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To: Ministry of Finance, Norway
From: Professors James P. Hawley and Andrew T. Williams
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Re: Comments on Consultation Paper

We want to thank the Norwegian Ministry of Finance for asking us to comment on the "Consultation paper – Evaluation of the Ethical Guidelines for the Government Pension Fund – Global." The Ministry of Finance is to be commended for the thoroughness and openness of this process and for seeking a broad range of voices to evaluate the results. This process is a model for other institutional investors wishing to improve their effectiveness as active owners.

We generally believe that the active ownership program of the Ministry and the Counsel on Ethics are working well and that they effectively implement the ownership responsibilities of the Government Pension Fund – Global (GPFG). Furthermore, while accepting the difficulties inherent in such an undertaking, that they appropriately reflect the ethical concerns that ownership implies. However, we do believe that the effectiveness of both the active ownership program and the Counsel on Ethics can be improved by closer coordination and more effective communication.

We are also very please to see that the GPFG declares itself to be a Universal Owner and that it views active ownership as an important part of its approach to responsible investment. Issues that confront a Universal Owner, particularly the need to consider the affect of firm specific externalities on the performance of the portfolio as a whole, are closely related to many of the issues raised by the evaluation of the ethical guidelines. An important aspect of universal ownership is a careful consideration of the way ethical guidelines and active ownership can work together to enhance portfolio returns by getting companies to modify behaviors that throws off negative externalities (e.g. green house gas emissions or the use of child labor). Inherent in this approach is a careful attention to strategies and practices that cut across firms and industries and to those initiatives where active ownership may lead to portfolio wide improvements.

Though it is beyond the boundaries of the current report, we urge the Ministry of Finance to consider how the Universal Ownership Hypothesis might be tested against the experience of GPFG and how the ideas it contains might be more fully implemented with regard to the fund's active ownership program. In particular, an examination of the feasibility of developing a quantitative analysis and/or a model of how negative externalities are in part internalized in the GPFG portfolio might be considered, perhaps with academic cooperation, and with an emphasis on quantifying value destroying externalities.

In the following sections we will comment on some of the issues raised for examination on pages 38 – 42 of the "Consultation paper – Evaluation of the Ethical Guidelines for the Government Pension Fund – Global." The report contains many interesting, thought provoking points, but we will confine our remarks to what we consider the most important issues. Furthermore, the Albright Group – Simon Chesterman[1] paper also raises many interesting issues and provides a wealth of useful suggestions, we will refer to it only in the context of the "Consultation paper."

Ownership Activities

We agree that the active ownership program of the Norges Bank has generally been effective and efficiently administered. We particularly agree with the proposition that from the Bank's role "as a universal investor with a long time horizon … the current evaluation process offers a good opportunity for debating and entrenching these perspectives in the general Norwegian public."[2] We urge the Norges Bank to take full advantage of this opportunity.

The report notes that the current focal area of environment and lobbing is somewhat narrow. While this is true we urge the bank to be careful when expanding its areas of concern. For active ownership to be effective, it should be closely tied to the Bank's role as a financial investor. Asking companies to increase their levels of disclosure around the impacts and risks resulting from climate change, for example, is an entirely appropriate extension of the Bank's existing priorities.[3] But extending the Bank's concerns to other focal areas should only be undertaken after a careful consideration of the issues involved and after broad, general agreement has been reached by the parties involved. Furthermore, the Bank should be pragmatic in its approach and carefully consider where its efforts are most likely to yield changes that will contribute the most to the total return of the funds portfolio.

We agree that the Bank should move to develop a clear set of guidelines around when engagement has failed and a set of clear and transparent consequences of failure. Divestment should be considered as only one of a range of consequences that could include continued monitoring, working with other institutional investors or NGOs and partial divestment or a freeze on further investments. In any case, the Bank will be obligated to monitor companies with which it has engaged to see whether behavior has changed. To efficiently perform this monitoring, the Bank may either develop adequate internal resources or rely on third party verification.

We also agree that cooperation with other investors is a key to both effective engagement and to establishing the Norges Bank as a leader in areas that are of particular concern to the Bank. However, this should not preclude the Bank from continuing to engage with companies on its own as direct engagement both communicates the Bank's concerns and helps the bank develop the kinds of resources necessary to be an effective active owner.

As recommended, transparency in reporting engagement activities, at the appropriate point in the process, can be both an important tool of engagement and an effective way to build

[1] "Assessment of Implementation of Articles 3 and 4 of the Ethical Guidelines for the Government Pension Fund – Global" by the Albright Group LLC and Simon Chesterman, 21 May 2008.
[2] "Consultation paper – Evaluation of the Ethical Guidelines for the Government Pension Fund – Global" , Ministry of Finance, p. 29
[3] Ibid, p. 29.

support for the Bank's programs. Thus, we concur with the recommendation that the Norges Bank continue the precedent set with the 2007 annual report.[4]

The Exclusion Mechanism

The exclusion mechanism is at the heart of the mandate given to the Council on Ethics and it is this institution that sets Norway apart from most other large institutional investors. Since exclusion is virtually the only tool the Council has at its disposal, we agree that it can be a blunt instrument and may not be the most effective way to achieve the goals envisioned for the Council. We support the proposition that the Council should be equipped with more policy measures and that, in practice, these policy measures will be most effective when coordinated with the Norges Bank's corporate engage activities. The Fund might want to consider making explicit that its ethical policy 'tools' can run the gamut between various forms of engagement to exclusion, the specifics varying with each case.

The expansion of the areas of concern beyond those already existing should be undertaken with the utmost care and consideration. In particular, the Council should be wary of including issues that may rise to the agenda because of transient concerns because it is likely to be difficult to remove an issue once it has been placed on the Council's list. In this regard, we agree that the Council in particular and the Ministry of Finance in general should understand that "it is not the purpose of the fund to serve as a tool of international aid policy, of trade and industry policy or for foreign policy."[5]

Greater dialogue between the Council and companies is likely to improve the effectiveness of the Council and it is most important that this communication should be coordinated with the Bank's corporate engagement activities in order to maximize effectiveness. Furthermore, the Council should increase its capacity, either internally or externally, to monitor company compliance with its decisions and it should make explicit and public those steps a company would need to take to satisfy the Council's concerns

Finally, we do not think that it would be useful to make focal areas public beyond those stated in the Council's guidelines. However, *ex post* transparency in the form of annual reports with supporting explanation for actions taken and not taken is very important and public discussion of the procedures, concerns and actions is crucial for the legitimacy and reputation of the Council.

Should changes be made to the interaction between the measures?

As noted above, we generally believe that the ethics and corporate engagement programs of the Government Pension Fund – Global have worked well and have been an effective expression of the Fund's ownership responsibility. However, also we believe that the overall effectiveness of both programs can improved by better communication and coordination between the Council and the Norges Bank's corporate engagement activities.

[4] Ibid. p. 30.
[5] Ibid p. 38

We agree that it would be beneficial to provide the two groups with a broader range of policy measures. We strongly support the establishment of an observation list which would be the subject of on going discussion between the Norges Bank and the Council on Ethics. However, we would suggest two lists. One list would be internal and private and would consist of companies in the early stages of engagement. A second list would consist of companies under active engagement or under active, public consideration by the Council. The second list should be made public and should be widely publicized. Private communication of the possible movement of a company from one list to the other would be an additional policy instrument the bodies could use to influence company behavior. The negative publicity associate with appearing on the public list would be an important policy instrument for both the Council and for the active engagement program. Thus we agree with the statement that, "The Ministry of Finance takes the view that the mechanism for the exclusion of companies has a role to play beyond the avoidance of contributions to grossly unethical conduct … in the form of serving as a threat that may move an active ownership process forward."[6]

In any case, we urge the Norges Bank and the Council communicate fully and to the extent possible with one another and that they coordinate their activities with regard to companies of interest to both bodies. This coordination and the possibility of using the full range of policy instruments available to both bodies is likely to be an important and effective way to broaden the list of policy measures available to the Norges Bank and the Council separately.

Organization of the work: should structural amendments or adjustments be made to the procedural rules?

We trust that the Ministry of Finance will make the appropriate amendments to the guidelines that govern the Council on Ethics and the corporate engagement program of the Norges Bank in order to 1) enhance communications between the two bodies through a series of regularly scheduled formal meetings and ongoing, informal contacts, 2) mandate the sharing of all relevant information between the two bodies in a timely manner and 3) the coordination of actions between the two bodies to ensure that the programs, actions, and engagements of each body have the maximum effectiveness.

Again, we thank the Ministry of Finance for soliciting our opinions. We would be happy to elaborate on any of the above points.

Regards

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[6] Ibid p. 40.