26] The Aotearoa Circle, above n 25.

[27] At 20.

[28] At 20.

[29] At 20.

[30] United Nations, "United Nations Secretary General's Road Map for Financing the 2030 Agenda for Agenda for Sustainable Development 2019-2021" (2019) <https://www.un.org/sustainabledevelopment/wp-content/uploads/2019/07/EXEC.SUM_SG-Roadmap-Financing-SDGs-July-2019.pdf> at 1.

[31] The Aotearoa Circle "Sustainable Finance Forum: Legal Opinion 2019" (2019) Sustainable Finance <https://www.theaotearoacircle.nz/sustainablefinance> at 3.

[32] Paris Agreement 2015.

[33] Above n 32.

financial markets is critical. Through investment, institutional investors have the opportunity to direct capital to sustainable technologies and solutions that are consistent with the transition to a low greenhouse gas emissions economy. For example, the World Bank is actively divesting from carbon intensive assets and funds, while the world's largest investment management corporation (BlackRock) have developed climate change investment strategies.[34] Likewise, countries around the world, including New Zealand, are trying to align finance with SDGs.[35] In 2015, the 193 member states of the United Nations adopted the SDGs.[36] The 17 SDGs set out a universal agenda to achieve sustainable development globally.[37] Institutional investors are needed to help achieve the SDGs by 2030.[38] The goals are ambitious, and were estimated to require $USD 5 -7 trillion of investment each year (from 2015 – 2030).[39] Government sector contributions were expected to account for no more than $USD 1 trillion a year, therefore placing responsibility on financial markets to account for the remainder. As of 2019, the United Nations estimated that the financing gap required to achieve the SDGs is currently $USD 2.5 – 3 trillion per year.[40] This "decade of action" requires significant financial investment to achieve these international targets. The United Nations is supporting regions and countries in developing Sustainable Finance Roadmaps which provide pathways and policy signals and set frameworks to enable the finance sector to contribute to this transition.[41] Therefore, the pressure for the private sector to contribute through responsible investment towards the SDGs is only going to intensify over the next decade.

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[34] The Aotearoa Circle, above n 31, at 11.

[35] United Nations Sustainable Development Goals.

[36] PRI Association "The SDG Investment Case" (2017) <https://www.unpri.org/download?ac=5909> at 9.

[37] Above n 35.

[38] PRI Association, above n 36, at 9.

[39] At 9.

[40] United Nations, above n 30, at 1.

[41] At 1.

Thirdly, there is increasing client demand for institutional investors to be more transparent about where money is being invested.[42] The financial markets are currently experiencing a consumer driven surge in demand of responsible investments.[43] Investors consider sustainability to be an important factor when making investment decisions. Investors are increasingly interested in accessing and using ESG related data.[44] Further, as a result of this client demand there is growing recognition that institutional investors may have a fiduciary duty to consider ESG factors when making investment decisions on behalf of clients.[45] This is further discussed in Chapter VII.

[42] PRI Association "Fiduciary in the 21st Century Final Report" (2019) <https://www.unpri.org/fiduciary-duty-in-the-21st-century-final-report/4998.article> at 2.

[43] Mark Camilerri, above n 7, at 23.

[44] PRI Association, above n 42, at 19.

[45] At 8.

III Responsible Investing in New Zealand

New Zealand has been no exception to the global trend of responsible investment. As of 2019, the responsible investment market in New Zealand was estimated to be worth $NZD 153.9 billion, or 52% of total professionally managed assets.[46] However, despite this trend New Zealand has made limited regulatory developments in this area. There are no broad hard laws monitoring how institutional investors are implementing responsible investment strategies. Current practice in New Zealand is heavily influenced by soft law and international principles. These are examined below.

A United Nations Principles for Responsible Investment

Thirty of New Zealand's largest institutional investors are United Nations Principles for Responsible Investment (PRI) signatories.[47] These include the Accident Compensation Corporation, New Zealand Superannuation Fund, ANZ New Zealand Investments Limited and Milford Asset Management.[48] The PRI are a voluntary and aspirational set of investment principles for institutional investors.[49] The PRI were developed by an international group of institutional investors and the drafting process was convened by the United Nations Secretary-General.[50] PRI signatories commit to implement the following six PRI across their organisation: to incorporate ESG issues into investment analysis and investment decision making, to be active owners and incorporate ESG issues into their ownership policies and practices, to seek appropriate disclosure on ESG issues by entities in which they invest, to promote acceptance and implementation of the Principles within the investment industry, to work together to enhance our effectiveness in implementing the Principles and to report on activities and progress towards implementing the Principles.[51] However, in New Zealand the influence of the PRI goes beyond its signatories. The six PRI are the commonly seen incorporated into non signatory's responsible investment policies and investment strategies (e.g. Booster Investments).[52]

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[46] RIAA "RI Benchmark Report New Zealand 2020" (2020) <https://responsibleinvestment.org/wp-content/uploads/2020/09/RIAA-RI-Benchmark-Report-New-Zealand-2020.pdf>.

[47] PRI Association "Signatory Directory" (2020) <https://www.unpri.org/signatories/signatory-resources/signatory-directory>.

[48] PRI Association, above n 47.

[49] PRI Association "What are the Principles for Responsible Investment?" <https://www.unpri.org/pri/an-introduction-to-responsible-investment/what-are-the-principles-for-responsible-investment>.

[50] PRI Association, above n 49.

[51] PRI Association, above n 49.

[52] Booster Investments Limited "Approach to responsible investing" (2020) <https://www.booster.co.nz/media/598499/boosters-approach-to-responsible-investing-mar-2020.pdf>.

B Responsible Investment Association Australasia

Several institutional investors in New Zealand are also members of the Responsible Investment Association Australasia (RIAA). RIAA members commit to support RIAA to promote, advocate for, and support approaches to responsible investment that align capital with achieving a healthy and sustainable society, environment, and economy.[53] A handful of investors, including AMP Capital Investors (NZ) Limited and New Zealand Superannuation Fund, are RIAA certified organisations.[54] Certified responsible investment management services must meet operational and disclosure requirements.[55]

C Investment Strategies

As a result of the PRI and international influence, institutional investors in New Zealand have adopted the use of responsible investment strategies, The primary strategies used in New Zealand are ESG integration and negative screening.[56] Active ownership is a common secondary strategy and is becoming increasingly popular.[57] Chapters IV – VI will discuss each of these strategies in further detail, including how they are used in New Zealand, and their limitations.

[53] RIAA "RIAA Strategy 2020 - 2022" (2019) <https://responsibleinvestment.org/wp-content/uploads/2019/11/RIAA_Strategy_2020-22_FINAL.pdf>.
[54] RIAA "Member Directory" (2020) <https://responsibleinvestment.org/directory/>.
[55] RIAA "Eligibility and Ongoing Requirements" <https://responsibleinvestment.org/ri-certification/>.
[56] RIAA "Responsible Investment Benchmark Report" (2019) <https://responsibleinvestment.org/wp-content/uploads/2019/07/Responsible-Investment-Benchmark-Report-NZ-2019.pdf> at 7.
[57] At 7.

IV ESG Integration

This chapter discusses ESG integration, the most popular responsible investment strategy in New Zealand. It evaluates the limitations of this strategy for promoting the ESG agenda. Firstly, the lack of transparency of institutional investor's ESG integration policies. More precisely, how this lack of transparency can lead to "ESG washing". Secondly, the confusion as to whether an institutional investor's fiduciary duty to their client allows, or requires, ESG integration in investment decision making. Possible regulatory solutions to these limitations, such as a codified fiduciary duty or ESG disclosure requirements, will then be discussed in Chapter VII.

ESG integration is the systematic and explicit inclusion of ESG factors by investment managers in financial analysis.[58] In particular, environmental criteria consider how the investee company performs as a steward of the natural environment.[59] This includes how the company contributes towards climate change. Social criteria consider how the investee company manages relationships with stakeholders.[60] This includes employees, the community, and suppliers. Governance criteria considers the investee company's leadership, executive pay, shareholder rights and other matters such as anti-corruption and tax transparency.[61] As mentioned, ESG integration is the most common responsible investment strategy used in New Zealand.[62] In 2018, $NZD 99 billion of professionally managed investments were subject to ESG integration.[63]

In New Zealand ESG integration can range from a broad approach to a well-defined integration strategy systematically embedded in the investment process.[64] The issue is that these responsible investment policies, which outline how institutional investors are using ESG integration, are often inaccessible to the general public. For example, among the self-declared responsible institutional investors in New Zealand, the RIAA estimated that only

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58 Global Sustainable Investment Alliance, above n 5.

59 NZX "Guidance Note: NZX ESG Guidance" (2019) <https://www.nzx.com/rails/active_storage/blobs/eyJfcmFpbHMiOnsibWVzc2FnZSI6IkJBaHBBcFVJIiwiZXhwIjpudWxsLCJwdXIiOiJibG9iX2lkIn19--e042af339239ee98a0e52a8dd3dd2b6ba0b46888/Guidance%20Note%20-%20NZX%20ESG%20Guidance%20-%201%20Jan%202019.pdf> at 5.

60 At 5.

61 At 5.

62 RIAA, above n 56, at 8.

63 At 7.

64 At 8.

60% disclose their responsible investment policies publicly.[65] This is despite the New Zealand Stock Exchange (NZX) Corporate Governance Code which recommends that investment companies provide non-financial information, such as ESG integration processes, annually.[66] The NZX also published the ESG Guidance Note 2019 which outlines the benefits of reporting on ESG integration and the different global frameworks available to do so.[67] Further, all regulated offers in New Zealand are subject to Part 2 of the Financial Markets Conduct Act which prohibits misleading or deceptive conduct, false or misleading representations and unsubstantiated statements made in relation to financial products and services.[68] Offers are also subject to Part 3 of the Financial Markets Conduct Act which requires the disclosure of features, benefits, and returns to investors.[69] Additionally, KiwiSaver providers, under section 129 of the KiwiSaver Act, are required to disclose a statement about whether the scheme takes into account ESG consideration in investment policies and procedures.[70] Despite these regulations, institutional investors are not explicitly required to report on ESG integration processes and on the ESG impacts of investment. There is limited verification relating to responsible investment claims.[71] This can lead to "ESG washing" whereby institutional investors market the use of an ESG integration strategy to attract socially minded clients, even though the ESG integration processes may be ineffective or unsuccessful. This is evidenced by the research undertaken by the RIAA. In 2018, the RIAA evaluated 25 self-declared responsible investment managers in New Zealand against a framework of best practice ESG integration.[72] The RIAA concluded that only eight investment managers were applying the best practice approach and could provide evidence of a detailed and systematic approach to applying ESG integration.[73] This concern is shared by the Financial Markets Authority, who in October of 2019, sought investor input on green bonds and other responsible investment products that take into account ESG considerations.[74] The submissions are to be used to help the Financial Markets Authority develop guidance on, among other things, what good

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[65] RIAA, above n 46, at 18.

[66] NZX, above, n 59, at 3.

[67] At 3.

[68] Financial Markets Conduct Act 2013, Part Two.

[69] Part Three.

[70] Financial Markets Authority "Consultation: Proposed guidance on green bonds and other responsible investment products" (2019) <https://www.fma.govt.nz/assets/Consultations/Consultation-on-green-bonds-and-other-responsible-investment-products.pdf> at 3.

[71] The Aotearoa Circle, above n 25, at 47.

[72] RIAA, above n 56, at 8.

[73] At 9.

[74] Financial Markets Authority, above n 70, at 3.

disclosure will look like. The Financial Markets Authority does see a clear need for further disclosure guidance, if not mandatory requirements for responsible investing. The Financial Markets Authority received 36 submissions and proposed to release the final guidance early in 2020.[75] However, as of October 2020, no such guidance has been released. ESG disclosure requirements reduce the risk that the information that institutional investors are providing is not sufficient for the public to verify the credibility of responsible investment claims. This will be discussed in Chapter VII(B).

A further limitation of ESG integration, as a responsible investment strategy, is that is unclear whether institutional investors are required to apply this to their portfolio. Using ESG integration when building an investment portfolio is considered to be best practice, however, some international organisations, such as PRI, argue that as part of an institutional investor's fiduciary duty to their client, they are legally required to use ESG integration in investment decision making.[76] If this was to be clarified, and institutional investors were aware that ESG integration is a part of their legal duty, they would be more likely to use ESG integration and more likely to follow best practice methodology. This will be discussed in Chapter VII(A).

[75] Financial Markets Authority, "FMA clarifies green bond disclosure requirements" (2019) <https://www.fma.govt.nz/news-and-resources/media-releases/green-bond-disclosure/>.

[76] PRI, above n 42.

V Negative Screening

Following ESG integration, negative screening is the second most common responsible investment strategy in New Zealand.[77] Negative screening has its roots in the beginning of the responsible investment movement and is easy way for institutional investors to create more ethical investment portfolios. However, unlike ESG integration, it is the nature of this strategy, rather than the lack of regulation or guidance, that limits its ability to promote the ESG agenda. Negative screening only prevents harm, rather than being able to create positive ESG impacts. This chapter will conclude that soft or hard law mechanisms will not enhance the benefits or negative screening, but rather that institutional investors should be aware that this strategy is most effective when used alongside other responsible investment strategies such as ESG integration or active ownership.

Negative screening is when institutional investors systematically exclude certain sectors, companies, or corporate behaviours from their investment portfolio.[78] It includes divestment and exclusion. While divestment refers to selling previous investments from their portfolio, exclusion is when an institutional investor refuses to make particular investments.[79] Negative screening is the most popular responsible investment strategy globally.[80] The most popular exclusions in New Zealand are controversial weapons production (such as land mines, nuclear explosive devices and cluster munitions), tobacco and animal testing.[81] Other common exclusions include whale meat processing, adult content, recreational cannabis and alcohol.[82] Institutional investors make exclusions based on ESG criteria and the New Zealand public's perception on how ethical activities are. While investment in these excluded activities is not always illegal, the activities themselves are almost always contrary to New Zealand law if they were to be carried out in New Zealand. Therefore, the rationale behind these exclusions can often be supported by some kind of law. For example, an institutional investor who divests from controversial weapons production is supported by the New Zealand Nuclear Free Zone, Disarmament, Arms Control Act 1987 or the Anti-Personnel Mines Prohibition Act 1998. Similarly, an institutional investor who divests from whale meat processing is supported by the International Convention for the Regulation of Whaling. A recent example of New Zealand

[77] RIAA, above n 56, at 11.
[78] Mark Camilerri, above n 7.
[79] Cedric Dawkins "Elevating the Role of Divestment in Socially Responsible Investing" (2018) J Bus Ethics 153(2).
[80] Global Sustainable Investment Alliance, above n 5, at 3.
[81] RIAA, above n 56, at 11.
[82] At 11.

legal developments influencing the use of negative screening was the New Zealand Super Fund's change in responsible investment policy in the wake of the 2019 Christchurch terrorist attack. Following the terrorist attack the New Zealand government swiftly enacted the Arms (Prohibited Firearms, Magazines, and Parts) Amendment Act 2019 (2019/12).[83] Short after, the New Zealand Super Fund divested in $NZD 19 million of gun companies captured by the new legislation.[84] In some countries financial regulators go further and prohibit investment in certain activities through legislation. For example, Italy, Ireland, Netherlands and Switzerland have all banned investment into controversial weapons such as land mines.[85] However, this approach has not been taken in New Zealand, instead institutional investors have been left to create divestment strategies that reflect or take into account developments in New Zealand law.

Negative screening allows institutional investors to disassociate themselves from unethical or irresponsible behaviour.[86] Furthermore, it allows institutional investors to express their ethical values publicly.[87] However, negative screening is limited in is its ability to create concrete changes in corporate behaviour.[88] There is evidence to suggest that the effect of negative screening on stock prices is negligible.[89] Further, negative screening does not benefit stakeholders nor contribute, towards solutions of ESG issues.[90] For example, there has been a global trend of divestment from fossil fuels. This has been the biggest divestment movement in history.[91] In 2019, of New Zealand's self-declared responsible investors who use negative screening, 80% were screening for companies that derive revenue from fossil fuel activities.[92] This is compared to 40% in 2018.[93] It should be noted that of this 80%, 25% were only screening companies which derived more than 10% of

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[83] Arms (Prohibited Firearms, Magazines, and Parts) Amendment Act 2019 (2019/12).

[84] NZ Super Fund "NZ Super Fund excludes gun companies" (2019) <https://www.nzsuperfund.nz/news-and-media/nz-super-fund-excludes-gun-companies>.

[85] The Law Library of Congress "Laws Prohibiting Investments in Controversial Weapons" (2016) <https://www.loc.gov/law/help/controversial-weapons/investments-controversial-weapons.pdf>.

[86] Alex Gorman "Note: Exit vs Voice: A Comparison of Divestment and Shareholder Engagement" (2017) 72 N.Y.U. Ann. Surv. Am. L. 113.

[87] Alex Gorman, above n 86.

[88] Alex Gorman, above n 86.

[89] D Chambers, E Dimson and E Quigley "To Divest or Engage? A Case Study of Climate-Change Activism" The Journal of Investing ESG Special Issue 29 (2) at 6.

[90] At 6.

[91] Alex Lenferna "Divest–Invest: A Moral Case for Fossil Fuel Divestment" in Ravi Kanbur and Henry Shue *Climate Justice: Integrating Economics and Philosophy* (Oxford Scholarship Online, 2018.).

[92] RIAA, above n 46, at 21.

[93] At 21.

revenue from fossil fuel activities.[94] However, there is still global debate as to whether institutional investors should be divesting from fossil fuels or engaging on climate related issues. Proponents for engagement in the "divest or engage debate" argue that divestment is only symbolic, removes the opportunity for communication, leaves corporations unconstrained and reduces the chance of the corporation reforming.[95] They argue that engagement is more effective[96] and that negative screening activists often target oil and gas investments, where complete divestment is unlikely as society is currently heavily reliant on these products.[97] Conversely, advocates of the divestment movement argue that negative screening should be used to affect social discussion rather than stock prices, and that divestment influences government policy, industrial development and corporate strategy.[98] They claim that one of the main purposes of the divestment movement is to raise awareness.

A further limitation of negative screening is that the exclusions applied by institutional investors are yet to fully align with the purpose of responsible investing, and investors perception of responsible investing.[99] For example, the most common exclusions in New Zealand are tobacco and controversial weapons.[100] However, according to the RIAA, New Zealand consumers are most interested in funds that screen out fossil fuels and human rights violations.[101] Organisations are using negative screening as a branding opportunity. Organisations know that if a product is labelled as an ESG product because it screens out "unethical" investments (such as tobacco and controversial weapons), it will attract investors.[102] The issue is that what an investor defines as an unethical investment is broader than the interpretation adopted by institutional investors. Hence, it has been suggested that institutional investors are using negative screening for branding reasons, rather than to create social change.[103]

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[94] RIAA, above n 46, at 21.

[95] Alex Gorman, above n 86.

[96] Vaska Atta-Dakura, David Chambers, Elroy Dimon, Zhenkai Ran and Ting Yu "Strategies for Responsible Investing: Emerging Academic Evidence" (2020) Journal of Portfolio Management 46(3) at 5.

[97] At 5.

[98] D Chambers, above n 89.

[99] At 4.

[100] At 4.

[101] At 4.

[102] S Harzmark and A Sussman "Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows" (2019) The Journal of Finance 74(6) 2789- 2837.

[103] V Atta-Darkua and E Dimson "Survey on Sector Exclusions" (2019) Working Paper, Cambridge Judge Business School.

Unlike ESG integration and active ownership, a regulatory response will not increase the effectiveness of negative screening in promoting the ESG agenda. Instead, institutional investors should be aware of these limitations. Firstly, institutional investors should only use negative screening for ESG issues where divestment, rather than an engagement strategy is more effective. Secondly, institutional investors should seek to align screens with a broader perception of ESG or disclose their definition of "unethical". Finally, in light of these limitations institutional investors who wish to make a positive ESG impact, rather than just preventing harm, should use other strategies such as ESG integration and active ownership alongside negative screening.

VI Active Ownership

Active ownership is the third most popular responsible investment strategy in New Zealand.[104] While less popular than ESG integration and negative screening, there is emerging academic evidence that active ownership is the most effective strategy for aligning the New Zealand economy with the wider interests of society. Institutional investors are being encouraged to use their "voice" as studies show that large institutional investors can systematically improve the corporate governance of the companies where they invest, whilst also bringing higher financial returns.[105] Like ESG integration, one of the limitations of active ownership is that it is not clear whether it is best practice or whether it is required as part of an institutional investor's fiduciary duty to their clients. Also similarly to ESG integration, active ownership will be more effective at promoting the ESG agenda if institutional investors are required to disclose how they are implementing this strategy. Both a codified fiduciary duty and the creation of a stewardship code, as will be discussed in Chapter VII, could be implemented in New Zealand to overcome these challenges.

Active ownership is when institutional investors use their shareholder power to influence or encourage investee companies to improve ESG integration or develop more sustainable business practices.[106] Active ownership reflects Principle Two of the PRI which states that that signatories should be "active owners and incorporate ESG issues into ownership policies and practices".[107] Active ownership is also reflected in Principle Five which encourages institutional investors to collaborate in efforts to build a dialogue with investee companies.[108] Unlike negative screening, the institutional investors retain their shareholding and communicate with the company's leadership.[109] The goal of active ownership is to express the institutional investors demand for change and influence the company towards ethical and sustainability goals. There are several methods of active ownership.

Firstly, institutional investors can use their formal shareholder rights. Institutional investors own shares in hundreds of companies and are often unable to attend all shareholder meetings. Hence, they often use a proxy, to vote on their behalf. Through an active

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[104] RIAA, above n 56, at 10.
[105] Vaska Atta-Dakura, above n 96.
[106] PRI Association, above n 42, at 2.
[107] PRI Association, above n 49.
[108] PRI Association, above n 49.
[109] PRI Association, above n 42.

ownership approach, institutional investors, could for example, make explicit commitments to vote on ESG issues or require proxy voting in alignment with ESG guidelines.[110] Another example of a formal investor right is filing shareholder resolutions. A shareholder resolution is a non-binding recommendation to the board of directors by investors. Active ownership encourages institutional investors to make ESG based recommendations to investee companies.[111] Regardless of whether the recommendation is successful, the resolution will often be enough to require the board of directors to at least consider the ESG issue.[112] For example, the institutional investor could gather support for a resolution which requires an impact study or sustainability report, where the investee company investigates the ESG impact of their operations and discloses this to investors.[113]

Alternatively, institutional investors can be active owners through informal channels such as direct communication with investee company's leaders.[114] For example, an institutional investor can outline key issues that they will engage on (e.g. climate change, human rights abuses) and the international standards they expect investees to comply with (e.g. United Nations Global Compact).[115] Institutional investors can outline their method of engagement with investees, monitor investees performance and escalate issues following unsuccessful engagements.[116] A good example of active ownership promoting the ESG agenda is BlackRock. In 2017, BlackRock wrote to the chairman of over 300 United Kingdom companies to announce it would vote against executive pay increases unless they were linked to strong and sustainable long-term corporate performance.[117] BlackRock stated that executives should not be rewarded for short term rises in share price.[118] Several United Kingdom companies responded by reducing chief executive officer pay, which a report of the House of Commons labelled "encouraging".[119]

[110] PRI Association "How ESG Engagement Creates Value for Investors And Companies" (2018) <https://www.unpri.org/download?ac=4637> at 5.
[111] Alex Gorman, above n 86.
[112] Alex Gorman, above n 86.
[113] Alex Gorman, above n 86.
[114] Alex Gorman, above n 86.
[115] PRI Association "A Practical Guide to Active Ownership in Listed Equity" (2018) <https://www.unpri.org/download?ac=4151> at 23.
[116] At 23.
[117] Jennifer Hill "Good Activist/Bad Activist: The Rise of International Stewardship Codes" (2018) Seattle University Law Review 41 at 512.
[118] At 512.
[119] At 512.

Some aspects of active ownership, such as meeting with investee companies or voting at annual general meetings, is common practice for institutional investors in New Zealand.[120] However, while some activities reflect business as usual for institutional investors, in order to be effective and create positive ESG impacts, institutional investors need to develop systematic processes and comprehensive policies. Furthermore, institutional investors need to be reporting on these policies. Currently, very few institutional investors publish information relating to their engagement activities. The RIAA estimated that only 9% of investment managers in New Zealand had public evidence of engagement in areas of active ownership.[121] Transparency around active ownership policies and reporting of outcomes is a severe limitation to this responsible investment strategy. Similarly to the lack of transparency of ESG integration processes, a lack of transparency around ownership policies can result in “ESG washing” where institutional investors advertise a ESG friendly ownership policy to attract investors but do not report on the extent of their commitment or the ESG impacts of their ownership practices.

Secondly, while the law assumes that institutional investors are engaged owners who are interested in their investee’s operations, in New Zealand this is not legally required. Institutional investors are under no explicit duty to their clients to act as active owners and engage with investee companies. However, the limits of institutional investors fiduciary duties are not clear and some commentators argue that institutional investors have a fiduciary duty to be active owners in relation to ESG issues.[122] Compared to many other jurisdictions, New Zealand law is behind in regulating active ownership. There is room for new regulations, such as a stewardship code, which encourages or requires greater active ownership by New Zealand’s institutional investors.

[120] RIAA, above n 56, at 10.

[121] At 10.

[122] PRI Association, above n 110, at 19.

VII International Regulatory Response

New Zealand is not the only jurisdiction hoping to overcome the limitations of popular responsible investment strategies such as ESG integration, negative screening, and active ownership. With the rise in popularity of these strategies, there has also been a global rise in responsible investment strategy regulation. This area of law is new, quickly developing and largely fragmented.[123] Internationally, there are over 730 hard and soft law policy revisions that support, encourage, or require investors to apply responsible investment strategies.[124] Of the hard and soft law instruments identified in PRI's Responsible Investment Database, 97% were developed after the year 2000. This chapter will evaluate three popular regulatory responses: codified fiduciary duties, ESG disclosure requirements, and stewardship codes. The chapter will analyse the relative benefits of each regulatory response, all three of which have not yet been adopted in New Zealand. After considering the international regulatory response, this chapter will ultimately conclude that the New Zealand ESG agenda would benefit from all three responses. However, this essay argues that in the current legal landscape New Zealand is most likely to adopt a stewardship code.

A Codified Fiduciary Duty

As discussed in Chapter IV and VI it is currently unclear whether the use of ESG integration or active ownership strategies are required by institutional investors who wish to fulfil their fiduciary duties. In most countries, institutional investors have a legal fiduciary duty to act in the best interests of their clients or beneficiaries.[125] Fiduciary duties are imposed on someone who exercises power in the interests of another. This includes making investment decisions for others.[126] Therefore, fiduciary duties apply to actors across the financial sector including directors of institutional investors.[127] Institutional investors owe a duty of care and a duty of loyalty to their beneficiaries. In the past, responsible investment was seen as an investment strategy that may compromise financial returns, and therefore breach this duty.[128] However, in 2005 the United Nations Environment Programme Finance Initiative published a report stating that integrating ESG considerations into investment decision making, so as to more reliably predict financial outcomes, is allowed and arguably required by institutional investors under their fiduciary

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[123] Dionysia Katelouzou and Alice Klettner "Sustainable Finance and Stewardship: Unlocking Stewardship's Sustainability Potential" (2020) European Corporate Governance Institute - Law Working Paper No. 521/2020 at 8.

[124] PRI Association, above n 42, at 8.

[125] Dionysia Katelouzou, above n 123, at 15.

[126] The Aotearoa Circle, above n 25, at 36.

[127] At 36.

[128] Dionysia Katelouzou, above n 123, at 15.

duty.[129] Since 2005, there has been a growing consensus globally as to this finding, with some countries even codifying this legal obligation.

In 2015, the PRI launched the project "Fiduciary Duty in the 21st Century" and conducted extensive research into the scope of fiduciary duties for institutional investors.[130] The PRI concluded that investors must incorporate ESG issues into the investment decision making process.[131] The PRI went so far as to say that investors that fail to incorporate ESG issues are failing their fiduciary duties and could be subject to legal challenge.[132] The PRI explicitly stated that ESG integration and active ownership in investment processes aligns with institutional investors duty of care and duty of loyalty to beneficiaries or clients.[133] Rather than having a "comply or explain" approach in relation to ESG integration, the PRI encourages a mandatory approach whereby countries to compel investors to integrate consideration of ESG into investment decision making.

In 2017, the Organisation for Economic Co-operation and Development (OECD) published a paper on Investment Governance and the Integration of ESG Factors.[134] The paper suggests that regulatory frameworks rarely make explicit reference to ESG factors, and therefore it is often up to institutional investors to decide to what extent ESG integration is consistent with their legal obligations.[135] Further, the paper comments that in common law jurisdictions some institutional investors have a legally binding fiduciary duty, which responsible investment strategies may help or hinder them to discharge.[136] The paper states that the narrow interpretation of fiduciary duties, which is that investors must maximise financial return for beneficiaries and therefore should not incorporate ESG consideration into investment decision making, is losing influence.[137] The paper supports a broad interpretation of the fiduciary duty of care and duty of loyalty to beneficiaries.[138] As support for this conclusion, the paper cited the 2014 United Kingdom Law Commission finding that in generating risk adjusted returns, institutional investors should take into

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129 Dionysia Katelouzou, above n 123, at 15.
130 PRI Association, above n 42, at 19.
131 At 8.
132 At 8.
133 At 21.
134 OECD "Investment governance and the integration of environmental, social and governance factors" (2017) <oecd.org/finance/Investment-Governance-Integration-ESG-Factors.pdf>.
135 At 10.
136 At 10.
137 At 46.
138 At 46.

account financially material ESG factors.[139] The paper suggests that in light of regulatory developments and the introduction of stewardship codes, ESG integration and active ownership could help investors carry out due diligence and therefore help discharge their duty of care.[140] In summary, the OECD held that considering ESG factors when assessing investment opportunities is acceptable under current interpretations of the fiduciary duty, but investing primarily on ESG factors (with no consideration of financial factors) is not.[141]

Further, in 2019, the International Organisation of Securities Commissions (IOSCO) published a report on sustainable finance and the role of securities regulators.[142] The report explores the issues facing the development of a sustainable finance market[143] and made ten recommendations, one of which was specifically for institutional investors (Recommendation Two). It states that "consistent with their fiduciary duties, institutional investors, are encouraged to incorporate ESG specific issues into their investment analysis, strategies and overall governance, and take into account material ESG disclosures of the entities in which they invest."[144]

Aside from support from international organisations such as PRI, OECD and IOSCO, clarification of institutional investors fiduciary duty in relation to ESG has also appeared in legislation relating to pension funds. In South Africa in 2011, the Pension Fund Act was amended to require an investment process in which funds consider all factors, including ESG, that may be relevant to long term success.[145] However, as there is no practical guidance available as to how this should be implemented and compliance is not monitored[146] there is limited evidence available as to the impacts of this development. More recent examples include the United Kingdom Department for Work and Pensions who published amendments to the Investment Regulations to clarify trustees' fiduciary duties to include the consideration of ESG factors. Closer to New Zealand, in 2018, the Australian Prudential Regulation Authority announced that it plans to update regulation

[139] OECD, above n 134, at 46.
[140] At 48.
[141] At 50.
[142] International Organisation of Securities Commissions. "Sustainable finance in emerging markets and the role of securities regulators" (2019) <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD630.pdf>.
[143] At 1.
[144] PRI Association, above n 42, at 14.
[145] At 46.
[146] At 46.

and guidance to clarify the obligations of regulated superannuation funds to consider ESG factors when setting their investment strategies.[147]

France, while not a common law country, provides an interesting comparison as they have gone a step further than creating a duty for institutional investors to consider ESG financial impacts in investment. The Plan d'Action pour la Croissance et la Transformation des Entreprises amended Article 1833 of the Civil Code to affirm the need for companies to consider any ESG issue inherent in their activities.[148] This applies to all companies, however, it only requires ESG issues to be taken into account, it does not require them to be prioritised. Therefore, institutional investors are required to consider ESG factors in their investment practices, however, an investment decision with a negative ESG impact will not necessarily be invalidated.

As a common law country, institutional investors in New Zealand have a legal fiduciary duty to act in the best interests of their clients or beneficiaries. Although institutional investors legally own shares in the investee company, the shares are held for the financial benefit of the clients of the institution.[149] For example, clients or investors provide fund managers with cash who then undertake to use the cash to generate financial returns for the benefit of the client/investor.[150] In New Zealand, the fiduciary duties of fund managers have been codified in several overlapping sources. This includes Part 4 of the Financial Markets Conduct Act 2013 which codifies the core duties of fund managers, mandatory duties outlined in the Trusts Act 2019, contractual commitments made in the governing document of a fund and the development of fiduciary duties contained in case law.[151] These sources hold that fund managers owe two key duties: to act in the best interests of investors and in furtherance of the purpose of the fund and to act with the care, diligence, and skill that would be expected of a prudent investment professional.[152] In accordance with these duties fund managers are permitted to, and arguably required to, take into account ESG risks that pose a material financial risk to their investment portfolio.[153] However, what is unclear is whether a fund manager's fiduciary duty extends to the consideration of non-

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[147] APRA "Short Topic Paper Four: Investments" (2018) <https://www.apra.gov.au/sites/default/files/short_topic_paper_four_-_investments.pdf>.
[148] French Civil Code, Article 1833.
[149] Aik Win Tan, above n 2.
[150] Aik Win Tan, above n 2.
[151] The Aotearoa Circle, above n 31, at 23.
[152] At 23.
[153] At 24.

financial ESG risks. It is not clear whether fund managers are permitted to consider ESG factors where the risk is not likely to financially impact on investors return.

The Sustainable Finance Forum commissioned a legal opinion which concluded that "scheme managers must take climate change into account when making investment decisions and/or designing investment policies, where to do otherwise could pose a material financial risk to the investment portfolio." This legal opinion did not comment on whether these conclusions could be extended beyond climate change considerations to include ESG factors broadly. One of the potential pathways in the Sustainable Finance Forum Interim Report is for regulatory reform to redefine roles and responsibilities of financial system participants through clarification that fiduciary duty is broader than financial returns.[154] The Report requested feedback on this proposal. The Final Report and Roadmap are due to be published in November 2020. Clarifying whether or not there is a duty for institutional investors to consider ESG factors when making investment decisions is critical. If institutional investors are aware that they could be subject to legal challenge they are more likely implement these responsible investments strategies, such as ESG integration, to a high standard.

There is clearly a growing consensus among international organisations and commentators that an institutional investors fiduciary duty can be interpreted to allow, or even require ESG integration in investment decision making. However, despite these theoretical developments, hard law clarifying the terms of the inherent fiduciary duties is not common internationally. As discussed above, pension fund regulation has been at the forefront of legislative developments. However, there are no examples of countries who have codified a broad investors duty to explicitly require ESG considerations, especially when the ESG considerations are not financially material. Current New Zealand law is open to the interpretation of a fiduciary that allows, and perhaps even requires, institutional investors to consider ESG factors that pose a material financial risk. However, on balance, it seems unlikely that New Zealand will codify a fiduciary duty to consider all ESG risks, regardless of financial risk, in investment decision making and ownership policies. Although heavily encouraged by the PRI, and supported by other international organisations, there are no examples of domestic legislation that create an explicit duty to use ESG integration or active ownership responsible investment strategies.

[154] The Aotearoa Circle, above n 25, at 29.

B ESG Disclosure Requirements

Regardless of whether institutional investors have a fiduciary duty to implement responsible investment strategies, it is important that where responsible investment strategies are implemented there is sufficient transparency around their implementation. The use of ESG integration and active ownership strategies are especially vulnerable to "ESG washing" whereby institutional investors hide behind broad or vague investment policies in order to attract ethically minded investors. One way to tackle the lack of transparency in the responsible investment market is through the use of ESG disclosure requirements. Mandatory disclosure regimes around the world vary and can include anything from the disclosure of shareholder voting to the disclosure of comprehensive ESG integration policies. Such regulation is designed to prevent corporate greenwashing and prevent institutional investors from using responsible investing as a marketing tool.

France has led the world in ESG disclosure regulation. In 2015, France adopted Article 173-VI of France's Law on Energy Transition for Green Growth (Article 173).[155] The regulation requires institutional investors to disclose in their annual report information on how ESG criteria are considered in investment decisions and how their policies align with the national strategy for energy and ecological transition.[156] The implementation decree for Article 173 detailed that investors must report on a "comply or explain" basis and smaller investors are exempt from detailed reporting.[157] It is interesting to note that Article 173 was met with some resistance from institutional investors.[158] Some investors claimed that the law was contrary to the principle of the freedom to invest. However, this appeal was not upheld by the French Constitutional Council on the basis that the law required disclosure of the investment decision process, rather requiring ESG friendly investment decisions themselves.[159] Ultimately the Ministry of Finance, Ministry of Ecology and professional associations created methodologies and frameworks that could be used by investors.[160] In 2019, the Ministry of Ecology, the AMF and the ACPR published a review of the application of the provisions of Decree no 2015-1850 of December 29, 2015 resulting from Article 173.[161] The report focuses on the country's 48 largest financial

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[155] Article 173-VI of France's Law on Energy Transition for Green Growth.

[156] Article 173-VI.

[157] Decree no 2015-1850 of December 29, 2015.

[158] PRI Association "French Energy Transition Law: Global Investor Briefing" (2016) <https://www.unepfi.org/fileadmin/documents/PRI-FrenchEnergyTransitionLaw.pdf> at 9.

[159] At 9.

[160] At 9.

[161] Ministère de la Transition Ecologique et Solidaire "Bilan de l'application des dispositions du décret n°2015-1850 du 29 décembre 2015 relatives au reporting extra-financier des investisseur" (2019)

groups and found that only 50% complied with the reporting requirements.[162] 44% fell short of the recommended requirements and 6% failed to report at all. This probably shows the limitations of using a "comply or explain" approach and the requirement for monitoring in order for regulation to be effective.

The European Union has recently developed an ESG disclosure policy. Following the European Commission's 2018 Action Plan on Financing Sustainable Growth, in December 2019 the European Union passed the Regulation (EU) 2019/2088 (the Regulation) on sustainability-related disclosures in the financial services sector.[163] The Regulation will come into force in March 2021 and apply to financial market participants, such as institutional investors.[164] The purpose of the Regulation is to increase transparency in regard to ESG integration and the consideration of ESG risks.[165] It seeks to create harmonised rules that will prevent corporate greenwashing and support the transition to a resilient and sustainable economy. Specifically, the Regulation requires investors to publish the following information on their websites: (1) information about their ESG integration policies in the investment decision making process,[166] (2) a statement on the policies used to consider the adverse impacts of investment decisions on ESG factors,[167] (3) information in regard to how the company's remuneration policies are consistent with ESG integration,[168] and (4) detailed information about products that have an "ESG objective" or "ESG characteristics".[169] Smaller investors (less than 500 employees) who do not consider the adverse impacts of investment decisions on ESG factors must explain why they take this approach and whether they will continue to do so in the future.[170] This "comply or explain" model is not available to larger investors (more than 500 employees) who are obliged to publish this information.[171] Additionally, investors must describe in pre contractual disclosures: (1) the manner in which ESG integration is incorporated in the investment decision making process, (2) the potential ESG impacts on the returns of

<https://www.ecologique-solidaire.gouv.fr/sites/default/files/Reporting%20extra-financier%20-%20Bilan%20de%20l%27appplication%20des%20disposition%20du%20d%C3%A9cret.pdf>.

162 Ministère de la Transition Ecologique et Solidaire , above n 161.

163 Regulation 2019/2088 (EU).

164 Article 20(2).

165 Article 1.

166 Article 3.

167 Article 4.

168 Article 5.

169 Article 7.

170 Article 4(1)(b).

171 Article 4(3) and (4).

financial products, and (3) information on how financial products consider adverse impacts on ESG factors.[172] In summary, the Regulation provides an overview of the EU's regulatory direction in relation to ESG disclosure. As the regulation does not come into force until 2021 the impact of the regulatory change is unclear. The details will be set out in the regulatory technical standards. However, it is clear that the future European legal landscape will have an expectation of ESG disclosure and monitoring.

In 2019, the PRI announced that climate change related disclosures would become mandatory for PRI signatories from 2020.[173] The PRI Reporting Framework is aligned with the Taskforce for Climate-related Financial Disclosures.[174] Climate indicators (SG 01 CC, SG 07 CC, and SG 13 CC) are now mandatory for PRI signatories.[175] Signatories who do not comply with the reporting requirements will be delisted.[176] Even if however, they retain the option to keep these disclosures private or public.[177] This reduces the impact of this regulation: if the PRI are the only ones to see this disclosure, the reporting framework does not help to combat the risk of corporate greenwashing or using ESG integration as a marketing ploy.

As requirements become more popular internationally the need for clear requirements in New Zealand will also intensify. The PRI have labelled 2020 as the year of ESG data and reporting. The European trend of sustainable related disclosures for the financial sector is a part of a bigger global trend of ESG related disclosures. Countries around the world, including Australia and New Zealand, are working towards requiring companies to report on ESG related risks. An easy solution would be to recommend New Zealand follow the lead of the European Union and adopt regulations similar to that of Regulation (EU) 2019/2088. However, these strict regulations may disproportionately affect the New Zealand financial markets in comparison to the larger economy in Europe. Strict regulations could discourage foreign investment that New Zealand is heavily reliant on. Further, institutional investors are comparatively less wealthy than European institutions, and therefore have less resources to dedicate to complying with requirements. For example, assets under professional management in Europe has estimated to have grown to EUR 23.1

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172 Regulation 2019/2088 (EU), Article 8.

173 PRI Association, "TCFD-based reporting to become mandatory for PRI signatories in 2020" (2019) <https://www.unpri.org/tcfd-based-reporting-to-become-mandatory-for-pri-signatories-in-2020/4116.article>.

174 PRI Association, above n 173.

175 PRI Association, above n 173.

176 PRI Association, above n 173.

177 PRI Association, above n 173.

trillion (approx. $NZD 40 trillion) by 2018.[178] In comparison, in 2018 assets under professional management in New Zealand was estimated to be only $NZD 261 billion. Alternatively, New Zealand could require ESG related financial disclosures by institutional investors on a "comply or explain" approach. This could be similar to the Regulation (EU) 2019/2088 rules for smaller investors (less than 500 employees) and reduce the disproportionate effect of a regulatory change would have on institutional investors. However, even under a "comply or explain" approach, it is likely that institutional investors in New Zealand, like in France, would meet compulsory ESG integration data disclosure with some resistance. This is in part due to the cost of gathering ESG data.[179] It is expensive for institutional investors to hire ESG rating agencies to provide ESG assessments of individual investee companies.[180] Further, due to the low level of ESG disclosure required by investee companies there is a low level of assurance of ESG ratings. There is also growing evidence as to the discrepancies and inconsistency of ESG ratings across different rating agencies.[181] Rating investee companies based on ESG data is also highly subjective and creates consistency issues across the financial sector.

A helpful comparison can be made between ESG disclosure requirements in the financial sector and the New Zealand Government's recent decision to design a climate related financial disclosure regime.[182] The Government is hoping to introduce legislation aligned with the Taskforce for Climate-related Financial Disclosure framework, that will apply to around 200 organisations, including large Crown Financial Institutions (such the Accident Compensation Corporation and NZ Superfund).[183] An analysis of the political and legal climate that supported this legal development demonstrates why this essay argues that strict ESG disclosure requirements, like that introduced in France and the EU, are unlikely to be introduced in New Zealand in the near future. Firstly, in terms of regulating the financial market, New Zealand tends to be a follower rather than a leader. The discussion around adopting the Taskforce for Climate-related Financial Disclosure framework only gained traction in New Zealand after the framework had been endorsed by other governments such

[178] EFMA, "Asset Management in Europe" (2019) <https://www.efama.org/Publications/Statistics/Asset%20Management%20Report/AssetManagementReport2019.pdf>

[179] The Aotearoa Circle, above n 25, at 47.

[180] At 47.

[181] Vaska Atta-Dakura, above n 96.

[182] James Shaw "New Zealand first in the world to require climate risk reporting" (2020) <https://www.beehive.govt.nz/release/new-zealand-first-world-require-climate-risk-reporting>.

[183] James Shaw, above n 182.

as Australia, United Kingdom and the EU.[184] Secondly, it is notable that when the government made the proposal, the reform had already gathered widespread support from institutional investors across New Zealand and Australia. For example, The Investor Group on Climate Change published a working group report which recommended the use of the Taskforce for Climate-related Financial Disclosure framework.[185] In comparison, requiring institutional investors to disclose how they consider ESG issues when making investment decisions is not as publicly supported. Finally, it is also notable that the Taskforce for Climate-related Financial Disclosure legislation is proposed to be enforced on a "comply or explain" approach. The New Zealand Government tends to favour this approach when regulating corporate governance and the financial markets. The idea being that rather than imposing binding laws, the regulators set out a recommended code which entities may either comply with, or if they do not comply, explain why not.[186] This allows entities to use alternative approaches or choose to comply with only parts of the regulation. The underlying rationale is that it lowers implementation costs, allows entities to adapt their approaches to developments and allows or higher industry buy in.[187] However, as evidenced by the French Review which was discussed above, a "comply or explain" approach can result in low levels of compliance and therefore reduce the desired effect of a regulatory solution.[188]

The New Zealand ESG agenda would benefit from mandatory ESG disclosure requirements for institutional investors claiming to be making responsible investments. Regulating ESG policy transparency will be critical to the success of ESG integration and active ownership in New Zealand. Without disclosure requirements, ESG integration by institutional investors is unable to be verified or monitored. These disclosures will allow institutional investors to demonstrate the effectiveness of their responsible investment commitments: separating those who are using responsible investment as a marketing tool, and those pushing for concrete ESG change. However, the chances of such a change being made are questionable. Due to the size of New Zealand's economy, the lack of international support outside of France and the EU, the lack of industry support and limited evidence as

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[184] Ministry for the Environment, "Climate -related financial disclosures" (2019) <https://www.mfe.govt.nz/sites/default/files/media/Climate%20Change/Climate-related-financial-disclosures-discussion-document.pdf> at 19.
[185] At 51.
[186] At 37.
[187] At 37.
[188] Ministère de la Transition Ecologique et Solidaire, above n 161.

to the effectiveness of a "comply or explain" approach, this essay concludes that it is unlikely New Zealand will adopt this regulatory response in the near future.

C Stewardship Codes

Like ESG disclosure requirements, stewardship codes can be used to regulate and encourage the use of active ownership and ESG integration. Internationally, stewardship codes are becoming common place in regulating how investors should exercise their ownership and governance responsibilities. Stewardship in this context refers to shareholder stewardship.[189] Shareholder stewardship includes monitoring and engaging with the board of directors of investee companies.[190] Stewardship codes typically apply to institutional investors and aim to mitigate institutional shareholder apathy.[191] Stewardship codes are produced by a variety of issuers such as regulatory bodies, stock exchanges or investor associations.[192] Who issues a stewardship code influences the effectiveness of the code.[193] Stewardship codes are regarded as soft law and are typically principles based, enforced on a "comply or explain" basis.[194] They are used across the globe and have varying amounts of government support. Stewardship codes often focus on policies such as identifying and managing conflicts of interest, voting, monitoring, and engaging with investee companies, consideration of ESG factors and collective action.[195] Many codes around the world are based on United Kingdom 2012 code or Japanese 2014 code, or both.[196]

Shareholders were historically assigned a passive role and were seen as merely beneficiaries of the board of directors' duty to increase profits who had no role other than

[189] Dionysia Katelouzou & Mathias Seims "The Global Diffusion of Stewardship Codes" in *Global Shareholder Stewardship: Complexities, Challenges and Possibilities* (Cambridge University Press, Forthcoming) at 10.

[190] Alice Klettner "The Impact of Stewardship Codes on Corporate Governance" (2017) 23 NZ BLQ at 259-275 at 1.

[191] Dionysia Katelouzou, above n 189, at 4.

[192] At 7.

[193] Jennifer Hill, above n 117, at 507.

[194] Alice Klettner, above n 190, at 2.

[195] EY "Q&A on Stewardship Codes" (2017) <https://www.ey.com/Publication/vwLUAssets/ey-stewardship-codes-august-2017/$FILE/ey-stewardship-codes-august-2017.pdf>.

[196] Jennifer Hill, above n 117, at 513.

electing the board.[197] This was due to the fact that shareholders were mostly individuals.[198] Active ownership become possible during the 1990's with the rise of powerful institutional investors.[199] The underlying rationale for this duty of stewardship is that shareholders who enjoy the limited liability and significant rights of ownership should be complemented by an obligation of attentiveness to the performance of the investee company in the short and long term horizon.[200] Those owning and managing shares on behalf of others should engage in effective stewardship to fulfil their mandate to protect the value of assets held in trust.[201] Stewardship codes also tackle the issues created by the lengthening ownership chain in investment practices. Institutional investors commonly employ asset managers and proxy advisors to make investment and voting recommendations. As the layers to agents expands, the ownership mindset of institutional investors is weakened.[202] Stewardship codes are designed to define institutional investors and asset managers duty towards investee companies and promote sustainable engagement on the part of institutional investors.[203]

In the United Kingdom the 1992 Cadbury Report concluded that institutional shareholders could contribute to the improvement of corporate governance through using voting rights and communication.[204] The 1998 Hampel Committee endorsed the recommendations of the Cadbury Report and encouraged fund managers to take a long term view with holdings in shares.[205] However, it was not until the Global Financial Crisis in 2008 that shareholder stewardship was regulated through the use of stewardship codes. Institutional investors were identified as one of the culprits of the Global Financial Crisis as they were not critical

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[197] Luca Enriques "Missing in Today's Shareholder Value Maximization Credo: The Shareholders" (2020) <https://promarket.org/2020/09/22/milton-friedman-value-maximization-credo-is-missing-the-shareholders/>.

[198] Luca Enriques, above n 197.

[199] Jennifer G. Hill, above n 193, at 498.

[200] Iris Chiu "Reviving Shareholder Stewardship: Critically Examining The Impact of Corporate Transparency Reforms in the UK" (2014) Delaware Journal of Corporate Law 38(3) at 1002.

[201] Brian Cheffins "The Stewardship Code's Achille's Heel" (2010) The Modern Law Review 73(6) at 1014.

[202] Simon Wong "Is institutional investor stewardship still elusive? (2015) Butterworths Journal of International Banking and Financial Law at 509 at 511.

[203] Iris Chiu "From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe?" (2016) Shareholder's Duties Nordic & European Company Law Working Paper No. 18-10 at 132.

[204] Brian Cheffins, above n 201, at 1007.

[205] At 1008.

of risky business practices.[206] While this institutional shareholder apathy was not the cause of the Global Financial Crisis, it did provide a tolerant context for misjudgement of risk by wayward bank executives.[207] In 2009, the Institutional Shareholders Committee (ISC) issued a Code on the Responsibilities of Investors which intended to provide guidance on best practice for institutional investors and had a goal of improving returns and reducing the chance of catastrophic outcomes as a result of bad strategic decisions by the board or management.[208] The 2009 Walker Report stated that a duty of stewardship was logical for shareholders who had significant rights of ownership and therefore enjoyed the advantage of limited liability.[209] Walker argued this advantage justified fund managers who invest on behalf of institutional shareholders should voluntarily commit themselves to a stewardship obligation, or explain why they are unwilling to do so.[210] Walker suggested the Financial Reporting Council (FRC) to take control of the ISC Code on the Responsibilities of Investors, which should be renamed the stewardship code.[211] The conclusions of the report were endorsed by the United Kingdom government.

In 2010 the FRC issued the stewardship code. The stewardship code was based on core principles such as institutional shareholders should develop and disclose a policy on the discharging of stewardship responsibilities, should monitor the companies they invest in, should have clear policies on voting, should establish guidelines on when and how they will intervene in the affairs of companies in which they own shares and should act collectively with other investors where appropriate.[212] The purpose of the stewardship code was to encourage shareholder engagement, especially in relation to an investee's management of risk.[213] The stewardship code was then revised in 2012 following the Kay Report.[214] In this revised version of the stewardship code, the goal of stewardship was to promote long term success of companies because effective stewardship benefits

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206 Iris Chiu "Institutional Shareholders as Stewards: Toward A New Conception of Corporate Governance" (2012) Brooklyn Journal of Corporate, Financial, & Commercial Law, 6(2) at 387.
207 Iris Chiu, above n 206, at 387.
208 Brian Cheffins, above n 201, at 1011.
209 At 1011.
210 At 1011.
211 At 1012.
212 At 1012.
213 Paul Davies "The UK Stewardship Code 2010-2020 from Saving the Company to Saving the Planet?" (2020) European Corporate Governance Institute - Law Working Paper No. 506/2020 at 6.
214 Selina S. Sagayam, Elizabeth Ising, Amy Kennedy, Jean-Philippe Robe, and Lori Zyskowski "UK Regulators Make Further Strides in Responsible Stewardship and Investing" (2020) The Corporate Governance Advisor 28(1) at 20.

companies, investors and the economy as a whole.[215] The stewardship code is voluntary and is enforced by the FRC. By international standards, the code is well regulated and enforced.[216] As of 2016, the FRC introduced a three tier ranking system whereby the FRC assesses each signatory and assigns them to a category based on their adherence to the stewardship code principles. Third tier organisations were given a period to improve their performance before 2017, when the third tier was removed and around 20 asset managers were removed as signatories.[217] This model distinguishes between those who have demonstrated a commitment to stewardship and those where improvement is necessary.[218] This information is available to the public and creates an incentive for investors to improve performance and comply with the code. The United Kingdom tiering model is the only example of a formal stewardship code enforcement mechanism.[219]

Japan were an early adopter of a stewardship code following the United Kingdom. The stewardship code was adopted in 2014.[220] The Japanese stewardship code is another example of a regulator led code.[221] It takes a "comply or explain" approach and is voluntary.[222] The stewardship code applies to all listed companies in its jurisdiction including asset managers, asset owners and proxy advisors.[223] Active ownership is the main responsible investment strategy used in Japan. The stewardship code was designed to create a "warmer climate" for foreign investors and shareholder activists, unlock the value of investee companies and increase investment returns.[224] Despite being voluntary in nature, the Japanese stewardship code has proven to influence institutional investor behaviour. For example, evidence has shown that the code has increased proxy voting disclosure by institutional investors.[225] After the code was revised in 2017, to recommend investors disclose voting on individual agenda item basis, there was a clear trend in the increase of such practices.[226]

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[215] At 21.
[216] Dionysia Katelouzou, above n 123, at 27.
[217] Dionysia Katelouzou and Konstantinos Sergakis "Shareholder Stewardship Enforcement" (2020) European Corporate Governance Institute - Law Working Paper No. 514 at 29.
[218] At 29.
[219] At 29.
[220] Gen Goto "The Logic and Limits of Stewardship Codes: The Case of Japan" (2019) 15 Berkeley Bus. L. J. 365 at 383.
[221] Jennifer Hill, above n 117, at 507.
[222] At 510.
[223] At 519.
[224] At 520.
[225] Dionysia Katelouzou, above n 217, at 12.
[226] At 12.

In recent years shareholder stewardship has evolved to include the process through which shareholders seek to influence companies in the direction of sustainable performance.[227] Initially institutional investors argued that their only duty is to maximise return on investment for their clients.[228] However, it is now generally accepted that there is room for institutional investors to assume social responsibility duties and that pushing for ESG policies will increase portfolio value.[229] As the apathy of institutional investors in monitoring the performance of investee companies was determined to be one of the causes of the Global Financial Crisis the prevention of further crisis, such as climate disaster, requires accountability on institutional shareholders in the control of investee companies' management.[230] A duty of stewardship draws the attention of institutional investors beyond short term financial return, prevents risk taking and re-embeds investors into society by recognising a social responsibility for sustainable performance.[231] At the time of writing, 84% of stewardship codes globally refer to ESG factors in some way.[232] Nations who have stewardship codes that reference ESG factors include South Africa, United Kingdom, Japan, Australia, Brazil, India, Canada, Malaysia, Hong Kong, Netherlands, Singapore, and Italy.[233] ESG references range from listing ESG as a consideration when making investment decisions to emphasising ESG as a core concern for investment practices.[234]

South Africa and the International Corporate Governance Network were among the first countries or organisations to emphasise the role of institutional investors in promoting ESG through stewardship.[235] In 2016, the International Corporate Governance Network published the International Corporate Governance Network Global Principles to provide a model for stewardship.[236] The principles were designed to be a point of reference for both

[227] Iris Chiu, above n 206, at 387.
[228] Luca Enriques, above n 197.
[229] Luca Enriques, above n 197.
[230] Simone Alvaro, Marco Maugeri and Giovanni Strampelli "Institutional Investors, Corporate Governance and Stewardship Codes: Problems and Perspectives" (2019) CONSOB Legal Research Papers (Quaderni Giuridici) No. 19 at 6.
[231] Dionysia Katelouzou "Shareholder Stewardship" in *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press, 2019) at 589.
[232] Dionysia Katelouzou, above n 123, at 18.
[233] At 19.
[234] At 18.
[235] Jennifer Hill, above n 117, at 515.
[236] International Corporate Governance Network "ICGN Global Governance Principles" (2017) <http://icgn.flpbks.com/icgn_global_governance_principles/ICGN_Global_Governance_Principles.pdf>.

investors and companies as well as policymakers and regulators worldwide.[237] The principles incorporated ESG into the wider definition of shareholder stewardship and the preamble stated that ESG consideration is a core component of the fiduciary duty owed by institutional investors to their beneficiaries.[238]

The United Kingdom stewardship code was revised and reissued in 2020. The 2020 version of the stewardship code goes beyond engagement and also provides guidance on exercising rights and responsibilities, investment approaches and corporate purpose.[239] Importantly, the purpose of the new stewardship code is to create a clear benchmark for stewardship as being the management of capital to create long term value as well as leading to sustainable benefits for the economy, environment and society.[240] The stewardship code not only encourages active ownership, but also encourages disclosure of ESG integration practices. For example, Principle 7 states that "Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities" and that "Signatories should explain how information gathered through stewardship has informed acquisition, monitoring and exit decisions".[241] However, it should be noted that institutional investors are predicted to have leeway in determining the extent to which they would like to consider ESG factors.[242] Engagement (Principles 9-11) requires institutional investors to disclose their engagement strategy and the outcomes of engagement that have occurred in the previous 12 months. Rights and responsibilities (Principle 12) requires signatories to actively exercise their rights and responsibilities.[243] Investors are required to disclose their voting policies and the results of their voting rights in investee companies.[244] The effectiveness of this will become apparent after the first set of disclosures are made under the 2020 code in 2021.[245] The FRC have noted that they will be paying special attention to how institutional investors have considered climate change when applying the code.[246]

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[237] Dionysia Katelouzou, above n 231, at 586.

[238] Dionysia Katelouzou, above n 231, at 586.

[239] Financial Reporting Council "UK Stewardship Code 2020" (2020) UK Stewardship Code <https://www.frc.org.uk/investors/uk-stewardship-code>.

[240] Financial Reporting Council, above n 239.

[241] Principle 7.

[242] Paul Davies, above n 213, at 26.

[243] Financial Reporting Council, above n 239, Principle 12.

[244] Principle 12.

[245] Paul Davies, above n 213, at 29.

[246] At 29.

The 2020 revision of the Japanese stewardship code also has a new focus on ESG and responsible investing. The code redefines stewardship responsibilities as the responsibilities of institutional investors to enhance the medium-to long-term investment return for their clients and beneficiaries by, among other things, considering sustainability (including ESG factors) consistent with their investment management strategies.[247] In relation to these responsibilities, institutional investors should disclose a stewardship policy, should monitor investee companies, have a clear voting policy and should report on how they fulfil their stewardship responsibilities.[248] The code also encourages institutional investors to support responsible investment down the investment chain.

Australia has recently developed two stewardship codes. They are industry led and reflect a strong self-regulatory approach.[249] In 2017, the Australian Financial Services Council published the Internal Governance and Asset Stewardship Standard.[250] This stewardship code is directed to asset managers, insurance companies, financial advisers and other financial services firms.[251] The stewardship code outlines how asset managers should exercise effective stewardship over their investments, encourage investee companies to meet the highest standards of governance and ethical practices and use the tools available to investors to hold boards and executives accountable.[252] The stewardship code is compulsory for all members and operates on a "comply or explain" basis.[253] The Australian Financial Services Council has encouraged all institutional investors to sign up. The stewardship is disclosure based and does not require members to carry out particular activities.[254] Therefore the Australian Financial Services Council encourages asset managers to consider disclosing ESG considerations, but does necessarily prescribe them to do so.[255] ESG considerations are not defined as a central part of stewardship.[256]

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[247] The Council of Experts on the Stewardship Code, "Japan's Stewardship Code" (2020) <https://www.fsa.go.jp/en/refer/councils/stewardship/20200324/01.pdf> at 5.

[248] At 10.

[249] Jennifer Hill, above n 117, at 507.

[250] Financial Services Council "FSC Standard 23: Principles of Internal Governance and Asset Stewardship" (2017) <https://www.fsc.org.au/web-page-resources/fsc-standards/1522-23s-internal-governance-and-asset-stewardship>.

[251] Tim Bowley and Jennifer Hill "Stewardship and Collective Action: The Australian Experience" (2020) European Corporate Governance Institute - Law Working Paper No. 491/2020 at 7.

[252] At 9.

[253] Financial Services Council, above n 250, at 1.

[254] At 1.

[255] At 14.

[256] Tim Bowley, above n 251, at 10.

In 2018, the Australian Council of Superannuation Investors (ACSI) published a stewardship code for asset owners such as public sector and industry superannuation funds.[257] The stewardship code is aspirational in nature and only applies to those who choose to become signatories.[258] Signatories are required to implement the six principles of the stewardship code on a "comply or explain" basis.[259] Comparatively, this ASCI stewardship code places more emphasis on sustainability as a key component of stewardship. Signatories are encouraged to incorporate ESG considerations into their investment strategies and to engage collaboratively with companies to improve their ESG performance.[260] An example of stewardship promoting the ESG agenda in Australia was reported in the ASCI Annual General Meeting 2018 Report.[261] ASCI reported that environmental and social activists who tabled voting proposals addressing ESG related concerns such as requesting more comprehensive disclosure from companies regarding climate related risks received support from institutional shareholders who were concerned with escalating ESG concerns.[262]

It is not clear why two codes have developed, and in 2019 the ACSI reviewed stewardship in Australia and concluded that it would be more effective if one stewardship code for institutional investors was developed.[263] A further obstacle to the success of stewardship in Australia is the effect of a small market economy. Commentators have noted that owing to the small, concentrated, and interconnected nature of the Australian market, institutional investors can be reluctant to engage in confrontational or aggressive activism with investee companies.[264] If New Zealand were to implement a stewardship code they would likely face similar problems, perhaps more so considering the comparatively smaller size of the New Zealand market.

[257] Australian Council of Superannuation Investors "Australian Asset Owner Stewardship Code FAQs" (2018) <https://acsi.org.au/wp-content/uploads/2020/01/Australian_Asset_Owner_Stewardship_Code_FAQs.pdf>.
[258] Tim Bowley, above n 251, at 10.
[259] Australian Council of Superannuation Investors , above n 257.
[260] Tim Bowley, above n 251, at 12.
[261] Australian Securities and Investments Commission "Report 609 Annual General Meeting Season 2018" (2019) <https://download.asic.gov.au/media/4997407/rep609-published-31-january-2019.pdf> 8-10.
[262] Australian Securities and Investment Commission, above n 261.
[263] Tim Bowley, above n 251, at 12.
[264] At 24.

There is no stewardship code in New Zealand. The Financial Markets Authority has published principles for corporate governance,[265] the NZX has published a corporate governance code[266] and the New Zealand Corporate Governance Forum has published guidelines for corporate governance and engagement.[267] However, these instruments are targeted towards all listed companies rather than institutional investors specifically. Therefore, they cannot be regarded as stewardship codes.

To begin the evaluation of whether New Zealand would benefit from, or is likely to create, a stewardship code this essay will assess whether the shareholder stewardship concept fits within the nature of a corporate in the New Zealand legal framework. The agency issue in corporate governance relates to the relationship between the investee company board of directors and the institutional shareholders.[268] The institutional shareholders bear risk as the board of directors delegate the primary role of generating and using wealth to management, who may act in their own self-interest.[269] This is why institutional shareholders have powers to monitor the board through formal rights such as appointing or removing directors.[270] The New Zealand Companies Act is based on this idea that shareholders, such as institutional shareholders, will act as gatekeepers.[271] The issue is that the law in New Zealand assumes that institutional investors are interested in using these rights, and therefore does not require them to do so.[272] For this reason institutional investors are often criticised for being morally apathetic, because they enjoy the advantage of limited liability and the significant rights of ownership rights but are not concerned with the long term sustainability of the investee companies. However, this criticism sees corporate governance going beyond requiring institutional investors just monitoring the board of directors, to shareholders owing a stewardship duty to wider stakeholders such as

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265 Financial Markets Authority "Corporate governance in New Zealand: Principles and guidelines" (2018) <https://www.fma.govt.nz/assets/Guidance/180228-Corporate-Governance-Handbook-2018.pdf>.

266 NZX "NZX Corporate Governance Code" (2020) <https://www.nzx.com/rails/active_storage/blobs/eyJfcmFpbHMiOnsibWVzc2FnZSI6IkJBaHBBclVNIiwiZXhwIjpudWxsLCJwdXIiOiJibG9iX2lkIn19--678885662221f9c9b27b0d6ce13afe89763296a1/Appendix%201%20-%20NZX%20Corporate%20Governance%20Code.pdf>.

267 New Zealand Corporate Governance Forum "Principles for Corporate Governance" (2015) <https://www.nzcgf.org.nz/assets/Uploads/guidelines/nzcgf-guidelines-july-2015.pdf>.

268 Iris Chiu, above n 206, at 391.

269 At 391.

270 At 391.

271 At 393.

272 Alice Klettner, above n 190, at 3.

society and the environment.[273] While this is a plausible argument, it does require a theoretical shift from institutional shareholder monitoring the board for agency problems in relation to their private interest, to institutional shareholders monitoring the board to require governance that takes into account the wider public interest.[274] This is referred to as enlightened shareholder value whereby directors fiduciary duties are focused on the company's long term value and impact on stakeholders and therefore an institutional shareholders duty is to monitor the long term performance of a company and the company's wider ESG impact.[275] As of 2019, the United Kingdom formally made this shift under section 172 of the Companies Act 2006 which states that directors of United Kingdom companies have a duty to promote the success of the company for the benefit of the members as a whole and in doing so have regard to, among other things, long term consequences, interests of employees and the interests of the community and the environment.[276]

However, there is a further argument that no theoretical shift would be required in New Zealand for shareholder stewardship to extend to ESG considerations. This is based on the argument, as discussed in Chapter II, that there is emerging evidence that having sustainable ESG objectives actually increases and protects financial interests. Therefore, considering the wider public interest still falls within the realm of institutional shareholders being concerned about their private interests.[277] Notably, the debate as to whether this theoretical shift is required for shareholder stewardship to be a viable option has not hindered the progress of stewardship codes in other countries, such as the United Kingdom and Australia who have (or have previously had) a similar definition of the nature of a company. Therefore, despite this theoretical debate a stewardship code could operate within the current New Zealand legal framework.

By international standards, New Zealand is late in adopting a stewardship code. Since the United Kingdom's first version of their code, stewardship codes have spread around the globe. Unlike other countries, who following the Global Financial Crisis shifted their focus to institutional investors being the weak link of corporate governance, New Zealand has been more focused on improving the governance of listed corporations as a whole.[278] For

[273] Iris Chiu, above n 206, at 394.
[274] Iris Chiu, above n 206, at 397.
[275] At 398.
[276] Companies Act 2006, s 172.
[277] Iris Chiu, above n 206, at 399.
[278] Alice Klettner, above n 190, at 2.

example, New Zealand has recently adopted a corporate governance code following international trends. It seems likely New Zealand may follow suit and create a stewardship code to fit in with international peers. This was the case in Australia. In 2012, both the ASCI and Australian Financial Services Council made submissions to the Australian government inquiry arguing that a stewardship code was unnecessary. However, a few years later both bodies relented as they were concerned about international standing and issued the stewardship codes discussed above in 2017 and 2018.

Conversely, it can also be argued that due to the abundance of international stewardship codes, developing a stewardship code in New Zealand may not be necessary. As of March 2019, foreign investment in New Zealand was estimated to be $NZD 429.2 billion.[279] The major sources of foreign investment were Australia, United Kingdom and United States of America: all of whom have domestic stewardship codes.[280] Therefore, New Zealand may benefit from other stewardship codes. Furthermore, when New Zealand institutional investors want to invest overseas, they will likely come across other codes themselves. This is, however, a weak argument, as stewardship codes only apply domestically. Therefore, while institutional investors may be exposed to international stewardship codes, they do not have to adhere to them.

If New Zealand were to develop a stewardship code, it seems likely that it will emerge from an industry level. The New Zealand government has not indicated any plans to create or support a regulator backed stewardship code. Further, as discussed earlier in this essay, New Zealand will often follow Australia's suit, who in this case have developed two industry level codes. Furthermore, it would seem likely that the code would be voluntary and on a "comply or explain" basis as this is the norm internationally. An enforcement model similar to the United Kingdom tiered ranking system would increase the incentives for investors to apply, but without a regulator backed code this type of formal enforcement system does not seem likely. One weakness of a stewardship code that is voluntary and industry led is that it is not immediately obvious who New Zealand institutional investors would be accountable to. The United Kingdom code states that beneficiaries and clients are in charge of keeping institutional investors accountable.[281] It can be argued that this is

[279] Statistics New Zealand "Foreign direct investment in New Zealand continues to increase" (2019) <https://www.stats.govt.nz/news/foreign-direct-investment-in-new-zealand-continues-to-increase#:~:text=At%2031%20March%202019%2C%20total,financial%20derivatives%20(%2418.0%20billion)>.
[280] Statistics New Zealand, above n 279.
[281] Alice Klettner, above n 190, at 8.

too weak of an accountability model. Beneficiaries are often too indifferent, or too dispersed to hold institutional shareholders to account.[282] If this is the case, it is worth questioning whether developing a stewardship code would be worthwhile.

One of the strongest arguments for New Zealand developing a stewardship code is its ability to monitor the whole investment chain. While institutional investors may be caught by developing hard laws relating to fiduciary duties and mandatory disclosure, intermediate parties such as proxy advisors and asset managers are often not caught by this hard law. In New Zealand, proxy advisors are often employed to provide analysis on voting policy and exercise votes on behalf of institutional shareholders.[283] This is relevant to stewardship codes as they often provide requirements or advice on voting policy and exercising of formal voting rights. Institutional investors will often blindly follow the recommendation of proxy advisors.[284] A stewardship code in New Zealand, should follow the Japanese model and explicitly encourage investors against this. The code should also encourage institutional investors to pass on their stewardship policies to proxy advisors. Furthermore, institutional investors in New Zealand often contract out the management of their assets to asset managers.[285] Stewardship codes can require institutional investors to pass their stewardship policies on to asset managers. Stewardship codes can play a significant role in co-opting such important players and extending fiduciary duties and transparency (albeit in soft law) along the investment chain and thereby dealing with the agency costs of outsourcing.[286]

Overall, there is a clear trend of including ESG integration and active ownership into stewardship codes. As soft law, stewardship codes are just one small part of a broader network of regulatory initiatives that will help regulate responsible investing. Stewardship codes can support other hard laws discussed above in this chapter. Despite the limitations of stewardship codes, they do have the potential to place ESG considerations within the scope of institutional investors fiduciary duties, encourage ESG integration and encourage active ownership.[287] The flexible nature of stewardship codes mean that they can complement hard law initiatives, or alternatively if New Zealand does not develop hard laws, the codes can help to encourage best practice.[288] Therefore this essay supports and

[282] Iris Chiu, above n 206, at 426.
[283] Alice Klettner, above n 190, at 6.
[284] At 6.
[285] At 11.
[286] Dionysia Katelouzou, above n 123, at 28.
[287] At 28.
[288] At 24.

encourages the adoption of a stewardship code in New Zealand. This essay predicts that an industry led, and voluntary stewardship code is likely to emerge in the near future.

VIII Limitations of Institutional Investors

Finally, this essay will consider whether institutional investors are in fact well placed to further the sustainable finance movement. The discussion so far embodies the positive narrative that institutional investors are part of the solution to a transition to a sustainable economy. However, there is a competing narrative that argues that internationally, hard and soft law initiatives have overestimated the corporate governance potential of institutional investors.[289] They argue that structural deficiencies mean that the effective application of responsible investment strategies is counter to the institutional investor culture.[290]

Firstly, and arguably most notably, institutional investors are myopic and prone to destructive short termism.[291] For example, institutional investors in Europe are estimated to have an average shareholder period of eight months and turn over their entire portfolio every 1.7 years.[292] This is exacerbated by the inappropriate performance metrics and financial arrangements that promote this short term focus.[293] These compensation schemes have incentive structures based on short term performance (often of one year or less) and therefore encourage excessive risk taking.[294] Therefore, proponents of the negative narrative see the investee company as needing protection from institutional shareholders.[295] They argue that shareholders rights need to be limited rather than strengthened, as institutional investors place pressure on investee companies to maximise short term profits over long term sustainability.[296] This is the biggest obstacle to institutional investors adopting a long term investment horizon.[297]

Secondly, institutional investors often own shares in hundreds or thousands of companies. This diversification is used as a risk management strategy but also has the effect of making

[289] Iris Chiu, above n 206, at 429.
[290] Alice Klettner, above n 190, at 5.
[291] Jennifer Hill, above n 117, at 500.
[292] Alice Klettner, above n 190, at 5.
[293] Simon Wong "Why Stewardship is Proving Elusive for Institutional Investors" (2010) Butterworths Journal of International Banking and Financial Law at 406.
[294] Simon Wong, above n 202, at 509.
[295] Jennifer Hill, above n 117, at 524.
[296] At 406.
[297] At 406.

effective monitoring impossible.[298] The costs of monitoring all their investments are excessive and act as a barrier to institutional investors being able to create change.[299] Examples of direct costs include legal advice and employee time spent on governance issues.[300] Furthermore, institutional investors are usually only able to achieve limited benefits against these costs incurred when employing responsible investment strategies.[301] For example, when employing an active ownership strategy where the investors shareholding is very small there is a high risk of free riding by other institutional investors.[302] Positive improvements in the governance of an investee company indiscriminately benefits all investors, and in fact comparatively, benefits more the larger shareholders of that company.[303] Institutional investors are operating in a highly competitive market and are not incentivised to take action or employ responsible investment strategies in companies they have small holdings in.

There would need to be widespread cultural changes to enable investors to integrate a long term ESG considerate approach.[304] In conclusion, the overarching sustainable finance goal of eradicating a short term approach to investment performance is unlikely to be achieved solely through the hard and soft law approaches discussed in this research essay.[305] Policymakers reliance on institutional investors to enable the transition to a sustainable economy ignores the challenges faced by investors in the financial sector and fail to appreciate the full extent of these limitations.[306] To unlock the full potential of institutional investors policymakers will need to tackle underlying structural impediments to make it more natural for investors to adopt a long term mindset.[307] The role of institutional investors may be more limited than advertised by policy makers but is still essential in the transition to a sustainable economy.

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298 At 407.

299 Alice Klettner, above n 190, at 8.

300 Aik Win Tan, above n 2.

301 Simone Alvaro, above n 230, at 34.

302 At 35.

303 At 35.

304 Deirdre Ahern, "The Mythical Value of Voice and Stewardship in the EU Directive on Long-term Shareholder Engagement: Rights Do Not an Engaged Shareholder Make" (2018) Cambridge Yearbook of European Legal Studies, 20 88–115.

305 Paul Davies, above n 213.

306 Roger Barker and Iris Chiu "Beyond shareholder stewardship – visions for responsible investment management and a new corporate governance" in *Corporate governance and investment management* (Edward Elgar Publishing, 2017) at 438.

307 Simon Wong, above n 293, at 411.

IX Conclusion

Responsible investors are primarily concerned with the environmental, social and governance impacts of their investments. In many countries, responsible investment reflects best practice for institutional investors. Institutional investors are using responsible investment strategies to protect financial return, support the global transition to a sustainable economy and meet increasing consumer demand for transparency and ethical investment. New Zealand has been no exception to the responsible investment trend. Responsible investment strategies are applied to billions of dollars of professionally managed assets in New Zealand. Institutional investors in New Zealand favour the responsible investment strategies of ESG integration, negative screening, and active ownership.

ESG integration is the most popular strategy applied to professionally managed assets in New Zealand. It varies from broad responsible investment policies to best practice ESG integration whereby investors systematically apply a well-defined integration strategy across their investment process. The greatest limitation of ESG integration is a lack of transparency from institutional investors. The general public are often unable to verify how institutional investors apply ESG integration strategies. Further, there is little to no data available as to the outcomes of these ESG integration strategies. This leads to a risk of "ESG washing" whereby institutional investors use responsible investment strategies to attract consumers, rather than to make a credible impact. A further limitation of ESG integration is that is unclear in New Zealand whether applying this strategy reflects best practice or is legally required under an institutional investor's fiduciary duty to their clients.

Negative screening is the oldest responsible investment strategy and remains popular in New Zealand. Negative screening is not regulated in New Zealand and exclusions often reflect developments in New Zealand and international law. A limitation of negative screening is the competing discourse as to its effectiveness. The divestment versus engagement debate calls into question whether negative screening is the most effect way for institutional investors to bring about change. Further, exclusions applied in New Zealand are yet to align with consumer demand. Consumers are most concerned with the screening of human rights violations and fossil fuel production, while institutional investors are most commonly excluding weapons production, tobacco, and animal testing. Institutional investors must be aware of these limitations and only use negative screening where appropriate, or alongside other responsible investment strategies.

Active ownership is the third most popular responsible investment strategy. It is however, the fastest growing and proving to be one of the most effective responsible investment strategies. Institutional investors can be active owners through the use of their formal shareholder rights such as voting or shareholder resolutions. Alternatively, institutional investors can communicate with investee company leadership through informal channels. Transparency around active ownership policies and the reporting of outcomes is a limitation of active ownership as a responsible investment strategy. To promote the ESG agenda and prevent "ESG washing", institutional investors should be required to disclose their ownership policies. Further, while active ownership is standard practice for some investors, it is unclear whether institutional investors are legally required to exercise shareholder rights as part of their fiduciary duty.

As a response to the global trend of responsible investing there has also been a rise of soft and hard law policies designed to regulate the use of responsible investment strategies. This essay evaluated three regulatory developments that have not yet been adopted in New Zealand: a codified fiduciary duty, ESG disclosure requirements and stewardship codes.

A codified or clarified fiduciary duty which requires the use of ESG integration or active ownership strategies in investment decision making is supported by international organisations such as the PRI, the OECD and IOSCO. Codifying or clarifying this duty would encourage or compel institutional investors to adopt ESG integration and active ownership policies. However, internationally, the codification of such a duty has only been seen in legislation relating to pension funds. Institutional investors in New Zealand do have fiduciary duties to their investors. However, the limits of this duty are not clear. This essay found that current law in New Zealand allows institutional investors to consider ESG risks that are financially material. However, on balance, this essay also concluded that New Zealand is unlikely to codify a broad fiduciary duty for all institutional investors to consider ESG factors in investment decision making, regardless of financial risk, unless this becomes commonplace internationally.

Some of the latest developments in responsible investing regulation has been in ESG disclosure requirements. France and the European Union have led the world by requiring institutional investors to disclose how they are applying ESG integration to their portfolios. These regulations mitigate the risk of "ESG washing". As ESG disclosure requirements become more popular in Europe, there will be increasing pressure for New Zealand to follow suit. This essay concludes that while critical for the success and credibility of responsible investment in New Zealand, strict disclosure requirements are unlikely to be adopted in the near future. Strict disclosure requirements would disproportionately affect the New Zealand economy. Further, this essay compared ESG disclosure requirements with the proposed legislation for climate related financial disclosures. This comparison demonstrated that ESG disclosure requirements are unlikely to be adopted in New Zealand without support from the financial markets industry and support from other international governments such as Australia.

Globally, stewardship codes are becoming common place in regulating how institutional investors exercise their shareholder responsibilities. An increasing number of stewardship codes now refer to ESG factors and are being used to encourage institutional shareholders to actively engage with investee companies on ESG issues. This essay concludes that New Zealand would benefit from a stewardship code. Despite the limitations of such a model, a stewardship code would still be effective in demonstrating best practice for institutional investors and would help to place ESG considerations within the scope of institutional investors fiduciary duties. This essay predicts that an industry led, and voluntary stewardship code is likely to emerge in the near future.

Finally, this essay discussed the limitations of relying on institutional investors to support the global transition to a sustainable economy. It is important to note that while institutional investors will play a key role in this transition, without significant cultural changes, sustainable finance will not be able to be achieved solely through the hard and soft law regulations discussed earlier. By nature, institutional investors are short term focused and are diversified to the point where effective monitoring of all investee companies is impossible. Despite the aforementioned weaknesses, this essay sees potential in institutional investors playing a role in transforming the economy to a sustainable economy.

As we head into the "decade of action" the demand for responsible investment is only going to intensify. With the financial impact of the COVID-19 pandemic still to be fully realised and as the world heads towards a climate disaster the demand for resilient and sustainable finance is only going to increase. Institutional investors hold the power to help transform the New Zealand economy into a sustainable economy. New Zealand, like many other countries must reflect on its hard and soft law regulations if it wishes to rely on the financial markets to transition to a sustainable future. Encouraging, and potentially compelling, institutional investors to invest responsibly would be a critical step in reaching global sustainable development goals.

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