- Occasional Paper Series -

Capital Matters

No. 4
June 2009

Quantifying Labor and Human Rights Portfolio Risk

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Abstract

This paper explores how pension funds and other investors can obtain data on the long-term sustainability risks posed by the labor and human rights (LHR) activities of global corporations, with a specific focus on supply chains. A robust analysis of LHR portfolio risk requires independently audited assessments that adhere to elemental reporting principles, analogous to those that govern audited corporate financial statements. One model for such assessments can be found in the factory auditing system built by the Fair Labor Association (FLA). The paper describes how the FLA functions and draws parallels to corporate reporting on conventional financial indicators. It discusses how investors might use that approach to obtain audited LHR statements and assesses some of the hurdles involved. Such statements would require the establishment of LHR auditing and reporting requirements similar to those promulgated by market regulators such as the Financial Accounting Standards Board and the International Accounting Standards Board. Investors could contribute to this process by setting up advisory entities such as an Extra-Financial Accounting Standards Board. To expand the small number of companies currently issuing audited LHR statements, investors could emulate the shareholder engagement approach employed by groups such as the Investor Network on Climate Risk and the Carbon Disclosure Project. Investors seeking a broad range of extra-financial reporting could magnify their influence by combining forces through the creation of an Investor Network on Sustainability Risk.

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Introduction

This paper should be read as a companion piece to "*Incorporating Labor and Human Rights Risk into Investment Decisions*."[1] The earlier study concluded that pension funds and other mainstream investors increasingly seek information about the long-term sustainability risks of corporate behavior regarding a wide range of social and workplace factors, such as policies and actions involving human capital and human resource policies as well as labor and human rights (LHR). It suggested that investors interested in assessing LHR portfolio risk can obtain quantifiable data from the global supply-chain factory monitoring associations designed to verify the labor codes of conduct issued by many multinationals. It pointed to one such group in particular, the Fair Labor Association (FLA), as a possible model for obtaining data that might be useful for investment analysis.

The current work is an attempt to flesh out those discussions. The ideal for investors would be to have LHR data from corporations that is as reliable as the financial data contained in the corporate financial statements filed by public corporations.[2] Despite all the drawbacks to traditional financial reporting that have become painfully evident in recent years, the basic set of ideas that underlie it remains unchallenged. Fundamentally, investors want to know that a company whose shares they own is honestly reporting on how the business is being run and the results it has produced. Elaborate reporting edifices have been built to ensure that companies share material information with shareowners. Generally Accepted Accounting Principles define what kind of financial information public corporations must report and how they must report it in the United States, while International Financial Reporting Standards do so in many other countries. Independent bodies maintain and enforce these standards, including the International Accounting Standards Board (IASB), the Financial Accounting Standards Board (FASB), the Securities & Exchange Commission (SEC), and similar agencies in other countries. Outside accounting firms audit company books and certify that the issued financial statements adhere to the required reporting standards. The accounting firms themselves must meet a variety of standards designed to ensure that they conduct their audits fairly and accurately, overseen by yet another set of regulators such as the Public Company Accounting Oversight Board in the United States.

The investor quest for LHR data is part of a larger effort to obtain more information about a wide range of corporate policies and actions regarding environmental, social, and governance (ESG) sustainability risks (with LHR falling under the S). Typically, companies have not been required to report such factors as part of their financial statements. Yet investors increasingly are convinced that they play a key role in long-term portfolio risk analysis. This view was summarized recently by the International Corporate Governance Network (ICGN), a global investor coalition. In late 2008, it published a Statement and Guidance on Non-financial Business Reporting, the product of a panel of experts brought together to consider what kind of so-called extra-financial reporting might be material to a long-term investment outlook.[3]

The statement asserted that:

"Long term success in managing a business in today's complex economic, environmental and social landscape is increasingly dependent on factors not reflected in financial statements and in some instances thought to be outside the corporation's sphere of concern."

"The ICGN Non-financial Business Reporting Committee's own deliberations, as well as the work of other interested groups, highlight a number of broad subject areas as being integral components of nonfinancial business reporting. These include not only corporate governance, which is a central focus of the ICGN's mission, but also areas such as intellectual capital, human capital, the environment, customer goodwill, reputation, human rights, anti-corruption, suppliers and community relations."[4]

The goal for investors should be to obtain ESG data that meets standards similar to those applied to traditional financial statements. Even conceptually, this can be challenging, since it may be more difficult to quantify issues such as how well a company is governed or whether its relations with employees or suppliers pose long-term sustainability risks. Nonetheless, the basic principles that underlie the existing corporate reporting edifice offer a practical starting point. In broad terms, these can be outlined as follows:

Specific standards To be useful in portfolio analysis, ESG reporting guidelines must define with a great degree of precision what companies should disclose and how they should disclose it, just as FASB and other regulatory bodies specify how they must define financial factors such as profit, loss, revenue, and goodwill. The definitions should be standard for all companies to the extent possible, to "facilitate comparisons with other companies and for the same company over time."[5] For example, guidelines should specify the LHR standards according to which companies should report, such as freedom of association, no child labor, no forced labor, etc. A set of common definitions is a key aspect of portfolio analysis, which requires comparisons of corporate LHR risks across industries and markets.

Independent verification Similarly, investors require independent verification of ESG data, just as they obtain for financial statements through the corporate audits performed by accounting firms. Investors need to know that the ESG reporting system a company has put in place is comprehensive, reliable, and capable of gathering the desired information, and that the data produced is accurate.

Transparency The ESG data itself must be public, as are corporate financial statements. This is a particular challenge for LHR data, given the often sensitive nature of potential labor and human rights violations.

The aim of this paper is to explore the question of how investors might create a corporate LHR reporting system using these basic principles. It starts with LHR in global supply chains, with the hope that the approach will prove useful for other social factors such as LHR in global lending and project finance, human capital and human resources, and community impacts. An initial premise is that investors do not need to invent an entirely new system to obtain quantitative LHR data on corporate supply chains. Instead, key elements of the corporate reporting principles spelled out above can be found in the LHR monitoring system developed by the FLA. Large public corporations that are FLA members already have built LHR reporting systems exhibiting many basic characteristics in accordance with these principles.

There are half a dozen international associations, sometimes called multi-stakeholder initiatives, involved in various aspects of LHR supply-chain monitoring. Although none was set up to serve investors, the FLA's approach comes the closest to meeting the principles outlined here for several reasons. It requires more independent factory monitoring than the others and is the only multi-company group that publicly discloses detailed LHR audit results.[6] In fact, the FLA reports can be used to construct a prototype time-series database using publicly available, independently audited assessments of LHR violations and remediation efforts that are comparable across time and among companies. While constructing such a database is beyond the scope of this paper, it would be analogous to the audited financial information that forms the foundation for investor assessments of corporate and portfolio performance. It could provide a model for what a robust corporate LHR statement might look like.

The FLA approach has a range of drawbacks and flaws that make it an imperfect model for investors. These will be discussed in this paper. Nonetheless, it offers a working model shareowners can use to begin addressing the question of whether LHR factors indeed are material to long-term portfolio performance, as the ICGN and other investor groups assert.

This paper proceeds along the following lines. Section One explains how the FLA works and draws parallels to conventional financial reporting, informed by the three principles outlined above.

Section Two discusses how investors might go about developing standards for corporate LHR reporting and audits, drawing on the extensive efforts undertaken by the major supply-chain labor monitoring associations. It discusses several paths investors might follow to set such standards. One could involve the creation by investors and other stakeholders of a standard-setting body for ESG issues modeled after existing reporting standards entities, such as an Extra-financial Accounting Standards Board (EFASB).

Section Three examines various tactics investors already have initiated to improve extra-financial reporting, which could be expanded to encompass more robust LHR reporting of the type envisioned in this paper. There are several campaigns for mandatory ESG reporting aimed at regulators such as the U.S. Securities & Exchange Commission and the European Union. Another approach can be found in efforts by investors focused on the portfolio risks posed by climate change and other environmental factors, such as the Investor Network on Climate Risk and the Carbon Disclosure Project. Eventually, it may make sense for investors seeking a broad range of extra-financial reporting to combine forces through the creation of joint efforts such as an Investor Network on Sustainability Risk.

Section One: LHR Statements

The FLA grew out of the Apparel Industry Partnership (AIP), a coalition of apparel and footwear companies, LHR groups, and consumer advocates formed in 1996 at the behest of then-U.S. President Bill Clinton following a highly publicized series of sweatshop scandals. The AIP worked for more than two years to draft a labor code of conduct for member companies to use throughout their global supply chains, and a factory monitoring system to enforce the code. The code draws heavily on the eight core conventions of the International Labor Organization, which address freedom of association, forced labor, child labor, and equal treatment of workers.[7] In 1999, AIP members created the FLA as a nonprofit organization. Its goal is "to improve working conditions around the world and to provide the public with information it could use to make informed purchasing decisions."[8] Although the FLA was not formed with investors in mind, the latter mission is a key reason why it publicly reports the results of its factory audits, making it a unique model among multi-stakeholder initiatives for the kind of public reporting required for investment portfolio assessment.

The FLA is governed by an 18-person board with equal representation by companies, civil society organizations, and colleges and universities (which join to enforce labor standards for the companies to which they license collegiate apparel and other products).[9] Corporate members range in size from large global companies to small family-owned enterprises and include manufacturers and retailers as well as their suppliers. This paper focuses on the organization's approach to the 27 so-called participating companies, which "make a sustained corporate commitment to the FLA by bringing their entire supply chain into the FLA program."[10] These include smaller companies as well as larger ones such as Adidas, Hanesbrands, H&M, Liz Claiborne, Nike, and Nordstrom.

The FLA performs two primary functions for participating firms. First, it guides companies in developing factory compliance systems whose function is to detect and remedy violations of the FLA's labor code. Companies develop these systems during the initial implementation period of their affiliation with the FLA. The companies' systems are referred to as *internal monitoring*, even though most companies actually hire outside LHR auditing firms to perform much of the work. The term helps to distinguish these company-managed systems from the FLA's second function, which it calls *independent external monitoring*, or IEM in its lingo.[11] This refers to unannounced audits of a random selection of each company's supply chain that are conducted by LHR auditing firms hired by the FLA, not by the company. The idea is to perform what amounts to reality field tests that gauge whether the companies' own compliance systems in fact perform as designed.[12]

Both of these functions are vital to the kind of LHR reporting required for robust portfolio analysis. There are a host of problems associated with the collection of such data that make the task of ensuring its accuracy more difficult than it is for conventional financial information. Until the outcry over sweatshops led to the creation of the FLA and other LHR monitoring groups in the 1990s, most global corporations took no responsibility for the working conditions in their supplier factories and had no means of supplying such data even if they had wanted to. Since then, many large companies in industries with extensive low-wage supply chains have built elaborate internal compliance systems to ensure that suppliers adhere to labor codes of conduct the companies have adopted. These systems often collect large amounts of data on LHR violations.

However, it can be challenging for even the largest companies to insist that all their suppliers adhere strictly to their code, or to the FLA's. Most global corporations like those in the FLA usually do not own or directly control the factories that produce the goods they sell. Instead, the production is bid out to suppliers who may number in the hundreds and change frequently. At the same time, many suppliers contract with multiple corporations, and some suppliers are giant global corporations themselves. (For example, Pou Chen Corporation, a Taiwanese company, produces some 200 million pairs of shoes a year, which represent roughly 18 percent of the world's athletic and casual shoes market.[13])

As a result, companies that wish to audit suppliers cannot simply draw up management and reporting policies and procedures and hire people to carry them out. Nor can they discipline or fire staffers who fail to do an adequate job. Instead, they must convince suppliers to go along with codes and audits, and find alternative ways to verify their compliance, such as factory inspections. Similar challenges arise with LHR concerns in other areas such as project lending and the extractive industries. There, too, potential LHR risks often arise in connection with activities that public corporations do not directly control, such as their reliance on local governments, security guards, police, or military.

The difficulties are compounded by suppliers' reaction to LHR monitoring. Many factories around the world have become adept at hiding labor violations from auditors, and at fixing problems to satisfy inspectors who show up for a day or two a year, only to return to the proscribed practices once they are gone.[14] Their incentives to do so are great, since suppliers face increased costs to remedy violations and can ultimately lose contracts altogether if they repeatedly violate a company's code.

LHR monitoring associations have struggled with these complex challenges since their inception. Most of them, including the FLA, require participating companies to set up compliance systems to enforce their codes in their supply-chain factories. To meet the FLA obligations, companies must have a monitoring system for all their supplier factories. The bulk of the actual factory audits typically are conducted by specialized LHR auditing firms that have sprung up in the past decade in response to the demand for such services by global corporations. (The FLA currently does not certify the outside auditing firms its member companies hire. This is a weakness in its approach. The firms vary widely in nature and quality, provoking much criticism and debate as well as recent attempts to standardize and professionalize a nascent industry, as will be discussed in greater detail in Section Two.)

The FLA companies' staff oversees this process, hiring the auditing firms, managing their reports, and working with factories to remedy violations. The FLA describes its approach as follows: "An internal audit usually includes interviews with factory management, workers, and trade union representatives; documentation review of factory policies, payroll, benefits and hours of work; and a tour of the facility to assess conditions."[15] The compliance staff also must make sure that factory employees have confidential channels through which they can report violations, and consult with LHR and other civil-society groups. Both steps are required by the FLA to provide alternative perspectives to audits about what is really going on inside often-secretive supplier factories.[16]

Companies that join the FLA can opt for a two- or three-year implementation period. At its completion, the FLA reviews the company's labor compliance system and accredits those that meet the criteria. "Accreditation does not mean that every factory in the company's supply chain, or even any single factory in its supply chain, is in full compliance with the FLA code. It does mean that the company has implemented mechanisms and procedures to increase code awareness, monitor and remediate noncompliance, and prevent persistent patterns of noncompliance. Each company's accreditation must be reviewed every two years."[17]

From a corporate reporting perspective, the internal compliance systems the FLA accredits are roughly equivalent to the information gathering companies perform to prepare their financial statements. At this point, the FLA does not require companies to describe their approaches in detail or to release all the results of their internal auditing, which could function as an LHR statement akin to a financial one. Instead, the association itself describes each company's approach in an annual report. While this is far from optimal for the purpose of investment analysis, it offers much more detail than most non-FLA companies release about their LHR monitoring activities.

For example, the group's 2007 report, the most recent available, says Adidas had 815 factories included in the FLA program in 2006.[18] The company had a 63-person Social and Environmental Affairs (SEA) unit which conducted audits at 197 of these factories that year, assisted by outside monitoring firms. Overall, the SEA conducted 869 factory visits for auditing, monitoring, or training purposes. Fewer than 5 percent of the visits were unannounced. Adidas also conducted 147 audits of factories bidding for work, 40 percent of which were rejected as suitable suppliers because their LHR practices had been found to be too far out of compliance with the FLA's labor code.

Investors need more detail than this to make informed comparisons about the long-term risk posed by companies' LHR practices. Ideally, they could get standardized descriptions of corporate audit systems, with key performance indicators such as the ratio of compliance staff to factories, adjusted by the number of workers per factory, and the percent of factories audited annually. They also could get performance indicators that sum up the detailed results of the company's audits, and the outcomes of any remediation efforts. Such metrics would help to quantify companies' capacity for measuring and mitigating long-term LHR risk. Standardized data along these lines could be built into LHR statements, as a companion to corporate financial statements and perhaps eventually just another set of entries on them.

The FLA is moving in this direction through a process called the Sustainable Compliance Leadership Initiative that it initiated in June, 2008.[19] The following September, a steering committee was formed consisting of representatives of Adidas, Nike, Nordstrom, Patagonia, Phillips-Van Heusen, and FLA staff. It concluded that a majority of FLA companies' supplier factories "still have transparency issues, major non-compliances and unsophisticated management systems." It suggested that the FLA develop a standard tool for companies to use in assessing factories, along with "a common understanding of what a model factory looks like, with clear criteria and indicators established as guidelines and to measure progress." The committee set a goal of the summer of 2009 to have the new assessment tool ready for use. Eventually, the FLA intends to make the assessment tool public.[20] It remains unclear exactly how much detail companies would be required to release about their internal compliance systems, or about the results of their factory audits.

Another model for quantifiable LHR data can be found in the FLA's second function, independent external monitoring, or IEM. The IEM is intended to be a status check on the reliability of companies' internal monitoring systems. Here is how the process works.[21] First, the FLA identifies a random sample of 5 percent of a company's factories. The samples are weighted by the LHR risks posed by each country in which the company operates and by the number of factories it has in each country. The FLA then hires third-party monitors to conduct the audits. (Although FLA companies are free to hire any audit firm for their own factory compliance systems, the FLA accredits the LHR auditors it uses in the IEM process, to ensure that they meet guidelines set by the FLA for how effective audits should be conducted.[22])

Neither the company nor the factory is informed of the date of an IEM audit. The visit, often conducted over one to two days, comprises interviews with factory management, workers, union representatives, and local non-governmental organizations; documentation review of factory policies; and a tour of the facility to assess the conditions. IEM monitors submit a written report of their findings to the FLA, the company, and the factory. The company has 60 days to submit a corrective action plan to the FLA that details its efforts to remedy any labor code violations. The FLA assists in the remediation effort and may conduct a follow-up visit to the factory to verify the remediation.

Random-sample auditing by auditors hired independently of the company is the FLA's way of verifying that companies' systems are successfully identifying and remedying LHR violations. The results are published on the FLA website in the form of IEM tracking charts.[23] The charts currently run annually from 2002 to 2008, with new results posted on a rolling basis as they come in. The charts report code violations found at individual factories. Many companies, FLA members and nonmembers alike, are reluctant to name factories, both for competitive reasons and due to fear that activists would use the information to criticize the company. As a result, the FLA assigns numerical codes to factories. The charts report all other details, leaving out only each factory's name and address.

For example, the 2007 charts contain reports on 15 Adidas factories in 10 countries.[24] One is a 918-worker outerwear factory in Vietnam which also produced that year for two other FLA companies, Nike and Patagonia.[25] The IEM audit found twelve instances of noncompliance with the FLA code of conduct, and eight instances of risks of noncompliance. Each problem is detailed by the category of the code it violates; the nature of the problem found; the sources used to identify the violation, such as worker interviews and factory records; any local and/or country laws violated; and any remedial steps taken by the factory's management or the FLA member company.

The violations at the Adidas factory in Vietnam run the gamut from excessive overtime to public announcements of worker disciplinary measures as a form of punishment. Most involved actions by the factory, but some spoke to failures by Adidas. For example, Adidas had not even provided the factory management with the FLA code. That led to a separate violation by the factory, for not posting the code in prominent places throughout the premises. The chart describes the remedy taken to fix the problem: "Management has developed a comprehensive system of policies and procedures together with training programs for communicating these to staff and workers."

The charts also detail findings that are not clear violations but seem to pose risks of noncompliance. One fell under the category of forced overtime and said: "Factory has no signed OT forms for June. These forms appear to be prepared after the fact, rather than used for voluntary OT signup in advance."

The FLA's IEM system offers investors an example of how an LHR reporting system can deal with the need for independent verification. If LHR statements can be seen as analogous to corporate financial statements, IEM data can play a role similar to the accounting-firm audit of a company's books. The goal of both is to ensure that the company's internal system for collecting information about its performance is sound, and that the metrics it reports to public shareowners accurately reflect that performance. Just as investors want independent assurance that companies are not misreporting their profits or sales, so too do they need confirmation about corporate LHR monitoring.

Perhaps even more important, the IEM shows it is possible to develop a reporting system that satisfies the reporting principle of transparency. The FLA's publication of all of its IEM results makes it unique among LHR supply-chain monitoring associations and is a key reason why the FLA approach offers a model that investors can build upon in the quest for quantifiable LHR data.[26] The fact that large corporations have agreed to the public release of detailed information about LHR violations in their supply chains sets an important example in the context of such sensitive issues. Their willingness to do so makes it more difficult for other corporations to argue that their reputation or competitive position could be damaged by investors' request for LHR monitoring and public reports of the results.

The FLA's publication of its IEM findings also offers investors a way to create the first prototype time series of LHR data based on actual results. Although the FLA's tracking charts do not name factories, they do assign a unique number to each one. They also identify all the factories used by each participating company. As a result, it would be a fairly straightforward exercise to aggregate all the chart data for each company. Doing so would provide annual LHR violation and remediation data by company for 2002 through 2008 (although not all companies have tracking charts information for all years, since they joined the FLA at different times).

Such a database would allow investors to evaluate each company's LHR risk, both over time and in comparison to other FLA members. The number of companies involved probably is not large enough to draw meaningful investment risk conclusions. Furthermore, the companies' membership in the FLA itself is evidence of a serious commitment to LHR risk reduction. As a result, it may not be particularly useful to compare FLA companies to each other, since any performance gaps among them are likely to be much smaller than the risks posed by the majority of global corporations that do not even have LHR supply-chain codes, much less compliance systems. However, a database of this nature would supply a model that investors could use to begin grappling with the many unexplored questions about how LHR risk can best be assessed. It would for the first time provide shareowners with a representative framework for quantifying such risk that employs an approach similar to the audited data on factors such as revenue and profit found on corporate financial statements.

As instructive as the FLA's approach may be for investors, it faces many of the same fundamental flaws encountered by all LHR monitoring. Even as factory audits have burgeoned into a global industry over the past decade, critics as well as corporate executives and monitoring association officials have questioned their efficacy in improving factory working conditions.[27] Many suppliers perceive monitoring as an attempt by the corporations for which they produce to impose costly and burdensome rules on them, without sharing the added expense. So they have resisted monitoring and its attendant remediation requirements. There is a widespread belief that factories in many developing countries have become adept at coaching workers to give auditors inaccurate reports so the factory will pass muster.[28]

“The traditional audit involves checking for compliance against each element of a code of conduct and often leads to a long list of issues that the factory will be required to resolve in a short period of time. This inevitably leads to factories looking for quick-fix solutions that are rarely sustainable.”[29] In addition, “audits are often perceived as policing; factories know they will fail and therefore try to hide the problems in order to get a good auditing result. This results in no trust between customers and their suppliers, and most importantly, only the finding is treated and not the cause, which will inevitably result in the problem reoccurring.”[30]

The inadequacies of monitoring were made strikingly clear in surveys of workers and managers the FLA conducted in 2007. The surveys were taken in five factories in Thailand and six in China, all of which produced for Adidas or Nike.[31] To ensure statistical validity, stratified random samples were selected that ranged from 80 workers in small factories to 200 in larger ones. About 70 percent of the 1,776 workers who filled out the survey reported filing a complaint or grievance with the factory’s management in the prior 12 months. This translates into the equivalent of roughly 16,000 complaints across the 11 factories. However, managers, who were surveyed independently, reported a combined total of just 1,760 complaints for the same period.

The findings drive home the tenuous nature of current monitoring techniques. They are particularly troublesome in light of the fact that it can be nearly impossible for a one- or two-day audit to uncover many systemic LHR violations without candid reporting from employees. As the FLA concluded: “The result clearly shows that a majority of workers’ complaints are not systematically dealt with, which means that they might not be resolved; that there is no transparency in handling these complaints, and that the risk of inconsistency and bias in providing solutions is high.”[32]

Even if monitoring does uncover code violations, the remediation all associations require can be ineffective. This conclusion comes through clearly in a second set of bottom-up, top-down surveys the FLA conducted in 2007 which focused on excessive overtime, a widespread problem in many low-wage Asian countries, particularly China. The surveys covered 15 soccer-producing factories, also in Thailand and China and also making goods for Adidas and Nike. They found that 48 percent of employees reported working more than 60 hours a week, the normal maximum under the FLA code of conduct.[33]

More surprising is that many managers conceded that the FLA limit frequently was exceeded. Four of the seven Chinese factories reported that employees had exceeded the 60-hour limit in two to five weeks during the prior 12 months. Managers at two of the four Thai factories reported this was the case in six to ten weeks. Furthermore, the majority of managers reporting excessive overtime said that more than 60 percent of the workforce was affected.[34]

The major monitoring associations as well as leading companies have been aware of such challenges and have struggled for years to find solutions. While there is no consensus about how to proceed, a number of them have been attempting to shift from policing-style audits to a more collaborative approach that attempts to convince supplier factories to take ownership of labor codes.

The FLA formally launched such an effort in 2005, called FLA 3.0.[35] (Others, such as Timberland, began experimenting with similar ideas even earlier.[36]) The goal is to achieve what the FLA calls "sustainable compliance." Instead of simply auditing factories for code compliance, the FLA and its member companies help each factory to develop its own compliance system. They first ask factories to assess their own ability to detect and remedy LHR violations. The FLA and the company then work with factory management to improve its capabilities. "The FLA recognizes that monitoring alone cannot create lasting Code compliance. An approach that comprises more than simply exposing and correcting violations is required for sustained protection of worker rights."[37]

"A cornerstone of FLA 3.0 is a change in the traditional mindset described above to one of recognition that compliance with labor standards is not yet the reality in most factories – the factory needs to become involved in a process of which compliance will be the end result. FLA 3.0 is grounded in the belief that requiring compliance simultaneously with an entire code of conduct is not a realistic approach. The FLA contends that in order for compliance to be effective, we must identify the root causes of that non-compliance and address them individually. The FLA 3.0 approach addresses problems one at a time in the form of priority issues. The FLA also believes that in order for labor compliance to be sustainable, the factory needs to take ownership of the process instead of having the process externally imposed on them from the buyer. In the FLA 3.0 model, the factory is an active participant in the process, and only factories that demonstrate a desire to improve conditions for their workers and a readiness to be transparent are invited to participate in the program."[38]

Other experts have come to similar conclusions. For example, a detailed study of Nike's LHR compliance system by three Massachusetts Institute of Technology professors found that auditing alone typically did not produce long-term factory compliance with the company's code of conduct (or with the code of the FLA, of which Nike is a member).[39] However, factories performed better if Nike staff engaged management as partners on a long-term basis, helping them to take more responsibility for a wide range of production improvements, including LHR management. As Nike worked with factories to improve efficiency and quality, they were more able to better schedule workloads, which helped to reduce chronic overtime work. Factories also invested more in training, which prompted more wariness among supervisors about mistreatment that could lead to higher turnover. "Likewise, workers who have been trained to 'stop the line' when they see a possible defect and/or work in more autonomous production cells, are also more likely to resist management abuses on the shop floor."[40]

The FLA has been slowly rolling out 3.0, starting with China and Thailand. In each participating factory, the FLA begins by conducting an IEM. But unlike the usual IEM audits, this one is designed to determine a baseline assessment of the factory's capacity to identify and rectify LHR violations, using key performance indicators the FLA has developed. The factory can then monitor its own deficiencies and improvements in partnership with the company and the FLA. "This creates an incentive for factories to be honest at the outset, since they know that progress will be measured incrementally and reported on over time. This creates a positive experience for both the factory and the company as opposed to the negative experience in the traditional model.

The final step for the FLA in the FLA 3.0 process is public reporting of these results on an aggregate level."[41] While the FLA has not yet reached this final step, its goal is to establish a system of key LHR performance indicators for factories that eventually will be released on the FLA tracking charts. This moves its approach even further toward a public disclosure approach, in line with investors' need for quantifiable data.

Robust portfolio analysis of LHR risk requires something like both of the functions performed by the FLA. Investors need LHR statements that detail a company's internal monitoring system and the results of its factory inspections. And they need independent factory audits that verify those statements and the systems they describe. Despite the imperfections of the FLA's approach to both, its efforts in these regards adhere to the basic reporting principles outlined in the Introduction.

Despite the FLA's elaborate LHR verification efforts, detecting such abuses remains a challenge in the face of factories' incentives to hide them and the fear employees may feel about exposing problems. While no system can be foolproof, further independent checks can be found in public reports on the subject. In recent years, several companies have created data systems to collect and analyze public reports about such allegations. One is ECOFACT AG, a Zurich firm that offers a service called RepRisk.[42] A web search tool looks for any negative comment about environmental and social issues, including LHR ones, involving any public or private corporations in the world.[43] The company says that: "RepRisk's assessment of the environmental and social performance of a company is based on the company's activities in the field as observed by independent third parties, and is not derived from information provided by the company itself." "As of February 2009, RepRisk had identified 8,900 listed and non-listed companies as well as 1,600 projects that are viewed as controversial. On average five new controversial companies and projects are identified and entered into the database every day."[44]

RepRisk and similar services help investors to track and assess external reports about companies that may prove damaging to their reputation. A reputation index it creates offers the ability to compare companies, industries, and even countries on the frequency and severity of the negative reports about them. However, RepRisk is by definition anecdotal, since it relies exclusively on reports that external entities happen to issue about individual companies. It doesn't attempt to uncover LHR or other ESG risk factors a particular company may face through any investigation of its own. Still, the systematic collection of public reports on corporate LHR activities offers an alternative perspective on the results of internal and external factory monitoring systems. Given the flaws in direct factory audits, such reports could unearth alleged risks they fail to detect.

Similar systems have been developed by other companies that advise investors on ESG risks. For example, a Stockholm company called GES Investment Services screens global corporations for evidence of noncompliance with international social and environmental norms, including LHR ones found in the Global Compact and other human rights conventions.[45] GES gives investors recommendations about companies found to be connected to a violation by an "official and credible body;" have had sanctions issued against them "by regional/national courts or an official body;" or have admitted responsibility for the incident(s).[46] GES issues ESG risk ratings based on "official company documents, dialogue with companies, information from non-governmental organizations, the media and GES partners."[47] It also sends clients weekly news alerts on reported violations.[48]

GES's approach involves a degree of investigation of alleged ESG risks at individual companies, since it engages in direct dialogue with some if problems have been flagged. GES also will engage companies found in violation of an international norm on behalf of investor clients in an attempt to seek remediation. This service includes the filing of proxy resolutions.[49]

Section Two: Extra-Financial Accounting Standards Board

While the FLA's approach to monitoring offers investors a possible model for what an audited corporate LHR statement might look like, it leaves many questions unanswered. Investors who see the potential utility of such statements would need to confront major challenges posed by the principles of specificity and of independent verification. They would need to specify the LHR standards against which companies would be audited; how companies should choose auditing firms to perform audits; and the auditing standards that both the audits and the auditors would need to meet. Delineating these is particularly difficult for investors given the current lack of quantifiable LHR data that might be used to correlate existing codes or other potential sources of standards to corporate or portfolio performance. Still, ongoing attempts by monitoring associations and other entities involved in the LHR auditing process to address such concerns can help pension funds and other investors think about approaches that might serve their interests.

Section One of this paper said that the FLA's monitoring system is centered on the group's code of conduct. The code spells out specific LHR standards to which member companies must hold their suppliers. As such it goes much further toward satisfying the specificity principle than is the case with most global corporations. In 2008, nearly 80 percent of the 250 largest global companies issued a CSR report, up from about 50 percent in 2005, and 45 percent of the 2,200 largest companies, according to a survey by KPMG.[50] Of those, 89 percent of the 250 largest specified that they had a supplier code of conduct, while 74 percent of the 2,200 largest did so.

However, the bulk of these supplier codes say little about LHR, and those that do often lack specificity. Only 20 percent of 1,800 large global companies had a code that addressed labor issues, according to a detailed analysis of their CSR reports by RiskMetrics.[51] Only 10 percent of them had codes that specifically dealt with the core ILO conventions on freedom of association and forced labor, while only 6 percent mentioned the convention on the worst forms of child labor and just 3 percent referenced the one on equal remuneration. This data indicates that most large public corporations have defined no specific LHR standards, and the minority that do define them according to their own criteria. The analogy to financial reports would be if regulatory bodies gave no definitions of what constitutes basic categories such as revenue and profit and left their meaning entirely up to companies to specify as they wished.

Despite the relative specificity of the FLA's code, it is by no means accepted as the norm amongst companies that do have LHR supplier codes. Nor are the core ILO conventions. Similarly, there is no agreement among the major monitoring associations about the specific LHR standards to which companies and their suppliers should be held.[52] This has been one of several chronic complaints by both companies and factories, which have protested for years about the sometimes conflicting and confusing demands made by multiple monitoring groups with different labor codes. In 2003, four multi-stakeholder monitoring initiatives and two consumer pressure groups formed the Joint Initiative on Corporate Accountability and Workers Rights (JO-IN) to grapple with these complaints.[53] The broad goal was to attempt to find common ground among the initiatives.[54] As part of this process, JO-IN has been working to develop a single LHR code, using the ILO as an advisor. The group proposed a draft code in 2005, but continued to search for a consensus throughout early 2009.[55]

The issues that have blocked their consensus illustrate the challenges faced by investors who might want an LHR reporting system centered on a single code that all companies would adopt. To take just one example, the concept of a living wage has divided labor experts for years and plagued monitoring associations as well. Several of the groups involved in JO-IN have a living wage standard in their code, including the Ethical Trading Initiative, the Clean Clothes Campaign, and Social Accountability International.[56] However, the FLA consistently has rejected the idea as unworkable.[57]

Specifying LHR standards is even more difficult for investors since most of the debate amongst experts and monitoring associations over the years has revolved around efforts to reconcile normative concerns with the burdens placed on employers. Very little work has been done to determine which specific standards might correlate to corporate or portfolio performance. One way to begin that analysis would be for investors to ask that companies require suppliers to adhere to the eight core ILO conventions, which are widely accepted by most nations but not systematically enforced by the ILO (which has no enforcement mechanism).

Standards for audits and auditors have been equally divisive among monitoring associations. Ever since LHR factory monitoring began, the audit process has been beset by questions. Global corporations require suppliers to allow third-party monitors into their factories as a condition of securing a supply contract. But if factory managers distrust or resent the idea, as many have, they can make the process difficult. Audits also involve potentially sensitive issues that can inhibit candid responses, such as child labor, physical abuse of workers, or the violation of local laws on health and safety, wages, overtime, etc.

At the same time, some employees in low-wage countries may be poorly educated or intimidated by managers, which can hamper their ability or willingness to supply information to auditors. Language can be a barrier, too. Such challenges lead to a host of problems, such as what questions auditors should ask when they visit a factory, how to get employees to speak freely about possible violations, how to tell if management has coached them to give false or misleading answers, whether auditors must speak the local languages or be trained to ask delicate questions, and whether individual auditors and the auditing firms for which they work should be accredited to perform social audits.

Monitoring associations have grappled with these problems for years and have set up a variety of mechanisms to deal with them.[58] Recently, several efforts have begun to create industry-wide professional bodies to accredit LHR auditors. After several years of discussion, a group of LHR auditing firms founded in 2008 a non-profit organization called the Global Monitoring Institute.[59] Based in Washington, D.C., the Institute's goals are to establish standards for individual auditors and for auditing firms, and eventually to serve as a professional oversight body for the LHR auditing industry.

A similar effort, called Social Auditor Standards, was initiated in 2008 by two U.S.-based nonprofits involved in LHR auditing.[60] One of them, Verité, performs factory audits for global corporations as well as assessment of labor risk for pension funds. The other, the Center for Reflection, Education and Action (CREA), has done extensive research about monitoring and worked with companies to improve factory audits. The goals of the project, which is funded by the U.S. Department of State's Office of International Labor Affairs and Corporate Social Responsibility, also are to devise audit standards and an accreditation system.

Input from investors could potentially play an important role in both the setting of LHR standards and for audits. So far, the activities in both arenas have involved little consideration of the needs of investors, who have been largely absent from all the debates. Their involvement would help shape the emerging field and spur the development of audited LHR data that follows the principles outlined above. One approach would for investors to reach out to entities such as JO-IN, the Global Monitoring Institute, and Social Auditor Standards. Many factors have played into the inability of the global monitoring industry to agree on LHR and audit standards over the past decade. A fresh voice from a key stakeholder could help spur the process.

Ultimately, investors may need to institute some kind of Extra-Financial Accounting Standards Board (FASB) body to create and maintain suggested standards for the kind of robust LHR codes and audits envisioned in this paper. While groups such as JO-IN, the Global Monitoring Institute, and Social Auditor Standards are pursuing similar objectives, their ability to come to any agreement is unclear. In addition, none are focused specifically on the needs of investors, which may augment or differ from some of the discussions already underway. This is particularly true regarding investors' need for publicly reported data. Many of the advocacy and other stakeholder groups involved in supply-chain monitoring associations are motivated primarily by normative concerns about mitigating LHR abuses. Quantitative data disclosure traditionally has been a secondary issue for many, as evidenced by the fact that the FLA is the only association to require it to any significant degree. And even the FLA so far excludes reporting about the vast majority of supplier audits that take place through companies' internal monitoring systems.

Investors who desire market-wide LHR data must either start from scratch, or begin with the work already under way at existing entities such as monitoring associations. Either way, they require a common set of LHR and audit standards to which all such groups would adhere, just as companies and accounting firms now follow financial reporting and auditing standards set by the SEC, FASB, the IASB, and more recently the Public Company Accounting Oversight Board.

The history of FASB suggests that investors could participate or even take the lead in codifying detailed reporting protocols on LHR and other ESG factors, in conjunction with other private-sector stakeholders such as accounting firms and labor and human rights groups. The setting of official government standards by private-sector entities like FASB has a long history, particularly in the United States. Although the SEC has the statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934, it has always relied on private bodies to perform these tasks, with oversight by the commission.[61] From 1936 to 1973, the standards were set by the American Institute of Certified Public Accountants, a professional organization. In 1972, a nonprofit organization called the Financial Accounting Foundation (FAF) was created, which set up FASB the following year.[62] Since then, the SEC has officially recognized FASB as the body responsible for setting and maintaining reporting standards for public corporations. FAF created a similar entity for state and local governments in 1984 called the Governmental Accounting Standards Board.[63]

The rationale for FASB's standard-setting actions is very much in keeping with the goals of investors seeking ESG data. FAF says that the standards its constituent bodies set "are essential to the efficient functioning of the economy because investors, creditors, auditors, and others rely on credible, transparent, and comparable financial information."[64] FASB's mission is to perform the same kinds of tasks for this information that investors now seek for extra-financial ESG reporting:

"The FASB develops broad accounting concepts as well as standards for financial reporting. It also provides guidance on implementation of standards. Concepts are useful in guiding the Board in establishing standards and in providing a frame of reference, or conceptual framework, for resolving accounting issues. The framework will help to establish reasonable bounds for judgment in preparing financial information and to increase understanding of, and confidence in, financial information on the part of users of financial reports."[65]

Given the embryonic state of ESG reporting in general and LHR disclosure in particular, investors would be well served by an entity or entities that could address the many unresolved issues involved in extra-financial data. Although FAF and FASB have evolved into elaborate organizations with formal processes and rule-making procedures, at their core they are nonprofit private-sector groups run by representatives drawn from professional associations such as the American Accounting Association and the American Institute of Certified Public Accountants.[66] At least initially, investors could create a more informal entity to make suggestions on LHR reporting and auditing protocols.

Similar standard-setting advice will be required for other aspects of ESG reporting as well. Given how specialized each of these subjects can be, separate groups of experts may be necessary to address each area. Longer term, investors and corporations may be better served if all such efforts were combined into an EFASB-type structure that could coordinate input about all aspects of ESG standards. Such a structure would be similar to the one used by FASB, which is advised on technical issues by its Financial Accounting Standards Advisory Council.[67] The council is composed of more than 30 people drawn from the ranks of preparers, auditors, and users of financial information. An EFASB could be composed of separate advisory councils that each focus on environmental, social, and governance reporting.

Section Three: Investor Network on Sustainability Risk

Any attempt to spur quantifiable LHR reporting requires companies and regulators to be persuaded that doing so is vital to investor interests and well-functioning capital markets. Clearly the combined voices of institutional investors carry more weight with both than the disaggregated arguments of individual ones. Investor collaboration is even more important in light of the growing global nature of investment as well as mounting cross-border interest in LHR and other extra-financial information. Investors in Europe must persuade not just European corporations and regulators of the need for such data, but also those in the United States and other global markets. The same is true of U.S. investors and those elsewhere. Collaboration by global investors at this early stage would avoid the situation now faced with financial reports, which are governed by competing systems in the United States and other major capital markets.[68]

Investors in the United States have made a variety of attempts to spur LHR monitoring and reporting through the proxy resolution process. Many of these resolutions have been filed or supported by religious groups motivated more by ethical concerns than by a desire to boost portfolio returns. Still, the resolutions typically speak primarily of public concerns over LHR abuses and the potential impact on the company. The first were filed in 1995, when the Interfaith Center on Corporate Responsibility (ICCR) coordinated a handful of proposals calling on U.S. companies to adopt labor codes covering their maquiladora operations in Mexico.[69]

One of the earliest shareholder resolutions specifically calling on a company to adopt labor standards for its entire global supply chain and enforce them with independent monitoring was filed at Walt Disney Company in 1998 by seven religious pension funds and a nonprofit shareholder advocacy group.[70] It said that “The public is concerned about the conditions under which the goods they purchased and the clothing they wear are produced.” The resolution requested Disney to establish “independent monitoring programs in conjunction with local respected religious and human rights groups” and to issue “public disclosure of contract supplier reviews on a regular basis.” The resolution received only 8 percent of the votes cast.

Since then, U.S. shareowner groups, mostly public and religious pension funds, have filed dozens of similar resolutions at companies perceived to have serious LHR problems. Typically they have involved ad hoc coalitions of five or ten shareowner groups, many organized by the ICCR or the New York City pension funds, both of which have taken the lead on the issue.[71] The number of labor standard and LHR reporting proposals peaked at 47 in 2001 and fell to 13 in 2008, while average support from other shareowners grew from 5 percent in 1995 to a peak of 17 percent in 2004 and ranged from 11 percent to 15 percent through 2008.[72] However, such resolutions have won greater backing at individual companies. For example, New York City funds won 49.8 percent of votes cast on a 2006 proposal at Lear Corporation that requested the company to implement the ILO Human Rights Conventions and UN Human Rights Norms in their international operations, and allow for independent monitoring of compliance.[73]

Part of the falloff in the number of LHR filings stems from a pullback by the New York funds, which had spearheaded many of the shareholder campaigns and became somewhat disillusioned with the efficacy of supply-chain factory monitoring.[74]

However, initial successes drove down the filings as well. “The decline can in part be explained by a series of victories in persuading groups of industry peers to work on the issue together, most notably the electronics and auto industries. The Interfaith Center was successful in working with companies in both sectors to help create industry initiatives to eradicate labor abuses. All told, shareholder proponents struck seven withdrawal agreements in 2007, nine in 2006, eight in 2005 and five in 2004.”[75]

These withdrawals, a standard procedure with many U.S. proxy resolutions, have taken a variety of forms. Most involve an agreement by the company to institute an LHR code and accept some kind of independent monitoring, although the definition of independent audits varies. One of the earliest agreements came in 2000, when the New York funds convinced Nautica Enterprises and Polo Ralph Lauren to accept monitoring in exchange for withdrawing a monitoring resolution.[76] Each had similar wording, calling on the company to commit to a code of conduct based on ILO principles as well as to outside, independent monitoring of compliance with it.[77]

Ralph Lauren agreed to adopt ILO guidelines and independent monitoring, while Nautica agreed to adopt a code very similar to the FLA one and to engage Verite, the nonprofit LHR auditing firm, in a comprehensive monitoring program.[78]

There are some obvious drawbacks to using proxy resolutions to achieve widespread corporate reporting standards on LHR. It can be a cumbersome process to file resolutions at hundreds of companies, even assuming lead investors could convince the mainstream investment community to support them. In addition, the resolution process is little used in many markets outside the United States.

A second path investors could pursue would be to press for more detailed LHR information through voluntary corporate reporting groups such as the Global Reporting Initiative (GRI) and the United Nation's Global Compact. As currently constructed, neither fulfills the three principles outlined above.[79] The Compact falls short on all three fronts. GRI offers a greater degree of specificity about the LHR standards on which companies should report. But it does not require independent verification, or the public disclosure of quantitative data about companies' supply-chain compliance systems and the LHR violations and remediations those systems produce.

Still, the approaches of both groups contain the basic building blocks that could be used to develop more robust standards like those employed by the FLA. They also have a variety of efforts underway to improve corporate reporting on LHR issues. For example, in September 2008, the GRI and the International Finance Corporation announced a joint project to help companies in emerging markets improve how they measure, manage, and report on social and environmental issues.[80]

In January 2009, the GRI and the United Nation Environment Program's Finance Initiative released a proposal for ESG reporting standards by financial service firms.[81] The guidance is structured using GRI guidelines and includes a Social section with a variety of LHR and human capital indicators. Although the proposed reporting guidelines are voluntary, it was the product of a five-year study by Finance Initiative members from the global banking, insurance, and investment industries. As a result, it could evolve into a de facto reporting standard for those industries, at least among large international firms.

In December 2008, the GRI and the Global Compact, along with a stakeholder alliance called Realizing Rights, began a broader initiative to "significantly improve understanding of how and why to publicly disclose policies and practice relating to human rights and how to embed this better understanding into globally applicable reporting standards."[82] The initiative, named "Human Rights: A Call to Action," explained its purpose as follows:

"While respect and support for human rights has emerged as one of the key issues facing business, the quality of reporting on the subject is lower compared with other environmental and social topics. There is a need to improve the quantity of reporting and help generate practical examples of how reporting can improve. Improving reporting, however, requires two steps. First, there needs to be a will to focus on the issue and bring attention to it as an important part of any CSR or sustainability approach. Second, companies need more practical help and ideas in how best to approach reporting on this subject."[83]

Yet another UN organization, the Principles for Responsible Investment (PRI), has mobilized collective investor voices in pursuit of better and more detailed reporting on LHR and other ESG factors.[84] Some of its efforts illustrate the limitations of voluntary reporting that takes place without a developed framework constructed on basic reporting principles. In January 2009, a coalition of 38 investors organized through the PRI's Engagement Clearinghouse repeated a campaign begun a year earlier to police the reporting of 130 companies that had signed on as members of the Global Compact.[85] The coalition wrote letters to more than 100 firms taking them to task for failing to produce the annual Communication on Progress (COP) Compact signatories had agreed to file. One singled out as a laggard was Gap Incorporated. However, despite its failure as a Compact member, Gap has long been one of the leaders among companies engaged in supply-chain monitoring of LHR issues and has disclosed much more about its activities in this arena than Compact members that have been praised for their COPs.[86]

A third avenue investors could pursue would be to introduce concerns about LHR data into ongoing discussions about mandatory ESG reporting by corporations. There are already a few precedents for required reporting on extra-financial factors, although they do not come close to the detailed rules and regulations that govern financial reporting. Denmark, France, Malaysia, Sweden, the UK, and the city of Buenos Aires have some form of mandatory ESG reporting.[87]

French companies, for example, have been required to include discussions of environmental and social conditions affecting them in their annual reports since 2001.[88]

Britain put in similar requirements in 2006, making corporate directors explicitly responsible for considering the social and environmental effects of their decisions.[89] The act requires a narrative review in annual reports that must include information about how environmental, employee, and social issues affect the company's ability to create value. However, the concept had been resisted as overly burdensome by the business community and then-Chancellor of the Exchequer Gordon Brown. "But with Brown now in the Prime Minister's chair, it seems clear that the U.K. government, at least, is unlikely to complain too loudly if companies attend to this duty in only a cursory fashion."[90]

Denmark's law is the most recently enacted and may prove to be the most demanding. In December, 2008, the Danish Parliament passed a law requiring the country's 1,100 largest companies to include statements about their corporate social responsibility (CSR) policies in their annual financial reports.[91] As of January, 2009, covered companies had to begin reporting on any CSR standards they use, how they are implemented, and any achievements that result. However, the law does not require firms to have any CSR policies, and any that do not can simply state so in their annual report. The law also gives companies an incentive to join the United Nations PRI by allowing those that are working with it to satisfy the new reporting requirements with annual PRI reports. Denmark's law will go further in 2010, when companies will be required to have their CSR reports audited under specific guidelines the government plans to issue.

A more specific reporting requirement was promulgated in the United States in March 2009, although it is tailored only to climate change. The National Association of Insurance Commissioners, which develops uniform regulatory policies among state insurance commissioners, adopted a mandate that insurers with annual premiums of $500 million "disclose to regulators the financial risks they face from climate change, as well as actions the companies are taking to respond to those risks." Effective May 1, 2010, those insurers must complete "Insurer Climate Risk Disclosure Survey every year."[92]

Several investor and other groups have been pressing the European Union to adopt similar requirements. In 2008, the European Sustainable Investment Forum (Eurosif), an association of socially responsible investment funds, set up a working group to develop policy positions on the issue.[93] It also has been developing a coalition to press for mandatory ESG reporting in Europe that includes the Association of Chartered Certified Accountants, the International Corporate Governance Network, the European Corporate Governance Institute, and CSR Europe. In late 2008, Eurosif discussed the mandatory ESG reporting with Richard Howitt, the European Parliament spokesperson on corporate social responsibility. The group followed up by raising the idea at a February 10 forum on corporate social responsibility (CSR) held in Brussels February 10 by the European Commission.[94] After the session, Eurosif agreed with several CSR groups to develop a reporting framework and key performance indicators to submit to the Commission and members of the European Parliament.[95] Eurosif followed up in April with a policy paper calling on the Commission to initiate a collaborative effort with interested parties to create sector-specific indicators and amend existing laws to require their disclosure in corporate annual reports.[96]

GRI made a separate call in March that did not go quite as far for publicly traded companies, but extended to government-owned companies and other entities as well. It asked governments worldwide to enact policies requiring companies to either "report on ESG factors or publicly explain why they have not done so," but to require mandatory reporting by "state owned companies, government pension funds and public investment agencies."[97]

The United States has experienced various attempts to institute broad-based mandatory ESG reporting as well. In 2004, a coalition of investors called the Corporate Sunshine Working Group proposed that the SEC require more extensive disclosure of social and environmental risks affecting shareholder value.[98] The proposal spelled out 20 items companies should report on, including several LHR-related ones.[99] The initiative did not result in any action by the SEC.

Other investors made a renewed approach to the agency in 2008. In October, the Investor Network on Climate Risk (INCR) sent a letter to the SEC on behalf of 14 large institutional investors asking it to expand its public company reporting requirements to include ESG factors.[100] The request was made in response to the agency's request for public comment on a major corporate reporting overhaul it initiated that year called the 21st Century Disclosure Project. It asked the SEC to appoint a shareowner representative to the Initiative's advisory committee and to create a subcommittee to consider how material ESG data can be integrated into SEC filings. The letter was also an extension of a formal petition INCR had submitted to the SEC in 2007 asking it to issue guidance on what kind of climate-related disclosures public companies should provide to investors. INCR staff met with SEC staff, and a Senate hearing was held on the topic, but as of early 2009 the agency had issued no guidance.

INCR's request seeks more detail than the broadly worded mandates of Denmark and other countries, and potentially could encompass the kind of audited LHR statements considered in this paper. The group's letter points out that many large corporations already issue some type of CSR report or other statement about ESG policies. But as INCR's letter said: "While many companies disclose ESG information in their sustainability reports and on their web sites, investors say that is not always enough given the financial risks ESG factors can create."[101]

INCR itself represents one model investors might adopt to press for comprehensive LHR reporting and auditing standards. The coalition was started in 2003 by Ceres, a coalition of investors and environmental groups.[102] Its aim is to promote "better understanding of the financial risks and investment opportunities posed by climate change. INCR leverages the collective power of these investors to promote improved disclosure and corporate governance practices on the business risks and opportunities posed by climate change." The group's membership has grown from an initial 10 investors managing $600 billion in assets to more than 70 investors managing more than $7 trillion of assets as of early 2009. Members include asset managers, state and city treasurers and comptrollers, public and labor pension funds, foundations, and other institutional investors.

INCR has engaged in a broad range of actions aimed at getting companies to measure, disclose, and mitigate their behavior that affects climate change. Many are similar to those investors would need to pursue to achieve similar results on LHR and other ESG issues. In addition to its disclosure petitions to the SEC, INCR has negotiated agreements with dozens of companies about their climate change activities, lobbied Congress over carbon emission standards, published research on climate change, and set out a Global Framework for Climate Risk Disclosure, "a standardized set of guidelines for improving corporate disclosure on the risks and opportunities for climate change."[103]

A similar model for the pursuit of quantifiable LHR data can be found in the Carbon Disclosure Project (CDP), a UK-based nonprofit set up in 2000 that also helps investors around the world gain access to information about corporate reporting on the environment.[104] Since 2003, CDP has published detailed data on the carbon emissions of companies whose ranks now total more than 3,000.[105] CDP gathers the data via detailed requests to companies. Although CDP does not currently require company responses to be independently audited, an increasing number of participating firms do so on their own initiative. "Companies are encouraged to follow the GHG protocol (http://www.ghgprotocol.org), a globally respected greenhouse gas accounting standard, to measure emissions."[106]

Another approach involving collective investor engagement on LHR and ESG issues can be found in Scandinavia. In 2008, a group of Norway's largest institutional investors started the Sustainable Value Creation (SVC), which is backed by the Minister of Finance and includes among its members major government entities such as the Ministry of Trade and Industry, the state oil company, as well as the company that manages Norway's $21 billion civil service pension fund.[107] The coalition's goal is to press companies to adopt policies that will lead to long-term sustainability across a broad spectrum of ESG issues. It started by attempting to elicit better reporting on some of these subjects from major Norwegian companies, which it pursued through an elaborate questionnaire.

The subsequent report, which was released at the Oslo Stock Exchange in December, 2008, said: "Companies were asked about core elements of responsible and sustainable business conduct – human rights, labour rights, responsible business conduct, the environment, anti-corruption, and health, working environment, and safety (HES). Companies were asked whether they have policies that address these issues, the scope of these policies, and implementation and compliance processes, as well as how the policies and associated activities are reported and communicated. The survey also highlights board accountability for these areas."[108] The survey found wide variations in the way Norwegian companies manage and report publicly about these issues. Labor and human rights emerged as areas of particular weakness. After the report came out, SVC initiated an effort to expand its membership in Sweden and Denmark.[109]

Three institutional investors from Finland, Norway and Sweden started a related effort in late 2008 called the Nordic Engagement Cooperation.[110] The NEC's intention is to directly engage companies on ESG issues. "The NEC collaboration will be based on a systematic screening of approximately 4,500 companies in order to identify and examine possible violations of international conventions and guidelines on ESG issues. This typically leads to the identification of some twenty candidate companies for more in-depth assessment. Every year, the ambition is to conduct an active dialogue with around ten companies."[111] The Norwegian member of the NEC, the insurer and pension fund manager KLP, is also a member of the SVC, which is formally constituted as a KLP project. KLP officials said that they hope the NEC could be a platform for the expansion of the SVC into other Nordic countries.[112]

Eventually, it may make sense for investors to unite their efforts into an Investor Network on Sustainability Risk that would encompass all aspects of engagement on ESG issues. INCR has created a powerful and effective voice for investors on one aspect of the E, climate change. Some of the groups mentioned above are striving to pull together similar collaborations that can harness investors' collective clout on other extra-financial factors. Many of them involve a lot of the same leading pension funds and other investors, approaching the same companies and market regulators, all on different facets of ESG. In the long run, it may be more effective to combine forces.

Conclusion

Although a growing number of mainstream investors believe that social factors such labor and human rights can pose reputational and operation risk to companies and hence to investment portfolios, no one has worked out a way to gather quantifiable, independently audited data on them that is analogous to financial information. This paper suggests that such a goal is a plausible one and offers some specific steps to move in that direction. Companies like those in the FLA already have built LHR monitoring systems that produce data of this kind. While only a small portion of it is currently released publicly, more is likely to emerge in the future. Investors can build off these examples by asking other companies to follow suit.

Longer term, quantifiable LHR portfolio analysis will only become possible if companies across many markets adopt a common approach to LHR reporting. To make that happen, investors need to help shape the many discussions underway about LHR standards and audits. A number of such efforts already are under way. However, they remain uncoordinated and duplicative. Investor interests on these and other ESG issues would be magnified by greater coordination.

Investor interests may be served by adopting such strategies for all ESG reporting. The principles of specificity, verification, and transparency apply to all such extra-financial factors and require similar standards. Elaborate external intermediary bodies such as LHR monitoring associations may be less necessary in some areas. For example, investors may be able to rely on audited reports from companies about human capital and human resource issues that potentially affect portfolio performance. Factors such as employee turnover, productivity, team production systems, and health and safety practices involve practices controlled by the company and in that sense are more directly comparable to audited financial data than are supply-chain LHR risks.

However, robust portfolio analysis of any of these factors requires the specification of a common set of reporting and auditing standards. Companies and regulators also must be persuaded to adopt such standards. At this level, the challenge for investors is similar across all ESG factors.

A collective voice for investors on all extra-financial factors could be enhanced by closer coordination among groups focused on corporate governance. Investor efforts on the G are far more advanced than they are for E and S and have been going on much longer. Dozens of entities around the world are engaged in efforts to set governance standards for companies, from the ICGN and the Council of Institutional Investors to shareowner engagement firms, stock markets, investment funds that focus on governance, and numerous governmental bodies such as the International Finance Corporation and the Organization for Economic Cooperation and Development. A number of them have efforts under way to expand extra-financial reporting to the E and the S like the ICGN's guidance on the subject. Joint efforts along these lines would enhance the likelihood of success.

I would like to thank Larry Beeferman for his comments and for his support and that of Richard Freeman, and Elaine Bernard. I am also grateful to Pat Doherty, Sean Gilbert, Shawn MacDonald, Jorge Perez-Lopez, and Alan Willis for their suggestions and John Trumpbour for his able assistance with proof-reading. I would like to express appreciation to the Levi-Strauss Foundation and the Jacob Wertheim fund for financial support for this paper.

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2 There are myriad problems with public-sector reporting, as has been made abundantly clear over the years by corporate reporting scandals such as Enron and Arthur Andersen or, more recently, the Ponzi scheme run undetected by Bernard Madoff for decades. Similarly, the subprime crisis and subsequent financial-market collapse of 2008 demonstrated the lack of clarity of traditional financial statements. Still, critics on all sides tend to react by demanding better reporting and oversight, suggesting that the basic concept remains widely held.

3 "Corporate reporting needs to be forward-looking says ICGN in new Guidance on Non-financial Business Reporting," ICGN Press Release, December 10, 2008, available at: http://icgn.org/index.php.

4 "ICGN Statement and Guidance on Non-financial Business Reporting," ICGN report issued December 10, 2008, accessed January 14, 2009 at http://icgn.org/news/releases/ICGN_Statement_NFBR.pdf.

5 Ibid.

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Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School

The Pensions and Capital Stewardship Project focuses on issues of retirement security, including employment-based retirement plans, and pension fund governance and management. It is also concerned with institutions, systems, and practices of pension fund investment that encourage capital markets and corporate policies to work more effectively for workers and the health and well-being of the community at large. The Project does this through research, education, and engagement with scholars and researchers, workers and unions, and practitioners.

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