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# **Incorporating Labor and Human Rights Risk Into Investment Decisions**

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PENSIONS AND CAPITAL STEWARDSHIP PROJECT  
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# Incorporating Labor and Human Rights Risk Into Investment Decisions

by Aaron Bernstein\*

## Abstract

*A mounting number of institutional investors and global lenders are widening conventional investment decision-making to incorporate assessments of the risks posed by company practices affecting labor and human rights. These efforts are part of a broader movement to include corporate environmental, social, and governance behavior into portfolio and lending decisions. While investors face significant obstacles analyzing all of these factors, some of the most difficult challenges involve the appraisal of labor and human rights risks, due to the lack of objective and quantitative data available about corporate activities in these areas. One model for obtaining such data can be found in the supply-chain factory monitoring regimes designed to verify the labor codes of conduct issued by many multinationals. In the absence of government regulation, the investment community may only find robust labor and human rights data, and achieve meaningful reductions in risky corporate behavior, by adopting the shareholder engagement tactics used to pressure companies about environmental and governance risks.*

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## Introduction

A mounting number of institutional investors and global lenders believe that a company's environmental, social, and governance (ESG) practices, including those involving labor and human rights (LHR), can affect its long-term performance and total return. This belief has stimulated efforts to incorporate assessments of ESG sustainability risks into portfolio decision-making. The idea emerged from the concept of corporate sustainability, which began as an analysis of whether a company can sustain its current business approach over a long time period in light of its impact on the environment. Investors have applied much the same approach to a wide range of corporate governance considerations, from the independence of boards of directors to executive remuneration schemes.

More recently, the sustainability risk perspective has widened to incorporate an extensive array of so-called social factors that are not quantified in corporate financial reports. The thinking is similar to the concerns about environmental impacts: A company's performance – and hence its stock price – could be endangered if its business practices run the risk of violating national or international social standards on labor and human rights or causing adverse impacts on local communities and cultures. Such violations may damage a company's reputation, undermining its standing with consumers, regulators, and lawmakers. They also may weaken its operational performance by increasing employee turnover and inhibiting worker motivation and productivity. For many of the same reasons, some investors are attempting to track related human capital metrics such as health and safety, team production systems, compensation, training, and worker skill levels. This paper analyzes a specific subset of factors that fall under the social category, namely, labor and human rights risks involving a company's employees and those in its global supply chain.<sup>1</sup>

Although investor assessments of ESG sustainability risks are similar to the consideration of such factors by environmentalists and human and labor rights activists, the two have markedly different goals. The former are motivated primarily by a desire for solid investment returns, while advocacy groups typically act out of ethical concerns.

A growing number of institutional investors and global lenders are attempting

to enhance investment returns by examining a company's LHR and other ESG sustainability risks. One early effort aimed at least partially at investors came through the Amsterdam-based Global Reporting Initiative (GRI), a nonprofit group formed in 1997 to develop guidelines companies can use to inform shareholders and the public about their ESG performance.<sup>2</sup> The GRI's six reporting protocols include one on human rights and another on labor rights.

A more recent effort began in 2006 with the founding of the Principles for Responsible Investment (PRI), a UN initiative to help the investment community fold ESG factors, including LHR, into equity investment decisions.<sup>3</sup> Some 200 asset owners, investment managers, and professional service providers have signed on to the PRI as of May 2008, representing \$13 trillion under management.

Parallel concerns about ESG risk have motivated the global lending community to develop similar assessment systems. The most significant one may be the Equator Principles, which were set out in 2003 by ten money-center banks working with the International Finance Corporation (IFC).<sup>4</sup> The Principles spell out ESG criteria, including LHR ones, for banks and international lending institutions like the IFC to use in the funding of large infrastructure projects in developing countries and elsewhere. Asset owner interest in ESG factors has inspired a growing body of investment research into corporate behavior in these areas. In the past several years, attempts to define and quantify LHR and other ESG impacts have been undertaken by academics, socially responsible investment (SRI) groups, nonprofit organizations, and mainstream financial and consulting firms such as The Goldman Sachs Group, Mercer, and RiskMetrics Group.<sup>5</sup>

All these efforts, on both the equity and debt sides, face common obstacles. One is the identification of LHR factors that might affect portfolio returns. The PRI, the IFC, and other efforts usually include some or all of the labor standards issued by the International Labor Organization (ILO).<sup>6</sup> However, some investors use different or additional criteria as well. A further difficulty is that most existing labor standards were developed to advance moral and social concerns, not returns. Obtaining robust data relating to companies' LHR risks is challenging as well, usually more so than for other ESG factors. The only publicly available database on specific labor violations in Western

multinationals' supplier factories is that of the Fair Labor Association (FLA). However, the FLA does not perform factory labor inspections in a way designed to aid investors – although it offers a potential model for doing so, as will be discussed later in this paper.<sup>7</sup>

The data deficiencies lead to other impediments. If investors cannot quantify LHR factors properly, it becomes difficult to link them to corporate performance or to stock prices. That, in turn, creates fiduciary concerns for some investors who want to include LHR factors into their portfolio decisions. Pension and insurance funds face this issue most acutely, since they are subject to strict fiduciary responsibilities in many countries.

A further concern is what investors and lenders should do about LHR lapses. One traditional SRI response has been to ban investments in companies that do not fit specified criteria. But that may not be the best way to ensure that companies manage LHR risks so as to maximize corporate performance and portfolio returns. It may be even more inappropriate for so-called universal owners, a phrase increasingly used to describe long-term investment strategies that typically buy indexes of an asset class and hold them for the long term without selling.<sup>8</sup>

Some investors have attempted an alternative approach by pressuring companies and infrastructure project managers to rectify LHR lapses. This kind of strategy, often referred to as shareowner engagement, has been most developed on the corporate governance front. A parallel but almost entirely separate engagement process has occurred since the 1980s, when anti-sweatshop activists began pressuring Western companies to adopt codes of conduct for their global supply-chain factories. However, those typically have been undertaken by activist and religious groups. While some try to use ownership of a company's stock to bring pressure on it, they typically have not done so out of a desire to maximize returns.

This paper examines these issues in the following order. The first section sketches out a brief history of how LHR and other ESG concerns have migrated from moral investment concerns to financial ones in both portfolio analysis and global lending. The second considers the methodological hurdles involved in the LHR investment thesis, including the identification of the criteria used and the deficiencies of the data sources available to assess LHR factors. The third examines possible approaches investors could use to

gather more robust LHR data. It also considers how investor concerns could mesh with corporate codes of conduct and the labor monitoring regimes designed to uphold them.

## Section One: How Labor and Human Rights Became Investment Concerns

Current investor interest in LHR and other ESG factors grew out of the SRI movement.

Initially, SRI was an effort to introduce ethical considerations into investment decisions. For example, the anti-apartheid movement of the 1970s and 1980s ultimately prompted many investors to shun stock ownership of companies that did business with apartheid South Africa. Other advocacy groups adapted SRI principles to a wide array of moral

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considerations, from the sale of tobacco and the manufacture of nuclear weapons to sweatshops, the environment, underserved inner cities, and religious discrimination in Northern Ireland. Some SRI investment funds screen out objectionable companies. Others attempt to steer money to good causes. The human rights, environmental, and religious groups leading these efforts typically do not present such decisions as designed to achieve superior returns, or even necessarily to match the returns they could achieve with comparable asset classes. Instead, the general perception seemed to be that it is worth the risk of giving up some returns to advance a moral good.

In the 1990s, a second generation of SRI products emerged around the idea that ESG concerns are not an automatic deterrent to risk-adjusted returns. This approach, which has been widely used by pension funds, allows investors to employ ESG factors with the comfort of analyses showing that they are not giving up market-based returns in the process.<sup>9</sup>

Today, both generations of SRI are co-mingled in a vast and growing market. The exact amount is difficult to pin down and depends on how SRI is defined, which can be

ambiguous. One widely used estimate of the size of the U.S. SRI industry has been published by the Social Investment Forum since 1995. Its most recent study reported that \$2.7 trillion worth of assets were invested in 2007 using one or more of three core SRI strategies: Screening out objectionable stocks; shareholder engagement; and investing in underserved communities.<sup>10</sup> The total amounted to 11 percent of the \$25 trillion under management in the United States last year.<sup>11</sup>

In recent years, a third generation of SRI has begun to emerge that perceives ESG factors not just as moral issues, but as key to financial returns. In this view, investors examine a company's actions regarding issues such as labor rights or the environment in the belief that they influence its long-term performance. This perspective has emerged for a variety of reasons. Investor interest in corporate environmental impacts grew out of events such as the release of toxic fumes from Union Carbide's Bhopal, India, plant in 1984 that killed thousands, as well as the Exxon *Valdez* oil spill in Alaska in 1989. More recently, the growing scientific consensus about the threat of global warming was brought home by weather-related catastrophes such as hurricane Katrina, which hit the insurance industry hard, as well as by regulations to control greenhouse gas emissions, particularly in Europe but also in some U.S. states and other countries. Similarly, the Kyoto Protocol and the advent of the European Union's Emissions Trading Scheme in 2005 awakened investors to the regulatory risks involved in corporate environmental behavior.

Corporate governance, too, has been gestating for years as an investment concern. The early 2000s scandals at companies such as Enron, Worldcom, Vivendi, and Parmalat prompted many mainstream investors to see poor corporate governance as a key risk that should be factored into investment analyses.<sup>12</sup> On the LHR front, the steady stream of sweatshop allegations about Nike Incorporated, Wal-Mart Stores Incorporated, and other companies over the past decade demonstrated the reputational risks that poor LHR practices can produce. Some Wall Street analysts have come to conclude that these factors have had a meaningful impact on some company's performance.<sup>13</sup> A number of corporations share a similar view. A study in 2008 by RiskMetrics found that 22 percent of 1,800 of the largest global companies say that labor conditions in their suppliers' factories around the world present material risks to their businesses and by extension, their shareholders.<sup>14</sup>

For the most part, investors have not articulated a separate rationale about how LHR risks might affect corporate performance. Instead, they tend to incorporate LHR into a broader thesis about all ESG factors. For example, the preamble to the UN PRI's principles states that "As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time)."<sup>15</sup> The third of its six principles says: "We will seek appropriate disclosure on ESG issues by the entities in which we invest." It then gives examples of possible actions investors might take, including that they "[a]sk for information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives (such as the UN Global Compact)." The Compact is yet another UN initiative, one that asks companies to adhere to ten principles, six of which involve LHR actions.

A similar perspective was articulated in a 2004 report issued by the Global Compact called "Who Cares, Wins," which became one in a series on the ESG topic. It argued that "[a] better inclusion of environmental, social and corporate governance (ESG) factors in investment decisions will ultimately contribute to more stable and predictable markets, which is in the interests of all market actors." It also concluded that a company's ESG management can increase shareholder value "by anticipating regulatory changes or consumer trends, and by accessing new markets or reducing costs;" and that companies are under "increasing pressure from civil society to improve performance, transparency and accountability, leading to reputational risks if not managed properly."<sup>16</sup> In 2007, another "Who Cares, Wins" report concluded that a strong case can be made for taking ESG performance into account in emerging markets, where it said social and governance issues tend to be underestimated.<sup>17</sup>

One of the most detailed enunciations of the ESG investment thesis that includes LHR factors came from a 2007 Goldman Sachs report called GS Sustain.<sup>18</sup> The report says it

*...incorporates corporate governance, social issues with regard to leadership, employees and wider stakeholders, and environmental management. We believe that it is a good overall proxy for the management quality of companies relative to their peers and, as such, gives insight as to their ability to succeed on a sustainable basis. We incorporate the ten principles of the UN Global Compact*

*covering human rights, labour standards, environment and anti-corruption into our ESG framework to the extent possible in every sector and believe that leadership on these issues is crucial.*

GS Sustain offers several other reasons why investors should focus on LHR and other ESG factors. Consumers care more about such factors, it asserts. Increased communications such as the global spread of cell phones and the Internet means that companies are operating in a more transparent environment. They also face heightened pressure from non-governmental organizations, whose ranks have doubled in the past decade and tripled in the past 15 years, the report says. In addition, shareholders have become more active, joining groups such as the UN PRI that focus on ESG issues. Goldman also cites evidence that companies have moved to protect themselves from ESG challenges through their participation in voluntary standards initiatives such as the Global Compact and the International Council on Mining & Metals.

Several leading business analysts have embraced the thesis that ESG helps the bottom line. For instance, Harvard Business School professor Michael Porter and a colleague concluded in a 2006 article that better integration of social considerations into core business operations could yield significant competitive advantage, but that companies must tailor their efforts to exploit “a small number of initiatives whose social and business benefits are large and distinctive.”<sup>19</sup> Likewise, a survey in 2008 by the Boston College Center for Corporate Citizenship and the Edelman public relations firm said that while many companies began by promoting corporate responsibility as a public relations strategy, they came to find “that responsible and sustainable practices enable companies to effectively manage risks and create new business opportunities.”<sup>20</sup> Another recent study by Alex Edmans of the University of Pennsylvania’s Wharton School found that companies on *Fortune* magazine’s “100 Best Companies to Work for in America” outperformed their peers not on the list.<sup>21</sup>

Some experts argue that the new perspective on ESG factors reflects fundamental shifts in the nature of business. Twenty years ago, financial statements reflected 75 percent to 80 percent of a company’s risk profile and value potential, according to New York University business professor Baruch Lev.<sup>22</sup> But today, they may capture only 20 percent, he asserts, because wealth is now created by knowledge and other intangible

assets such as skills and human capital that are more affected by ESG concerns, rather than by land, factories, physical labor, or even finance capital.<sup>23</sup> Another factor at work has been the shift of global manufacturing to emerging markets, where low wages, poorly enforced labor standards, and weak regulatory oversight can pose higher ESG risks.

Although investor assessments of ESG sustainability risks are similar to the consideration of such factors by environmentalists and human and labor rights activists, and indeed grew out of them, the two have markedly different goals. Investors are motivated by a desire for solid investment returns, while nonprofit and other advocacy groups typically act out of moral and ethical concerns. In practice, there remains a fair amount of overlap between the two. Some SRI advocates employ the ESG investment language to characterize morality-based investor behavior.<sup>24</sup> And the transition from the second generation thinking on the issue to the third remains an evolutionary process for some investors, such as the California Public Employees Retirement System (CalPERS) and Norway's Government Pension Fund-Global.<sup>25</sup>

The ESG investment thesis has advanced in fits and starts along all three of its dimensions. It is probably the most developed on the governance front. More than a decade ago, activist investors such as Relational Investors LLC began pursuing investment strategies based on the idea that improving a company's sub par corporate governance could bring above-market returns.<sup>26</sup> Today this perspective has become an article of faith among many mainstream institutional investors around the globe. They do constant battle with companies to get them to adopt what the shareowners consider to be good-governance practices.<sup>27</sup> Engagement funds like Relational, which buy stakes in companies they believe to have poor governance and prod management to improve, have proliferated in Europe, the United States, and to a lesser extent in other markets.<sup>28</sup> The idea that such practices correlate with high returns is so widespread that it even has led to the creation of good-governance stock-market indices, including ones in emerging-market countries where corporate governance can lag the standards of U.S. and European markets.<sup>29</sup> The indices incorporate the stocks of companies that adhere to a specified set of governance standards.

Investor concern about environmental factors is well on the way to becoming

institutionalized, too. Here the ESG investment thesis emerged from the concept of sustainability, which began as an analysis of whether humanity's impact on the environment can be sustained over a long period. Investors and lenders picked up this framework to examine the risk sustainability analyses entail not just for the environment, but for the company itself. They worry, for example, that if a corporation does not track its carbon footprint, it could suffer unexpected setbacks as governments around the world move toward stricter emission policies.

Ceres, a U.S. network of environmental groups and investors, has been prodding companies on sustainability since its founding in 1989.<sup>30</sup> Initially, its efforts seemed more in line with traditional environmental advocacy. But over the years it has focused increasingly on investor risk. In 1997, it formed the GRI, which evolved into an independent organization offering a detailed reporting framework that companies, nonprofits, and other entities can use to inform both the public and investors about their environmental practices as well as labor and other social practices.

In 2003, Ceres launched a project called the Investor Network on Climate Risk, which as of early 2008 involved more than 60 investors managing over \$4 trillion of assets.<sup>31</sup> INCR members include asset managers, state and city treasurers and comptrollers, public and labor pension funds, foundations, and other institutional investors.

INCR's goal is to convince corporations to analyze the sustainability of their business practices as they relate to climate change and to disclose the results to investors. It has pushed companies to track and report on their greenhouse gas emissions and to measure the financial, legal, and regulatory risks. INCR builds on efforts begun in 2002 by the London-based Carbon Disclosure Project, which acts on behalf of institutional investors that had some \$57 trillion under management as of early 2008.<sup>32</sup> The Project "seeks information on the business risks and opportunities presented by climate change and greenhouse gas emissions data from the world's largest companies: 3,000 in 2008."<sup>33</sup> It houses the world's largest collection of greenhouse gas emissions data.

Investors have had a much more difficult time grappling with the social dimensions of ESG. Sometimes LHR and other considerations such as corruption have been relative after-thoughts.<sup>34</sup> For example, companies that use the GRI guidelines often do not

bother with its LHR protocols, and even when they do, the information is usually cursory at best.<sup>35</sup> Four of the nine specific LHR topics the GRI suggests that companies cover

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were not mentioned at all by half or more of companies using the GRI framework, according to a recent study that examined a random sample of 100 GRI firms.<sup>36</sup> A mere 2 percent of companies fully complied with all the GRI's reporting requirements for its LHR protocol.

There are a variety of efforts under way to convince companies to measure and

disclose LHR practices as they increasingly do with their governance and environmental ones. Most of these, like the GRI, lump them in along with other ESG factors and accord them varying degrees of emphasis. One such attempt came with the 2003 adoption of the Equator Principles. In the prior years, several large banks had discussed the possibility of developing a common set of guidelines they could use to assess the non-financial impacts of global infrastructure projects they finance, such as oil pipelines or power plants. They were motivated by years of criticism from advocacy groups, which frequently charge that Western banks and the companies they bankroll to carry out such projects often ignore issues such as LHR and the environment.<sup>37</sup> In 2002, the banks met in London with the IFC to discuss these issues.<sup>38</sup> Out of those talks came the Principles, which initially were signed by Barclay's, Citigroup, Credit Suisse First Boston, and seven other large banks.<sup>39</sup> As of mid-2007, a total of 51 financial institutions had signed on, representing around 85 percent of the world's cross-border project finance.<sup>40</sup>

Although much of the criticism of the project finance industry has come in underdeveloped and emerging-market countries, the ten Principles apply to all new projects with a total cost of \$10 million or more. They require the lenders to consider a project's impact on a variety of ESG factors, including labor and the environment, as well

as others relevant to infrastructure development in poorer countries, such as involuntary settlement, indigenous people, community health, and cultural heritage.<sup>41</sup> The signatory institutions agree not to make loans to project sponsors who do not demonstrate that they can build and operate in accordance with the principles.

The UN PRI has quickly developed into one of the most widely embraced investor efforts involving LHR concerns. These principles, like the Equator ones, came about in part as a result of financial institutions. In 2003, the Finance Initiative of the UN's Environment Program made a presentation on ESG investing to a meeting of the International Corporate Governance Network, a London-based investor group.<sup>42</sup> Later that year, the UN Global Compact began working with the stock broker community on the same subject. (The Global Compact's primary mission is to encourage companies – not investors – to consider environmental and LHR issues.) After a series of studies on incorporating ESG into investment decisions, the PRI was launched in 2006.<sup>43</sup>

Initially, the PRI attracted the most support from pension funds, whose representatives still make up most of its board. Most of the 200 institutions that have signed so far are based in Europe, the UK, Brazil, Canada, and Australia, including SRI and pension funds as well as some mainstream investment managers and service providers.<sup>44</sup> Only a handful of U.S. organizations have become involved.

Its unclear how many PRI signatories are involved out of a desire to enhance returns, as opposed to traditional ethical motivations. Unlike the Equator Principles or those at the heart of the Global Compact, which state ESG concerns, the PRI deals with process. The six principles to which asset owners and managers subscribe when they join the PRI commit them to incorporating ESG into their investment analyses, to actively engage companies on these factors, and to promote them throughout the investment community.<sup>45</sup> As a result, each institution chooses the ESG factors on which it wishes to focus; there is no obligation to pursue every one. Many signatories already were doing at least something along these lines before the PRI was formed, which likely is a reflection of the large number of SRI funds among their ranks.<sup>46</sup> It is even less clear how many PRI participants pursue LHR issues as well as other ESG ones. A number have done so, as will be discussed in Section Three. However, attempts to do so face steep information hurdles, the subject of the next section.

## Section Two: The LHR Data Deficit

Investors hoping to factor ESG concerns into portfolio decisions have struggled with the lack of hard data about all three. Even seemingly straightforward information can be difficult to pin down. A company's governance structure is one of the easier factors to observe, since public corporations disclose items such as whether they have one person serving as both the chief executive officer and as the chairman of the board (a practice still common in the United States even though it is frowned upon by many U.S. good-governance experts). But it can be significantly more burdensome to discern, for example, whether directors have undisclosed social or other ties to the CEO that may compromise their independence.

Similarly, some large Western companies are beginning to disclose environmental practice data such as their emissions of harmful substances such as greenhouse gases. But many still release very little, and even fewer emerging-market companies do so. Fewer yet present investors with robust risk assessments of their environmental footprint, much less those of their global supply chains.

The data deficit is most acute for social factors, particularly LHR ones. This dimension of ESG concern remains so embryonic that it lacks even a basic consensus about the metrics that should be of concern to investors. For example, the PRI and others interested in ESG investment analysis have not yet spelled out the precise details of the LHR standards they would like to apply. Instead, most turn to existing standards that were defined by groups like the Global Compact whose goals are to improve LHR around the world, not to boost portfolio returns. Yet the Compact's definitions are primarily suggestive and offer no detailed guideposts that investors might use to compare LHR activities across companies and industries.

The Compact's ten principles are derived from the Universal Declaration of Human Rights and the ILO's Declaration on Fundamental Principles and Rights at Work. However, the organization does not incorporate either wholesale. Instead, it spells out its own ten broadly-worded principles, including two on human rights: "Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and Principle 2: make sure that they are not complicit in human rights

abuses.”<sup>47</sup> Another four address labor standards: “Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining; Principle 4: the elimination of all forms of forced and compulsory labour; Principle 5: the effective abolition of child labour; and Principle 6: the elimination of discrimination in respect of employment and occupation.” Although the Compact offers a brief commentary on each principle, each lacks further specificity and must be defined by signatory companies.

Other ESG analysts employ overlapping but substantially different LHR definitions, which are often similarly imprecise. KLD Research & Analytics, Incorporated has been providing ESG research to SRI and other investors since 1988, making it one of the most experienced analysts in the field. Its database offers ESG research on more than 4,000 companies in more than 50 global markets.<sup>48</sup> Because it has been around so long, KLD’s approach remains a mix of second- and third-generation ESG analysis. The company defines its mission both as providing “global research and index products to facilitate the integration of environmental, social and governance factors into the investment process,” and as effecting “greater corporate accountability and, ultimately, a more just and sustainable world.”<sup>49</sup> As a result, it is not clear whether KLD’s metrics are motivated solely by a concern for returns.

Either way, KLD’s approach to LHR assessment differs substantially from that of the Global Compact. It seeks to identify a company’s strengths and weaknesses on a range of ESG criteria. For labor rights, strengths are defined as follows: “The company has undertaken outstanding or innovative initiatives primarily related to labor rights in its supply chain, or has particularly good union relations outside the U.S.” Labor rights weaknesses are defined as: “The company’s operations have had major recent controversies primarily related to labor standards in its supply chain.”<sup>50</sup> KLD also examines companies’ relations with indigenous peoples and whether they do business in Burma. It also employs catchall categories covering whether a company “has undertaken exceptional human rights initiatives not covered by other KLD ratings,” or “The company’s operations have been the subject of major recent human rights controversies not covered by other KLD ratings.” KLD also examines a range of corporate “employee relations” factors that may in some circumstances intersect with traditional labor rights, such as health and safety and union relations. KLD has few ways

of discerning problems that the press does not expose. Nor does it attempt a systematic assessment of company management systems designed to monitor and mitigate LHR risks.

However LHR is defined, there are few independently audited sources of information about non-financial corporate behavior. There are many news accounts and academic and nonprofit studies that use external data sources, including examinations of subjects such as corruption, community impacts, and labor and human rights. However, most focus on countries, such as those tallied by Transparency International.<sup>51</sup> Few systematically gather information about individual companies or infrastructure projects. Those that do tend to provide opportunistic and episodic reports when abuses are uncovered, which is of limited use for investors who require a systematic analysis of corporate behavior. Other sources of information about individual company LHR activity typically do not disclose their findings publicly, such as Verité, a nonprofit organization that conducts confidential labor audits of global supply-chain factories for Western companies.<sup>52</sup>

As a result, investors generally are left to rely on whatever happens to turn up in news accounts and information provided by the companies themselves. The latter is problematic for a number of reasons. While many large Western companies issue annual corporate responsibility reports that may discuss LHR issues, their accounts typically lack the detail investors need to make a thorough risk assessment. A survey in 2006 of the 500 global corporations with the largest annual revenue found that 73 percent engaged in some form of external reporting on LHR policies and practices.<sup>53</sup> However, few emerging-market companies do so, and the overall results may overstate the actual reporting.<sup>54</sup>

A similar lack of LHR reporting characterizes the Global Compact, which contains one of the more extensive public databases of corporate ESG reports.<sup>55</sup> Some 3,700 companies from 120 countries had signed on to the voluntary initiative by early 2008.<sup>56</sup> In addition to pledging to adhere to its 10 principles, they also agree to issue an annual Communication on Progress, describing what they have done to implement the principles. They are encouraged, but not obliged, to use the Global Reporting Initiative (GRI) guidelines to do so. However, 916 were listed as either non-communicating

or inactive as of early 2008, meaning only 75 percent provided any form of external reporting.<sup>57</sup> In January 2008, the Compact struck nearly 400 companies from its participant list because they had not reported as required.<sup>58</sup>

A second problem with corporate LHR self-reporting is that even when it exists, the vast majority of it is unaudited by outsiders, including those that follow the GRI and Global Compact. For example, as of May 2008, only 115 of the 16,649 reports submitted to the GRI by 4,282 companies indicated that they were checked by third parties in any way.<sup>59</sup> This raises serious reliability questions,

## **The Compact's ten principles are derived from the Universal Declaration of Human Rights and the ILO's Declaration on Fundamental Principles and Rights at Work.**

particularly in light of the accounting scandals involving independently audited financial statements of companies such as Enron and Arthur Andersen. The accounting industry is highly regulated around the world, with governmental regulatory bodies that lay out detailed standards by which companies report their financial information to shareowners and by which their auditors review that information and certify its validity. Given that investors nonetheless were left unaware of billions of dollars of fraudulent book-keeping, they have few reasons to take completely unscrutinized corporate assertions about LHR at face value.

Furthermore, companies may be even less willing to issue accurate reports on LHR than on either traditional financial results or other extra-financial behavior involving the environment or governance. Many of the LHR practices likely to pose investment risks, such as child labor or physical abuse of workers, are against the law in most countries. Companies may be less inclined to look for or report such violations on their own initiative, even if prompted by investors. After all, a corporation's report of low earnings or high debt may damage its stock price or ability to borrow, but it typically will not pose a legal or regulatory threat.

Even companies that may want to give robust LHR reports face significant obstacles

in doing so. Much of the concern in these areas has focused on global supply chains, usually involving factories in developing countries. In the past two decades, many Western multinationals have issued labor codes of conduct for such factories and set up sometimes elaborate systems to monitor them for compliance. All have struggled for years to come up with meaningful inspection methods. Even groups co-managed by corporations concede that problems abound.<sup>60</sup> Abused workers can be afraid to speak honestly to factory auditors, especially if interviews take place at the workplace where supervisors are present. Critics complain that supplier managers often coach workers on what to say to compliance auditors and keep two sets of books to hide abuses such as wage under-payment or non-payment or excessive overtime.<sup>61</sup>

A look at an exemplary Global Compact report illustrates just how inadequate most public LHR data is for portfolio analysis. The Compact singles out what it calls notable Communications on Progress that offer “inspirational examples.”<sup>62</sup> Only 170 fit this criteria out of 3,179 reports filed with the Compact as of February 15, 2008 (and the 170 include multiple reports from the same company). One notable Communication was the 2006 Corporate Responsibility Review issued in August 2007 by the Coca-Cola Company.<sup>63</sup> Coke had been the subject of a lawsuit and judicial inquiries over allegations that a supplier bottler in Columbia conspired with paramilitary groups to intimidate union activists there and was complicit in the deaths of eight union leaders.<sup>64</sup> The charges led to widespread university student boycotts of Coke in the United States, although the lawsuit was dismissed in 2006.

In January 2007, the company released a Workplace Rights Policy and Human Rights Statement as part of its Compact commitment. The policy and statement assert that Coke follows the Compact’s LHR principles for its wholly-owned manufacturing operations, which produce 17 percent of the company’s annual production. However, the review gives no hard data about how the principles have been implemented, whether any violations have been uncovered, and what if anything might have been done to correct them. The statement says only: “Our intention is that by the end of 2007, all Company manufacturing facilities will have been assessed by third parties to ensure compliance with the Policy.”

Coke’s review is ambiguous about the application of its LHR policies to the suppliers

that produce the other 83 percent of its output. Unlike many multinationals, Coke has significant partial ownership of most of its bottling suppliers. The review says the company's Supplier Guideline Policies were updated and re-launched in 2007 and "emphasize the importance of responsible workplace policies and practices that comply, at a minimum, with applicable environmental laws and with local labor laws and regulations." It is unclear whether that means its suppliers are held to the Compact principles, although the clause "at a minimum" suggests that this may not be the case. Either way, the only quantified information on LHR in the entire review consists of a single data point: Third-party auditors assessed 1,029 supplier facilities in 2006, up from 1,016 the year before.

Although the Compact holds up Coke's report as exemplary, it offers virtually nothing investors can use to assess the long-term LHR risks of buying its stock. The review states that the company and its "bottling investments," which presumably means its partially owned suppliers, employed 71,000 around the world at the end of 2007. It doesn't say what percent work for the parent company as compared to its suppliers. It gives no description of its LHR auditing process for either group. A factory may be audited once a year for ten minutes by outside groups with no experience in LHR. The audits may be announced in advance to the factory managers, a practice widely criticized by labor and human rights groups. Or they may follow critics' suggestions for avoiding allegations like those Coke faced in Columbia, which call for supplier factories to be inspected several times a year through random, unannounced audits which include offsite worker interviews and consultation with local LHR groups or other non-governmental organizations that may be familiar with local employment problems. Coke's review offers no information that would shed light on any of these possibilities.

Nor does the review quantify any results about what its 1,029 audits produced. LHR violations could be rampant or virtually nonexistent, they could have doubled or halved between 2005 and 2006, the company could have attempted to deal with any problems it found in any factory, or with none. Essentially, investors learn virtually nothing about Coke's LHR risks, other than the company has adopted a variety of ambiguously explained policies to deal with them that may apply to some or all employees involved in producing its products.

Despite the lack of quantifiable data, an expanding universe of analysts is casting about for research methods that might capture LHR activity. Most of the work is taking place as part of a broader attempt to study all ESG factors. Because the SRI market is so large and well-established, there are dozens of firms that focus on ESG research. Some focus on extra-financial stock analyses, such as KLD Research & Analytics, Asset4, Vigeo, and EIRIS.<sup>65</sup> Others are units of mainstream financial institutions, such as Goldman Sachs and RiskMetrics.<sup>66</sup> In 2004, a group of asset owners and asset managers formed the Enhanced Analytic Initiative to spur more ESG research. The Initiative doesn't perform research itself but instead "seeks to address the absence of quality, long-term research which considers material extra-financial issues. The Initiative incentivises research providers to compile better and more detailed analysis of extra financial issues *within* mainstream research."<sup>67</sup> In a recent evaluation of the state of ESG research, the Initiative found that "[s]trongly under-researched areas still exist, such as analysis into the impact of human capital management, workplace and stakeholder related issues."<sup>68</sup>

It is difficult to assess the reliability of much of the LHR research, because it is often proprietary. Still, the methodologies that are public suggest how far the field remains from hard metrics that investors can use to make portfolio decisions. For example, Goldman Sachs' GS Sustain is an attempt to include ESG into investment analysis.<sup>69</sup> GS Sustain measures 20 to 25 "objective and quantifiable indicators" of corporate ESG behavior, depending on which ones are relevant to particular industries. Its analysis of LHR factors focuses largely on how companies manage their global supply chains. It says: "We incorporate the ten principles of the UN Global Compact covering human rights, labor standards, environment and anti-corruption into our ESG framework to the extent possible in every sector and believe that leadership on these issues is crucial."<sup>70</sup>

To assess corporate behavior in these areas, GS Sustain looks at factors such as whether a company has adopted a labor code of conduct. GS Sustain also takes into consideration a company's participation in industry labor-monitoring collaborations such as the FLA and the percent of its suppliers whose factories it says are assessed for violations of its labor codes.<sup>71</sup>

Goldman is candid about the inadequacy of the data available. "While most companies in our ESG universe disclose policies on equal opportunity (that prohibit discrimination

and harassment in the workplace), freedom of association, prohibition of child labor, and employee training, few provide consistent data that can be used to compare companies across the global industry.”

GS Sustain does contain more quantifiable data on several LHR-related issues such as health and safety, as well as on other related human-capital metrics. It measures fatalities for companies and their suppliers, both in absolute terms and as a rate per 100 man-hours or 50,000 employees. It also quantifies lost-time injury rates from fatalities, permanent disabilities and lost workday cases per million hours worked. Employee health management is evaluated by a company’s health and safety policies and training capacities, and by its on-site medical facilities and disclosure of health-and-safety performance – although not all companies disclose such information publicly. GS Sustain also collects data on employee gender diversity and average compensation per employee as proxies for a company’s ability to retain and motivate employees.

Goldman recognizes that such data, while quantifiable, remains incomplete and often unaudited. For example, it points out that European companies often disclose training hours per employee, while U.S. ones generally do not. There are many other problems as well. Emerging-market countries may have less reliable government supervision of health and safety reporting, casting more doubt on data they may report. Furthermore, average compensation per employee, which usually is derived by dividing a company’s annual payroll and benefit spending by its workforce head count, can vary widely depending on factors such as how much of a company’s production is outsourced to suppliers whose employees are not included in the calculation.<sup>72</sup>

An even more ambitious attempt by RiskMetrics faces similar challenges. The firm serves some 2,300 institutional investors worldwide by rating companies around the world on a wide variety of governance, financial, legal, and other risk factors.<sup>73</sup> Last year, RiskMetrics introduced what it calls Sustainability Risk Reports, which rate more than 1,800 global companies on 300 environmental and social indicators.<sup>74</sup> These include several dozen labor and human rights factors that RiskMetrics spells out for its clients, such as whether a company has a code of conduct that includes core ILO standards, and whether it has policies on related labor and human capital issues such as race and sex discrimination, health and safety, a living wage, and excess work

hours.<sup>75</sup> The approach is modeled on RiskMetrics' Corporate Governance Quotient (CGQ), which assigns each company a ranking out of 100 percent based on a scorecard of governance practices. Companies are also ranked relative to their industry.<sup>76</sup>

A beta version of the Sustainability Risk Report applies the CGQ approach to environmental and social best practices, including sub-scores on labor and human rights practices. It employs a governance lens to examine board and management oversight of LHR, the level of disclosure, evidence of internal accounting systems in place to monitor policies, and whether companies have taken strategic action. RiskMetrics says that “[r]elative scoring data for each company enables investors to compare performance and capabilities across industry sectors to assess a company’s progress towards best practices.”<sup>77</sup>

**Coke’s review is ambiguous about the application of its LHR policies to the suppliers that produce the other 83 percent of its output.**

Like Goldman Sachs, RiskMetrics has little choice but to rely primarily on company-supplied information, complemented by its own research. It says: “Data is derived from company documents, our NGO partner network, direct engagement with company officials and other outreach initiatives, to provide the perspective of multiple stakeholders.”<sup>78</sup> As a result, RiskMetrics can only provide independent assessment of a company’s responses through anecdotal reports that NGOs, news accounts, and other external sources happen to supply on a particular company. It is one of the first efforts to quantify LHR indicators on a large scale so they can be related to financial performance.

Asset4, based in Switzerland, bills itself as the “world’s leading provider of objective and measurable extra-financial information.” It is taking an approach similar to RiskMetrics. Asset4 has built an assessment system based on 250 ESG factors, some of which cover a company’s policies, management systems, and internal controls and the others that attempt to track the performance outcomes. Like RiskMetrics, Asset4 aggregates its 250 indicators into an overall rating for each company that is designed to give investors a way to make comparisons across industries and markets.<sup>79</sup>

Investors' ability to assess LHR risks today is analogous to what they faced 100 years ago in trying to obtain financial information about the public companies they owned. Back then there were no official rules like the Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards they had to follow and no Financial Accounting Standards Board or Securities and Exchange Commission or International Accounting Standards Board to make sure that they did. Some companies didn't even bother to issue financial reports at all. For example, in a 1901 letter to Westinghouse Electric shareholders, George Westinghouse explained that the directors and largest shareholders had decided not to disclose financial reports for the previous four years because they felt it would not be in "the interests of all." Westinghouse did not distribute another annual report until 1906.<sup>80</sup> Often investors had to rely on little more than faith that the company was being run well and not exposing them to excessive risk.

Corporate reporting on LHR risks today is much the same. Many global companies hire auditing firms to assess LHR factors in their own and supplier factories. They tell the auditors what to look for and how to look, and release virtually none of the results publicly. Instead, most issue corporate social responsibility reports or Global Compact ones which assure the public that their factories are being inspected and that all is well, but offer few or no details.

## **Section Three: Potential Sources of LHR Data**

Goldman Sachs, RiskMetrics, KLD, and other LHR investment researchers all face the same problem of finding company data that is either independently reported by outsiders, or that is audited by reliable outsiders if provided by companies. Although the field remains in a nascent stage, there are several possible approaches the investment community could take which might lead to LHR reporting that is closer to the audited financial statements issued by public companies.

One possibility is to push for various forms of government regulation that could yield useful data. Some related proposals are already in the works. For example, in April 2008, a task force headed by former United Nations official John Ruggie, who is now

a professor at Harvard University, proposed that the UN Human Rights Council require companies to establish a human rights policy and carry it out via human rights impact assessments.<sup>81</sup> The following month, a British cabinet minister announced that his office would initiate a study on how to standardize the measurement of social returns on investment.<sup>82</sup> Ultimately, investors could be best served by the kind of governmental standard setting now done for traditional financial corporate reporting by bodies such as the Financial Accounting Standards Board in the United States and the International Accounting Standards Board in London.

Another approach is to gather and synthesize data from government agencies, as Goldman, RiskMetrics, and others have begun to do. Many countries have regulatory agencies that address a variety of LHR and related human capital factors. For example, the U.S. National Labor Relations Board collects public information about a range of corporate labor-law violations, as well as the remedies taken or imposed on the company.<sup>83</sup> Other sources in the United States include the federal Occupational Safety and Health Administration, the Equal Employment Opportunity Commission, and numerous state agencies such as the California Division of Occupational Safety and Health.<sup>84</sup> The Securities & Exchange Commission also requires U.S. companies to disclose factors that can materially affect their performance, which can include descriptions of labor union contracts and the possibility of strikes.

There are many problems with using such data to assess corporate behavior and risk. One involves long-standing complaints of understaffing at many agencies. Another is selection bias that can emerge if, for example, organized workers feel that union protection makes it safer to report violations without possible reprisal from management. Also, it would be a mammoth undertaking to integrate all such public reporting just for the United States, much less worldwide. But much data does exist and has begun to be mined by ESG researchers. RiskMetrics, for example, has for years included OSHA and EEOC data as part of its risk assessment screen of U.S. companies. However, these data are limited to the United States, so they are not included in the sustainability risk reports RiskMetrics began publishing in 2007.<sup>85</sup>

Other public LHR data sources include private-sector groups that monitor complaints, news accounts, and lawsuits on such issues. For example, the London-based Business

and Human Rights Resource Centre collects human rights news and other kinds of reports on more than 4,000 companies in over 180 countries.<sup>86</sup> Some suppliers of LHR research, such as Verité, make extensive use of this kind of information, usually to alert themselves to potential LHR issues with particular companies.<sup>87</sup>

A third category of possible LHR data is company self-reporting that currently is not audited or released publicly. Some of this could prove the most useful to investors in the long run, although it is likely to be the most difficult to obtain. About a fifth of 1,800 of the largest global corporations have published a labor code of conduct, according to the 2008 RiskMetrics study mentioned above.<sup>88</sup> Companies issue these codes to govern their own factories and offices and/or those of their suppliers. They're typically based on widely recognized labor standards such as those issued by the ILO, although they are voluntary in nature and are not legally enforceable. Some 35 percent of European companies publish labor codes, vs. just 8 percent in the Americas excluding the United States, RiskMetrics found. In the United States, the only country RiskMetrics has studied for more than one year, 22 percent of Standard & Poors 500 companies had a labor code in 2007, up from 13 percent in 2005.

Like Coke, some Global Compact signatories and other multinationals say they perform LHR audits of their factories and those of their suppliers. Overall, about half of the global companies with codes say they monitor supplier factories for compliance, according to the RiskMetrics study. Some hire outside auditing firms to carry out this work, from nonprofits specializing in LHR such as Verité to large publicly-traded quality-inspection firms such as Geneva-based SGS Group.<sup>89</sup> Most companies do not release such information either to the public or to any sort of outside auditing group, whether it is individual factory audits or aggregate results for its entire workforce or supply chain. Yet for those companies that do audit supplier factories, extensive repositories of data exist in a form that investors could demand from corporations if they wish.

There are significant obstacles to obtaining such data. Companies have many valid reasons to treat it as proprietary. Its release could spur LHR advocates and other critics to attack a company's behavior, potentially harming its reputation (and perhaps its profits and stock price). Such fears would be heightened for companies that perform LHR factory audits when their rivals do not. LHR auditing also can be a source of

competitive advantage, particularly given how many companies have struggled for years to come up with workable and affordable factory monitoring systems.

Even if corporate LHR audit data were obtainable, there are equally challenging impediments to its use for portfolio analysis. There is no uniformly accepted LHR code of conduct, which means companies can be auditing for different violations. Even when companies do adhere to a core set of principles such as those of the ILO or the Global Compact, they often do not have a uniform standard by which audits are performed. Some companies pay extra for firms such as Verité to perform audits that include off-site worker interviews and consultations with local non-governmental organizations. Other companies use less-costly auditors that employ quality-inspection personnel to perform LHR audits, even though critics argue that they may not be qualified to carry out such inspections.

One potential solution to these dilemmas is for investors to demand that companies submit factory audits and auditors to independent review, much as they hire accounting firms to audit their financial statements. There are a number of organizations set up to perform something along these lines. However, they were established not for investors, but to assure the public about company LHR behavior and to provide the companies themselves with assurance that LHR lapses will not incur reputational or other damage. Most of these groups sprang up in the 1980s and 1990s in response to widespread sweatshop allegations against companies such as Nike, Disney, and Gap. Examples include the Clean Clothes Campaign, the Electronic Industry Code of Conduct (EICC), the FLA, Social Accountability International (SAI), the Worker Rights Consortium (WRC), and the Worldwide Responsible Apparel Production (WRAP) .

These LHR monitoring groups could provide investors with a starting point for the collection of quantifiable LHR data. Each engages companies differently, posing a variety of problems for investors in search of corporate risk analysis inputs. For example, the FLA and the SAI are associations comprised of nonprofit groups and companies that want to engage in LHR auditing. Both promulgate labor codes and certify the auditing systems of member corporations as well as the outside auditors the companies use. However, their codes, while similar, differ in material respects, as do their auditing standards. Companies involved in the SAI submit individual factories for certification one

by one as they are ready.<sup>90</sup> By contrast, the FLA requires member companies to submit about 5 percent of their factories to random, independent audits conducted by the FLA, in addition to the more extensive auditing systems they are required to maintain as well.<sup>91</sup>

The data available from each process differs markedly. Investors could look to the SAI to reassure themselves about the LHR practices at individual factories, but that would not necessarily give them information about a company's entire workforce or supply chain. The FLA's approach is intended to provide the public with an assessment of an entire company's LHR approach. However, even that may be of limited use for a robust corporate risk assessment, since the FLA's random audits, being random, are performed in different factories each year, with no follow-up at specific ones.

A related possible data source could be so-called International Framework Agreements, which have been negotiated almost exclusively between European labor unions and European multinationals such as Volkswagen and Carrefour. The fifty or so agreements in existence today function much like a code of conduct, in which the company agrees to follow certain labor standards. However, most currently do not apply to global supply chains and lack independent external factory monitoring, which limits their usefulness to investors in their current form.<sup>92</sup>

One FLA project offers what may be the best template for investors in search of hard LHR data. Since 2002, the group has published what it calls "Tracking Charts" on its website.<sup>93</sup> These charts provide details of LHR violations at individual factories, which are tracked across time. While the name of each factory is not disclosed, each has a code number that can be tracked. The country in which each is located is listed, along with what it produces, how many workers it has, and which FLA companies it supplies. The charts describe the factory's noncompliance with each section of the FLA's code, covering issues such as child labor, forced labor, and freedom of association. It also describes any remediation efforts the factory has undertaken in response to the audits, as well as the outcome of such efforts. The FLA says the charts, along with its summary reports on each member company, "represent the most comprehensive body of independent reporting on companies' efforts to promote adherence to international labor standards published to date."<sup>94</sup>

The charts offer a prototype for the type of disclosure investors could demand from every company. A handful of individual companies have released somewhat similar LHR data that has been audited by outside groups. For example, Mattel Incorporated and Freeport McMoRan Copper and Gold Incorporated have submitted to independent LHR monitoring by the International Center for Corporate Accountability, a nonprofit group based at the City University of New York's Baruch College.<sup>95</sup>

Despite the detailed nature of such data, it remains far from adequate for investment analysis. Some critics attack corporate codes of conduct and their monitoring standards as inadequate.<sup>96</sup> More broadly, both the companies and the advocacy groups that comprise the FLA are aware that even after a decade of trying, LHR compliance remains a work in progress.<sup>97</sup> Since it is unlikely that LHR violations will ever disappear completely, one question for investors is how to gauge when a company's LHR risk reaches an acceptably low level. Even detailed factory violation records may not provide an answer for a specific company. Some may show higher numbers of violations not because their factories have worse conditions or riskier standards, but because their LHR systems are better at catching problems. Similarly, some may be better at remedying problems than others.

A partial method for dealing with this issue could be for investors to focus on the management oversight systems and internal controls companies have set up to manage LHR risks in their supply chains. However, they are likely to find little reassurance from companies that do not participate in any external monitoring regimes such as the FLA. This poses a particular problem for large institutional investors who tend to be universal owners and therefore would need to assess most if not all companies. The majority of large global companies do not belong to such bodies. Of the few that do, only a few dozen submit to random, independent factory monitoring regimes like that of the FLA. As a result, it is currently impossible to make meaningful risk comparisons between a Nike Incorporated, which has submitted its supply-chain factories to extensive independent inspection through the FLA, and companies that offer no externally verified supply-chain monitoring data.

One partial solution to these limitations could be for investors to prod the LHR

monitoring groups to merge or to adhere to common codes and inspection standards and methods. Ideally, this would be done in conjunction with the Global Compact, the Global Reporting Initiative, the Principles for Responsible Investment, and other efforts underway to provide private-sector LHR standards and enforcement. Some of the groups have been engaged in just this dialogue themselves, primarily because of complaints from companies and supplier factories about the proliferation of competing monitoring systems. However, it has been a lengthy process. In 2003, six groups began the Joint Initiative on Corporate Accountability and Worker Rights (JO-IN) to work toward a common approach.<sup>98</sup> In December 2007, JO-IN finally completed a pilot project in Turkey.<sup>99</sup> At this stage, a common code and monitoring standards remains a distant goal.

Investors could take steps in this direction by adopting the shareowner engagement strategies used to reduce corporate environmental and governance risks to LHR ones. Such engagement has taken many forms, from the Carbon Disclosure Project to broader efforts like the International Corporate Governance Network or the Council of Institutional Investors, which lobby companies and governments for better corporate governance rules and practices. Most of the labor monitoring associations discussed above are involved in engagement efforts as well. Shareowners have participated in many campaigns over the years and have added their voice as investors to those of the advocacy groups that participate as well. However, most of those doing so are religious and other SRI investors that engage companies on LHR issues out of moral principle, not to enhance portfolio returns.<sup>100</sup> To date, few investors have joined labor code monitoring groups for that reason.

Still, a growing number of investors are applying engagement strategies to LHR, to press for more disclosure as well as for improvements in policies and practices. One early example was the emerging-market screen set up by CalPERS in 2000. The screen focused not on individual companies, but on entire countries, excluding the fund's investments in those that did not meet specified LHR and other social standards.<sup>101</sup> CalPERS engaged in extensive dialogue with countries such as the Philippines that did not make the cut about how to improve their laws and regulations.<sup>102</sup> In 2007, CalPERS did away with the screen in favor of what it called a principles-based approach. The principles cover much the same ground as the screen, including LHR, corruption,

and other political risks.<sup>103</sup> CalPERS' investment managers are required to apply the principles to companies in emerging market countries, which includes engaging corporations on their policies and practices and reporting back to CalPERS on the results. The new policy statement says: "By adopting the Emerging Equity Markets Principles, CalPERS strives to influence emerging market countries and companies by advancing a dialogue about important issues of concern to institutional and other investors and to provide guidance in making investment decisions."<sup>104</sup>

Other investors are pursuing engagement through the Principles for Responsible Investment. In late 2006, the organization established the PRI Engagement Clearinghouse, a private intranet site where PRI signatories can solicit support from other signatories for ESG engagement efforts.<sup>105</sup> In January 2008, Morley, a U.K. asset manager with some \$328 billion under management, used the clearinghouse to enlist 18 asset owners and managers to write a letter to 78 CEOs whose companies had not filed Communications

on Progress (COP) as required by their commitments to the UN Global Compact, including Arcelor Mittal, Caisse d'Espargne, Edelman, and Standard Chartered.<sup>106</sup> The ad hoc investor group included traditional SRI funds such as Domini Social Investments, large public pension funds like the U.K.-based Universities Superannuation Scheme, and more mainstream financial institutions such as France's Crédit Agricole Asset Management, and Sweden's Carlson Asset Management. A statement from Morley said: "Where companies have committed to produce a COP, but not delivered on that commitment, then it is sensible for investors to use their influence to ensure that the management does deliver."

**Overall, about half of the global companies with codes say they monitor supplier factories for compliance.**

Some investors who have been engaging Western companies about LHR concerns for years in the United States and Europe do couch their concerns in terms of the risks posed to corporate performance. In October 2007, a group of religious and SRI funds and a labor pension fund wrote to Cummins Incorporated about charges that the Columbus, Indiana-based engine manufacturer had violated the labor rights of some of its employees belonging to the International Brotherhood of Teamsters.<sup>107</sup> The group

expressed concern that the company had violated its labor code of conduct in a way that “will harm Cummins’s reputation and long term shareholder value.” It requested that the company set up an independent third-party monitoring system to police its factories, along with a binding dispute resolution system to resolve any LHR violations that might be uncovered.

In December 2007, the labor pension fund, the SEIU Master Trust, followed up by submitting a shareholder resolution for Cummins’ 2008 annual meeting. The resolution would “Amend our company’s policies, standard purchase contracts and supplier code covering Cummins, its subsidiaries, joint ventures and suppliers, based on the ILO standards;” and “Establish a credible monitoring process that assess adherence to these standards.”<sup>108</sup> Essentially, the resolution calls on Cummins to set up an FLA-type factory monitoring system to perform independently verified labor audits, analogous to the financial audits performed by corporate accounting firms. The resolution was defeated at the company’s annual shareholder meeting held May 13, 2008.<sup>109</sup>

## Conclusion

Investors concerned about LHR risk can follow the lead of those who have engaged companies on other ESG factors. The hurdles are likely to be steeper on all fronts. More research remains to be done to define the LHR criteria that might relate to corporate performance. Should investors simply employ well-established standards such as the ILO principles or national labor laws? Or does a focus on corporate performance require a re-thinking of some metrics? For example, some advocacy groups have pursued the concept of a living wage, which calls for companies to pay enough to meet specified minimum living standards according to local market prices. Living wage campaigns have been undertaken in a wide variety of environments, from the United States to the poorest countries in the world, and also play a role in the labor codes of some factory auditing systems.<sup>110</sup>

Yet investors may be more concerned about pay levels that attract appropriately skilled workers, reduce turnover, and maximize worker motivation and productivity.

Goldman Sachs' GS Sustain drew some tentative conclusions along these lines from a comparison of payroll per employee to debt-adjusted cash flow per employee. In a section entitled "Rethinking employee compensation: The more you pay the more you get," its report said: "There is an exponential relationship between the payroll per employee and the debt adjusted cash flow companies earn per employee. This breaks with the common preconception of improving operational efficiency through cutting payroll and, on the contrary, seems to suggest that companies that invest in their workforce will reap exponential benefits."<sup>111</sup> Investors may need to examine many other LHR and related human capital metrics to determine whether and how they might inform portfolio analysis.

However investors define LHR metrics, obtaining detailed data about them will require major effort given the often sensitive nature of the issues involved. In addition, it may be difficult to separate data requests from demands that companies ameliorate LHR violations. For example, factory inspection systems are less likely to uncover problems if workers are not convinced that coming forward to report them will lead to improvements. So asking companies for better data on violations likely would require investors also to ask them to set up ways for workers to speak candidly about problems. One possible approach would be for investors to join or partner with the existing labor code monitoring efforts. Another could be the creation of investor networks dedicated to LHR risk, or the expansion of those like the Investor Network on Climate Risk to include LHR concerns. Investors also could advocate for legislative and/or regulatory corporate disclosure requirements, analogous to those enforced for financial reporting by bodies such as the Securities & Exchange Commission, the Financial Accounting Standards Board, and the International Accounting Standards Board.

Any approach is likely to require investor engagement much like that undertaken by SRI and advocacy groups. This could be problematic for investors who may be reluctant to mix desires for maximum returns with moral concerns. However, at a broad level it may prove difficult to distinguish LHR engagement motivated by morality from that driven by portfolio concerns. Most mainstream investors are just beginning to explore this complex subject. One way for them to start could be to learn from the years of work already undertaken in this arena by LHR advocacy and monitoring groups.

Over the longer term, efforts to incorporate LHR factors into investment decisions likely would be more effective if they are coupled with attempts to do the same for human capital and other workplace-related issues. As discussed, some research already looks at both kinds of factors, which can be closely interrelated. Issues such as pay, benefits, and health and safety can fall into both categories, so any analysis that examines the effect they all have on corporate performance might produce more meaningful results.

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## Endnotes

- 1 This paper does not address human capital metrics or human rights violations outside of the employee relationship, such as those that arise when companies do business with repressive regimes or in global lending for infrastructure projects.
- 2 <http://www.globalreporting.org/Home>.
- 3 <http://www.unpri.org/>.
- 4 <http://www.equator-principles.com/index.html>.
- 5 [http://www.unglobalcompact.org/docs/summit2007/gc\\_esg\\_embargoed\\_until030707pdf.pdf](http://www.unglobalcompact.org/docs/summit2007/gc_esg_embargoed_until030707pdf.pdf); <http://www.mercer.ca/pressrelease/details.jhtml/dynamic/idContent/1292285>; and <http://www.riskmetrics.com/issgovernance/esg/sustainability.html>.
- 6 The ILO standards are available at: <http://www.ilo.org/ilolex/english/subjectE.htm>.
- 7 <http://www.fairlabor.org>.
- 8 For a description of the universal ownership concept as it applies to ESG investment analysis, see “Universal ownership: exploring opportunities and challenges,” Conference report, April 10-11, 2006, Saint Mary’s College of California, at: [http://www.stmarys-ca.edu/fidcap/docs/2006\\_MIC\\_UO\\_Report\\_FINAL.pdf](http://www.stmarys-ca.edu/fidcap/docs/2006_MIC_UO_Report_FINAL.pdf).
- 9 There is an extensive literature describing and analyzing the SRI field. One overview can be found at [http://www.sristudies.org/html/sixteen\\_studies.html](http://www.sristudies.org/html/sixteen_studies.html).
- 10 “2007 Report on Socially Responsible Investing Trends in the United States,” Social Investment Forum, March 5, 2008, at: [http://www.socialinvest.org/pdf/SRI\\_Trends\\_ExecSummary\\_2007.pdf](http://www.socialinvest.org/pdf/SRI_Trends_ExecSummary_2007.pdf).
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23 Baruch Lev's work on intangible assets can be found at: <http://pages.stern.nyu.edu/~blev/vitae.html#PUBLICATIONS>.

24 The US Social Investment Forum, a national association of SRI groups, explained the growth of SRI assets in the United States in 2007 by saying: "Money managers are increasingly incorporating social and environmental factors into their investing practices, acknowledging the demand for social investing products and services from institutional and individual investors, socially concerned high-net-worth clients, individuals seeking SRI options in their retirement and college-savings plans and 'mission-driven' institutions such as foundations, endowments, labor unions, and faith-based investors." See: "2007 Report on Socially Responsible Investing Trends in the United States," Social Investment Forum, March 5, 2008, at: [http://www.socialinvest.org/pdf/SRI\\_Trends\\_ExecSummary\\_2007.pdf](http://www.socialinvest.org/pdf/SRI_Trends_ExecSummary_2007.pdf).

25 For example, CalPERS investment policies address non-return issues such as the conditions of workers it employs directly or through contractors, as articulated in "Statement of Investment Policy for Responsible Contractor Program," August 15, 2004. Similarly, Norway's Global Pension Fund has a set of investment guidelines aimed at respecting human rights and other ethical considerations. See: "The Report from the Graver Committee," Norwegian Ministry of Finance, July 11, 2003, at <http://www.regjeringen.no/en/dep/fin/Selected-topics/andre/Ethical-Guidelines-for-the-Government-Pension-Fund---Global-/The-Graver-Committee---documents/Report-on-ethical-guidelines.html?id=420232>.

26 <http://www.rillc.com/index.htm>.

27 See, for example, the governance policies advocated by groups such as the Council of Institutional Investors, at [www.cii.org](http://www.cii.org), or the International Corporate Governance Network, at <http://www.icgn.org/>.

28 One prominent U.S. example is Breeden Partners, started in 2005 by former Securities & Exchange Commissioner Richard Breeden. See Anderson, Jenny, "Ex-Chairman of S.E.C. Set to Start Hedge Fund," New York Times, September 13, 2005.

29 Examples include: The Novo Mercado in Brazil, at <http://www.bovespa.com.br/Companies/NovoMercadoSpecial/NovoMercadoi.htm>; the Istanbul Stock Exchange Corporate Governance Index at <http://www.ise.org/indices.htm>; and the Shanghai Stock Exchange Governance Index at [http://www.sse.com.cn/sseportal/en\\_us/ps/ggxx/zsjbxx.jsp?indexName=&indexCode=000019](http://www.sse.com.cn/sseportal/en_us/ps/ggxx/zsjbxx.jsp?indexName=&indexCode=000019).

30 <http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=415&srcid=494>.

31 <http://www.incr.com/NETCOMMUNITY/Page.aspx?pid=261&srcid=219>,

accessed February 10, 2008.

32 <http://www.cdproject.net/index.asp>, accessed February 11, 2008.

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34 Another part of the investment world has focused on social factors such as urban revitalization and investments in inner cities and in minority communities and minority-owned enterprises. Those considerations share many similarities to the LHR ones considered in this paper. However, the conversations have only recently begun to intersect in the past few years and remain largely separate. See, for example, the Pension Funds and Urban Revitalization project at Oxford University (a joint effort with the Harvard Labor and Worklife Program's Pensions and Capital Stewardship Program), at <http://urban.ouce.ox.ac.uk/network/#d071211>; the Institute for a Competitive Inner City, at <http://www.icic.org/site/pp.aspx?c=fnJNKPNhFiG&b=3416281>; and the Milken Institute's Center for an Emerging Domestic Markets at <http://www.icic.org/site/pp.aspx?c=fnJNKPNhFiG&b=3416281>.

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36 "Reporting on Human Rights," A survey conducted by the Global Reporting Initiative and the Roberts Environmental Center (Claremont McKenna College), 2008. This study looked only at the nine topics or "aspects" of the GRI's human rights protocol. However, this category includes topics conventionally considered as labor rights, such as freedom of association, child labor, and forced labor. Confusingly, the GRI has a labor protocol whose 14 aspects address not labor rights per se, but workplace and human capital issues such as the benefits provided to full- and part-time workers and the average hours of training provided per employee every year.

37 Watchman, Paul Q.

38 This history is recounted at: <http://www.equator-principles.com/principles.shtml>.

39 The other seven were ABN Amro, Calyon, HVB Group, Rabobank, Royal Bank of Scotland, West LB and Westpac. See Watchman, Paul Q., Angela Delfino and Juliette Addison, "EP 2: THE REVISED EQUATOR PRINCIPLES: Why hard-nosed bankers are embracing soft law principles," Client Briefing, LeBoeuf, Lamb, Greene & MacRae, January, 2007, at: [http://www.equator-principles.com/documents/ClientBriefingforEquatorPrinciples\\_2007-02-07.pdf](http://www.equator-principles.com/documents/ClientBriefingforEquatorPrinciples_2007-02-07.pdf).

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- 41 <http://www.equator-principles.com/principles.shtml>.
- 42 The following history draws from: “The Working Capital Report,” July, 2007, United Nations Environment Programme Finance Initiative, at <http://www.unepfi.org/fileadmin/documents/WorkingCapital.pdf>.
- 43 The UN PRI and Finance Initiative and related groups have commissioned a series of studies on topics related to the ESG investment thesis, such as the fiduciary obligations of pension-fund and insurance-fund trustees and the materiality of ESG factors to investment returns. Links to these studies can be found at: <http://www.unepfi.org/publications/investment/index.html>.
- 44 An updated list is at <http://www.unpri.org/signatories/>.
- 45 <http://www.unpri.org/principles/>.
- 46 A 2007 survey the PRI commissioned of its members found that a third of asset managers and 17 percent of asset owners had formal ESG policies by 2000.
- 47 The Compact’s principles can be found at: <http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/index.html>.
- 48 <http://www.kld.com/research/socrates/index.html>.
- 49 KLD’s mission is defined at: <http://www.kld.com/about/index.html>.
- 50 KLD’s methodology can be found at: [http://www.kld.com/research/data/KLD\\_Ratings\\_Methodology.pdf](http://www.kld.com/research/data/KLD_Ratings_Methodology.pdf).
- 51 See <http://www.transparency.org/>.
- 52 See <http://www.verite.org/>.
- 53 Ruggie, John G. “Human Rights Policies and Management Practices of Fortune Global 500 Firms: Results of a Survey,” Corporate Social Responsibility Initiative, Working Paper No. 28, John F. Kennedy School of Government, Harvard University, September 1, 2006.
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62 [http://www.globalcompact.org/COP/notable\\_cops.html?submit\\_x=page&pc=10&pn=1](http://www.globalcompact.org/COP/notable_cops.html?submit_x=page&pc=10&pn=1).

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65 <http://www.kld.com/>; <http://www.asset4.com/>; <http://www.vigeo.com/csr-rating-agency/index.php?>; and <http://www.eiris.org/>.

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