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Comments on Ethical Guidelines

by Robert C. Pozen

This e-mail is submitted in response to the public consultation and the consultation paper ("Paper") initiated by the Norwegian Ministry of Finance ("Minister") with respect to the Ethical Guidelines ("Guidelines") of the Norwegian Government Pension Fund ("Fund"). This e-mail represents the personal opinion of Robert C. Pozen, and does not necessarily reflect the views of MFS Investment Management or Harvard Business School.

Let me begin by congratulating the Minister on the adoption and implementation of the Guidelines to date. The Minister, the Council on Ethics ("Council") and the Norges Bank Investment Management ("Bank") have thoughtfully carried out their responsibilities under the Guidelines, yet they have been open to suggestions for improvements as shown by this public consultation. Therefore, this submission will focus on the following areas:

I. Clarification of Fund Obligations
II. Exclusion for Certain Weapons Manufacturers
III. Exclusion for Human Rights Violators
IV. Organizational Structure for Decisions
V. Reconsideration Process for Excluded Companies

I. Clarification of Fund Obligations

As the Paper recognizes, the Guidelines incorporate two different types of obligations for the Fund – to earn favorable long-term returns and to avoid the Fund's contribution to specified gross or serious ethical violations. The first set of obligations in the Guidelines are "based on the assumption that favorable returns in the long run are dependent on sustainable development in economic, ecological and social terms." (p. 11). This assumption is supported by the Universal Owner Hypothesis: that one portfolio company's externalization of costs will have a negative effect on other portfolio companies, "with the outcome being a negative impact on the overall return of the portfolio" of a large, well-diversified institutional investor (p. 9).

Although this assumption and hypothesis may be true in certain situations, they will not apply in all situations. For example, the externalization of negative costs from one portfolio company may be absorbed by a private company that cannot be held in the Fund's portfolio. Alternatively, external costs may be absorbed by governmental units financed by a mix of taxes that are borne mainly by people who are neither shareholders nor pension beneficiaries.

As the Paper explains (p. 11), the second set of obligations is based more on a deontological perspective than a consequential approach aimed at delivering the best outcome for the Fund. In my opinion, however, the consequential approach should have a much higher priority for the Fund than the deontological perspective. If a company's activities are so reprehensible, why is it justified for the Fund simply to sell investments in that company? The sale of even 1% of a company's stock will have a minimal effect on its activities over the long term. While Norwegians may feel less guilty after the sale, the rest of the world will continue to suffer from the company's activities.

Under the Guidelines, of course, the Minister must find that the company is likely to continue its reprehensible activities in the future – before deciding to have the Fund sell that company's stock. Moreover, the Minister may postpone such a sale in order to evaluate whether the risks of holding the company's stock may be reduced to acceptable levels by ownership actions. But these determinations have largely been hypothetical exercises by the Minister. To assure the priority of the consequential approach over the deontological perspective, the Minister should be required to actually take relevant ownership actions to try to change a company's conduct and to sell its stock only if the company does not respond appropriately to such actions.

II. Exclusion for Certain Weapons Manufacturers

Under the Guidelines, the Minister may exclude from the Fund's investments companies that manufacture certain types of weapons like cluster bombs. The criteria for this exclusion are relatively straight-forward, but the Fund's sale of such a company's stock is highly unlikely to change the company's manufacturing practices. Again, although Norwegians may feel less guilty after such a sale, it does nothing to help stop the spread of these weapons deemed so ethically objectionable by the Guidelines.

This deontological perspective is particularly problematic in situations where the Norwegian Government continues to purchase other military equipment from the same company sold by the Fund because it manufactured other types of weapons. In these situations, which have happened in the past, Norway could take consumer as well as ownership actions in an effort to persuade a company to change its manufacturing policies. For example, Norway could work with other like-minded countries to stop buying military aircraft from a company unless it halted production of certain weapons deemed ethically objectionable by these countries.

III. Exclusions of Serious Human Rights Violators

The criteria in the Guidelines for serious violators of human rights are much less clear than the criteria for manufacturers of certain weapons. In excluding companies from the Fund's investments for human rights violations, the Minister has cited compacts, conventions or resolutions of the United Nations, the ILO or other international bodies. However, these generally apply to member countries, rather than public companies; and some countries have not ratified all of these international standards. Indeed, the Guidelines do not exclude tobacco companies, although smoking is banned or discouraged by certain international standards. Thus, it would provide helpful notice to companies if the Minister announced in advance exactly which international standards would be applied in determining human rights violations under the Guidelines.

The Paper describes the range of public and other sources used by the Council in finding and assessing whether a company has committed a serious violation of human rights (p. 16-17). But some corporate executives have expressed concern that the information sources of the Council are heavily weighted toward groups whose principal purpose is to criticize the conduct of multi-national companies. To counter these concerns, the Council should make sure that it solicits information from sources on both sides of any issue. For instance, the Council has cited serious allegations from plaintiffs' papers in class action suits, which have not yet been decided on the merits, without consulting the lawyers defending the company in these suits.

Before issuing its recommendation to the Minister, the Council regularly asks the subject company for its view on the Council's draft report. This is an excellent practice, which can help the Council avoid confusion or factual errors. However, some corporate executives believe that, by the time they receive a draft report, the Council has come fairly close to reaching a conclusion. Therefore, it would be helpful for the Council to contact the target company at an earlier stage in the process and pose a specific set of questions about the issues being examined. In addition, the Council should later solicit the target company's comments if the Council drafts an adverse recommendation to the Minister.

IV. Organizational Structure for Decisions

As the Paper notes, the policy tools available to the Council are quite limited. It can only recommend that a company be excluded, or not be excluded, from the Fund's investments. In specific, the Council has no power to suggest ownership actions by the Fund, which might influence the conduct of the company. By contrast, the Bank is authorized to engage in ownership actions, on behalf of the Fund, to influence the conduct of the company. Indeed, when the Minister receives a sale recommendation from the Council, he Minister typically asks the Bank to develop an ownership strategy for that company.

I agree with the position of Professor Chesterman and the Albright Group – that the division of functions between the Council and the Bank be retained (p. 40). Each institution has a different perspective and plays a different role. The Minister benefits from hearing more than one viewpoint, especially on difficult cases.

However, the Council and the Bank should be encouraged to exchange information and work more closely together. In some cases, they could present a joint plan to the Minister; in other cases, they may argue opposing positions before the Minister. To facilitate such cooperation, the Guidelines should be revised to allow the Council to recommend ownership actions as well as divestitures. The Guidelines should also require the Council to share information and consult with the Bank before making any final recommendation to the Minister. These suggestions are consistent with those in the Paper (p. 31-32).

V. <u>Reconsideration Process for Excluded Companies</u>

The Paper recognizes that the exclusion of companies from the Fund's investments has a negative impact on its expected return and risk (p. 17-18). In addition, if a company is excluded from the Fund's investments, it may be difficult for the Bank or the Council to have a fruitful dialogue with that company. Although the Minister has taken one company off the excluded list, that happened mainly because the company made a business decision to stop exploring for oil or gas in a particular graphic area.

After a company is placed on the excluded list, the Minister usually says that the Council will regularly monitor the company to determine if its stock should be reinstated as a Fund's investment. Such regular monitoring may be an unrealistic goal given the work load of the Council relative to its resources. It also does not seem realistic for the Minister to switch positions on a company very quickly.

Therefore, the Minister might establish a readmission procedure, which could be initiated by the Council or the company, at any time after three years from the date the company was originally excluded from the Fund's investments. Such a procedure would allow the Council to focus its attention on an excluded company if and when there were good reasons to believe that the company's situation had materially changed in relevant respects. The potential to initiate restatement procedures would also give excluded companies the incentive to change their behavior in a manner that would overcome the initial concerns of the Minister under the Guidelines.

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I hope that these comments will be useful in the Minister's consultation of the Guidelines. If the Minister or staff wants to discuss these comments further, please feel free to contact me.

Sincerely,
Bob Pozen