
Financing Environmental Change: A New Role for Canadian Environmental Law

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Financial institutions occupy a central role in equity and debt markets, providing the finance that shapes economic development and thus environmental pressures. Environmental regulation has traditionally focused on development itself but not those that financially sponsor developers. To achieve an environmentally sustainable economy in Canada, new regulations and policies to promote environmentally friendly financing in the financial services sector are necessary. This article explains why financing environmental change is crucial, surveys the main private financial institutions in Canada relevant to this task, and makes recommendations on how financial regulation and its broader institutional context can be reformed to support sustainable development.

Les institutions financières occupent une place centrale dans les marchés boursiers et obligataires. Elles fournissent les ressources financières modelant le développement économique et les pressions environnementales qui en découlent. Au Canada, la réglementation environnementale s'est traditionnellement concentrée sur le développement économique plutôt que sur son financement. Pour développer une économie durable, il est nécessaire d'énoncer de nouveaux règlements et politiques promouvant des pratiques de financement respectueuses de l'environnement dans le secteur des services financiers. L'auteur explique les raisons pour lesquelles il est crucial de financer le développement durable, passe en revue les institutions financières pertinentes à cet égard, et recommande des réformes de la réglementation financière et de son contexte institutionnel.

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Introduction	147
I. Environmental Aspects of Financial Markets	148
A. <i>Sustainable Development, Capital Allocation, and Financial Institutions</i>	148
B. <i>The Ethical Investment Movement</i>	153
C. <i>Environmentally Responsible Financing in Canada</i>	155
II. Reforming Financial Markets Regulation	162
A. <i>The Marginalization of Environmental Policy</i>	162
B. <i>Bringing the Environment into Financial Services Regulation</i>	168
C. <i>New Policies to Link Environmental Performance to Financial Performance</i>	171
D. <i>Addressing the Heterogeneity of the Financial Sector</i>	175
III. Regulating for the Financing of Environmental Change: The Wider Context	182
A. <i>Corporate Governance</i>	182
B. <i>Economic Instruments</i>	186
C. <i>Environmental Liability for Financial Sponsors</i>	189
D. <i>Corporate Environmental Reporting</i>	195
Conclusion	198

Introduction

Environmental regulation in Canada, as in most other nations, hardly addresses the financial services sector—the banks and investors that finance development. To most environmental lawyers, this might seem a strange comment, as the province of environmental law is not normally associated with banks, pension funds, or other financiers. If anything, those who trade in money are seen as rather environmentally innocuous or irrelevant, away from the main action, whether it be tackling forestry companies in British Columbia or prosecuting midnight polluters in Ontario. Although Canada has made great strides in improving its environmental laws since the 1970s, this lack of interaction between environmental and financial policy is arguably Canadian environmental law's greatest handicap. Because financial markets shape decisions concerning future development and thus resulting environmental pressures, the reform of investment, banking, and other financial services to promote more environmentally sensitive financing should be a government priority.

The challenge for Canadian policy reformers, therefore, is to find ways to embed environmental standards and responsibilities into financial markets. Quite simply, when granting a loan for a development project or investing in a company's shares, financial organizations must be encouraged to take into account the possible environmental impacts of their financing. Notions of environmentally responsible behaviour must be extended beyond the companies that develop, pollute, and consume to include the financiers that make possible—and profit from—these often harmful activities. While financiers might wish to eschew supporting polluting activities where such activities directly erode investment returns or pose a credit risk, more often than not, environmental considerations tend to be ignored or trivialized by financiers. “Defensive” banking to avoid obvious environmental risks and to check that clients meet existing environmental regulations is usually insufficient to promote substantial change in corporate environmental performance.

This article considers how financial institutions can be reformed to promote environmentally responsible financing (“ERF”). It begins by examining the relevance of financial markets to sustainable development and the various techniques by which ERF is currently being furthered in Canada. Differences between pension plans, mutual funds, and other financial organizations are highlighted, as environmental reformers need to be sensitive to the institutionally specific characteristics of financial market entities. More generally, the article also canvasses broader reforms to financial markets as a whole, such as corporate governance and environmental reporting improvements. In addition to the Canadian perspective, some pertinent reforms from other countries such as the United Kingdom, United States, and Australia are considered to illustrate possible new directions for Canadian environmental law.

I. Environmental Aspects of Financial Markets

A. Sustainable Development, Capital Allocation, and Financial Institutions

The biggest environmental impact of private financiers is not their own ecological footprint, but their strategic role in allocating capital to other businesses.¹ Since the financial sector sponsors and profits from economic development, it arguably should share responsibility for ensuring that such development does not harm the environment. If economic growth is to be kept within ecological limits, market institutions that finance growth must be given the right directions, incentives, and information so that financial resources shift from polluting industries in favour of environmentally benign activities. Once appropriately informed and guided, financial institutions would, through their investment decisions, conditions of financing, and monitoring of companies, become an instrument of environmental governance.² Given their ability to provide financial leverage, financial organizations are in effect “gate keepers” to the economy. Schemes to diffuse environmental policy more effectively through the market must therefore target those strategically placed financiers that have the capacity to communicate and enforce policy goals and standards.

Financial institutions are gate keepers principally because they have amassed vast empires of financial assets. The “institutionalization” of financial markets has put these assets increasingly into the control of banks, pension funds, and other financial institutions, rather than into the hands of individual retail investors.³ The contraction of public sector financing for development has also been a factor in shaping the phenomenal rise in the number of private financial institutions. Philanthropic bodies including religious groups, universities, and foundations also participate in financial markets, but the vast bulk of money flows through private financiers. In 1997, institutional investors including mutual funds owned nearly fifty per cent of all shares in Canadian publicly traded corporations, up from ten per cent as recently as 1988 and considerably higher than a miniscule one per cent in the late 1970s.⁴ By 1998,

¹ William L. Thomas, “The Green Nexus: Financiers and Sustainable Development” (2001) 13 *Geo. Int’l Envtl. L. Rev.* 899.

² For an elaboration of this theme see B.J. Richardson, *Environmental Regulation Through Financial Organisations* (Toronto: Kluwer Law, 2002) [Richardson, *Environmental Regulation*].

³ See Jeffrey G. MacIntosh, “The Role of Institutional and Retail Investors in Canadian Capital Markets” (1993) 31 *Osgoode Hall L.J.* 371 [MacIntosh, “Canadian Capital Markets”].

⁴ Canada, Senate, Standing Senate Committee on Banking, Trade and Commerce, “The Governance Practices of Institutional Investors”, online: Parliamentary Internet Parlemcnaire <<http://www.parl.gc.ca/36/1/parlbus/commbus/senate/com-e/bank-e/rep-e/rep16nov98-e.htm>>.

Canadian institutional investors had amassed financial assets equal to almost 116 per cent of the country's GDP, with pension funds holding the largest share.⁵

Financial service providers are also risk takers, seeking to profit from the transformation of capital into a development resource.⁶ Although businesses fund the majority of their investment projects from the income they generate through sales and other activities, both the development of new businesses and the expansion of established businesses often require turning to the financial markets. Businesses have two main choices for raising money in the financial markets—debt and equity financing. Firms perceived by financiers to pose a greater risk of business failure or underperformance can expect to pay higher rates of interest than others. Similarly, the higher rate of return required by equity holders will force the firm's stock price down.

Contrary to economic theory, however, empirical evidence suggests that financial markets do not always allocate capital efficiently. Unsustainable, speculative bubbles may suck in financial resources at some times, while underinvestment can arise at other times or in other sectors. Such distortions can be attributed to the "herd mentality" of investors, along with a preference for quick profits.⁷ In the process, financiers are prone to ignoring the social and environmental effects of company and project investments unless they are perceived as "financially relevant". Numerous studies highlight market failures to address environmental impacts, including the undervaluation of ecological properties, the discounting of future environmental costs and benefits,⁸ and an inability to address the problem of "scale", that is, keeping aggregate resource use in the economy within biosphere limits.⁹

Even critics who ignore the ecological weaknesses of financial markets acknowledge a telling distinction between the "real" economy and "real" investment on the one hand and the "financial" economy and its often ephemeral investments on the other.¹⁰ The real economy involves investments in functional goods and services, such as manufactured products, buildings and transportation, as well as investment in services such as health care and education. By contrast, the financial economy, managed by banks and investors, emphasizes securities trading and related activities

⁵ OECD, *OECD in Figures: Statistics on the Member Countries 2002* (Paris: OECD, 2002) at 58. As of mid-2001, pension plans managed assets valued at \$580.1 billion: Statistics Canada, *Quarterly Estimates of Trusteed Pension Funds: First Quarter 2002*, vol. 30:1 (Ottawa: Income Statistics Division, 2002) [Statistics Canada, *Quarterly Estimates*].

⁶ See Ron S. Dembo & Andrew Freeman, *Seeing Tomorrow: Rewriting the Rules of Risk* (New York: John Wiley & Sons, 1998) at 5-6.

⁷ See Adam Harnes, *Unseen Power: How Mutual Funds Threaten the Political and Economic Wealth of Nations* (Toronto: Stoddart, 2001) at 76-77.

⁸ See e.g. Richard Costanza et al., *An Introduction to Ecological Economics* (Boca Raton, FL: St. Lucie Press, 1997).

⁹ See Herman E. Daly, "Allocation, Distribution, and Scale: Towards an Economics That Is Efficient, Just, and Sustainable" (1992) 6 *Ecological Econ.* 185.

¹⁰ See e.g. Jim Stanford, *Paper Boom: Why Real Prosperity Requires a New Approach to Canada's Economy* (Toronto: J. Lorimer & Canadian Centre for Policy Alternatives, 1999) at 46-47.

which may have only a tenuous connection with productive investment. Most stock purchases do not provide new capital for real investment since the bulk of stocks traded are not newly issued corporate shares, but rather are traded between investors looking for profit. To illustrate, between 1990 and 1998, new stock issues by Toronto Stock Exchange-listed companies accounted for merely five per cent of the value of all shares traded on the exchange.¹¹ Moreover, a considerable portion of investment by financiers is directed to such securities. For example, some forty per cent of the total value of occupational pension funds in Canada is invested in stocks and thirty-seven per cent in bonds.¹² Consequently, conclude Baker and Fung, "insofar as the financial sector expands and pulls away more resources from the rest of the economy, it is diminishing the amount of resources available to produce goods and services of real value."¹³

Of course, some share trading not connected with initial investments can serve economically and environmentally valuable goals. The trading of previously issued shares provides investors with liquidity, which helps to ensure that capital is efficiently shifted to new investments as necessary. Share trading can also give investors additional incentives to seek information about the performance of existing companies, which affects their behaviour. For instance, if investors become aware that a company has been involved in a costly pollution incident, they may discount the value of its shares. A highly liquid share market, therefore, can provide a direct incentive for companies to avoid pollution controversies despite the apparently fleeting attention of money traders.

According to a more sanguine view of financial markets, the growing institutional character of investment activity is leading to a shift away from ephemeral and short-term trading activities to a preference for long-term, sustainable development. In their book, *The Rise of Fiduciary Capitalism*, Hawley and Williams herald the institutional investor as a new voice for promoting corporate social and environmental responsibility. This is because institutional investors are "universal owners" holding a broad portfolio of stocks and possessing an interest in the health and long-term sustainability of the entire economy rather than the profitability of individual businesses. Hawley and Williams argue that institutional investors, as long-term fiduciary investors and majority shareowners, are not concerned primarily with short-term returns on investment, but rather with long-term performance to meet the needs of their present and future beneficiaries.¹⁴ Similarly, Monks argues in *The New Global Investors* that the universal investor (or "Global Investor") "is likely to

¹¹ *Ibid.* at 23.

¹² Statistics Canada, *Quarterly Estimates*, *supra* note 5 at 8.

¹³ Dean Baker & Archon Fung, "Collateral Damage: Do Pension Fund Investments Hurt Workers?" in Archon Fung, Tessa Hebb & Joel Rogers, eds., *Working Capital: The Power of Labor's Pensions* (Ithaca: ILR Press, 2001) 13 at 36.

¹⁴ James P. Hawley & Andrew T. Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make America More Democratic* (Philadelphia: University of Pennsylvania Press, 2000) at xv-xvi.

make good decisions for the long-term of society, because it can afford in most cases to take a long-term view, and a diversified view. An ordinary domestic investor may need to reap profits in the short term.”¹⁵

This universal owner status, Hawley and Williams suggest, gives institutional investors an interest in public policy issues beyond traditional macroeconomic concerns, such as the environment, health, and other programs that help build human and physical capital. They state: “[A] universal owner that really wants to maximize the shareholder value of its portfolio would need to develop public policy-like positions and monitor regulatory developments and legislation on a number of key issues to the economy as a whole.”¹⁶ Accordingly, businesses favoured for investment are those operated in a financially, socially, and environmentally responsible manner that supports a healthy and sustainable economy. In turn, businesses that pay attention to environmental and social causes are expected to be stronger financial performers over the long term.¹⁷

These conflicting perspectives of financial markets can be somewhat reconciled by taking into account the institutionally specific characteristics of financial service organizations and the differences in their financial services and products. Financial organizations are not a homogeneous group, but retain institutionally particular characteristics arising from their individual legal forms and market sectors.¹⁸ There are, therefore, features of some financial institutions that could create or strengthen a preference for sustainable, long-term financing, particularly with the aid of certain environmental law reforms. For example, because of their extended liabilities, life insurance companies and pension funds should be biased toward longer-term investment.¹⁹ Banks also should have an interest in the sustainability of a borrower’s business to ensure loan repayment, which can often be contracted over a thirty-year period. The trend toward holding stocks in pooled index funds, rather than through ad hoc, short-term trading, should also reinforce incentives for sustainable financing.²⁰

¹⁵ Robert A.G. Monks, *The New Global Investors: How Shareowners Can Unlock Sustainable Prosperity Worldwide* (Oxford: Capstone, 2001) at 105.

¹⁶ Hawley & Williams, *supra* note 14 at 170.

¹⁷ See Ronald M. Roman, Sefa Hayibor & Bradley R. Agle, “The Relationship Between Social and Financial Performance: Repainting a Portrait” (1999) 38 *Bus. & Soc’y* 109; Jennifer J. Griffin & John F. Mahon, “The Corporate Social Performance and Corporate Financial Performance Debate: Twenty-Five Years of Incomparable Research” (1997) 36 *Bus. & Soc’y* 5.

¹⁸ Hawley and Williams indeed admit that the capacity of organized investors to promote sustainability is constrained by a variety of legal and institutional structures: Hawley & Williams, *supra* note 14 at 148.

¹⁹ See Paul L. Davies, “Institutional Investors in the United Kingdom” in D.D. Prentice & P.R.J. Holland, eds., *Contemporary Issues in Corporate Governance* (Oxford: Oxford University Press, 1993) 69 at 79.

²⁰ See John C. Coffee, Jr., “Liquidity Versus Control: The Institutional Investor as Corporate Monitor” (1991) 91 *Colum. L. Rev.* 1277 at 1288.

Mutual funds, however, are more competitive and are prone to myopic trading practices in the quest to grab profits to attract impatient customers.²¹

The responses of all types of financial institutions to environmental issues would appear at this stage to be driven primarily by the prospect not that an environmental problem per se will be costly to their corporate clients, but that the accompanying government environmental policies and regulations will be costly to clients. Although responsible environmental and social performance can sometimes be treated as a proxy for a financially well-managed company, the main factor that appears to encourage investors to respond to long-run sustainability issues is the possibility that their investors' failures may result in investors incurring tort or regulatory liability, the imposition of pollution charges, or the generation of other regulatory costs. This suggests that the mobilization of financial institutions as a force for environmental change cannot be divorced from existing environmental law regimes, although, as will be shown later in this article, some environmental laws are much more likely to encourage environmentally responsible financing than others.

One reason why institutional investors may fail to support sustainable financing is because the corporate bosses and money managers through whom they work tend to favour maximizing short-term gains to enhance their placement in the market.²² Often, because the rules of financial regulation require that persons be authorized to conduct investment business, investment decisions (particularly of pension funds) are delegated to authorized fund managers, such as money management firms.²³ Delegating investment strategies to fund managers raises agency problems, and surveys in Britain have shown that fund managers can deviate from the ethical investment policies dictated by their principals.²⁴

Another factor that can undermine sustainable financing is the practice among fund managers of constructing investment portfolios with a diversity of investments and risks, based on the precepts of modern investment portfolio ("MIP") theory. This theory holds that fund managers can mitigate the effects of specific risks associated with individual firms by holding a diversified portfolio that resembles the overall market.²⁵ Environmental and ethical investment screens would appear to conflict with

²¹ See generally Josef Lakonishok, Andrei Shleifer & Robert W. Vishny, "The Structure and Performance of the Money Management Industry" [1992] Brookings Papers on Economic Activity: Microeconomics 339.

²² See Robert A.G. Monks & Nell Minow, *Power and Accountability* (New York: HarperCollins, 1991) at 201-202; see also Allen Sykes, *Capitalism for Tomorrow: Reuniting Ownership and Control* (New York: John Wiley & Sons, 2000).

²³ See Davies, *supra* note 19 at 72.

²⁴ See UK Social Investment Forum, "Response of UK Pension Funds to the SRI Disclosure Regulation" by Eugenie Mathieu, online: UK Social Investment Forum, <<http://www.uksif.org/Z/Z/Z/lib/2000/10/reprt-pf-disc/index.shtml>>.

²⁵ See generally William F. Sharpe, *Portfolio Theory and Capital Markets* (New York: McGraw-Hill, 1970); Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance*, 7th ed. (Boston: McGraw-Hill/Irwin, 2003) at 187-94.

MIP theory, because screens can make investment portfolios less diverse and so more vulnerable to market fluctuations, thus possibly generating lower financial returns for beneficiaries.²⁶ The implementation of MIP-based investment portfolios can also lead to fragmented investor shareholdings, which can in turn reduce the leverage of individual financial institutions wishing to engage in shareholder activism—which as we will see is another technique of ethical financing.²⁷ Although the assumptions of MIP theory are considered problematic by many commentators²⁸—for example, because markets operate under imperfect information and institutional investors are too large to have a neutral impact on financial markets—MIP theory retains its prestige among financial regulators and underpins much financial law, which commonly emphasizes restrictions on concentrated ownership and fiduciary obligations that require extensive portfolio diversification.²⁹

B. The Ethical Investment Movement

The capacity of financial institutions to promote sustainable development was first recognized in the ethical investment movement. Beginning in North America and Western Europe in the 1970s, a limited number of financial entities—namely, pension funds, specialist ethical funds, and philanthropic foundations—began to *consciously* invest according to environmental, social, and other principles.³⁰ The potential of private financial organizations to be a force for environmentally and socially sound development is no longer regarded as quackery, but as a serious issue gaining some policy-makers' attention. For instance, the EU's *Fifth Environment Action Programme* (1992-2000) noted the environmental relevance of investors and lenders,³¹ while the United Nations Environment Programme launched a "Financial

²⁶ See Phillips, Hager and North Investment Management Ltd., "Does Socially Responsible Investing Hurt Investment Returns?", online: Phillips, Hager and North Investment Management Ltd. <http://www.phn.com/pdfs/SRI%20Articles/does_sri_hurt.pdf>; Robin Ellison, "The Golden Fleece?: Ethical Investment and Fiduciary Law" (1991) 5:4 Tr. L. Int'l 157.

²⁷ See J.E. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford: Clarendon Press, 1993) at 168-69.

²⁸ On the inefficiency of capital markets see e.g. Werner F.M. De Bondt & Richard H. Thaler, "Further Evidence on Investor Overreaction and Stock Market Seasonality" (1987) 42 J. Fin. 557; Bruce N. Lehmann, "Fads, Martingales, and Market Efficiency" (1990) 105 Q. J. Econ. 1.

²⁹ See W.A. Lee, "Modern Portfolio Theory and the Investment of Pension Funds" in P. Finn, ed., *Equity and Commercial Relationships* (Sydney: Law Book Company, 1987) 284 at 303; Michael E. Porter, "Capital Disadvantage: America's Failing Capital Investment System" (1992) 70:5 Harv. Bus. Rev. 65.

³⁰ On the emergence of ethical investment see John G. Simon, Charles W. Powers & Jon P. Gunneman, *The Ethical Investor: Universities and Corporate Responsibility* (New Haven: Yale University Press, 1972); Charles W. Powers, *Social Responsibility and Investments* (Nashville: Abingdon Press, 1971).

³¹ EC, Commission, *Towards Sustainability: A European Community Programme of Policy and Action in Relation to the Environment and Sustainable Development* (Luxembourg: EC, 1993) at 58 [EC, *Towards Sustainability*].

Institutions Initiative”, allowing banks and other financial entities to pledge themselves to specified sustainable development practices.³² Although Canadian governments have not yet sponsored any policy initiatives in this field, the National Round Table on the Environment and the Economy had the prescience to commission a report on the subject in 1992.³³ Despite the paucity of encouragement from governments, greater societal awareness of environmental problems has helped support a proliferation of environmental financial products.³⁴ These products include green mortgages, ethical mutual funds, and pollution damage liability insurance.³⁵

For corporate financing, there are three primary ways by which investors and lenders can promote corporate environmental performance. First, financial institutions may use positive and negative screens in lending and investment decisions. This process involves the application of social, environmental, and ethical guidelines or “screens” to the selection and retention of investments and loans.³⁶ Negative screens are criteria that exclude certain companies from financing, such as those with poor environmental records or human rights problems. An example of a positive screen criterion is a history of having made an exemplary contribution to environmental sustainability, such as developing new pollution control technologies. As there is no consensus on what qualifies as “environmental” or “ethical” financing, however, some form of public benchmarking or standard setting would seem appropriate. A second technique for promoting corporate environmental performance is economically targeted investment (“ETI”), which involves the financing of community development or microenterprise schemes that contribute to the welfare of local communities.³⁷ Third, shareholder activism and corporate engagement may be used to influence corporate policy and practice on social and environmental issues.³⁸ This influence can be applied through various methods, including proxy voting, corporation-shareholder dialogue, submission of shareholder proposals, and litigation.

³² UNEP Finance Initiatives, “Statement by Financial Institutions on Environment & Sustainable Development”, online: UNEP Finance Initiatives <<http://unepfi.net/fii/english.htm>>.

³³ See J. Anthony Cassils, *The Financial Services Industry and Sustainable Development: Managing Change, Information and Risk* (Ottawa: National Round Table on the Environment and the Economy, 1993).

³⁴ See Sonia Labatt & R.R. White, *Environmental Finance: A Guide to Environmental Risk Assessment and Financial Products* (New York: John Wiley & Sons, 2002) at 10.

³⁵ Insurance is another arm of the financial services sector that is highly relevant to environmental management, principally in relation to coverage for pollution risks. Insurance is not considered in this article, but see generally Benjamin J. Richardson, “Mandating Environmental Liability Insurance” (2002) 12 *Duke Env'tl. L. & Pol'y F.* 293 [Richardson, “Mandating”].

³⁶ See generally Peter D. Kinder, Steven D. Lydenberg & Amy L. Domini, *The Social Investment Almanac: A Comprehensive Guide to Socially Responsible Investing* (New York: Henry Holt and Company, 1992); Russell Sparkes, *The Ethical Investor* (London: HarperCollins, 1995) at 167-92.

³⁷ See Tessa Hebb, “Introduction: The Challenge of Labor’s Capital Strategy” in Fung, Hebb & Rogers, *supra* note 13, 1. ETI is discussed in greater detail below at text accompanying notes 80-92.

³⁸ See e.g. David Vogel, “Trends in Shareholder Activism: 1970-1982” (1983) 25:3 *Cal. Mgmt. Rcv.* 68; Andrew K. Prevost & Ramesh P. Rao, “Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds?” (2000) 73 *J. Bus.* 177.

Where corporations are largely self-financing, with little need for loans or capital through bond and share issues, shareholder activism becomes more important than ethical screens as a means to influence corporate behaviour.

Despite such laudable innovations, environmental investment and other forms of ethical financing are presently not widely practised. For example, in the Netherlands, ethical investment (excluding bank-based ethical lending) in 2000 amounted to a mere two per cent share of the nation's investment market,³⁹ compared to the US with a high of about twelve per cent.⁴⁰ The Canadian ethical investment market is also quite small, as discussed below.⁴¹ While the size of the ethical fund sector currently appears too small to influence sustainable development by generating a meaningful share price differential between more and less environmentally sound businesses, ethical funds are useful for providing liquidity for venture capital and other small, start-up businesses, which in turn can disseminate wider environmental benefits. Ethical funds can also be effective when they seek to target and affect a particular business's environmental practices.

C. Environmentally Responsible Financing in Canada

A number of investment and lending institutions in Canada are involved to various degrees in environmentally and socially responsible financing. These institutions range from specialist ethical mutual funds to large pension plans. Canadian ethical investment funds typically target a smorgasbord of concerns, of which the environment is merely one—albeit a primary—component. Churches led the way, establishing the Taskforce on the Churches and Corporate Responsibility (“TCCR”) in 1975 to tackle apartheid in South Africa and human rights abuses in other countries.⁴² In the 1980s, the TCCR successfully mobilized shareholder action to pressure Canadian banks to cease lending to South Africa. In addition to church groups, the labour movement in Canada emerged in the 1980s as a force for ethical investment through union-based pension funds and labour-sponsored venture capital funds.⁴³ The work of the church and labour sectors in turn helped pave the way for discrete ethical funds catering to individual retail investors and investment

³⁹ Ethical Investment Research Service, “Ethical Investment in Europe” at 4, online: Ethical Investment Research Service <www.eiris.org/Files/EIRISnewsletterPDFs/2000/SUPPJul_Aug00.pdf>.

⁴⁰ Social Investment Forum, *2001 Report on Socially Responsible Investing Trends in the United States* (Washington, D.C.: Social Investment Forum, 2001) at 2, online: Social Investment Forum <http://www.socialinvest.org/areas/research/trends/SRI_Trends_Report_2001.pdf>.

⁴¹ See Social Investment Organization, “Canadian Social Investment Review 2002”, online: Social Investment Organization <<http://www.socialinvest.ca/CSIR2002.pdf>> [SIO, “Social Investment Review”].

⁴² See Russell Sparkes, *Socially Responsible Investment: A Global Revolution* (Chichester, U.K.: John Wiley & Sons, 2002) at 311 [Sparkes, *Socially Responsible Investment*].

⁴³ See Jack Quarter *et al.*, “Social Investment by Union-Based Pension Funds and Labour-Sponsored Investment Funds in Canada” (2001) 56 *Relations Industrielles* 92.

institutions. These funds chose the mutual fund form as the vehicle for making investments. The first ethically screened mutual fund in Canada was the Ethical Growth Fund, founded in 1985. A decade later there were fourteen similar funds nursing assets of almost two billion dollars.⁴⁴ Concomitantly, the issue of ethical screens began to be considered by pension funds, including established public pension funds like the Ontario Teachers' Pension Plan Board.⁴⁵ This evolution in ethical investment in Canada has occurred without legislative imprimatur.

In terms of financial services regulation, institutions within Canada's financial services sector were historically segmented from one another, owing to regulatory constraints and high transaction costs.⁴⁶ Canadian financial services were divided into discrete branches (e.g., banking and insurance), each with its own legislative regime, which restricted each sector to a specific turf of financial services. There was a mix of federal and provincial legislation and governing financial regulators, but the regimes were sufficiently harmonized to ensure segmentation of financial service providers. After the mid-1970s and especially since the 1990s, financial markets were deregulated, resulting in a greater mixing of financial products and services across traditional institutional lines.⁴⁷ In particular, the Canadian banking industry has been dramatically transformed due to revisions to the federal *Bank Act* and related financial laws,⁴⁸ enabling banks to extend their financial services to securities trading. Many banks now operate their own mutual funds.

Nowadays, quantitative and prescriptive regulation of investment businesses in Canada has been substantially jettisoned in favour of regulation through prudential investment standards.⁴⁹ Solvency and liquidity requirements and consumer protection standards are the mainstay of financial regulation. The goals have been to protect depositors' and investors' funds and to avoid broader risks to money supply in the economy.⁵⁰ Prudential regulation of financial services is primarily the responsibility

⁴⁴ See generally Eugene Ellmen, *The 1998 Canadian Ethical Money Guide* (Toronto: James Lorimer, 1997) at 89-148; David Skinner, *The Ethical Investor: A Guide to Socially Responsible Investing in Canada* (Toronto: Stoddart, 2001).

⁴⁵ See Greg Crone, "Teachers Debate Ethics of Investing" *Financial Post* (12 April 1999) C1.

⁴⁶ This discussion draws upon Brian Z. Gelfand, *Regulation of Financial Institutions in Canada*, looseleaf (Scarborough, Ont.: Carswell, 1999) at para. 1.8; Jacob Ziegel, Leonard Waverman & David W. Conklin, eds., *Canadian Financial Institutions: Changing the Regulatory Environment* (Toronto: Ontario Economic Council, 1985).

⁴⁷ See Evelyn Kintner, "Politics and Deregulation in the Canadian Banking Industry" (1993) 23 *Am. Rev. Can. Stud.* 231.

⁴⁸ See e.g. *Bank Act*, S.C. 1991, c. 46; *Financial Consumer Agency of Canada Act*, S.C. 2000, c. 9.

⁴⁹ For example, the federal *Bank Act* provides: "The directors of a bank shall establish and the bank shall adhere to investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return" (*ibid.*, s. 465).

⁵⁰ See generally Edward Tasch & Stephen Viederman, "New Concepts of Fiduciary Responsibility" in Fritjof Capra & Gunter Pauli, eds., *Steering Business Toward Sustainability* (Tokyo: United Nations University Press, 1995) 125.

of the federal Office of the Superintendent of Financial Institutions (“OSFI”),⁵¹ which administers banking legislation and regulates federally chartered trust, insurance, loan companies, and pension plans.⁵² The provinces regulate provincially chartered financial institutions through their ministries of finance and securities commissions and are moving toward greater administrative centralization of their controls over financial markets. In Ontario, pension, trust, and insurance regulation has been brought under the auspices of the Financial Services Commission of Ontario. Similarly, in Quebec, the regulation of financial products and services has been amalgamated under a single financial services entity known as the Bureau des services financiers. Surprisingly, there is little regulation in Canada that specifically pertains to fund managers, although the potential for abuse of their position, conflicts of interest, and other maladies has been recognized in Canadian law reform discussions.⁵³

To date, however, there remains an enormous abyss between financial services regulation and environmental law. It is virtually impossible to trace any reference to the environment in Canadian financial laws. Like other countries, government strategy has been to treat environmental policy as a distinct sphere of concern, to be regulated by separate authorities and laws. Interestingly, the Department of Finance Canada published in 2001 a sustainable development strategy, but its focus is greening the Department’s internal operations rather than the much more serious agenda of the environmental impact of its laws and policies.⁵⁴

Although it has attracted little attention from regulators preoccupied with deregulation reforms, recent studies reveal an emerging niche for ethical financing in Canada’s financial markets. A national survey conducted in 2002 by the Social Investment Organization (“SIO”) found assets of environmentally and socially responsible investments as of June 2002 at \$51.4 billion, amounting to 3.3 per cent of the total investment market (slightly up from 3.2 per cent in the first survey in June 2000).⁵⁵ This investment included some \$16.7 billion in assets managed by investment management firms (acting for pension plans, religious institutions, and universities); a further \$4.32 billion of assets held by ethical mutual funds; and \$5.62 billion in labour-sponsored, venture capital funds. An additional \$24.1 billion was

⁵¹ The OSFI was established by the *Office of Superintendent of Financial Institutions Act*, R.S.C. 1985, c. 18.

⁵² These institutions are regulated pursuant to the *Insurance Companies Act*, S.C. 1991, c. 47; *Trust and Loan Companies Act*, S.C. 1991, c. 45; *Cooperative Credit Associations Act*, S.C. 1991, c. 48; and the *Pension Benefits Standards Act*, R.S.C. 1985 (2d Supp.), c. 32.

⁵³ See Industry Canada, *Investment Funds in Canada and Consumer Protection: Strategies for the Millennium* by Glorianne Stromberg (Ottawa: Industry Canada, 1998) at 113, online: Industry Canada <<http://strategis.ic.gc.ca/pics/ca/mainbody.pdf>>.

⁵⁴ Department of Finance Canada, “The Department of Finance 2001-03 Sustainable Development Strategy: Planned Results for 2003-04”, online: Department of Finance Canada <www.fin.gc.ca/susdev/SDSplan03_e.pdf>.

⁵⁵ SIO, “Social Investment Review”, *supra* note 41.

invested in assets of institutional investors (e.g., pension funds and investment banks) that manage their funds primarily or wholly in-house using social or environmental screens. A further \$453 million was the estimated value of shareholder activism (i.e., the value of shares voting in favour of initiatives to promote social and environmental issues). In the lending sector, the survey found some \$69 million devoted to community investment through credit unions and related community-based financiers and \$127 million in ethically responsible lending from banks. Whether these levels of financing will increase in years to come without any policy reforms is hard to ascertain, although public opinion and shareholder surveys show that Canadians increasingly prefer ethical investment.⁵⁶

In the US and UK, ethical investment has been facilitated by the creation of ethical investment indexes—the Dow Jones Sustainability Indexes⁵⁷ and the Financial Times Stock Exchange's FTSE4Good,⁵⁸ respectively. The Toronto Stock Exchange has not yet followed suit, although in January 2000, Canada's Michael Jantzi Research Associates ("MJRA") introduced the private Jantzi Social Index.⁵⁹ The rise of ERF in Canada has been aided by improved research and information on corporate environmental performance from entities such as MJRA and publications such as EthicScan Canada's Corporate Ethics Monitor.⁶⁰

As can be seen from the ethical investment statistics above, the majority of ethical financing in Canada occurs in the pension and ethical mutual fund sections. Occupational pension plans provided by employers hold over seventy per cent of the combined value of all pension schemes in Canada.⁶¹ The rise in assets held by Canadian pension plans in recent decades has been truly astonishing.⁶² Pension plans are governed by contract law and trust law overlain by pension legislation. Because pension plans are established specifically as a vehicle to invest employees' deferred salaries and provide them with a retirement income, pension fund trustees are subject to strict fiduciary duties that can discourage them from considering social and environmental factors in their investment decision-making.⁶³ While some of the major

⁵⁶ See e.g. Ian Jack, "Shareholders Support Social Values, Poll Finds" *Financial Post* (14 March 2003) FP5.

⁵⁷ See online: Dow Jones Sustainability Indexes <www.sustainability-index.com>.

⁵⁸ See online: FTSE4Good Index Series <www.ftse4good.com>.

⁵⁹ See online: Michael Jantzi Research Associates Inc. <www.mjra-jsi.com/jsi>.

⁶⁰ See Sparkes, *Socially Responsible Investment*, *supra* note 42 at 314.

⁶¹ See Statistics Canada, "Employer Pension Plans (Trusteed Pension Funds): Third Quarter 2002", *The Daily* (17 March 2003), online: Statistics Canada <<http://www.statean.ca/Daily/English/030317/d030317e.htm>>. The other type of pension schemes are state pensions (e.g., the Canada Pension Plan) and personal pensions that are privately arranged (e.g., an individual's registered retirement savings plan ["RRSP"]).

⁶² See Kirk Faleoner, *Prudence, Patience and Jobs: Pension Investment in a Changing Canadian Economy, Technical Report* (Ottawa: Canadian Labour Market and Productivity Centre, 1999); see generally Gordon L. Clark, *Pension Fund Capitalism* (Oxford: Oxford University Press, 2000).

⁶³ See Al Emid, "The Ethical Choice: It Takes a Steady Hand to Balance Fiduciary Responsibility with Ethical Goals" *Benefits Canada* 21:4 (April 1997) 89.

public occupational pension funds (e.g., Ontario Municipal Employees Retirement System)⁶⁴ and union-controlled pensions are adopting ethical investment policies,⁶⁵ most private pension plans in the corporate sector ignore environmental issues.⁶⁶

Unlike pension plans, mutual funds can be flexibly marketed to pursue a wide range of investment portfolios, including environmental ones. In 2002, some \$427 billion was invested in over 2,500 Canadian mutual funds, mostly established by banks and life insurance companies.⁶⁷ A mutual fund is essentially a financial intermediary administered by a fund manager that sells units (shares) to the public and invests the money it receives. Mutual funds offer investors low-cost access to professional management of their funds and to a diversified equity portfolio, which reduces the risk to their investment. Under the current legislation, mutual funds are subject to provincial securities laws, as harmonized through National Instrument 81-102.⁶⁸ Although only a small (albeit growing) proportion of these funds claim to be dedicated specifically to socially and environmentally responsible investment, there is no legal barrier to a mutual fund being established for an ethical cause. However, fiduciary obligations require that ethical mutual funds invest according to what they preach. A problem here is that “ethical investment” tends to be a self-awarded title; the institutions set their own criteria for what is ethical. The absence of any objective basis for determining what qualifies as “ethical” or “environmentally responsible” may impede the expansion of the ethical mutual fund market.⁶⁹ Furthermore, passively contributing to ethical investment funds arguably cannot be a substitute for proper ethical deliberation about questions of social and environmental responsibility in the market.⁷⁰ Deliberation is an important facet of shareholder activism, which may in some cases be the most appropriate method for influencing corporate management. The ethical mutual fund industry may consequently offer little more than an

⁶⁴ Ontario Municipal Employees Retirement System, “Statement of Investment Policies and Procedures for the Ontario Municipal Employees Retirement System”, online: Ontario Municipal Employees Retirement System <<http://www.omers.com/investments/statementofinvpol.html#social>>.

⁶⁵ See Quarter *et al.*, *supra* note 43.

⁶⁶ See Anne Pappmehl, “Sustainable Development and Your Portfolio: Does It Make Sense to Invest in a Company Known for Bad Environmental or Labour Practices? An Increasing Number of Pension Fund Managers Think Not” *Benefits Canada* 26:12 (December 2002) 49.

⁶⁷ Canadian Securities Administrators, “Striking a New Balance: A Framework for Regulating Mutual Funds and Their Managers” at 1, online: Manitoba Securities Commission <http://www.msc.gov.mb.ca/legislation/notices/81_402.pdf>.

⁶⁸ “National Instrument 81-102: Mutual Funds” (2000) 23:4 O.S.C. Bull. (Supp.) 59. On mutual fund governance see generally OECD, Directorate for Financial, Fiscal and Enterprise Affairs, *Governance Systems for Collective Investment Schemes in OECD Countries* by John K. Thompson & Sang-Mok Choi (Paris: OECD, 2001), online: Organisation for Economic Co-operation and Development <<http://www.oecd.org/dataoecd/3/3/1918211.pdf>>.

⁶⁹ See Michael S. Knowl, “Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment” (2002) 57 *Bus. Law.* 681; Craig Mackenzie, “The Choice of Criteria in Ethical Investment” (1998) 7 *Bus. Ethics: A European Review* 81.

⁷⁰ See Paul F. Ramshaw, “Ethical Investment: Retail Ethics and Participatory Democracy?” (1998) 29 *Cambrian L. Rev.* 105.

impoverished “retail ethic” that serves to sanitize people’s conscience without any fundamental challenge to the market status quo. Fortunately, the integrity of ethical mutual funds can be enhanced where there exist independent, ethical investment associations and research services that can help formulate criteria and methodologies for environmental and social investing.⁷¹

At the other end of the investment scale, the Canadian statistics reveal a disappointingly low level of bank-based ethical lending. The SIO figures, however, probably understate the extent to which social and environmental factors are incorporated into bank lending, because some lenders conduct environmental due diligence appraisals and related checks on regular loans.⁷² Further, some banks also provide environmental advisory services, particularly to the small business sector.⁷³ Nonetheless, Canadian banking regulation does not incorporate any specific environmental standards or procedures to encourage such practices. The OSFI, which supervises the banking sector, focuses only on keeping Canadian banks within the framework of risk-based capital standards. Presently, the only material source of legal “pressure” on Canadian banks to pay attention to the environment has come from pollution liability legislation, which has raised the possibility of lenders becoming jointly liable for the environmental harms caused by their borrowers.⁷⁴ As Canadian liability laws tend, however, to narrowly focus on contaminated land and water, rather than damage to biological diversity and other ecological attributes, the potential of existing environmental liability rules to encourage lenders to monitor their borrowers’ total environmental performance is reduced.

So far, there is little evidence that Canadian banks pay careful attention to the long-term environmental performance of borrowers. Indeed, Canadian banks have been publicly criticized for not being more open about the social and environmental aspects and effects of their financing.⁷⁵ Industry surveys have identified the Royal Bank as the most environmentally and socially responsible bank among mainstream Canadian lenders.⁷⁶ The only Canadian bank that has specifically cast itself as an ethical lender is the Citizens Bank of Canada, which in 2002 disbursed \$127 million in commercial loans that conformed with its ethical policy.⁷⁷ While the Canadian Bankers Association (“CBA”) has made public relations statements about the

⁷¹ See online: Social Investment Organization <<http://www.socialinvestment.ca>>.

⁷² See generally Jan Jaap Bouma, Marcel Jeucken & Leon Klinkers, *Sustainable Banking: The Greening of Finance* (Sheffield, U.K.: Greenleaf Publishing, 2001).

⁷³ See Labatt & White, *supra* note 34 at 75.

⁷⁴ See Scott G. Requadt, “Lender on a Hot Tin Roof: The Developing Doctrine of Lender Liability for Environmental Cleanup in Canada” (1992) 50 U.T. Fac. L. Rev. 194.

⁷⁵ See e.g. “Banks Urged to Disclose Ethical Issues in Reports” *Financial Post* (7 November 2002) FP2.

⁷⁶ See e.g. Harvey Schachter, “Beyond the Bottom Line” (1996) 103:5 *Canadian Banker* 24.

⁷⁷ SIO, “Social Investment Review”, *supra* note 41 at 6. See also Citizens Bank of Canada, *Ethical Policy Compliance Report 2001* (Vancouver: Citizens Bank of Canada, 2001), online: Citizens Bank of Canada <<http://www.citizensbank.ca/downloads/epr2001.pdf>>.

environment and banking,⁷⁸ apart from the usual self-interested statements about protecting banks from environmental liability, the CBA's contributions have been rather brief and superficial.⁷⁹

Another arm of Canada's ethical financing movement, ETI, targets economic investment to local communities, the underprivileged, and charitable causes. This work is relevant to the environment, as the promotion of social justice has long been recognized as a pillar of a sustainable society.⁸⁰ ETI in Canada is financed mainly through labour-sponsored venture capital funds and community credit unions. A venture capital fund is similar to a mutual fund but caters to investors prepared to take higher risks for the promise of greater returns.⁸¹ Venture funds invest in fledgling, private enterprises that encounter difficulties raising financing from conventional sources.⁸²

Through Labour-Sponsored Investment Funds ("LSIFs"), trade unions control some fifty per cent of the available venture capital in Canada.⁸³ The LSIFs were created under the auspices of provincial legislation, with statutory goals to promote collateral social and economic benefits to workers and to encourage worker involvement in fund management. Quebec was the first province to establish an LSIF, passing legislation in 1983 to establish the Solidarity Fund (Fonds de solidarité des travailleurs du Québec), under the financial sponsorship of the Quebec Federation of Labour.⁸⁴ Several other Canadian provinces have copied the Quebec model (e.g., British Columbia, Manitoba, and New Brunswick), although the Ontario model is less committed to ensuring worker control and ETI goals in order to aid workers.⁸⁵ In all provinces, however, the provision of tax breaks to LSIF contributions has helped to stimulate their growth, and this may have been a more salient driver than investors' desire to promote social goals.⁸⁶

Credit unions (and related co-operatives, such as the "caisses populaires" in Quebec) are also active in promoting ETI in local communities. A credit union is a

⁷⁸ See e.g. Canadian Bankers Association, "Your Business, Your Bank and the Environment", online: Canadian Bankers Association <<http://www.cba.ca/en/content/publications/environment.pdf>>.

⁷⁹ Canadian Bankers Association, "Lending and the Environment: What Are the Risks to Lenders?", online: Canadian Bankers Association <www.cba.ca/en/content/publications/lending_environment.pdf>.

⁸⁰ On social justice and sustainability see Igor Vojnovic, "Intergenerational and Intragenerational Equity Requirements for Sustainability" (1995) 22 *Envtl. Conservation* 223.

⁸¹ See generally Chris Bovaird, *Introduction to Venture Capital Finance* (London: Pitman, 1990).

⁸² See Edward A. Zelinsky, "The Dilemma of the Local Social Investment: An Essay on 'Socially Responsible' Investing" (1984) 6 *Cardozo L. Rev.* 111; Sarah Diefendorf, "Venture Capital & the Environmental Industry" (2000) 7 *Corp. Envtl. Strategy* 388.

⁸³ See Tessa Hebb & David Mackenzie, "Canadian Labour-Sponsored Investment Funds: A Model for U.S. Economically Targeted Investments" in Fung, Hebb & Rogers, *supra* note 13, 128 at 128.

⁸⁴ *An Act to establish the Fonds de solidarité des travailleurs du Québec (F.T.Q.)*, R.S.Q. c. F-3.2.1; Hebb & Mackenzie, *ibid.* at 129.

⁸⁵ See generally *Community Small Business Investment Funds Act*, S.O. 1992, c. 18.

⁸⁶ Hebb & Mackenzie, *supra* note 83.

distinct financial co-operative, owned and controlled by its members, who contribute personal savings into a common fund and in return receive low interest loans and annual dividends.⁸⁷ In the 1900s, Quebec was the first province to introduce credit unions, and this sector is virtually entirely regulated by provincial statutes.⁸⁸ As of 2001, Canada's credit union sector consisted of some 681 credit unions and 914 caisses populaires, with a total of 10 million members.⁸⁹ They hold approximately seven per cent of the total domestic assets held by Canadian financial institutions.⁹⁰

Registration as a credit union removes the need to comply with the more onerous regulation of ordinary banking businesses, but to be registered, members of the union must have something in common, such as being domiciled in the same neighbourhood or working for the same employer.⁹¹ As each member becomes a shareholder and has one vote, regardless of financial contribution, credit unions provide an alternative and more democratic form of financial management than that offered by other financial service organizations. Although credit unions and caisses populaires have traditionally focused on the provision of residential mortgage financing, consumer credit, and deposit services to members, they are also increasingly involved in ethical investment and ETI. A number have established ethical mutual funds, such as the Ethical Growth Fund founded in 1986 by Vancouver City Savings Credit Union.⁹²

II. Reforming Financial Markets Regulation

A. *The Marginalization of Environmental Policy*

It is not easy to integrate environmental policy into financial markets regulation. Governmental regulation of capital flows has principally been a response to market failures regarding information asymmetry, externalities, and monopolistic practices.⁹³ Market failures to protect the environment are not ordinarily seen as part of this remit.

⁸⁷ See generally Charles Ferguson & Donal McKillop, *The Strategic Development of Credit Union* (Chichester, U.K.: John Wiley & Sons, 1997).

⁸⁸ See e.g. Ontario's *Credit Unions and Caisses Populaires Act*, S.O. 1994, c. 11; see generally Canadian Co-operative Credit Society, *Canadian Credit Union Law: A Detailed Survey* (Don Mills, Ont.: CCH Canadian, 1987).

⁸⁹ Department of Finance Canada, "Canada's Credit Unions and Caisses Populaires", online: Department of Finance Canada <www.fin.gc.ca/toce/2003/ccu_e.html>.

⁹⁰ *Ibid.*

⁹¹ See e.g. *Credit Unions and Caisses Populaires Act*, *supra* note 88 at ss. 30(1)-(2).

⁹² See Carolyn Purden, "B.C. Fund Combines Ethics and Investment Growth" *Canadian Churchman* 113:5 (May 1987) 12. See also Ferne Burkhardt, "Credit Union Announces New Stewardship Initiatives" *Canadian Mennonite* 4:8 (17 April 2000) 23.

⁹³ See generally Tamar Frankel & Clifford E. Kirsch, *Investment Management Regulation* (Durham, N.C.: Carolina Academic Press, 1999).

In regulating financial markets, states have aimed not to replace market-based capital allocation with a command economy—which, as the experience of the former communist bloc showed, can produce massive economic inefficiencies and environmental problems—but rather to improve the efficiency and liquidity of capital allocation so that it can support broader economic activity. Financial reform in OECD countries has tended to be shaped by the “financial repression” thesis, namely, that state economic intervention to control where money flows risks provoking capital flight, fragmented capital markets, and other inefficiencies.⁹⁴ Instead, it is said that governments should confine themselves to broader, prudential regulation, aggressively intervening only in cases of destabilizing market abuses.

This “softy-softly” approach to financial markets regulation, while promoting capital liquidity that offers important economic benefits, has had the unfortunate effect of exacerbating market volatility and speculative booms that ultimately seem harmful to the economy and society.⁹⁵ Phillips’s *Political History of the American Rich* presents the growing “financialization” of the economy caused by the deregulation of financial markets. The effect of deregulation, claims Phillips, has been to fuel feverish stock market speculation, accompanied by accelerated economic inequality and the marginalization of communities and workers not considered relevant to this Wall Street economy.⁹⁶ The growing globalization of financial markets appears to be aggravating these effects.⁹⁷

While there is no apparent move in Canada or other OECD countries to re-engineer tighter state control over financial markets, new controls over banking and investment systems will surely be needed if governments are to promote sustainable financing. Governments’ existing techniques for environmental protection—encompassing planning, environmental impact assessment, pollution licensing, et cetera—have not achieved a sufficient realignment of economies toward sustainable development. Major international environmental studies demonstrate a continuing environmental decline in nearly all countries despite over three decades of legislative

⁹⁴ See Ronald I. McKinnon, *Money and Capital in Economic Development* (Washington, D.C.: Brookings Institution, 1973); Edward S. Shaw, *Financial Deepening in Economic Development* (New York: Oxford University Press, 1973); Glenn Yago, “Financial Repression and the Capital Crunch Recession: Political and Regulatory Barriers to Growth Economics” in Benjamin Zycher & Lewis C. Solomon, eds., *Economic Policy, Financial Markets, and Economic Growth* (Boulder, Colo.: Westview Press, 1993) 81.

⁹⁵ The Asian financial crisis of the late 1990s is a notorious example of these problems: see David C. Cole & Betty F. Slade, “The Crisis and Financial Sector Reform” (1998) 15 ASEAN Econ. Bull. 338. See generally Don Goldstein, “Uncertainty, Competition, and Speculative Finance in the Eighties” (1995) 29 J. Econ. Issues 719.

⁹⁶ Kevin Phillips, *Wealth and Democracy. A Political History of the American Rich* (New York: Broadway Books, 2002) at 108-12.

⁹⁷ See generally Ilhan Meric & Gulser Meric, eds., *Global Financial Markets at the Turn of the Century* (Amsterdam: Pergamon, 2001).

reform.⁹⁸ This indicates that a new approach that targets the underlying processes of capital allocation is needed. The mobilization of financial institutions as a driver for improved corporate environmental performance does not mean that existing, effective environmental law techniques should be abandoned, but rather that the targeting of the financial sector should *complement* and *supplement* existing methods. It is preposterous to suggest that banks or mutual funds could operate national parks or be urban planners; financial service providers' truncated expertise and management capacity preclude them from undertaking many of the specialist functions of modern government environmental agencies.

So what can be expected of financial institutions? Their value lies in financiers' strategic market position, which can be manipulated by government rules, information tools, and monetary incentives to enable environmentally sound companies to flourish at the expense of polluters and resource degraders. Financial institutions cannot amorously coordinate themselves toward any overarching environmental policy goals, such as reducing a given pollutant by a desired amount or conserving a given level of an environmental resource. Only the state can set such broad environmental policy goals, informed by public consultation and scientific evidence. The problem for the state, however, is that its existing tools have often not allowed the attainment of these objectives. In Canada, the government's ability to control greenhouse gas emissions, reduce pesticides, curb land clearing, and so on has been questioned in recent reports.⁹⁹ The solution is to tackle development patterns at source in the initial capital allocation processes and thereby reduce the number of polluting and environmentally destructive companies extant to make overall policy goals more achievable. In essence, a more environmentally responsible financial sector is one that will benefit society through its diffused, downstream effects on the economy, where there will arise many more Body Shops and Ben and Jerry's businesses and far fewer Union Carbides and Enrons. Regulation should aim not to impose pervasive and pedantic environmental requirements on financiers—an approach that would surely generate a bureaucratic leviathan—but rather to provide procedural mechanisms that facilitate and nurture the conditions for more environmentally responsible financing. The aim should be to create a process that encourages a culture in financial markets that is much more responsive to environmental concerns, not a regulatory straitjacket to meet prescribed goals.

Harnessing financiers as a mechanism for environmental change through liability rules, environmental risk reporting, economic incentives, and other procedural techniques would not only plausibly improve the environmental quality of our economy—as emerging reforms discussed later in this article demonstrate—but

⁹⁸ See generally Linda Starcke, ed., *State of the World 2003: A Worldwatch Institute Report on Progress Toward a Sustainable Society* (New York: W.W. Norton & Company, 2003).

⁹⁹ See e.g. David Richard Boyd, *Canada vs. the OECD: An Environmental Comparison* (N.p., 2001), online: Environmentalindicators.com <<http://www.environmentalindicators.org/ntdocs/PDF/FullReport.pdf>>. See also David R. Boyd, *Unnatural Law: Rethinking Canadian Environmental Law and Policy* (Vancouver: University of British Columbia Press, 2003).

would likely do so without unacceptable cost. How would this be possible? The key is to shift the nature of the environmental regulation system from being primarily about government inspectors laboriously verifying industry's compliance with rules to focusing more on encouraging financiers to implement environmental management processes which are then scrutinized by regulators. Rather than costly, inflexible, prescriptive regulation, the new system of incentives would aim to encourage key market institutions to establish processes of internal self-control to monitor and control economic activities harmful to the environment. Thus, companies and industries with a neutral or positive environmental performance seeking approval from the state to develop would have already passed the environmental appraisal systems of financial institutions. In contrast, firms potentially injurious to the environment would find their proposals grounded without the support of banks and investors. Government authorities would therefore be substantially relieved of the difficult cases, and development approvals and ongoing controls for the remainder could be more readily processed. With fewer environmentally harmful companies operating, the overall burden on the environmental regulatory system would be reduced. Of course, it must be acknowledged that such broad economic and environmental benefits to society would not necessarily be welcomed by the financial sector, given that it would carry a greater regulatory burden. If all financial institutions were required to reform their practices, the additional costs would likely be passed on to borrowers and clients. But this solution would not take away the political risks to the state that arise from disciplining financial markets.

Ever since the state became an agent for development, the generation of wealth and abundance has been the primary foundation of political legitimacy. The rise of the modern capitalist economy has been accompanied, however, by major environmental degradation and social inequality that call into question this economic *Zeitgeist*.¹⁰⁰ The state's options to address these side effects are limited. Lindblom portrays the market as a "prison" constraining public policy choices.¹⁰¹ The fact that capital is mostly in private hands means that state institutions are unable to directly organize economic production according to necessary environmental or social criteria. Regulators, in turn, often have a self-interest in giving preferential treatment to the agents of capitalism, as their prosperity is perceived as a prerequisite to regulators' own power in terms of maintenance of mass social loyalty and as a source of state revenue.¹⁰² Citizens tend to electorally reward governments that preside over periods of economic growth and to punish governments associated with economic

¹⁰⁰ On the environmental protest that can challenge growth politics see generally Judith I. McKenzie, *Environmental Politics in Canada: Managing the Commons into the Twenty-first Century* (Don Mills, Ont.: Oxford University Press, 2002).

¹⁰¹ Charles E. Lindblom, "The Market as Prison" (1982) 44 J. Pol. 324.

¹⁰² See Volkmar Lauber, "Ecology Politics and Liberal Democracy" (1978) 13 Gov't and Opposition 199 at 205-12.

decline. For these reasons, capitalist interests hold a special position of access to political decision making in market systems.¹⁰³

Because individual companies are unable or unwilling to address their own environmental impacts, the state must intervene selectively to address the most serious points of conflation. One of the basic factors of production—nature—can no longer assumed to be a given. The state is consequently in a quagmire in that it must restrict the mechanisms of capitalist accumulation to minimize their worst excesses while simultaneously allowing those same mechanisms to operate freely to produce the abundance necessary to satisfy the collective welfare.¹⁰⁴ A further aggravation is that the high public costs of implementing environmental protection and social welfare measures can exacerbate the budgetary crises that commonly afflict modern states.¹⁰⁵

One response that Western states have taken is to channel social protest away from the sphere of production to the domain of consumption.¹⁰⁶ The politics of consumption often involve less economically sensitive causes, such as urban amenities, housing, parks, and the like. Social protest tends to be channelled through the polyarchal institutions of the liberal democratic state, for example through opportunities to make submissions in environmental assessments and public inquiries.¹⁰⁷ While governments tend to be more willing to actively protect communities' local amenities and public health, interference in investment decisions and other aspects of the financial and production economy is much less tolerated. In Canada, for example, the Walkerton water contamination scandal provoked a swift government response to protect local drinking water,¹⁰⁸ but control of industrial greenhouse gas emissions—which Canada has apparently accepted as posing a serious and immediate threat to the planet, as evidenced by its recent ratification of the *Kyoto Protocol to the United Nations Framework Convention on Climate Change*¹⁰⁹—has been evaded or delayed by Canadian governments because of the higher stakes involved in regulating this aspect of economic production.¹¹⁰ The state's tolerance of consumption politics is also reflected by its seemingly anonialous approval of credit unions, building societies, and other types of democratically

¹⁰³ See Charles Edward Lindblom, *Politics and Markets: The World's Political-Economic Systems* (New York: Basic Books, 1977) at 170-88.

¹⁰⁴ See K.J. Walker, "The State in Environmental Management: The Ecological Dimension" (1989) 37 *Pol. Stud.* 25 at 32; on these contradictions see generally Claus Offe, *Contradictions of the Welfare State* (Cambridge, Mass.: MIT Press, 1987) at 119-29.

¹⁰⁵ See James O'Connor, *The Fiscal Crisis of the State* (New York: St. Martin's Press, 1973).

¹⁰⁶ See generally Manuel Castells, *City, Class and Power* (New York: St. Martin's Press, 1978).

¹⁰⁷ For an Australian perspective on these issues see John Cole, "Environmental Law and Politics" (1981) 4:1 *U.N.S.W.L.J.* 55.

¹⁰⁸ See Dennis R. O'Connor, *Part Two, Report of the Walkerton Inquiry: A Strategy for Safe Drinking Water* (Toronto: Ontario Ministry of the Attorney-General, 2002).

¹⁰⁹ 37 *I.L.M.* 32.

¹¹⁰ See Steven Bernstein, "International Institutions and the Framing of Domestic Policies: The Kyoto Protocol and Canada's Response to Climate Change" (2002) 35 *Pol'y Sci.* 203.

organized local financial institutions.¹¹¹ Yet these reforms have not disturbed the core of modern financial markets, and the existence of these institutions has been tolerated as a way to help fund improvements to living conditions and amenities for poorer communities and so maintain the legitimacy of financial markets.

For the state to direct where private financial institutions allocate capital in order to defend social and environmental causes would be a political disaster and would likely engender major economic inefficiencies given that regulators typically lack the required information and expertise. However, through national pension schemes governments could to some extent enhance public control over capital allocation.¹¹² The Swedish and New Zealand national pension schemes, for instance, have recently been amended to enable authorities to better direct funds towards social and environmental investments.¹¹³ In Sweden, the AP-fonden (National Pension Funds) must “take environmental and ethical considerations into account ... without relinquishing the overall goal of high return on capital.”¹¹⁴ In the case of New Zealand, the *New Zealand Superannuation Act 2001* specifies in paragraph 61(d) that a “statement of investment policies, standards, and procedures must cover (but is not limited to) ... ethical investment, including policies, standards, or procedures for avoiding prejudice to New Zealand’s reputation as a responsible member of the world community ...”¹¹⁵ No such equivalent duties exist in the *Canada Pension Plan Investment Board Act 1997*,¹¹⁶ which governs administration of Canada’s national pension safety net; indeed, the Pension Plan Investment Board has sustained criticism for some supposedly unethical investment choices.¹¹⁷

To influence private pensions and other commercial financial institutions, however, will require subtle and less intrusive techniques, and crucially, methods that offer profits from environmentally sound financing. Certainly, ecological modernization theory suggests that there can be a healthy synergy between economic development and environmental protection where economies and technologies are

¹¹¹ See generally Ferguson & McKillop, *supra* note 87; Alastair Hudson, *The Law on Investment Entities* (London: Sweet & Maxwell, 2000) at 276-94.

¹¹² See Roberto Mangabeira Unger, *Democracy Realised: The Progressive Alternative* (London: Verso, 1998) at 148-50.

¹¹³ See generally John Myles & Paul Pierson, “The Comparative Political Economy of Pension Reform” in Paul Pierson, ed., *The New Politics of the Welfare State* (Oxford: Oxford University Press, 2001) 305.

¹¹⁴ Tredje AP-fonden, *Third Swedish National Pension Fund Annual Report 2002* (Stockholm: Tredje AP-fonden, 2002) at 6, online: Tredje AP-fonden <http://www.ap3.se/upload/ap3_arsred2002_eng.pdf>.

¹¹⁵ (N.Z.), 2001/84, s. 61(d).

¹¹⁶ S.C. 1997, c. 40.

¹¹⁷ See Sandra Cordon, “Critics Call for Halt to CPP Investments in Tobacco Companies” *Canadian Press* (5 December 2002).

“modernized” to allow for more efficient and less wasteful development.¹¹⁸ Ecological modernization scholarship, however, has not yet looked at the financial services sector and the techniques that could promote a similar synergy for investors and lenders.

B. Bringing the Environment into Financial Services Regulation

How, then, can financial laws be reformed to facilitate environmentally responsible financing? Because private financial institutions will likely remain the dominant providers of development capital, governments should collaborate with financiers and share responsibility with them to achieve environmental policy goals. Harnessing financial service providers in this way would be congruent with broader shifts in patterns of modern governance oriented toward delegating and sharing responsibilities with the private sector. Because of the perceived advantages of the private sector in terms of its managerial skills, cost efficiency, and client knowledge, private organizations in many Western countries are being enlisted to deliver government policy in sectors ranging from health and education to local amenities and transport.¹¹⁹ In the environmental field especially, there is wide acknowledgement of the desirability of “sharing responsibility” with the private sector.¹²⁰

Such delegations of authority can be viewed in terms of the desire of policy-congested states, incapable of satisfying competing societal demands, to off-load some responsibilities to civil society and the market.¹²¹ Many regulatory theorists emphasize that government agencies operate increasingly in a pluralistic setting wherein effective governance resides in flexible, collaborative mechanisms by which state functions are shared with or devolved to private interests.¹²² Rather than mere “government”, which denotes hierarchical, state-based administration and implies a demarcation between public and private sectors, governance involves the contribution of, and interaction between, both state and non-state interests in ordering relationships and making policy. Strategies for governance rely upon a combination of rules, incentives, and informational mechanisms by which the state seeks to steer and coordinate the non-governmental sector.¹²³ Freeman also sees governance as a process

¹¹⁸ See Peter Christoff, “Ecological Modernisation, Ecological Modernities” (1996) 5 *Envtl. Pol.* 476; Charles O. Holliday, Stephen Schmidheiny & Philip Watts, *Walking the Talk: The Business Case for Sustainable Development* (Sheffield, U.K.: Greenleaf Publishing, 2002).

¹¹⁹ See generally John D. Donahue, *The Privatization Decision: Public Ends, Private Means* (New York: Basic Books, 1989).

¹²⁰ See EC, *Towards Sustainability*, *supra* note 31.

¹²¹ See generally Jurgen Habermas, *Legitimation Crisis*, trans. by Thomas McCarthy (Boston: Beacon Press, 1975).

¹²² See e.g. Martin Rein, “The Social Structure of Institutions: Neither Public nor Private” in Sheila B. Kamerman and Alfred J. Kahn, eds., *Privatization and the Welfare State* (Princeton, N.J.: Princeton University Press, 1989) 49.

¹²³ See Gerry Stoker, “Governance as Theory: Five Propositions” (1998) 50 *Int’l Soc. Sci. J.* 17.

of “negotiated relationships” between public and powerful private actors.¹²⁴ Because of their control over capital allocation, financial organizations are the kind of strategically placed organizations that should be part of processes of environmental governance. Schemes to more effectively diffuse environmental policy through the market must therefore address financial institutions that have the capacity, through their investing and lending decisions, to improve the dissemination of policy goals and standards.

The well-documented failings of command-and-control environmental regulation suggest that regulation-forced changes, such as mandatory financing of ethical causes and adoption of complex environmental performance standards, would likely be subverted by the financial sector.¹²⁵ Bodies ranging from the European Commission to the OECD that have examined environmental regulations have found serious problems and have called for alternative approaches that place more reliance on market institutions and methodologies and less emphasis on administrative governance.¹²⁶ While command regulation has yielded some ad hoc environmental improvements, such as reduced air emissions of lead and sulphur dioxide, the deployment of predominantly sector-based controls, organized, for instance, around pollutant-by-pollutant or industry-by-industry regulation, has produced economic inefficiencies and sometimes the displacement of the environmental problem rather than its resolution.¹²⁷ The extensive labyrinth of public controls on environmental activities exemplifies Susskind’s notion that modern governments have produced a “hyper-regulated” society.¹²⁸ Regulatory overload has manifested itself as ineffective law enforcement, unintended side effects, escalation of unresolved conflicts, and budgetary overruns for environmental agencies.¹²⁹

Drawing on the theory of autopoietic systems, Teubner and other regulatory theorists stress that the future of environmental law resides in the use of incentive, informational, and other procedural policy instruments, coupled with harnessing third

¹²⁴ Jody Freeman, “The Private Role in Public Governance” (2000) 75 N.Y.U. L. Rev. 543.

¹²⁵ On the failings of command environmental regulation see Klaus Bosselmann & Benjamin J. Richardson, “Introduction: New Challenges for Environmental Law and Policy” in Klaus Bosselmann & Benjamin J. Richardson, eds., *Environmental Justice and Market Mechanisms: Key Challenges for Environmental Law and Policy* (The Hague: Kluwer Law International, 1998) at 1-4; Bruce A. Ackerman & Richard B. Stewart, “Reforming Environmental Law” (1985) 37 Stan. L. Rev. 1333.

¹²⁶ See e.g. OECD, *Environmental Policy: How to Apply Economic Instruments* (Paris: OECD, 1991); EC, Commission, “Economic Evaluation of Environmental Policies and Legislation” by Risk & Policy Analysts Limited, online: Europa <http://europa.eu.int/comm/environment/envcco/others/environmental_policies_and_legislation.pdf>.

¹²⁷ See Richard B. Stewart, “A New Generation of Environmental Regulation?” (2001) 29 Capital U. L. Rev. 21.

¹²⁸ Richard Susskind, *The Future of Law: Facing the Challenges of Information Technology* (Oxford: Clarendon Press, 1996).

¹²⁹ On the limits of regulation generally see Gunther Teubner, “Juridification: Concepts, Aspects, Limits, Solutions” in Robert Baldwin, Colin Scott & Christophler Hood, eds., *A Reader on Regulation* (Oxford: Oxford University Press, 1998) 389 at 406-408.

party, non-governmental entities as mechanisms of governance.¹³⁰ This approach to environmental governance has important implications for strategic reliance on financial institutions as a mechanism of environmental change. The cognitive limits of substantive command regulation have been linked to the increasing “differentiation” of modern society. Parsons has theorized that modernization is fundamentally constituted by a process of differentiation that “disaggregates” society into various subsystems, such as politics, law, and the market.¹³¹ Taking this further, according to Luhmann’s theory of autopoiesis (meaning “self-production”),¹³² modern societies are essentially systems of *communication* comprising subsystems that are cognitively open (i.e., they can “observe” and absorb information from their surroundings) but operationally closed, as their mode of operation is not influenced by normative factors external to them. These subsystems therefore function self-referentially in accordance with their own norms and protocols.¹³³ The legal system can thus be understood as only one of a plurality of social systems, and as there is no single, functionally dominant system, policy-makers must rely on indirect mechanisms to influence the behaviour of companies and other entities, rather than attempt to engineer change through highly interventionist, prescriptive controls.

While one can question whether autopoietic theory can be readily transferred from individual organisms to social systems and disagree with its positivist connotations, the theory nonetheless assists our understanding of some of the underlying structural problems of contemporary environmental law (and other regulatory) systems.¹³⁴ The enormous expansion and intensification of environmental standards and rules in recent decades is now widely observed, and the inflexibilities and inefficiencies of command regulation tend to confirm the autopoietic thesis regarding the weaknesses of certain legal controls in directing economic behaviour. The implication of autopoietic theory, therefore, is that influencing the market “subsystem” through the mechanisms of law and politics will not be effective unless

¹³⁰ See Gunther Teubner, Lindsay Farmer & Declan Murphy, eds., *Environmental Law and Ecological Responsibility: The Concept and Practice of Ecological Self-Organization* (Chichester, U.K.: John Wiley & Sons, 1994); Neil Gunningham & Darren Sinclair, *Leaders and Laggards: Next-Generation Environmental Regulation* (Sheffield, U.K.: Greenleaf Publishing, 2002) at 189-204.

¹³¹ Talcott Parsons, *The Evolution of Societies*, ed. by Jackson Toby (Englewood Cliff, N.J.: Prentice-Hall, 1977); see also Niklas Luhmann, *The Differentiation of Society*, trans. by Stephen Holmes & Charles Larmore (New York: Columbia University Press, 1982).

¹³² Used by biologists and systems theorists, autopoiesis describes a self-referential system, where its elements are created by, and in turn generate, the operations of the system. An allopoietic system, by contrast, is one where the system’s elements are derived from the system’s environment: see Vladimir Degtiar, “Autopoietic-Allopoietic Approach to Social Systems” (2000) 1 *J. Applied Sys. Stud.* 31.

¹³³ See Niklas Luhmann, *Ecological Communication*, trans. by John Bednarz, Jr. (Chicago: University of Chicago Press, 1986). See also Gunther Teubner, “How the Law Thinks: Toward a Constructivist Epistemology of Law” (1989) 23 *Law & Soc’y Rev.* 727.

¹³⁴ For further analysis of the complexities and problems of autopoietic theory see Arthur J. Jacobson, “Autopoietic Law: The New Science of Niklas Luhmann” (1989) 87 *Mich. L. Rev.* 1647.

such intervention is conveyed in the norms and codes understood by the market.¹³⁵ In other words, using private financiers as mechanisms of environmental change requires deploying techniques that are reasonably congruent with the customs and structure of financial markets; environmental concerns must be presented in financially relevant terms. Autopoietic theory also suggests that the coordination of different subsystems can be advanced through organizations that straddle subsystem boundaries, which can enhance mutual understanding and link subsystem activities.¹³⁶ In this sense, financial organizations such as banks and investors can be seen as “boundary” institutions, straddling the economic and administrative subsystems of society. For example, banks exposed to rules of liability for financing environmentally harmful developments in turn can become a force for communicating environmental standards among borrowers to avoid liability-producing situations.

Because substantive regulation prescribing goals is unrealistic, policy-makers need to place greater emphasis on *procedural* techniques of regulation that can facilitate (but not dictate) change. Such procedural techniques include informational and incentive policy instruments that encourage greater awareness among regulatees of their social and environmental impacts. The emphasis on procedure can help implement, as Orts suggests, a “reflexive” style of legal regulation, whereby companies learn more about the cost of their impacts and adjust their behaviour accordingly in light of evidence, publicity, and pressure.¹³⁷ Environmental regulation that can be implemented through the existing structures and procedures of the financial services sector can thus potentially allow for more effective communication of environmental concerns and desired inmanagement changes than what is attainable solely through externally directed, administrative-based controls.

C. New Policies to Link Environmental Performance to Financial Performance

Crucial to this alternative approach to regulation is that corporate environmental performance must be made more financially relevant. This challenge has two aspects. First, there is the relationship between a company’s environmental and financial performance. Second, there is the question of whether ethical investment funds are more profitable than conventional funds. Regarding the first aspect, there is a growing body of empirical data being gathered on the profitability of companies that emphasize environmental performance.¹³⁸ There are also numerous studies that

¹³⁵ See generally Gunther Teubner, *Law as an Autopoietic System*, trans. by Anne Bankowska & Ruth Adler (London: Blackwell, 1994).

¹³⁶ See Bob Jessop, *State Theory: Putting the Capitalist State in its Place* (Cambridge: Polity Press, 1990) at 330.

¹³⁷ Eric W. Orts, “Reflexive Environmental Law” (1995) 89 Nw. U. L. Rev. 1227.

¹³⁸ See e.g. David Edwards, *The Link Between Company Environmental and Financial Performance* (London: Earthscan, 1998).

highlight a correlation between corporate environmental and social performance and share value.¹³⁹ They show in many cases that companies guilty of environmental regulatory offences suffer a far greater monetary penalty through reduced share value.

As regards the second aspect—profitability, although literature suggests that ethical investment can match or exceed conventional investment, the evidence is generally equivocal.¹⁴⁰ The reasons advanced by commentators for why ethical investment funds may produce superior returns include: ethical screening helps to identify companies that manage their risks and liabilities well; and ethical financing is congruent with and reinforced by a broader social movement concerned with environmental integrity.¹⁴¹ Because ERF is relatively young, however, there is little evidence that can be used to analyze the returns of using environmental screens. Many studies have therefore relied on back-testing techniques (i.e., reviewing existing data to calculate what would have happened in the past if a certain methodology had been used to construct an investment portfolio).¹⁴² Even if such methods reveal an ERF advantage, one must not overlook the additional transaction costs associated with using an ethical screen and the monitoring of companies' environmental performance. Another consideration is that investment returns in environmentally problematic industries and companies, such as the oil sector, would not likely be so profitable if these industries and companies had to pay for their full environmental impacts through pollution charges.¹⁴³

A requirement on companies to publicly report on their environmental activities and to present such information in financially relevant terms would be necessary to make environmental risk a more prominent factor in investment and lending calculations. Because shareholder activism is also a key means of articulating ethical financing preferences, reformers should also look at how financial institutions participate in their investee companies and publicly disclose their shareholder voting policies. Effective shareholder activism and other strategies of corporate engagement depend upon reforms to corporate governance to give a voice to shareholders and

¹³⁹ See e.g. Paul Lanoie, Benoit Laplante & Maité Roy, "Can Capital Markets Create Incentives for Pollution Control?" (1998) 26 *Ecological Econ.* 31; Paul Asmundson & Stephen R. Foerster, "Socially Responsible Investing: Better for Your Soul or Your Bottom Line?" (2001) 14:4 *Can. Investment Rev.* 26.

¹⁴⁰ See e.g. Michael V. Russo & Paul A. Fouts, "A Resource-Based Perspective on Corporate Environmental Performance and Profitability" (1997) 40 *Academy of Management J.* 534; C.A. Mallin, B. Saadouni & R.J. Briston, "The Financial Performance of Ethical Investment Funds" (1995) 22 *J. Bus. Fin. & Acc.* 483.

¹⁴¹ See Peter Camejo, *The SRI Advantage: Why Socially Responsible Investing Has Outperformed Financially* (Gabriola Island, B.C.: New Society Publishing, 2002) at 47-49.

¹⁴² See Sparkes, *Socially Responsible Investment*, *supra* note 42 at 243.

¹⁴³ See Camejo, *supra* note 141 at 7.

other interested stakeholders. Proxy contest requirements and shareholder communication rules are some of the current impediments to this voice.¹⁴⁴

A further tranche of necessary reforms is provision of better economic incentives. By taxing environmental harms such as waste emissions and resource depletion, governments can help convey in a more financially relevant way the costs and benefits of environmental activities. To be politically viable, however, eco-taxes would need to be offset by reductions in other types of corporate taxes. “Pricing” environmental use can thus be another building block for reforming financial regulation. Environmental liability rules can also affect the behaviour of environmental financiers, not only if the businesses they fund are hurt, but also if the financial sponsors are vicariously liable. Evidence from the US suggests that the targeting of lenders caused banks to alter quite dramatically their financing practices in response to the Superfund contaminated land cleanup legislation.¹⁴⁵ The role of these and other techniques in creating a more supportive framework for environmental financing is considered later in this article.

Apart from getting the right mix of financial incentives and reporting requirements, the internal governance of financial organizations should be reformed. People who contribute to investment funds arguably should be consulted on how the administration and investment decisions of those funds are conducted. In relation to pension funds, for instance, elements in the labour movement have struggled for years to strengthen worker control of their pension plans to ensure that they only invest in industries and companies known to treat workers well.¹⁴⁶ In 1976, Drucker prematurely claimed in *Unseen Revolution: How Pension Fund Socialism Came to America* that the US was the world’s first socialist country because workers, through their pension funds, had come to own a significant stake of the equity capital of American businesses.¹⁴⁷ Drucker overlooked, however, the fact that the pension plan beneficiaries neither controlled nor directed the corporations in which their pension monies were invested and also ignored the fact that corporate management typically appointed the trustees that control occupational pension plans.¹⁴⁸ Presently, labour movement activists in Canada and elsewhere are attempting to acquire greater representation on pension fund boards of trustees, either through joint or sole trusteeship or by establishing advisory boards to these bodies.¹⁴⁹ The prospects for

¹⁴⁴ See A.A. Sommer, Jr., “Corporate Governance in the Nineties: Managers vs. Institutions” (1990) 59 U. Cin. L. Rev. 357.

¹⁴⁵ See Richard K. Harper & Stephen C. Adams, “CERCLA and Deep Pockets: Market Response to the Superfund Program” (1996) 14:1 Contemp. Econ. Pol’y 107.

¹⁴⁶ See Peter F. Drucker, *The Unseen Revolution: How Pension Fund Socialism Came to America* (New York: Harper & Row, 1976).

¹⁴⁷ *Ibid.* at 1.

¹⁴⁸ See Jeremy Rifkin & Randy Barber, *The North Will Rise Again: Pensions, Politics and Power in the 1980s* (Boston: Beacon Press, 1978) at 11-12 (discussing US pensions).

¹⁴⁹ Freya Kodar, *Corporate Law, Pension Law and the Transformative Potential of Pension Fund Investment Activism* (LL.M. Thesis, Osgoode Hall Law School, 2002) [unpublished] at 57.

democratizing pension administration appear to be greatest in union pension funds and public pensions, because they are less closely tied to market pressures and because corporate management does not appoint their pension fund trustees.¹⁵⁰ Quebec pension legislation goes the furthest in Canada in providing for worker control through election of worker representatives on pension management committees.¹⁵¹

Finally, the prudential controls governing financial organizations would also need to incorporate environmental risk factors. There could be scope within existing regulatory parameters for financial regulators to impose some environmental standards as conditions of financial institutions' authorizations. For instance, lenders and investment institutions could be obliged to report on the environmental profiles and risks of their financing activities. At a minimum, this would seem to require maintenance of ethical investment disclosure obligations. Further, investors and lenders arguably should be obliged to *consider* the social and environmental effects relevant to the companies and projects they finance. Essentially, this would be a model of environmental appraisal, complementing existing governmental systems of environmental impact assessment. Already, the insurance sector undertakes a similar surrogate regulatory role in relation to the management of pollution liability risks.¹⁵² Of course, to expect financiers to appraise and report on the environmental activities of their clients would be a wasteful and costly exercise if regulators did not offer clear guidelines and establish verification and auditing mechanisms. Work on standardizing possible evaluation criteria is already being made by various bodies, such as the UK's Department for Environment, Food and Rural Affairs¹⁵³ and the Ethical Investment Research Service ("EIRIS").¹⁵⁴ Indeed, the contribution made by ethical advisory and research bodies such as EIRIS in evaluating corporate environmental performance points to a seminal role such bodies can play in the emerging networks of environmental governance. In reforming financial regulation, lenders may also need to be offered incentives to introduce differential interest rates (and hence the cost of capital) to reflect the environmental risks of different types of development.¹⁵⁵ For example, the Netherlands in 1995 introduced a Green Investment Directive to provide

¹⁵⁰ Marleen O'Connor, "Labor's Role in the Shareholder Revolution" in Fung, Hebb & Rogers, *supra* note 13, 67 at 69.

¹⁵¹ *Supplemental Pension Plans Act*, R.S.Q. c. R-15.1, s. 147(1).

¹⁵² See Richardson, "Mandating", *supra* note 35.

¹⁵³ Corporation of London, *Financing the Future: The London Principles: The Role of UK Financial Services in Sustainable Development* by Forum for the Future (London: Department for Environment, Food and Rural Affairs, 2002), online: Forum for the Future <http://www.forumforthe future.org/uk/uploadstore/London%20_principles_full_report.pdf>.

¹⁵⁴ Ethical Investment Research Service, "Corporate Environmental Management, Policy and Reporting", online: Ethical Investment Research Service <<http://www.eiris.org/Files/Otherpublications/EMSPAPER.pdf>>.

¹⁵⁵ In the home loan and building financing markets, some lenders are offering "green mortgages" as a way of meeting consumer demand for environmentally friendly, energy-efficient houses. See Labatt & White, *supra* note 34 at 72.

tax deductions for interest payments and dividend yields from approved environmental investment funds.¹⁵⁶

To ensure that financial regulators would monitor compliance with such environmental provisions, it would also be necessary to impose certain fundamental environmental duties in the main financial statutes. In the UK, for instance, during drafting of the *Financial Services and Markets Act 2000*,¹⁵⁷ the UK Social Investment Forum unsuccessfully argued before the House of Commons Environmental Audit Committee that the act should include a reference to sustainable development in the Financial Service Authority's mandate and the Authority should be required to promote the provision of environmental investment and environmental lending products.¹⁵⁸ Ultimately, environmental protection has to be legislated as a core duty of financial regulators to ensure that it is not trivialized as a marginal statutory responsibility.

Overall, the aim of government regulation should be primarily to make corporate *environmental* performance relevant to financial institutions' evaluation of corporate *economic* performance. Without such a synergy, environmental policy measures will likely be resisted by financial organizations as a set of extraneous, imposed requirements. Bringing private financiers into the web of environmental governance must rely principally upon provision of incentive and informational tools, rather than authoritarian mechanisms. Financial institutions can assist in the environmental governance of markets as investors supplying the resources for environmental initiatives; as stakeholders exercising influence over corporate management; and as valuers evaluating and pricing businesses' environmental risks. As financiers become more sensitive to the social and environmental sequelae of their decisions, they should become an increasingly important means of transmitting and amplifying environmental policy through the economy.

D. Addressing the Heterogeneity of the Financial Sector

Reforming the financial services sector to make it more responsive to environmental and social concerns must also address the legal and market context of specific financial institutions. The financial services sector is a heterogeneous phenomenon. Despite market liberalization reforms that have encouraged convergence

¹⁵⁶ See Marcel Jeucken, *Sustainable Finance and Banking* (London: Earthscan Publications, 2001) at 92-94.

¹⁵⁷ (U.K.), 2000, c. 8.

¹⁵⁸ UK Social Investment Forum, Press Release, "UK Social Investment Forum Tells MPs of Need to Include Environment in Framework for Financial Services Regulator" (19 April 1999), online: UK Social Investment Forum <<http://www.uksif.org/Z/Z/Z/lib/1999/04/19a-press/index.shtml>>. Substantial policy work has been undertaken in many countries on defining the management principles of "sustainable development", and it is now widely referenced in legislation throughout the world, including the *Canadian Environmental Protection Act, 1999*, S.C. 1999, c. 33, s. 3 [CEPA]. On what sustainable development may mean for the financial services sector see Corporation of London, *supra* note 153.

and assimilation of financial services, financial organizations retain distinctive institutional characteristics shaped by their legal structure and obligations, the nature of their financial services, and the influence of market forces involved. Consequently, financiers may respond differently, and sometimes less effectively, to the same environmental reforms. Pension schemes and mutual funds—two of the largest financial institutions in the Canadian market—have quite different legal personalities and financial objectives and illustrate this caveat quite well.

Occupational pension funds are unique in that they are established to pay benefits upon their members' retirement.¹⁵⁹ The consequential fiduciary obligations on fund trustees can hamper ethical investment. Although Canadian courts have hardly considered the issue, there are several cases in the UK and US where the relationship between ethical investment and pension fund trustees' fiduciary responsibilities were considered.¹⁶⁰ In Britain, notions of fiduciary responsibility were interpreted in *Cowan v. Scargill*,¹⁶¹ *Martin v. City of Edinburgh District Council*,¹⁶² and *Harries v. Church Commissioners for England*¹⁶³ as constraining pension fund trustees from embracing ethical criteria in investment policy.¹⁶⁴ This constraint arises because the best interests of trust beneficiaries have generally been considered as their *financial* interests. The genesis of this approach is in the conception of trusts in the nineteenth century as a means of protecting family wealth over succeeding generations.¹⁶⁵ In *Harries*, Donald Nicholls V.C. accepted that there were at least two exceptions to the duty to maximize financial returns; namely, where the aims of the charity and the objects of investment would conflict and where particular investments would detract from the charity's work, the trustees must weigh the extent of financial loss from offended supporters and the financial risk from exclusion.¹⁶⁶ In the US case of *Board of Trustees of the Employees' Retirement System of the City of Baltimore v. Mayor and City Councillors of Baltimore*,¹⁶⁷ a court found that a city ordinance requiring a municipal authority pension fund to disinvest from companies engaged in business in South Africa did not cause trustees to violate their prudential investment duties so long as the cost of investing according to social responsibility precepts was *de minimis*.

¹⁵⁹ On the development and role of pensions see generally Robin Blackburn, *Banking on Death, or, Investing in Life: The History and Future of Pensions* (London: Verso, 2002).

¹⁶⁰ See James D. Hutchinson & Charles G. Cole, "Legal Standards Governing Investment of Pension Assets for Social and Political Goals" (1980) 128 U. Pa. L. Rev. 1340; David Hayton, "English Fiduciary Standards and Trust Law" (1999) 32 Vand. J. Transnat'l L. 555.

¹⁶¹ (1984), [1985] Ch. 270, [1984] 2 All E.R. 750, [1984] 3 W.L.R. 501.

¹⁶² (1987), [1988] S.L.T. 329 (Ct. Sess.).

¹⁶³ (1991), [1993] 2 All E.R. 300, [1992] 1 W.L.R. 1241 [*Harries* cited to All E.R.].

¹⁶⁴ For analysis see J.H. Farrar & J.K. Maxton, "Social Investment and Pension Scheme Trusts", Note (1986) 102 Law Q. Rev. 32.

¹⁶⁵ On the roots of trusts see Alastair Hudson, *Principles of Equity and Trusts* (London: Cavendish Publishing, 1999).

¹⁶⁶ *Harries*, *supra* note 163 at 304.

¹⁶⁷ 562 A.2d 720 (Md. C.A. 1989).

Although there is growing evidence that pursuing an ethical policy does not necessarily mean lower financial returns—and may actually enhance returns through avoidance of companies that pose costly environmental risks—there have been no emphatic judicial decisions on this aspect of trustees' fiduciary duties. In Canada, there is a dearth of case law on ethical investment altogether, although courts have unequivocally affirmed that pension funds are subject to trust law precepts as clarified by statute.¹⁶⁸ Both Manitoba and Ontario, however, have enacted legislation to improve the prospects for ethical investment. Following recommendations from the Manitoba Law Reform Commission, in 1995 the province's *Trustee Act*¹⁶⁹ was amended to explicitly permit trustees to consider non-financial criteria in developing investment policies.¹⁷⁰ In 1988, Ontario enacted the *South African Trust Investments Act*¹⁷¹ to permit trustees to divest or to reject investments in companies doing business in apartheid South Africa without infringing their duty despite the effect on investment proceeds.

More radical possibilities for reform of pension funds can be found overseas. One way in which pensions could become an instrument of environmental change is through legislative requirements for trustees and their agents to take account of the environmental effects of their investment decisions, if any, or at least to publicly report on their policies in this respect. The UK was the first country to take a bold step in this direction when, in July 1999, the government amended a regulation under the *Pensions Act 1995*¹⁷² in order to require occupational pension fund trustees to disclose their policies on socially responsible investment and on the exercise of shareholder rights, including voting rights.¹⁷³ A similar requirement was imposed on local government pension funds.¹⁷⁴ This UK initiative stimulated similar reforms in several European countries and Australia.¹⁷⁵ The SIO has been lobbying for such a reform in Canada, and it supported an unsuccessful attempt in September 2002 to pass at the federal level an opposition private member's bill modeled on the UK

¹⁶⁸ *Bathgate v. National Hockey League Pension Society* (1994), 16 O.R. (3d) 761 at 776, 110 D.L.R. (4th) 609 (C.A.), leave to appeal to S.C.C. refused [1994] 2 S.C.R. viii, 114 D.L.R. (4th) vii; *Boe v. Alexander* (1987), 41 D.L.R. (4th) 520 at 526-27, 15 B.C.L.R. (2d) 106 (C.A.), leave to appeal to S.C.C. refused [1988] 1 S.C.R. xiv, 43 D.L.R. (4th) vii.

¹⁶⁹ S.M. 1995, c. 14, s. 79.1.

¹⁷⁰ Manitoba Law Reform Commission, *Ethical Investment by Trustees* (Winnipeg: Manitoba Law Reform Commission, 1993).

¹⁷¹ R.S.O. 1990, c. S.16, as rep. by *Government Process Simplification Act* (Ministry of the Attorney General), 1997, S.O. 1997, c. 23, s. 12.

¹⁷² (U.K.), 1995, c. 26.

¹⁷³ *Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc), Amendment Regulations 1999*, S.I. 1999/1849, s. 2(4).

¹⁷⁴ *Local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 1999*, S.I. 1999/3259, s. 5.

¹⁷⁵ See Benjamin J. Richardson, "Pensions Law Reform and Environmental Policy: A New Role for Institutional Investors?" (2002) 3:5 J. Int'l Fin. Markets: Law and Regulation 159.

law.¹⁷⁶ Internationally, legislation requiring pension fund managers to disclose or take account of environmental, social, or ethical considerations in their investment policies has now arisen in France,¹⁷⁷ Germany,¹⁷⁸ and Belgium.¹⁷⁹ The French law includes obligations to actually consider environmental issues in investment decisions, although these requirements pertain to public sector pensions.¹⁸⁰ In Australia, the *Financial Services Reform Act 2001*¹⁸¹ applied an ethical disclosure obligation to a wider range of investment products than that found in the European examples, covering pensions, managed investment products, and investment life insurance products.¹⁸² Like the UK initiative, however, none of these reforms statutorily defines “ethical investment”, and all only superficially address the problem of monitoring compliance. Recent surveys of the effect of the UK reforms suggest that while there has been a significant increase in the adoption of ethical investment policies by pension funds, the quality and implementation of such policies has been quite variable.¹⁸³ There has also been a major expansion in ethical investment in France since 2000, possibly attributable to its recent legislative reforms.¹⁸⁴

Whereas the Canadian pension sector has faced the problem of reconciling ethical investment with trustees’ fiduciary responsibilities, mutual funds have been able to largely avoid this problem. This is because the mutual fund form, catering to both retail and institutional investors, can be adapted to pursue a wide variety of desired investment goals. Of course, when pursuing an ethical investment policy, a mutual fund must exercise care to achieve the optimal financial returns within the

¹⁷⁶ Bill C-394, *An Act to amend the Pension Benefits Standards Act, 1985*, 2d Sess., 37th Parl., 2002.

¹⁷⁷ Art. L214-39 C. mon. et fin.; Art. L135-8 C. sécur. soc.

¹⁷⁸ *Gesetz zur Reform der gesetzlichen Rentenversicherung und zur Förderung eines Kapitalgedeckten Altersvorsorgevermögens (Altersvermögensgesetz)*, v. 29.6.2001 (BGBI.1, art. 10 § 115 Nr. 4).

¹⁷⁹ *Loi relative aux pensions complémentaires et au régime fiscal de celles-ci et de certains avantages complémentaires en matière de sécurité sociale*, *Moniteur belge / Belgisch Staatsblad*, 15 May 2003, 2003-04-28/36, art. 42.

¹⁸⁰ The relevant part of the French law provides: “Il met en oeuvre les orientations de la politique de placement. Il contrôle le respect de celles-ci. Il en rend compte régulièrement au conseil de surveillance et retrace notamment, à cet effet, la manière dont les orientations générales de la politique de placement du fonds ont pris en compte des considérations sociales, environnementales et éthiques” (C. sécur. soc., *supra* note 177).

¹⁸¹ (Cth.).

¹⁸² See Benjamin J. Richardson, “Ethical Investment and the Commonwealth’s Financial Services Reform Act 2001” (2002) 2 *Nat’l Env’tl. L. Rev.* 47.

¹⁸³ Just Pensions, *Do UK Pension Funds Invest Responsibly? A Survey of Current Practice on Socially Responsible Investment* by David Coles & Duncan Green (London: Just Pensions, 2002) at 1, online: UK Social Investment Forum <<http://www.uksif.org/J/Z/Z/lib/2002/files/07/jp-ukpf-do/ukpf2002-justpens.pdf>>.

¹⁸⁴ See European Sustainable and Responsible Investment Forum, “Socially Responsible Investment Among European Institutional Investors: 2003 Report” at 46-48, online: Eurosif <<http://www.eurosif.org/pub/lib/2003/10/srrept/eurosif-srrept-2003-all.pdf>>.

parameters of its stated policy. Thus, where a mutual fund advertises an ethically responsible investment policy, fiduciary and contractual obligations arise in that the fund must practice what it preaches. Dedicated ethical investment funds usually require much more than mere compliance with environmental law as a criterion for inclusion in an investment portfolio. For example, Canada's Ethical Funds demands that businesses adopt "an effective environmental management system" and demonstrate a "[l]evel of commitment to disclosure of environmental practices including compliance record."¹⁸⁵

Although Canadian regulation of the mutual fund industry, as in other jurisdictions, does not distinguish between ethical mutual funds and traditional mutual funds, some commentators have suggested that investment regulation should make a distinction because the unique investment agenda of ethical funds gives rise to specific expectations from investors.¹⁸⁶ It is no longer a matter of crudely maximizing financial returns, but of applying a policy of ethical screens and, if necessary, engaging in shareholder activism. Through shareholder activism, ethical mutual funds (along with other institutional investors) can be an instrument for environmental governance, applying pressure to corporate management to make policy changes that affect the environment.

Consequently, regulation should aim to improve the objectivity and transparency of ethical funds' investment policies and should require disclosure by mutual funds of how they exercise their shareholder rights. Indeed, a prominent concern in recent government inquiries in Canada into mutual fund governance has been the way funds vote their share holdings.¹⁸⁷ In addition to selecting and trading corporate stocks, mutual fund managers vote millions of shares on behalf of the fund investors. This process, known as proxy voting, keeps mutual fund clients in the dark about how their fund is voting on a particular issue or whether their mutual fund manager voted at all. Ideally, however, fund managers should vote according to proxy voting guidelines issued by their mutual fund company. Yet there is no requirement in National Instrument 81-102: Mutual Funds or in related regulations for funds to disclose proxy voting practice or ensure that shares are voted in any particular way.¹⁸⁸ Consequently, Canadian ethical mutual funds may not be adequately applying their stake in corporations to improve the environmental performance of investments.

¹⁸⁵ Ethical Funds, "Environmental Practices Screen", online: Ethical Funds® <www.ethicalfunds.com/do_the_right_thing/sri/ethical_principles_criteria/environmental.asp>.

¹⁸⁶ See George Djurasovic, "The Regulation of Socially Responsible Mutual Funds" (1997) 22 J. Corp. L. 257.

¹⁸⁷ See e.g. Stephen I. Erlichman, "Making it Mutual: Aligning the Interests of Investors and Managers—Recommendations for a Mutual Fund Governance Regime for Canada", online: Ontario Securities Commission <<http://www.osc.gov.on.ca/en/About/Publications/makingitmutual.pdf>>; Industry Canada, *supra* note 53; Ontario Securities Commission, "Regulating Conflicts of Interest in the Management of Mutual Funds: The Current Regime" (1995) 18:9 O.S.C. Bull. 1167.

¹⁸⁸ *Supra* note 68.

Admittedly, some mutual funds are voluntarily disclosing their voting guidelines and voting activity, but this disclosure is not occurring systematically.¹⁸⁹

Although mutual funds are seen as the preferred vehicle for ethical financing, the mutual fund sector generally is not a natural ally of sustainable investment. Pension fund investment is probably more compatible with sustainable investment. Pension funds tend, on average, to hold shares for longer periods than mutual funds because of their longer-term financial liabilities.¹⁹⁰ Because portfolio turnover ratios are lower in pension funds than among other institutional investors, pension fund managers also have more opportunity for engaging in shareholder activism. Furthermore, unlike the mutual fund industry, pension funds are not competitive. Their focus on performance is one of ensuring that returns are adequate to meet anticipated liabilities, not to attract investors. Mutual funds do compete to attract investors, and this competition leads to an emphasis on profit gains and market share, rather than long-term returns. Furthermore, owing to their competitive nature, mutual funds are much less likely than pension funds to be shareholder activists.¹⁹¹ This is because efforts by mutual funds to increase corporate value through shareholder activism will benefit all shareholders and may thus benefit rival funds. It must be noted, however, that the distinction between mutual and pension fund investment styles can sometimes be blurred, given that some pension funds invest through mutual funds rather than devise their own investment portfolios.¹⁹²

In contrast to equity investors, banks face some unique challenges and opportunities for addressing environmental concerns. Unlike pension or mutual funds, which must rely on publicly reported information to assess the environmental performance of companies, banks have the advantage of being able to obtain additional information about environmental risk and other aspects of a borrower's environmental performance as part of the loan process. Another difference between investors and lenders in their responses to corporate environmental performance stems from liability rules. Whereas investment shareholders are largely protected by rules of limited company liability from the environmental liabilities of their investee companies,¹⁹³ lenders face liability risks if they become too closely involved in their

¹⁸⁹ See e.g. Susan Heinrich, "Ethical Funds Comes Clean on Voting Policies" *Financial Post* (6 July 2000) D4.

¹⁹⁰ Public and union pension funds display this characteristic more than private pension plans: see O'Connor, *supra* note 150.

¹⁹¹ See Eric Becker & Patrick McVeigh, "Social Funds in the United States: Their History, Financial Performance, and Social Impacts", in Fung, Hebb & Rogers, *supra* note 13, 44 at 64 (referring to very low levels of shareholder resolutions sponsored by US ethical mutual funds).

¹⁹² See World Bank, *Private Capital Flows to Developing Countries: The Road to Financial Integration* (Oxford: Oxford University Press, 1997) at 129.

¹⁹³ See Kevin F. Forbes, "Limited Liability and the Development of the Business Corporation" (1986) 2 *J.L. Econ. & Org.* 163.

borrower's business or take possession of loan security.¹⁹⁴ So far, there is a paucity of Canadian case law on lenders' environmental liabilities,¹⁹⁵ although US litigation has demonstrated the powerful effect lender liability can have on banks' environmental policies.¹⁹⁶

Even if a lender is shielded from direct environmental liability, its borrower's financial difficulties caused by an environmental problem could still be a reason for concern. Insolvency law can have a bearing on this situation. Conflicts can arise between the claims of creditor banks and any outstanding environmental expenses owed by a bankrupt firm, such as the costs associated with a regulator's cleanup order.¹⁹⁷ The traditional norm in bankruptcy codes is that priority is given to the claims of secured creditors such as bank lenders. In the absence of court determinations to the contrary, this norm can result in environmental debts being unpaid and so displaced onto society. Canadian courts have concluded that environmental remediation and related expenses should sometimes take priority over the distribution of assets to the bankrupt company's creditors. In the notable *Panamericana* case, the appointed receiver-manager was directed by the Alberta Court of Appeal to implement the environmental authority's order to clean up oil wells in accordance with provincial environmental regulations, despite the corporate licensee's bankruptcy and even though the expense of protecting the wells meant less money for distribution to creditors.¹⁹⁸ Consequently, when environmental reformers address the role of the banking sector, they must pay attention to the unique problems posed by lender liability and insolvency legislation.

Although it can thus be seen that the heterogeneity of financial service providers requires various institution-specific reforms, there are also some common regulatory themes. Liability rules, economic incentives, fiduciary responsibilities, and informational policy instruments, while all requiring adaptation to specific institutional contexts, need to be applied throughout financial markets to create a stronger foundation for sustainable investment. Harnessing financiers as drivers for

¹⁹⁴ See John J. Lyons, "Deep Pockets and CERCLA: Should Superfund Liability Be Abolished?" (1986-87) 6 *Stan. Envtl. L.J.* 271; Gunther Teubner, "The Invisible Cupola: From Causal to Collective Attribution in Ecological Liability" (1994) 16 *Cardozo L. Rev.* 429 [Teubner, "The Invisible Cupola"].

¹⁹⁵ See e.g. *Busse Farms Ltd. v. Federal Business Development Bank* (1996), [1997] 5 *W.W.R.* 34, 150 *Sask. R.* 305 (Q.B.), aff'd (1998) 168 *D.L.R.* (4th) 27, [1999] 7 *W.W.R.* 737, 172 *Sask. R.* 133 (C.A.), leave to appeal to S.C.C. refused [1999] 3 *S.C.R.* vi [Busse Farms]. See also Jimmy Y. Levy, "Landlord and Lender Liability for Hazardous Waste Clean-up: A Review of the Evolving Canadian and American Case Law" (1992) 20 *Can. Bus. L.J.* 269; Requadt, *supra* note 74.

¹⁹⁶ See Scott R. Alexander, "CERCLA's Web of Liability Ensnarers Secured Lenders: The Scope and Application of CERCLA's Security Interest Exception" (1991) 25 *Ind. L. Rev.* 165.

¹⁹⁷ See James D. Barnett, "Conflict Between Bankruptcy and Environmental Law and Policy: The Courts Are Still Out" (1991) 1:2 *Envtl. Fin.* 191.

¹⁹⁸ *Panamericana de Bienes y Servicios v. Northern Badger Oil & Gas Ltd.* (1991), 117 *A.R.* 44 at 59-61, 81 *D.L.R.* (4th) 280, [1991] 5 *W.W.R.* 577 (C.A.), leave to appeal to S.C.C. refused [1992] 1 *S.C.R.* x; see also *Canada Trust v. Buloa Corp. Ltd.* (1980), 34 *C.B.R.* (N.S.) 145 (Ont. H.C.J.), aff'd (1981) 39 *C.B.R.* (N.S.) 152 (Ont. C.A.).

sustainability requires complementary reforms to provide stronger financial incentives, provision of more and clearer environmental information, and more effective leverage in corporate affairs. These are policy instruments that can support a reflexive style of environmental governance that works with, rather than against, the protocols and norms of financial markets. The role of these policy instruments in promoting a broader climate conducive to environmental governance through financial markets is considered in the next section.

III. Regulating for the Financing of Environmental Change: The Wider Context

A. Corporate Governance

A raft of regulatory reforms to financial institutions is necessary to provide a stronger foundation for sustainable lending and investment. To begin with, the system of corporate governance in Canada is not sufficiently supportive of shareholder activism. Given the role of shareholder engagement as a pathway for ethical investment, systems of corporate governance should be adjusted to enable or direct investee shareholders to be more active in corporate decision making. Most Canadian ethical funds merely use a screening approach, which tends to reduce their influence on corporate management. Yet some companies may not be responsive to ethical pressures derived simply from buying or selling their shares.¹⁹⁹ Ethical fund screening practices tend to reward “good” businesses but may do little to change the behaviour of “bad” ones.²⁰⁰ A more activist approach may be needed in such circumstances.

Shareholder proposals sponsored by institutional investors are one means by which institutions can wield influence over company management.²⁰¹ Such proposals can push companies into structured dialogues with shareholders and other stakeholders, in the hopes of changing corporate policy. In theory, given the size of institutional investors’ stock holdings and their fiduciary obligations to enhance shareholder value, investors should have adequate incentives to challenge underperforming companies. The reality, however, is that social and environmental policy shareholder resolutions are not commonly used in Canada and are only used with any regularity in the US and Britain; in the 1998 proxy season in the US, for example, 289 ethical policy shareholder resolutions were filed at 116 companies.²⁰² These figures do not reflect additional, behind-the-scenes diplomacy, such as investor shareholders meeting privately with management to make their views known.

¹⁹⁹ See Sparkes, *Socially Responsible Investment*, *supra* note 42 at 29-35.

²⁰⁰ See Hebb, *supra* note 37 at 5.

²⁰¹ See Diane Del Guercio & Jennifer Hawkins, “The Motivation and Impact of Pension Fund Activism” (1999) 52 *J. Fin. Econ.* 293.

²⁰² See Becker & McVeigh, *supra* note 191 at 64.

Investor activism in Canada is presently limited, but is gradually garnering support. Shareholder proposals have increased recently, in part due to the stronger coordination of church-based investors through the TCCR.²⁰³ Canadian trade unions through their pension plans are also exerting more influence. Survey data from the Shareholder Association for Research and Education reveals that the number of corporate governance and social responsibility proposals submitted by shareholders increased from less than three in each year from 1994 to 1996, to sixty-three and forty in 2000 and 2001, respectively.²⁰⁴ In 1998, a coalition of mainly labour unions and church groups founded the Active Shareholder Working Group, which later played a key role lobbying for amendments to company law rules on shareholder proposals.²⁰⁵ Recently, the TCCR campaigned against Talisman Energy for investing in Sudan. With the aid of public pensions including the Caisse de dépôt et placement du Québec, the TCCR secured twenty-seven per cent support for its social resolution,²⁰⁶ which may well have contributed to the twenty-five per cent discount exacted by shareholders on Talisman's share price for a period.²⁰⁷

Most shareholder proposals do not address social or environmental responsibility concerns. Usually, investors get involved in takeover defences, charter amendments, corporate restructurings, and CEO compensation deals.²⁰⁸ Of the forty proposals filed in Canada in 2001, only two addressed such ethical concerns, namely proposals made to Sears Canada and the Hudson's Bay Company to improve their codes of conduct with respect to labour standards. None of the forty shareholder proposals wooed a majority of votes, although they may ultimately achieve more subtle results. On 30 April 2003, a new record was set when a shareholder proposal from Ethical Funds calling upon steel manufacturer IPSCO to disclose facility-specific toxic and

²⁰³ See online: Taskforce on the Churches and Corporate Responsibility <www.web.ca/~tccr>.

²⁰⁴ Shareholder Association for Research and Education, "Shareholders Back Calls for Disclosure on Board Independence" *Prospectus* 1:2 (Fall/Winter 2001) 2, online: Shareholder Association for Research and Education <<http://www.share.ca/files/newsletters/prospectus2.pdf>>; Social Investment Organization & Taskforce on the Churches and Corporate Responsibility, "Socially Responsible Shareholdership in Canada: A Handbook for Institutional Investors" by Rory O'Brien at 7, online: Social Investment Organization <<http://www.socialinvest.ca/shareholdership/handbooktoc.html>>.

²⁰⁵ Mark Thomsen, "Canadian Parliament Votes to Give Socially Responsible Shareholder Proposals Equal Billing", online: SocialFunds.com <www.socialfunds.com/news/article.cgi/article641.html>.

²⁰⁶ See Christian Brothers Investment Services, Inc., "SRI: 2000 Active Ownership Strategy" *Principles: An Investment Newsletter* (October 2000) 1 at 2, online: Christian Brothers Investment Services, Inc. <http://www.cbisonline.com/newsletter/2000/newsletter_0010.pdf>

²⁰⁷ See Alan Freeman, "Investors Eye Talisman's Sudan Stake" *The Globe and Mail* (17 October 2001) B1; "Talisman Pullout from Sudan Would Benefit Its Investors" *The Globe and Mail* (17 October 2001) B12. Talisman's share price began to rise again the day after the company announced the sale of its controversial holdings in Sudan. See James Stevenson, "Talisman's Sudanese Ethical Discount Removed: Stock Closes Up 1.7%" *Canadian Press* (31 October 2002).

²⁰⁸ See MacIntosh, "Canadian Capital Markets", *supra* note 3.

greenhouse gas emissions received the support of a huge 49.2 per cent of the shares voting.²⁰⁹

There has been a protracted debate in the corporate governance literature on shareholder rights and democratization of company affairs. Commentators have offered various explanations for the low levels of shareholder activism in Canada, including the difficulty in coordinating and communicating among shareholders, agency costs, and free rider problems.²¹⁰ MacIntosh argues that institutional investors' ability to monitor investee companies is hampered by their large portfolios, limited staff, and lack of appropriate expertise.²¹¹ He also suggests that the need or desire of investors to maintain liquid portfolios can result in the acquisition of small blocks without significant voting clout.²¹² There is also the tendency of fund managers to side with company management for fear of losing collateral business (e.g., banking and insurance services).²¹³ However, a key barrier to institutional activism has been legal restraints impeding the ability of institutional investors to become more involved in corporate governance.²¹⁴

Recent amendments to the *Canada Business Corporations Act* ("CBCA") should facilitate shareholder proposals and communications on environmental and other ethical concerns.²¹⁵ Previously, the CBCA allowed registered shareholders to file proposals provided that they were not submitted for "promoting general economic, political, racial, religious, social or similar causes."²¹⁶ The exclusion clause had been exploited several times as grounds for refusing to circulate a shareholder proposal, such as in 1987 when the Ontario Court of Appeal upheld Varsity Corporation's refusal to circulate a proposal on disinvestments in South Africa.²¹⁷ Further, communication between shareholders was severely restricted by reason of the definition of "solicitation" regarding the soliciting of proxies under the act.²¹⁸

²⁰⁹ Ethical Funds, News Release, "Record Support for Shareholder Proposal at IPSCO to Disclose Toxic and Greenhouse Gas Emissions" (2 May 2003), online: Ethical Funds® <www.ethicalfunds.com/do_the_right_thing/about_ef/newsroom/2003_articles/05_02_03.asp>.

²¹⁰ See Catherine McCall & Réjane Wilson, "Shareholder Proposals, Why Not in Canada?" (1993) 5:1 Corp. Governance Rev. 12.

²¹¹ Jeffrey G. MacIntosh, "Institutional Shareholders and Corporate Governance in Canada" (1996) 26 Can. Bus. L.J. 145 at 158-71.

²¹² *Ibid.*

²¹³ Pound argues that banks and insurance companies are more likely than pension funds to support management in a proxy contest, possibly so as to preserve future business ties with the company: John Pound, "Proxy Contests and the Efficiency of Shareholder Oversight" (1988) 20 J. Fin. Econ. 237.

²¹⁴ See MacIntosh, "Canadian Capital Markets", *supra* note 3 at 387.

²¹⁵ See *An Act to amend the Canada Business Corporations Act and the Canada Cooperatives Act and to amend other Acts in consequence*, S.C. 2001, c. 14 [CBCA Amendments].

²¹⁶ R.S.C. 1985, c. C-44, s. 137(5)(b) [CBCA].

²¹⁷ *Re Varsity Corp. and Jesuit Fathers of Upper Canada* (1987), 60 O.R. (2d) 640, 41 D.L.R. 384 (C.A.), *aff'd* (1987) 59 O.R. (2d) 459, 38 D.L.R. (4th) 157 (H.C.J.) [Varsity]; see also Sparkes, *Socially Responsible Investment*, *supra* note 42 at 311.

²¹⁸ CBCA, *supra* note 216, s. 150(1)(b).

Restrictive interpretations of the rules by the courts narrowed their interpretation even further.²¹⁹ The recent amendments to the *CBCA* were the result of years of lobbying by the TCCR, a fact that underscores the role of ethical investor associations as a necessary ingredient for achieving legislative reform.

The amended *CBCA* requires management to circulate all shareholder proposals unless they fail to deal substantially with the business affairs of the corporation.²²⁰ Concomitant amendments include an increase in the word count for proposals from two hundred to five hundred words,²²¹ and a clarification of the definition of “solicitation” to allow shareholders to communicate freely with each other, provided that the shareholder is not seeking to obtain another shareholder’s proxy.²²² Further, rules permitting shareholder proposals only from registered shareholders (i.e., investment companies that are the shareholders of record) have been repealed, now allowing beneficial shareholders to also file proposals.²²³ Apart from the shareholder proposal provisions, the *CBCA* requires that shareholders approve fundamental changes to the corporation, including changes to the corporate articles and bylaws.²²⁴ As the *CBCA* covers some 160,000 federally incorporated businesses, including almost fifty per cent of the largest companies in Canada, the potential impact of these reforms is significant.

Commentators have suggested a range of other corporate governance reforms that could further empower institutional investors. For example, Gilson and Kraakman proposed appointment of minority independent directors to corporate boards, nominated by institutional investor groups rather than enterprise management.²²⁵ Another approach, based on the idea of obliging investee shareholders to be more active, would require investment institutions to register their share votes, thereby spurring institutions to formulate and express a view on all issues put to a vote at shareholder meetings. In response to the Myners report, which was critical of the “culture of non-intervention” among British institutional investors, the UK Department for Work and Pensions has proposed a legal duty that pension fund administrators “must, in respect of any company or undertaking ... in which they invest such assets, use such rights and powers as arise by virtue of such investment in

²¹⁹ See e.g. *Verdun v. Toronto-Dominion Bank*, [1996] 3 S.C.R. 550, 139 D.L.R. (4th) 415 (beneficial owner not entitled to submit proposals); *Varity*, *supra* note 217.

²²⁰ *CBCA*, *supra* note 216, s. 137(5), as am. by *CBCA Amendments*, *supra* note 215, s. 59(3).

²²¹ *CBCA*, *ibid.*, s. 137(3), as am. by *CBCA Amendments*, *ibid.*, s. 59(2); *Canada Business Corporations Act Regulations 2001*, S.O.R./2001-512, s. 49.

²²² *CBCA*, *ibid.*, s. 147, as am. by *CBCA Amendments*, *ibid.*, s. 67(2).

²²³ *CBCA*, *ibid.*, s. 137(3), as am. by *CBCA Amendments*, *ibid.*, s. 59(1).

²²⁴ *CBCA*, *ibid.*, ss. 103, 173.

²²⁵ Ronald J. Gilson & Reinier Kraakman, “Reinventing the Outside Director: An Agenda for Institutional Investors” (1991) 43 *Stan. L. Rev.* 863.

the best interests of the members and beneficiaries of such scheme.”²²⁶ This would include diligent voting of shareholding rights. The US has also made reforms in this area. Effective 6 August 2003, the Securities and Exchange Commission (“SEC”) has amended its regulations under the *Investment Advisers Act of 1940*²²⁷ to require all US mutual fund companies and investment advisers to disclose proxy votes, voting policies, and their actual voting record.²²⁸

Canadian regulators have been toying with changes to the rules governing disclosure of institutional investors’ voting policies and practices. The Canadian Securities Administrators recently proposed a rule that would require mutual funds’ annual Management Discussion of Fund Performance (“MDFP”) to include a statement of “how the portfolio advisers or the manager of the investment fund voted on matters relating to issuers of portfolio assets of the investment fund, other than routine business of those issuers.”²²⁹ While this proposal ostensibly mandates disclosure of voting, because the disclosure would appear in the annual MDFP, any discussion by the mutual fund of its voting record would likely be cursory, perfunctory, and rather abstract. There would likely be few details given of votes on a company-specific basis, so investors would lack information to determine whether votes were being cast appropriately. Coupled with the existing rule prohibiting mutual funds from acquiring active, large ownership rights in investee companies, the scope for investor participation in corporate governance remains legally quite restricted in Canada.²³⁰

B. Economic Instruments

Economic instruments such as environmental taxes and tradable pollution allowances can greatly improve the pricing of environmental behaviour in markets and thereby provide incentives to financial institutions to favour companies that are less injurious to the environment. Economic instruments have figured prominently in

²²⁶ U.K., Department for Work and Pensions, “Encouraging Shareholder Activism: A Consultation Document” at 8, online: Department for Work and Pensions <<http://www.dwp.gov.uk/consultations/consult/2002/myners/shareact.pdf>>.

²²⁷ 15 U.S.C. §§80b-1 (2003).

²²⁸ Proxy voting, 17 C.F.R. § 275.206(4)-6 (2003).

²²⁹ “National Instrument 81-106: Investment Fund Continuous Disclosure: Form 81-106F1 Contents of Annual and Quarterly Management of Report of Fund Performance” at 6, online: Saskatchewan Financial Services Commission <www.spsc.gov.sk.ca/ssc/files/publish/81-106/81-106formf1.pdf>.

²³⁰ See “National Instrument 81-102: Mutual Funds” (*supra* note 68), which restricts mutual funds to holding securities representing no more than 10 per cent of the voting rights of issued shares, or purchasing a security for the purpose of exercising control over management of the issuer of the security. Similar restrictions exist in other jurisdictions, such as in the EU. See EC, *Directive 2001/108/EC of the European Parliament and of the Council of 21 January 2002 amending Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), with regard to investments of UCITS*, [2002] O.J. L. 41/35.

recent environmental law reform debates.²³¹ The OECD, an active proponent of their use, has defined them as “instruments that affect costs and benefits of alternative actions open to economic agents, with the effect of influencing behaviour in a way that is favourable to the environment.”²³² Economic instruments are applauded for their ability to promote more cost-effective achievement of environmental policy.²³³ The methodological pluralism of economic instruments allows each business to tailor its own means of reducing pollution. In relation to the financial side of sustainable development, economic instruments should help make the financial costs and benefits of corporate environmental behaviour more transparent and relevant to the calculations of investors and lenders. By harnessing the methodologies of the market, economic policy instruments can help implement a “reflexive” style of legal regulation, whereby businesses can learn more about the cost of their impacts and adjust their behaviour accordingly.²³⁴ Unless equity and debt prices reflect environmental performance and risk, ethical financing will remain somewhat arbitrary in determining which businesses to support.

Not only can economic instruments be used to good effect as a means of environmental policy, they can be applied directly to the activities of lenders and investors to encourage environmentally beneficial financing. For instance, a tax on transactions in financial markets could discourage short-term speculative trading and thereby promote sustainable productive investments. Baker and Fung advocate a tax on financial market short-term trading (covering trades in stock, bonds, options, etc.), and the allocation of the money raised to public investments.²³⁵ They point out that the US, for instance, actually had a short-term trading tax until 1964.²³⁶

Another possibility is to offer tax concessions to profits associated with environmental financing. Because companies engaged in environmentally beneficial activities tend to be disadvantaged by markets that fail to take account of the negative and positive environmental externalities of economic activity, such tax concessions are a justified subsidy. The Netherlands has gone the furthest in using tax law in this way. The Dutch Green Investment Directive was established in 1995 to provide tax deductions for interest payments and dividend yields from government-approved

²³¹ See generally Theodore Panayotou, *Instruments of Change: Motivating and Financing Sustainable Development* (London: Earthscan, 1998).

²³² OECD, *Environmental Policy: How to Apply Economic Instruments* (Paris: OECD, 1991) at 10. See also OECD, *Climate Change: Designing a Practical Tax System* (Paris: OECD, 1992); OECD, *Managing the Environment: The Role of Economic Instruments* (Paris: OECD, 1994).

²³³ See generally Richard B. Stewart, “Economic Incentives for Environmental Protection: Opportunities and Obstacles” in Richard L. Revesz, Phillippe Sands & Richard B. Stewart, eds., *Environmental Law, the Economy and Sustainable Development* (Cambridge: Cambridge University Press, 2000) 171; T.H. Tietenberg, “Economic Instruments for Environmental Regulation” (1990) 6:1 *Oxford Rev. Econ. Pol’y* 17.

²³⁴ See Orts, *supra* note 137.

²³⁵ Baker & Fung, *supra* note 13, 36.

²³⁶ *Ibid.* at 37.

environmental investment funds.²³⁷ To qualify, a fund must invest at least seventy per cent of its assets in environmentally friendly projects (e.g., renewable energy technologies) that the Dutch environmental agency has determined to be acceptable.²³⁸ The attractive interest rate returns help improve the risk-return margin and thereby induce more investors to support these types of developments.²³⁹ Recent analyses herald the success of the Dutch scheme in generating increased investment in environmental projects.²⁴⁰ The Dutch innovation also points to how one determines objective criteria for ethical investment.

Although such an initiative has not yet been contemplated in Canada, the SIO has sought to have income tax legislation amended to provide more finance for ETI. The SIO has been lobbying the federal government to give individuals the right to invest their Retirement Savings Restoration Plan ("RSRP") in loan funds for low-income communities through ETI schemes.²⁴¹ Currently, federal policy is to permit RSRP eligibility only to funds that are guaranteed by governments. The federal Department of Finance has cited technical considerations, such as non-arm's-length dealing, in rejecting the SIO's proposal.²⁴²

While the history of implementing economic instruments suggests that staunch industry opposition can emasculate reform proposals,²⁴³ in the context of financial service markets, the prospects for reform seem more promising. Environmental taxes directly affect company balance sheets, and financial institutions should support pollution charges, since as low-energy users, they would not be heavily penalized by new charges.²⁴⁴ For tradable pollution allowances, companies that are able to generate cost savings through trade in pollution allowances could become more attractive investment opportunities for financial organizations. Creating new markets for environmental goods could thereby also significantly augment environmental financing.²⁴⁵

²³⁷ Jeucken, *supra* note 156 at 92-94.

²³⁸ *Ibid.* at 94.

²³⁹ *Ibid.* at 95.

²⁴⁰ Bert Scholtens, "Greenlining: Economic and Environmental Effects of Government Facilitated Lending to Sustainable Economic Activities in the Netherlands", online: Rijksuniversiteit Groningen <<http://www.ub.rug.nl/eldoc/som/e/01E04/01E04.pdf>>.

²⁴¹ Social Investment Organization, "SIO Calls for RRSP Fairness" *SIO Forum* (December 2001) 4.

²⁴² *Ibid.*

²⁴³ See e.g. Benjamin J. Richardson, "Economic Instruments and Sustainable Management in New Zealand" (1998) 10 *J. Env'tl. L.* 21; Benjamin J. Richardson, "Economic Instruments in UK Environmental Law Reform: Is the UK Government 'Sending the Right Signals'?" (2001) 3 *Eur. J. L. Ref.* 427.

²⁴⁴ On the in-house environmental impacts of financiers see e.g. Penny Street & Philip E. Monaghan, "Assessing the Sustainability of Bank Service Channels" in Bouma, Jencken & Klinkers, *supra* note 72, 72.

²⁴⁵ See Sparkes, *Socially Responsible Investment*, *supra* note 42 at 168-69 (discussing new market opportunities for financiers from carbon trading schemes).

To what extent would Canadian authorities be prepared to use economic instruments in these ways? Compared to other OECD nations, Canada has been rather taciturn in embracing economic instruments for environmental policy.²⁴⁶ In an exploration of possible applications in 1994, the Canadian ministers of the environment and finance established the Task Force on Economic Instruments and Disincentives to Sound Environmental Practices.²⁴⁷ The *Canadian Environmental Protection Act, 1999*'s mandate to authorities to introduce economic instruments²⁴⁸ has not yet been translated into practice, though Canadian authorities have tentatively begun to implement pollution allowance trading.²⁴⁹ Ontario, for instance, has adopted an emissions reduction trading program for sulphur dioxide and nitrogen oxides.²⁵⁰ Further, commercial fisheries accounting for over half of the value of Canadian fish landings have been managed since the early 1990s through more than forty property rights-based programs analogous to emissions trading.²⁵¹ The federal government's Climate Change Plan of 2000 envisages a domestic, carbon trading scheme to help meet obligations under the Kyoto Protocol,²⁵² but the government has so far rejected using energy taxes.²⁵³ Certain tax concessions are being offered for accelerated depreciation of some renewable energy technologies.²⁵⁴ The extensive environmental taxes in the EU, particularly the Benelux and Scandinavian countries, point to some new directions Canadian authorities might one day pursue if the political will arises.²⁵⁵

C. Environmental Liability for Financial Sponsors

Because financial institutions intend to profit from the companies they fund, arguably they should share responsibility for any environmental costs caused by such companies. The "polluter pays" principle, which has dominated discussions of

²⁴⁶ See Russell S. Jutlah, "Economic Instruments and Environmental Policy in Canada" (1998) J. *Env'tl. L. & Prac.* 323.

²⁴⁷ Canada, *Final Report of the Task Force on Economic Instruments and Disincentives to Sound Environmental Practices* (Ottawa: Task Force on Economic Instruments and Disincentives to Sound Environmental Practices, 1994).

²⁴⁸ *CEPA*, *supra* note 158, s. 322.

²⁴⁹ See Katrina Miriam Wyman, "Why Regulators Turn to Tradeable Permits: A Canadian Case Study" (2002) 52 *U.T.L.J.* 419.

²⁵⁰ *Emissions Trading*, O. Reg. 397/01.

²⁵¹ See Wyman, *supra* note 249 at 423-24.

²⁵² Government of Canada, "Climate Change Plan for Canada", online: Government of Canada <www.climatechange.gc.ca/plan_for_canada/plan/pdf/full_version.pdf>.

²⁵³ See "Environment Minister Rules Out Carbon Tax to Fight Greenhouse Gases" *Canadian Press* (1 May 1999).

²⁵⁴ See Government of Canada, *supra* note 252.

²⁵⁵ Among the growing literature see EC, Commission, *Database on Environmental Taxes in the European Union Member States, Plus Norway and Switzerland; Evaluation of Environmental Effects of Environmental Taxes* (Luxembourg: EC, 1999); Jarmo Vehmas *et al.*, "Environmental Taxes on Fuels and Electricity—Some Experiences from the Nordic Countries" (1999) 27 *Energy Pol'y* 343.

environmental liability, focuses on what should be paid for rather than who is the polluter.²⁵⁶ The precept that liability should attach to those that "cause" pollution begs the question of what is meant by "cause". Without loans from banks or equity purchases by investors, many companies would be unable to continue financing their activities without major adjustment. Financial sponsorship is thus intimately part of the "cause" of corporate activities that harm the environment. Financiers' contribution here differs from that of other stakeholders in a business, such as its workers and suppliers, because lenders and investors potentially wield considerably more power over corporate management than other stakeholders. By making financial sponsors partly liable for such harms, there would exist a potent disincentive to enter into financial relationships with polluting industries. This should lead to fewer polluting developments and the decline of harmful industries.

Environmental liabilities have so far arisen primarily in relation to debt financing. There are several ways by which environmental pollution might affect banks.²⁵⁷ The first is direct lender liability, whereby a bank becomes responsible for the environmental liabilities of its client. Depending on the applicable environmental law, this could arise for a bank by: taking title to property pursuant to foreclosure; acting in a fiduciary capacity, including managing day-to-day operations of industrial facilities; and owning premises previously contaminated by toxic substances. The financial institution may find itself faced with remediation costs imposed by an environmental regulator that far exceed the value of the original loan. Second, associating with polluting companies might pose a "reputational" risk for lenders. In the context of heightened societal concern for the environment, financial institutions may feel the need to attach more importance to the fostering of good standing in areas of social responsibility, environmental performance, and ethical integrity.²⁵⁸ Third, lenders may be confronted with indirect credit risks caused by environmental problems that pose a financial hardship to a borrower. Environmental costs that undermine a company's ability to repay loans can ensue from the purchase of equipment required to meet pollution permit standards or fines for non-compliance. The value of contaminated real property collateral can also decline dramatically, and in an insolvency situation, a lender's claims may not necessarily have priority over those of other creditors.²⁵⁹

²⁵⁶ See Sanford E. Gaines, "The Polluter-Pays Principle: From Economic Equity to Environmental Ethos" (1991) 26 *Tex. Int'l L.J.* 463.

²⁵⁷ See Christopher Stoakes, "The Loans that Come Back to Haunt" *Euromoney* (March 1997) 34; Mark A. Hofmann, "Banks Must Use Care in Assessing EIL Risks" (1994) 28:15 *Bus. Ins.* 31.

²⁵⁸ Consider, for example, how the World Bank's reputation has suffered from its sponsorship of environmentally harmful projects in developing countries. See Bruce Rich, *Mortgaging the Earth: The World Bank, Environmental Impoverishment and the Crisis of Development* (Boston: Beacon Press, 1994).

²⁵⁹ See Debra L. Baker, "Bankruptcy—The Last Environmental Loophole?" (1993) 34 *S. Tex. L. Rev.* 379.

Apart from the likely political obstacles to making lenders vicariously liable for the environmental harms of their borrowers, commentators have discovered that there is considerable difficulty in designing an optimal liability regime—one that provides appropriate incentives for banks to eschew the funding of environmentally contentious developments, but does not stifle socially valuable investments.²⁶⁰ Two aspects to this problem are retroactive liability and joint and several liability. While the retroactive character of some environmental liability regimes may further environmental compensation goals, there is not much of a deterrence effect from penalizing organizations for unforeseeable, non-negligent contamination caused by distant activities.²⁶¹ This situation can be compounded by the presence of joint and several liability, which is a mechanism for mutual regulation, encouraging each party to contract only with other reputable parties and creating strong incentives for parties to monitor one another's behaviour.²⁶² Joint and several liability rules may be at odds with the polluter pays principle to the extent that they encourage the channelling of liability to the deepest pockets, often those of the financial lenders.²⁶³ This can cause "overdeterrence" of deep pocket parties and "underdeterrence" of less solvent parties, who may believe that no claims will be brought against them for environmental harm.²⁶⁴ Allowing deep pocket parties to recover contributions from joint tortfeasors generates additional transaction costs and is of little value if the joint tortfeasors are insolvent.

Overall, current economic theory suggests that a model of "partial" lender liability for borrowers' environmental harms is appropriate.²⁶⁵ This may mean limiting liability, as banks suggest, to where they exercise operational control, because it is only in such cases that lenders can reasonably be assumed to understand what is actually happening. However, in the context of reforms proposed to corporate environmental reporting and financial regulation, liability may be justified in a wider class of situations where financiers have the *capacity* to influence corporate environmental conduct.

Since the early 1990s, Canadian lenders have become more sensitive to environmental liability threats.²⁶⁶ The Canadian Bankers Association has expressed its opposition to environmental liability laws that would impose retroactive and joint liability, and it has stated that merely holding a security interest in contaminated

²⁶⁰ See Rohan Pitchford, "How Liable Should a Lender Be? The Case of Judgment-Proof Firms and Environmental Risk" (1995) 85 *Am. Econ. Rev.* 1171.

²⁶¹ See Lyons, *supra* note 194.

²⁶² See Teubner, "The Invisible Cupola", *supra* note 194.

²⁶³ See Tom H. Tietenberg, "Indivisible Toxic Torts: The Economics of Joint and Several Liability" (1989) 65 *Land Econ.* 305.

²⁶⁴ See Michael J. Gergen, "The Failed Promise of the 'Polluter Pays' Principle: An Economic Analysis of Landowner Liability for Hazardous Waste" (1994) 69 *N.Y.U.L. Rev.* 624.

²⁶⁵ For details on what is "partial" see Pitchford, *supra* note 260.

²⁶⁶ See Heather D. Whyte, "Environmental Liability Scares Away Bank Loans" *The Financial Post* (19 June 1992) 5; Tyrus Reiman, "Lender Liability All the Rage" (1991) 15:4 *Can. Law.* 33.

property should not trigger liability for environmental cleanup.²⁶⁷ Under both provincial and federal environmental legislation, owners and those in possession or control of property may be held liable for any environmental damage.²⁶⁸ Lenders who hold a security interest in the land of the creditor may be exposed to environmental liability if the lender claims the security and possesses the property. It is unlikely, however, that current legislation would ensnare lenders. In British Columbia, for instance, the *Waste Management Act*²⁶⁹ and the *Contaminated Sites Regulation*²⁷⁰ impose liability on lenders and their representatives only when their acts or omissions directly cause or contribute to the contamination of the property. There is, as yet, little Canadian case law on lenders' environmental liabilities.²⁷¹ It should be noted, however, that since banks generally act through receivers, who are agents of the defaulting corporation and not the lender, banks are still financially vulnerable if a client's loans cannot be repaid and its collateral property is degraded and made worthless.

As the US Superfund experience demonstrates, the banking industry is able to effectively lobby against changes to environmental liability regimes that might hurt its financial position. Following a series of court judgments that interpreted the environmental liability provisions of the Superfund legislation²⁷² as making banks jointly liable for cleanup of contaminated land when they had the "capacity to influence" clients through their financing of the management of polluting enterprises,²⁷³ the major banks successfully pressured Congress into amending the legislation to provide them with a stronger safe harbour.²⁷⁴ The legislation clarified what actions lenders may take without becoming liable as an owner of contaminated property, including what conduct constitutes "participation in management". The US experience has influenced developments in Europe, where the European Commission

²⁶⁷ Letter from Paul Griffin, Director, Provincial & Community Affairs, Western Canada, Canadian Bankers Association, to Margaret Eriksson, Chair, British Columbia Advisory Panel on Contaminated Sites (23 July 2002), online: Ministry of Water, Air & Land Protection <http://wlapwww.gov.bc.ca/epd/epdpa/contam_sites/ministers_panel/submissions/Canadian_Bankers_Assoc.pdf>.

²⁶⁸ See Adam Szwercas & Risa Schwartz, "Lender Liability: Responsibility vs. Dcep Pockets" (1995) 19:4 Can. Law. 39.

²⁶⁹ R.S.B.C. 1996, c. 482, s. 26.5(3).

²⁷⁰ B.C. Reg. 375/96, ss. 20, 25.

²⁷¹ See e.g. *Busse Farms*, *supra* note 195. See also Levy, *supra* note 195.

²⁷² Known in full as the *Comprehensive Environmental Response, Compensation and Liability Act*, 42 U.S.C. §§ 9601-9675 (1980).

²⁷³ See especially *United States v. Fleet Factors Corp.*, 901 F.2d 1550 (11th Cir. 1990) [*Fleet*]; see further Joseph Jude Norton, "Lender Liability in the United States" in Ross Cranston ed., *Banks, Liability and Risk* (London: Lloyd's of London Press, 1995) 329 at 358.

²⁷⁴ See *Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996*, Pub. L. No. 104-208, §§ 2501-04, 110 Stat. 3009; see also Olaf de Scnerpont Domis, "New Law Finally Limits Environmental Liability" *American Banker* (2 October 1996) 3.

released in 2002 a draft environmental liability directive.²⁷⁵ Following pressure from financial markets, the Commission's proposal avoids specifically attaching liability to financial sponsors but leaves open the possibility of lender liability where banks exercise operational control over polluting facilities or sites.²⁷⁶ Canadian banks have similarly demonstrated their ability to thwart potential environmental liability-producing laws. Recently, the federal government amended the *Nuclear Safety and Control Act* to make it easier for private sector financial institutions to own and build nuclear power plants in Canada by making it clear that banks and other financing institutions that invest in nuclear reactors could not be held responsible for environmental expenses.²⁷⁷

In addition to the question of lender environmental liability, there is the older and more heated debate on shareholder liability.²⁷⁸ The cardinal principle in Western systems of company law is that the company is a separate legal person from the members who constitute it.²⁷⁹ A corollary principle is that, absent exceptional circumstances, investors (i.e., shareholders) in the company are not liable beyond the amount they invest. If the value of liability or other claims against the company exceeds the value of the firm's assets, the owners risk losing only their investment in the company. Corporate limited liability has the side effect of transferring business risks to creditors, and it can undermine the polluter pays principle to the extent that insolvent firms are able to abandon environmental debts. Thus, in principle, imposing liability on institutional shareholding investors for the environmental impacts of their portfolio companies could promote ethical investment because of the lower liability risks offered by green companies.

In reality, the issue of shareholder liability is politically contentious—at odds with revered notions of corporate limited liability—and could create major disincentives to new investment. The ceiling on shareholder liability is said to be justified as serving a number of beneficial functions,²⁸⁰ including encouraging new business formation; improving the liquidity and efficiency of security markets; and enabling investors to achieve a less risky, diversified portfolio of assets by reducing

²⁷⁵ EC, Commission, *Proposal for a Directive of the European Parliament and of the Council on Environmental Liability with Regard to the Prevention and Remedying of Environmental Damage*, [2002] O.J. C. 151/132. The directive is likely to be adopted into law in 2004.

²⁷⁶ See Benjamin J. Richardson, "Environmental Liability and Banks: Recent European Developments" [2002] J.I.B.L. 287.

²⁷⁷ *Nuclear Safety and Control Act*, S.C. 1997, c. 9, as am. by *An Act to Amend certain Acts and instruments and to repeal the Fisheries Prices Support Act*, S.C. 2002, c. 17, ss. 22-23.

²⁷⁸ See Frank H. Easterbrook & Daniel R. Fischel, "Limited Liability and the Corporation" (1985) 52 U. Chicago L. Rev. 89.

²⁷⁹ See e.g. *Salomon v. Salomon and Co. Ltd.* (1896), [1897] A.C. 22, [1895-99] All E.R. Rep. 33, 13 T.L.R. 46 (H.L.). On Canadian law see e.g. Jacob S. Ziegel, "Is Incorporation (with Limited Liability) Too Easily Available?" (1990) 31 C. de D. 1075.

²⁸⁰ See Easterbrook & Fischel, *supra* note 278 at 94.

investors' needs to closely monitor corporate management.²⁸¹ These justifications for limited liability have, however, been strongly contested.²⁸² First, limited shareholder liability is, in effect, a subsidy for investment, insulating shareholders from the environmental risks of their corporations and so encouraging overinvestment in hazardous activities.²⁸³ Moreover, the concentration of stock ownership in a few hands suggests that the reality of shareholder and corporation separation can be a fiction. In fact, for a closely held corporation or corporations wholly owned by a parent corporation, it has been argued that limited liability should be abandoned.²⁸⁴ Additionally, major institutional shareholders, who are relatively well placed to obtain information and monitor the risks of companies' activities, may be in a position to influence the environmental activities of corporations. By contrast, the victims of toxic torts and statutory violations are arguably less well placed to monitor and avoid the hazards of companies.

Various mechanisms have been devised to neutralize the adverse effects of limited liability short of its wholesale abandonment. These include equitable corporate veil-piercing rules and statutory exceptions where actions inconsistent with the separation of the corporation from its owners have been taken.²⁸⁵ Among the various academic proposals on where to strike the balance on the continuum of liability, Mendelson has advocated a "capacity to control" test whereby major investors possessing a controlling influence would be held liable for corporate wrongs.²⁸⁶ Already, Superfund liability was interpreted in the seminal *Fleet Factors Corporation* case as extending to a bank where its involvement in the financial management of the corporation gave it the "capacity to influence" decisions despite no actual involvement in the business.²⁸⁷ Liability for a corporation's environmental damages could also be imposed on a shareholder when the size of its holdings gave it the capacity to significantly influence the corporation. Consequently, institutional investors in a controlling position would be compelled to supervise company managers more closely.²⁸⁸ While Canadian legislators and courts do not appear likely

²⁸¹ See Forbes, *supra* note 193; Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991).

²⁸² See Christopher D. Stone, "The Place of Enterprise Liability in the Control of Corporate Conduct" (1980) 90 Yale L.J. 1; James A. Brander & Tracy R. Lewis, "Oligopoly and Financial Structure: The Limited Liability Effect" (1986) 76 Am. Econ. Rev. 956.

²⁸³ See Stone, *ibid.*

²⁸⁴ See Paul Halpern, Michael Trebilcock & Stuart Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 U.T.L.J. 117 at 148.

²⁸⁵ See e.g. Stephen B. Presser, "Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics" (1992) 87 Nw. U. L. Rev. 148; Carsten Alting, "Piercing the Corporate Veil in American and German Law—Liability of Individuals and Entities: A Comparative View" (1995) 2 Tulsa J. Comp. Int'l L. 187.

²⁸⁶ Nina A. Mendelson, "A Control-Based Approach to Shareholder Liability for Corporate Torts" (2002) 102 Colum. L. Rev. 1203.

²⁸⁷ *Fleet*, *supra* note 273 at 1557.

²⁸⁸ See Mendelson, *supra* note 286.

to embrace any far-reaching changes to the doctrine of corporate limited liability in the foreseeable future, some measure of corporate veil-piercing should be encouraged if financial institutions are to take more care in assessing the environmental risks associated with the companies they sponsor.

D. Corporate Environmental Reporting

A fourth pillar for environmentally responsible financing is obliging companies to report on their environmental performance. While Canadian companies are not currently required to routinely report in their financial statements on their environmental activities and costs, the regulatory trend in other jurisdictions is towards mandatory corporate environmental reporting. Why is environmental reporting relevant to ethical investment and lending? It is well documented that the ethical financing sector utilizes corporate annual reports and accounts in their assessment of companies.²⁸⁹ Financial institutions must have timely and comprehensive information available to support efficient investment and lending decisions. Mandating disclosure of environmental liabilities and costs under securities laws and other company legislation can facilitate financiers' appraisal of the environmental behaviour of businesses. In theory, if accurate information is publicly available, market forces can respond by feeding environmental costs and performance into the cost and terms of finance.

Corporate environmental reporting in Canada and other countries so far has occurred mostly on a voluntary basis, and consequently, the scope and quality of corporate disclosure has been uneven.²⁹⁰ Although banks can use contractual mechanisms to compel borrowers to provide certain environmental information as part of loan appraisal procedures, equity investors depend on publicly available information. European countries are leading the trend toward mandatory public environmental reporting, with reforms to this end adopted in Denmark, Norway, Sweden, the Netherlands, and Australia.²⁹¹ In 2002, the European Commission published a report entitled *Corporate Social Responsibility*, which refers to the desirability of corporate environmental reporting standards.²⁹² There are also extensive environmental disclosure rules contained in the SEC's reporting

²⁸⁹ See George Harte, Linda Lewis & David Owen, "Ethical Investment and the Corporate Reporting Function" (1991) 2 *Critical Persp. Acct.* 227 at 234.

²⁹⁰ See e.g. James Guthrie & Lee D. Parker, "Corporate Social Disclosure Practice: A Comparative International Analysis" (1990) 3 *Advances in Pub. Int. Acct.* 159.

²⁹¹ See KPMG Environmental Consulting, *International Survey of Environmental Reporting* (De Meern, Netherlands: KPMG Environmental Consulting, 1999), online: Scientific Institute for Environmental Management <<http://www.wimm.nl/publicaties/kpmg1999.pdf>>.

²⁹² EC, Commission, *Corporate Social Responsibility: A Business Contribution to Sustainable Development* (Luxembourg: EC, 2002) at 19, online: Europa <http://europa.eu.int/comm/employment_social/publications/2002/ke4402048.pdf>.

requirements, which have operated since the early 1970s.²⁹³ Yet even the previously revered US reporting system showed itself to have serious flaws in the wake of the Enron scandal, which occurred in part because of the SEC's inadequate monitoring of Enron's financial accounts and reports.²⁹⁴ Regulating environmental reporting is most likely to be effective when accompanied by detailed guidance on reporting criteria.

While the *CBCA* contains extensive provisions on corporate financial disclosures, there is no reference to environmental reporting.²⁹⁵ The provincial securities commissions oblige public corporations to report the current and anticipated financial or operational effects of environmental protection requirements in an Annual Information Form ("AIF").²⁹⁶ This requirement, however, is easily discharged with a few perfunctory words. For example, Shell Canada's 2002 AIF, a short document of some twenty-five pages, contains only one page devoted to environmental information with a brief statement of environmental expenditures.²⁹⁷ The AIF is complemented by other Canadian environmental reporting systems, such as the National Pollutant Release Inventory, which requires businesses to report on releases and transfers of many substances.²⁹⁸ A recent survey commissioned by Industry Canada on corporate environmental reporting revealed that only twenty-six per cent of Canada's one hundred largest companies routinely prepare environmental or social reports, many of which offer only single, issue-by-issue analyses without canvassing broader linkages between economic and environmental practices.²⁹⁹ Other studies of environmental reporting in Canada have concluded that mandating additional disclosure "would seem to be the only successful alternative."³⁰⁰

Besides regular reporting, corporate environmental management systems ("EMS's") can help financial institutions evaluate the environmental performance of clients.³⁰¹ In essence, EMSs provide a framework of standards and processes for

²⁹³ See Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency* (1999) 112 Harv. L. Rev. 1197.

²⁹⁴ See U.S., Staff of Senate Committee on Governmental Affairs, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs*, 107th Cong., Committee Print (2002).

²⁹⁵ *Supra* note 216, Part XIV on financial reporting.

²⁹⁶ For instance, as prepared in accordance with the Ontario Securities Commission, "Policy Statement 5.10: Rule 51-501 AIF and MD&A" (2000) 23:50 O.S.C. Bull. 8365.

²⁹⁷ Shell Canada, "Annual Information Form" at 14, online: Shell Canada Limited <www.shell.ca/code/investor/aif.pdf>.

²⁹⁸ See Bradley C. Karkkainen, "Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?" (2001) 89 Geo. L.J. 257 at 348.

²⁹⁹ Stratos, *Stepping Forward: Corporate Sustainability Reporting in Canada* (Ottawa: Stratos, 2001), online: Stratos <http://www.stratos-sts.com/sts_files/Stratos.full.report.pdf>.

³⁰⁰ Nola Buhr & Marty Freedman, "A Comparison of Mandated and Voluntary Environmental Disclosure: The Case of Canada and the United States", online: California State University Stanislaus <<http://panopticon.csustan.edu/cpa96/pdf/buhr.pdf>>.

³⁰¹ See John Voorhees, "Global Environmental Solutions: Management Systems and Synchronicity" (1999) 28 Stetson L. Rev. 1155; David Monsma, "Sustainable Development and the Global Economy: New Systems in Environmental Management" (2000) 24 Vt. L. Rev. 1245.

corporations to adopt so as to improve their internal use of materials and energy and a structure for companies to identify, appraise, and minimize their environmental risks. By summarizing environmental performance data, EMSs can help financial organizations efficiently assess the risks posed by clients. Davies suggests that “by looking for [EMS] registration in loan applications, banks can determine several facts relevant to the health of their loan portfolios.”³⁰²

Financial institutions may also benefit when they adopt an EMS to control their own direct and indirect environmental effects. There are a burgeoning number of packaged EMSs,³⁰³ notably the International Standardization Organization 14000 series³⁰⁴ and the EU’s Eco-Management and Audit Scheme (“EMAS”).³⁰⁵ Significantly, the EMAS was amended in 2001 to encompass financial services.³⁰⁶ The previously narrower focus of EMAS on industrial sites rather than company-wide environmental practice impeded the adoption of EMAS to the service sector, including financial service organizations. Under Annex VI of the new EMAS Regulation of 2001, participating organizations must consider all environmental aspects of their activities, including “indirect environmental aspects” arising from “capital investments, granting loans and insurance services.”³⁰⁷ This is a seminal change, because a financial organization’s direct ecological footprint (e.g., its energy use and waste) is markedly different from the impact of the companies it finances, which will usually be much more pervasive.

Obliging financial institutions to report on their own environmental impacts could also be beneficial. Regular reports would include information on in-house resource consumption and waste and, more importantly, the environmental dimensions of loans and investments. In addition to the “reflexive” qualities of such a procedural regulation, which would stimulate organizational change by increasing financiers’ awareness of their environmental impacts, these environmental reports could help financial authorities in their prudential regulation of banks and investors. Regrettably, current international surveys show little evidence of environmental reporting by financial service organizations.³⁰⁸ On 30 May 2001, the European Commission issued a recommendation on corporate environmental reporting, which

³⁰² Chris Davies, “What ISO 14001 Means for the Banking Industry” (1999) 106:3 *Can. Banker* 8 at 8.

³⁰³ See generally Jennifer Nash & John Ehrenfeld, “Codes of Environmental Management Practice: Assessing their Potential as a Tool for Change” (1997) 22 *Ann. Rev. Energy & Env’t.* 487.

³⁰⁴ See generally Ruth Hillary, ed., *ISO 14001: Case Studies and Practical Experiences* (Sheffield, U.K.: Greenleaf Publishing, 2000).

³⁰⁵ EC, *Council Regulation 1836/93 of 29 June 1993 allowing voluntary participation by companies in a Community eco-management and audit scheme (EMAS)*, [1993] O.J. L. 168/1.

³⁰⁶ EC, *Council Regulation 761/2001 of 19 March 2001 allowing voluntary participation by organisations in a Community eco-management and audit scheme*, [2001] O.J. L. 114/1.

³⁰⁷ *Ibid.*, 26.

³⁰⁸ See Riva Krut & Ashley Moretz, “The State of Global Environmental Reporting: Lessons from the Global 100” (2000) 7 *Corp. Env’tl. Strategy* 85.

demanded that financial institutions also be required to report on their environmental activities.³⁰⁹ To date, the German banking and insurance sectors have demonstrated the strongest commitment to environmental reporting but have acknowledged the difficulties in extending environmental accounting from the direct environmental effects of the financial organization to the indirect environmental effects of its investment decisions.³¹⁰ There is no systematic environmental reporting by Canadian financial institutions, apart from the inclusion of environmental statements in the AIF required of all *CBCA* businesses.³¹¹

Financial institutions' environmental reporting could be enhanced if linked to eco-labelling schemes that enable third parties to assess the environmental performance of lenders and investors. This would be particularly useful in the retail investment markets, where individual investors could direct their money to those mutual funds that practice sustainable financing. Environmental reporting would also assist consumers interested in green mortgages in the housing finance market. To date, the EU is the only jurisdiction to have introduced an eco-label scheme capable of being adapted to financial services and products.³¹² The EU's Eco-label Regulation was revised in 2000 to enable the scheme to apply to a much wider range of contexts, covering "any goods and services" including, in theory, financial services.³¹³ The development of an eco-label for the financial sector should stimulate marketing and reward innovation in this area.

Conclusion

This article has argued that because of their gatekeeping role within the economy, financial market institutions should be environmentally regulated and, thereby, become a force for promoting positive environmental change. Unfortunately, apart

³⁰⁹ EC, *Commission Recommendation of 30 May 2001 on the recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of companies*, [2001] O.J. L. 156/33 at 36.

³¹⁰ See Association for Environmental Management in Banks, Savings Banks, and Insurance Companies, "Time to Act: Environmental Management in Financial Institutions", by Gabriele Urban & Karin von der Emde at 10, online: Association for Environmental Management in Banks, Savings Banks, and Insurance Companies <<http://www.vfu.de/time2act.pdf>>; Michael van Mark, "Environmental Protection and Financial Services' Policy Measures Taken in Germany" in EC, Commission, *Final Report: Workshop on Sustainable Development—Challenge for the Financial Sector* (Luxembourg: EC, 1998) at 54-59.

³¹¹ See e.g. Ethical Funds, "Annual Information Form", online: Ethical Funds® <http://www.ethical-funds.com/pdf2/investor_resources/reports_investor_materials/EF%20AIF_CleanEng_FINAL_0602.pdf>

³¹² Traditionally, eco-labels are applied to individual consumer products rather than services, for which the environmental impact is much harder to assess: see generally OECD, *Eco-Labeling: Actual Effects of Selected Programmes*, Working Paper No. 44, Doc. No. OCDE/GC(97)105 (1997), online: OECD <[http://www.oilis.oecd.org/olis/1997doc.nsf/linkto/ocde-gd\(97\)105](http://www.oilis.oecd.org/olis/1997doc.nsf/linkto/ocde-gd(97)105)>.

³¹³ EC, *Council Regulation 1980/2000 of 17 July 2000 on a revised Community eco-label award scheme*, [2000] O.J. L. 237/1.

from the desire to avoid the traditional kinds of environmental liabilities, financial institutions often lack the motivation to care for the environment. Regulatory reform of this sector also faces considerable political and economic barriers. Consequently, governments will need to rely principally on financial incentive and informational mechanisms to steer financiers towards sustainable investment. An economy in which environmentally benign companies enjoy a priority to capital allocation is one that will surely align us much closer to sustainability than current forms of environmental law can achieve.

While there has been a paucity of environmental reform of Canadian financial markets to date, this article has revealed some positive initiatives in other countries including Australia, the Netherlands, and the UK. Even in these jurisdictions, however, there is considerable room for more extensive reform. The history of environmental law in Canada and elsewhere reveals that what was once unimaginable is today the ordinary. In the UK a decade ago, the Thatcher government was among the most belligerent opponents of a carbon tax proposed by the European Commission, but now Britain has its own carbon tax and did not even wait for the rest of Europe to lead the way.³¹⁴ Ultimately, the momentum for reform in Canada and other countries will hinge upon a sense of environmental urgency in society and the consequential political mandate for reform. The recent announcement of Canada's National Round Table on the Environment and the Economy to undertake a major study of the role of capital markets in shaping sustainable development may suggest that the prospects for reform in Canada are strengthening.³¹⁵

³¹⁴ Richardson, *Environmental Regulation*, *supra* note 2.

³¹⁵ National Round Table on the Environment and the Economy, "Capital Markets", online: National Round Table on the Environment and the Economy <http://www.nrtee-trnec.ca/eng/programs/Current_Programs/Capital-Markets/Capital-Markets_E.htm>.