

# Norm-based Exclusions

**How responsible  
investors  
handle controversial  
companies**

January 2012

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# Introduction

SRI initially consisted in excluding business sectors considered as reprehensible (tobacco, alcohol and weapons) on moral grounds. In Northern Europe, where this practice is still very widespread, other types of exclusions have been developed, which are aimed at safeguarding the reputation of major institutional investors, and at avoiding them being linked with controversial issues that affect the companies they invest in. These exclusions usually involve violations of major international human rights or environmental protection norms. They are often called as norm-based exclusions.

In France, SRI funds prefer best-in-class approaches to so-called ethical exclusions. However, the idea of excluding companies in order to avoid black sheep is gradually gaining ground among SRI funds voices. Moreover, an increasing number of investors outside the SRI community view norm-based exclusions as a tool that is applicable to all their assets, and that enables them to avoid criticism of their legitimacy and social usefulness, which has risen constantly since the beginning of the financial crisis. Whilst investors had only gone down the path of multi-dimensional sustainable development up until now, they currently seem increasingly willing to adopt strong and sometimes political positions, in order to safeguard their reputations, by implementing norm-based exclusions on the grounds of specific issues, such as respect for human rights. This is especially the case for the exclusion of so-called controversial weapons, which have now been banned by international conventions.

In fact, the survey of 250 European institutional investors conducted by Novethic in 2011 shows that, among investors who state that they include ESG issues for all their assets invested in equities, 62% apply norm-based exclusions, while only 36% use best-in-class approaches.

The demand from retail investors is more diffuse and indirect by nature; however, the introduction of norm-based exclusions could make it easier for them to buy in to SRI. Indeed, these policies enable a more credible SRI policy to be achieved, since it excludes more companies that are the subject of controversies in the media, although their global CSR approach may enable them to be selected by a number of SRI funds.

At this stage, norm-based exclusion practices are not always identical between one player and another. There is not even a consensus on names. Although "norm-based" is not a rare term, some people favour "exclusion of worst practices", or mention it in a wider context, as an integral part of their ethical exclusion policy. The aim of this report is therefore to define this concept, to specify the norms under consideration, and the practices that derive from those norms, as well as the goals that various players associate with these norm-based exclusions. So far, very little research has been issued about this emerging phenomenon. It was therefore interesting to draw up a comparative analysis of the main European practices.

# I.

## Framework

### What do we mean by “norm-based exclusion”?

Norm-based exclusions have been developed with the idea that, even if companies do not face the same legal requirements regarding environmental, social or governance issues between one country and another, they must be in a position to comply with a certain number of fundamental international norms in order to meet the requirements of responsible investors, regardless of the business involved or the country in which they operate. Unlike ESG selection approaches, which are usually based on comparisons between companies in the same sector (best-in-class), norm-based exclusion therefore aims to be more “all-encompassing” by establishing minimum ESG norms.

However, referring to “norms” is not the prerogative of norm-based approaches, as companies’ ESG evaluation matrices have historically been drawn up by relying on a norm-based framework, primarily by extra-financial rating agencies, in order to guarantee their soundness and enforceability. There are nonetheless two fundamental differences between the ESG selection approach and norm-based exclusion:

- Although the extra-financial analysis performed as part of a norm-based approach focuses on various ESG issues (human rights, corruption, etc.), as does the best-in-class approach, it only dwells on a limited number of criteria, which are factored in on an individual basis. In other words, the proven violation of a norm may lead to a company’s exclusion, regardless of the quality of its overall CSR policy. Conversely, under a best-in-class approach, a company’s ESG rating is derived from the weighted average of scores awarded according to a large number of criteria (one hundred, in some cases), which enable a company to achieve a high extra-financial score despite a controversy that is specific, and limited in scope.
- The traditional ESG evaluation process relies mainly on public data circulated by issuers, even though it usually takes its stakeholders (NGOs, trade unions, etc.) into account. In fact, these stakeholders are the main source of information in a norm-based analysis. Their criticisms, which are conveyed by the media, enable behaviours that may reflect as many violations of international conventions to be identified. After checking the reliability of the information source and assessing the gravity of the facts, the information is forwarded to the companies. In this way, they have a right of reply, which will enable their responsiveness and ability to propose corrective measures to be assessed.

Having made this distinction, the norm-based exclusion process does not simply exclude all companies that are the subject of allegations involving a violation of international norms made by their stakeholders. Checking the reliability of information sources, assessing the violation according to its gravity, its systematic nature and its frequency, and assessing the measures implemented by the company in order to rectify it are necessary stages for identifying proven, serious and repeated violations, to which the company has provided no satisfactory response. In fact, this is why an increasing number of extra-financial rating agencies offer a dedicated service, which makes the task of

identifying potential exclusions easier for investors. Although the services offered by EIRIS (Convention Watch) and Ethix (Norm-Based Screening) are the most widely known, GES Investment Services (GES Global Ethical Standard), Inrate (Screening), MSCI (MSCI ESG Impact Monitor) and Vigeo (Ethical Compliance Monitoring) also offer such services<sup>1</sup>.

### From engagement to norm-based exclusion

Although foreign investors usually use the terms “*exclusion*” and “*negative screening*” to describe the norm-based exclusion approach, the issue of excluding a security for violating a norm is not systematic. Other approaches (shareholder engagement, watch list, investments freeze) can be combined with the assessment of whether a company is complying with norms.

The assessment stages described above, which aim to ensure that a violation is sufficiently serious to lead to a security being excluded, often result in a process of dialogue with the company, if only to grant it a right of reply regarding the facts of which it is accused. Investors may also engage with the company, in order to encourage it to take the appropriate measures for putting an end to said violation, and to ensure that it will not reoccur. In this case, exclusion is no more than the final step in the controversy assessment process, in cases where the incriminated company turns out to be unable to put an end to the violations that it is guilty of.

During the timeframe required to engage with a company, many investors decide to place that company on a watch-list, which tells it that they expect improvements, and that otherwise, they will withdraw their investment. For some investors, this timeframe is also accompanied by a freezing of investments in the securities concerned.

### “Dialogue, observation and exclusion”: the approach adopted by KLP, the Norwegian insurance company



(Source: SRI Report, KLP, December 2011)

<sup>1</sup> For further details on providers of extra-financial information used as part of the norm-based exclusion process, please consult Novethic's *Overview of extra financial rating agencies*, Novethic, September 2011.

## Main benchmark norms

Among the international norms that investors use most frequently, the International Labour Organisation's conventions are undoubtedly the most specific, while the Global Compact principles represent a framework that is used more as a means of interpretation based on underlying norms.

### The ILO Conventions

There are currently 189 International Labour Organisation conventions, covering a wide spectrum, 159 of which are currently in force. Among the most wide-ranging, we would especially point to the eight fundamental ILO conventions that deal with four major issues: freedom of association, non-discrimination, and the prohibition of child and forced labour.

- The freedom of association and protection of the right to organise convention, 1948 (No. 87);
- The right to organise and collective bargaining convention, 1949 (No. 98);
- The forced labour convention, 1930 (No. 29);
- The abolition of forced labour convention, 1957 (No. 105);
- The minimum age convention, 1973 (No. 138);
- The worst forms of child labour convention, 1999 (No. 182);
- The equal remuneration convention, 1951 (Nº 100);
- The discrimination (employment and occupation) convention, 1958 (Nº 111).

As part of the norm-based assessment process applied by most financial players, the connection between fundamental conventions and other conventions raises a question, inasmuch as it is the fundamental conventions that are usually formally specified in exclusion policies. In practice, however, most funds seem to apply the full extent of the ILO conventions to all the issues that they monitor, particularly where the occupational safety conventions (Nos 155 and 187) are concerned.

That being said, this body of conventions has the advantage of covering the major social issues relating to employment law, and of being widely recognised at the international level, even though not all 183 ILO Member States have ratified all the conventions, far from it in fact (the United States, for instance, has only ratified 14 of them).

### The OECD Guidelines

The OECD Guidelines for multinational companies amount to a detailed corporate code of conduct, which covers all the major social responsibilities for companies. These principles therefore address the following issues: human rights, employment and professional relationships, the environment, combating corruption, the solicitation of bribes and other forms of extortion, the interests of consumers, science and technology, competition, and lastly taxation. The OECD Guidelines, which were drawn up in 1976, were last updated in 2011. The latest version includes new, stricter norms, particularly in the area of human rights.

The Guidelines are not binding, but include a process for handling complaints and for mediation, which is provided by National Contact Points (NCPs). According to the OECD, these "NCPs help companies and their shareholders to take appropriate measures to further the objectives of the Guidelines". They provide a platform for mediation and conciliation between companies and their stakeholders (trade unions, NGOs, etc.), in order to resolve practical issues that may arise when implementing the Guidelines.

In this way, the OECD Guidelines not only provide a complete framework of recommendations for companies in terms of ESG issues, but are also linked to a mediation system for applying those Guidelines, which makes them a functional tool, and one that is, in fact, regularly used by investors seeking to implement a norm-based exclusion process.

### **Anti-corruption conventions**

Where corrupt practices are concerned, there are two instruments that have an international reach, and enable investors to base their approach on specific texts:

- The OECD Anti-Bribery Convention (1999) establishes legally binding norms aimed at "making the bribing of foreign public officials in international business transactions a criminal offence". This is the first anti-bribery instrument, which targets the "supply" side of a transaction tainted by corruption. The 34 OECD Member Countries and four non-member countries (South Africa, Argentina, Brazil and Bulgaria) have adopted this Convention.
- The United Nations Convention against Corruption (2005) is also a legally binding international instrument for combating corruption. The Convention covers various aspects of the combat against corruption: prevention, incrimination, international cooperation and asset recovery. The Convention has been ratified by around 150 UN Member States to date.

Both these conventions therefore represent a sound norm-based framework for combating corruption, which is perfectly suited for use in the norm-based exclusion processes implemented by investors. As they are ratified by countries, they commit those countries to preventing and sanctioning corruption among their nationals, which includes the business activities of companies operating on their territory.

Other texts are often used for reference purposes as part of norm-based exclusion processes, even if they are less directly applicable to companies. They nonetheless serve as a body of values that can be used for assessing companies or countries.

### **The Universal Declaration of Human Rights**

The Universal Declaration of Human Rights (UDHR), which was adopted in 1948, recognises the existence of fundamental freedoms and rights that are shared by all. This declaration includes a strong civil and political dimension, which makes it complementary to the ILO Conventions, with which it nonetheless shares many principles.

Although it is first and foremost intended for countries, investors also refer to the UDHR in order to assess companies' behaviour in their sphere of influence, whether that behaviour involves respecting the fundamental freedoms of the populations close to their production plants, or, more broadly, appealing to the governments of the countries in which they operate. This second dimension is rarely taken into account by French investors. It finds more favour with Anglo-American investors, who talk about advocacy on the assumption that multinational companies have a political role to play in the countries in which they do business, particularly where non-democratic regimes are involved.

### **The Rio Declaration**

The 1992 Rio Declaration on Environment and Development is the framework that investors mention most often where the environment is concerned. The Declaration is not legally binding by nature, and is primarily intended for countries, whose cooperation is necessary in order to protect the environment. However, it does confirm the Declaration of the United Nations Conference on the Human Environment, which was adopted in

Stockholm in 1972, and stated at that time that "to achieve this goal [the preservation of the environment], will demand acceptance of responsibility by citizens and communities, and by enterprises and institutions at every level, all sharing equitably in common efforts."

Still in the environmental sphere, the Convention on Biological Diversity (1993) is also used as a benchmark norm by investors. The aim of that Convention is "the conservation of biological diversity, the sustainable use of its components, and the fair and equitable sharing of benefits arising from the use of genetic resources."

## **The Global Compact: a framework that tends to create a consensus**

The Global Compact, which was launched by Kofi Annan in 2000, is an initiative backed by the United Nations. Participating companies voluntarily commit to comply with the following ten "universally accepted" principles, which cover human rights, labour standards, the environment and anti-corruption:

1. Businesses should support and respect the protection of internationally proclaimed human rights; and
2. Make sure that they are not complicit in human rights abuses
3. Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
4. The elimination of all forms of forced and compulsory labour;
5. The effective abolition of child labour; and
6. The elimination of discrimination in respect of employment and occupation.
7. Businesses should support a precautionary approach to environmental challenges;
8. Undertake initiatives to promote greater environmental responsibility; and
9. Encourage the development and diffusion of environmentally friendly technologies.
10. Businesses should work against corruption in all its forms, including extortion and bribery.

The Global Compact is not legally binding, and is not a norm, but is defined as a "set of values". Although the Global Compact involves a voluntary commitment from companies, over 6,000 of them have already signed up to it, including around 1,600 in Europe. It is maybe this enthusiasm from companies that has made it so successful with investors. In fact, although it is not a norm, or a code of conduct, the Global Compact is the framework that investors use most often as a basis for norm-based criteria.

What might appear a paradox is actually more a misuse of language, since the Global Compact's ten principles are actually drawn from a certain number of international norms that have been described above (the UDHR, the ILO Conventions, the Rio Declaration and the United Nations Convention against Corruption). For investors who use the Global Compact, the aim is therefore not to exclude companies that have not signed up to the Compact, but to exclude companies that are guilty of violating one of the underlying norms, and therefore one of its principles, regardless of whether they are signatories.

There is nonetheless a risk of confusion where using the Global Compact as an analytical framework is concerned, inasmuch as it is not only used for norm-based purposes, but also in traditional ESG selection processes. Indeed, for some players, compliance with the Global Compact is understood more as the drawing up and implementation of a global CSR policy that is in line with its ten principles. For instance, the French pensions reserve fund (FRR)'s responsible investment policy has been explicitly based on the Global Compact's

principles since the Fund was launched, whilst no norm-based approach was applied before 2008. The same goes for the Belgian Asset Managers Association (BEAMA), which has defined a certain number of required criteria for a fund to qualify as a "Sustainable and Socially Responsible Investment UCIs (SRI)". The BEAMA methodology includes the following criterion, among others: "For an investment product to be included into an SRI portfolio, it must meet the following minimum standards: 1. Compliance with the UN Global Compact principles [...]"<sup>2</sup>. In this context, "complying with minimum standards" does not mean systematic exclusion in case of non-compliance.

Moreover, although most investors understand the meaning of the expression "Global Compact Compliance", which is used by Sustainalytics, for instance, to describe its norm-based assessment service, as the absence of any violation of the Global Compact's principles it can also be used in a completely different way. Indeed, companies that participate to the Global Compact are required to publish in their annual report a description of the ways in which they are implementing its ten principles. Those companies that actually publish this "Communication on Progress" are then formally compliant with the Global Compact.

## Controversial weapons: a case in point

### **The Mine Ban Treaty and the Convention on Cluster Munitions**

The exclusion of controversial weapons such as anti-personnel mines and cluster bombs has created a broad consensus among investors. From a norm-based point of view, the ban is justified by the adoption of the Ottawa Convention or "Mine Ban Treaty" in 1997, which prohibits the use, storage, production and transfer of anti-personnel mines, as well as by the entry into force of the Convention on Cluster Munitions (CCM) aimed at banning and eliminating cluster bombs.

The Ottawa Convention was ratified by 156 countries, including the European countries (except for Poland, which signed the Convention but did not ratify it), but not by the United States. The Convention on Cluster Munitions was signed by 111 countries and ratified by 66 of them, including the European Union Member States, but once again not by the United States.

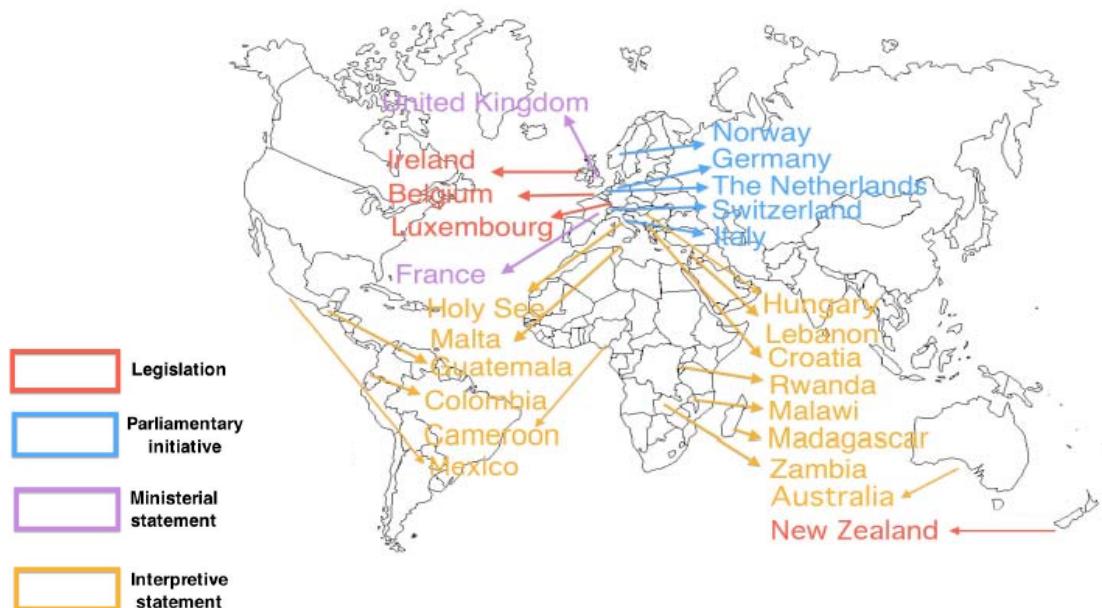
Moreover, we would note that, for some investors, the term "controversial weapons" extends to other types of weapons, such as nuclear weapons, and depleted uranium weapons etc., depending on the legislation adopted in their own country.

### **The financing of controversial weapons**

In each country, the ratification of these treaties results in the adoption of domestic legislation banning these weapons. This legislation usually includes manufacturing, stockpiling, using and selling these weapons, but does not explicitly mention their financing, which amounts to a legal void in this area. Belgium is the first country to have adopted legislation on the financing of controversial weapons in March 2007. The Belgian Asset Managers Association (BEAMA) now provides its members with a list of companies identified with the assistance of Ethix, the extra-financial rating agency, which they are free to exclude from their portfolios in order to ensure that they comply with the law. Since then, Ireland (2008), Luxembourg (2009), New Zealand (2009), and Italy (June 2011), have followed Belgium's lead. Many countries have not explicitly introduced the

<sup>2</sup> <http://www.beama.be/duurzame-icbs-fr/definitie-en-methodologie-dmvi>

issue of financing these businesses into their legislation, but have nonetheless confirmed that financing them was banned, since it represented a form of assistance for these businesses.



### Ban on the financing of cluster bombs across the world

(Source: IKV Pax Christi and Netwerk Vlaanderen, May 2011<sup>3</sup>)

In France, the law does not explicitly forbid the financing of this type of weapons; however, the Law of July 2010 on the banning of cluster bombs nonetheless specifies that "it is also forbidden to assist, encourage or incite anyone to involve themselves in one of the banned activities mentioned above"<sup>4</sup>. In fact, during the debate on the draft law in the French Senate, Hubert Falco, the Secretary of State for Defence and Veterans, specified that: "Where financing is concerned, it is clear in our mind that all informed direct or indirect financial assistance for a business that manufactures or trades in cluster bombs would amount to assistance, encouragement or incitement, which fall under the criminal law on complicity to commit or the committing of crimes specified in this draft law. If the French National Commission for the Elimination of Anti-Personnel Mines (CNEMA)'s work on monitoring the application of the law concludes that the law is inadequate on this point, the Government will draw the necessary conclusions, and suggest the necessary legal changes to Parliament."<sup>5</sup>

The French Asset Management Association (AFG), to which Amnesty International and Handicap International appealed recently, has taken these further details from the legislator on board, since it has launched a working group applying this law to asset management this year.

<sup>3</sup>

[http://www.ikvpaxchristi.nl/UK/below\\_thematic\\_security\\_and\\_disarmament\\_cluster\\_munition\\_home\\_stop\\_explosive\\_investment\\_s.htm](http://www.ikvpaxchristi.nl/UK/below_thematic_security_and_disarmament_cluster_munition_home_stop_explosive_investment_s.htm)

<sup>4</sup> Law N° 2010-819 of July 20<sup>th</sup> 2010

<sup>5</sup> [http://www.assemblee-nationale.fr/13/cri/2009-2010-extra/20101008.asp#INTER\\_0](http://www.assemblee-nationale.fr/13/cri/2009-2010-extra/20101008.asp#INTER_0)

## II.

# Processes designed to preserve investors' reputation

Although SRI funds based on the best-in-class model have often been designed with the idea of encouraging a more sustainable development model via financial leverage, the aims of investors that use norm-based exclusions are materially different. For these institutional investors, the aim is first and foremost to protect their reputation by avoiding any risk of being criticised by civil society (NGOs and trade unions), or by their beneficiaries (policyholders, pensioners) because of investments in particularly controversial companies. As a result, these institutional investors usually choose approaches that apply to all their assets, and are not just restricted to a few SRI funds.

### **Demand from asset owners**

Since the beginning of the downturn, financial players have held a high profile in the media. Through movements like *Occupy Wall Street*, civil society is gradually calling into question their ability to serve the economy and society, rather than their own interests. In the Nordic countries, this is not a new development. Investments made by the Norwegian Government Pension Fund or the large Dutch pension funds regularly make headlines in the media, thereby forcing their managers to change their investment policies.

The attention paid to reputational risk probably explains why, when these investors publicly disclose the list of companies excluded from their investments, they do not always distinguish between ethical and norm-based exclusions. For these investors, this is a global exclusion process, the aim of which is to avoid investing in "controversial" securities.

Some investors also opt for norm-based exclusion in order to improve their risk management. In this case, they want to exclude companies with controversial ESG practices that could have a significant financial impact, primarily because these companies are endangering their licence to operate.

For instance, Vedanta, the mining company that is often excluded by investors due to its environmental and human rights practices, saw its operating licence for a bauxite mine project suspended by the Indian government, following a major controversy in 2010. This company, which is excluded by many investors, therefore has both reputational and operational risk issues.

Several investors decided not to participate in the Glencore's IPO in May 2011 for the same reason. The Swiss company, which specialises in mining, managed to raise around US\$10 billion, but is nonetheless criticised for human rights violations and tax evasion. The company's IPO brought Glencore's controversial ESG practices into sharp focus, as well as the lack of transparency on management of these issues, which may ultimately threaten its operating rights in some locations. This is why the Ethos Foundation publicly announced in July 2011 that it was excluding the company due to "the risks for investors that arise not only from controversies relating to environmental and social damage allegedly caused by Glencore, but also from the company's attitude".

### **The Norwegian Government Pension Fund**

The Norwegian Government Pension Fund Global's policy is often used as an example in terms of excluding companies that are guilty of breaching international norms. The Government Pension Fund, which is the largest in Europe, developed this approach very early on, in order to legitimise its very existence with the Norwegian population, which was originally not very keen to see its oil windfall invested all over the world via the financial markets.

In fact, from 2001 onwards, the Norwegian Ministry of Finance appointed an advisory commission, which is responsible for assessing whether some of the oil fund's investments contradicted Norway's commitments in terms of international law. The Norwegian Government implemented the commission's recommendations for the first time in 2002, when it excluded Singapore Technologies Engineering, due to its anti-personnel mines manufacturing business. By publishing its ethical guidelines in 2004, the Ministry of Finance made its investment policy widely applicable; the aim of this policy is to exclude from the Norwegian Government Pension Fund Global portfolio investments that constitute an unacceptable risk of contributing to serious or systematic human rights violations, serious violations of the rights of individuals in the event of war or conflict, severe environmental damage, and gross corruption.

The Council on Ethics is responsible for identifying companies that ought to be excluded, and submits its proposals for excluding or monitoring a company to the Ministry of Finance.

The Fund, which has investments in over 8,000 companies, allocates substantial resources to identifying potential controversies and checking that they are founded. The Council on Ethics has appointed consultants to follow the news on all the companies in the portfolio, and receives a very detailed monthly report on companies accused of serious norm violations everywhere in the world, and particularly in Asia.

All companies that are guilty of norm violations are not systematically excluded from the portfolio. In its assessment, the Ministry of Finance primarily takes into account the seriousness and extent of the violation, and ultimately decides whether to exclude a company on the basis of the Council on Ethics' recommendations, depending on the willingness of the company to make improvements.

Since the introduction of this policy, a total of around thirty companies have been excluded, in accordance with the Fund's guidelines, plus around thirty others due to their tobacco or nuclear weapons-related businesses. Five of them have since been reinstated. The most symbolic exclusions currently in force are Wal-Mart, Freeport McMoRan, Rio Tinto, and Barrick Gold, while the most recent ones are Samling Global and Lingui Development Berhad.

### **A well-regarded exclusion list**

The list of companies excluded by the Norwegian pension fund has always been the subject of very detailed public disclosure, which includes the Ministry of Finance's decision and the expert report produced by the Council on Ethics in support of the exclusion. This strategy, combined with the size of the Fund, has given it significant influence not only over companies, but also over other financial players. As a result, many of them have excluded the same securities as the Norwegian pension fund, in order to avoid being accused of investing in a company that their Norwegian counterpart has called into question. This is the case for the insurance company KLP (Norway), and for the Petercam (Belgium) and Pictet (Switzerland) asset management companies where their SRI or theme-based funds are concerned. The risk turned out to be real, since the New Zealand Green Party did in fact in 2011 accuse the New Zealand Superannuation Fund of continuing to invest in companies excluded by the Norwegian pension fund.

Lastly, this process amounted to a fundamental step for both KLP and Generali, the Italian insurance company, which followed the Norwegian pension fund's exclusions for a certain period, and subsequently led both companies to define their own individual norm-based exclusion strategy.

### **The Dutch pension funds**

In the Netherlands, the media and civil society examine institutional investors' practices regularly. In this country, where mandatory pension assets are capitalised via large pension funds, retirees ask for an explanation from their asset managers on a regular basis. For instance, following the Zembla TV programme broadcast in March 2007, the controversy was strong enough to result in the major national pension funds rapidly defining exclusion policies on controversial weapons, in line with the treaties ratified by the Netherlands. In fact, the funds applying such exclusions, which now represent the bulk of the SRI market in the Netherlands, increased by 88% between 2007 and 2009 according to Eurosif, amounting to €266 billion at that time.

Today, ABP and PFZW, the two largest pension funds in the country, with €350 billion of aggregate assets managed by APG and PGGM respectively, have implemented advanced and transparent norm-based exclusion processes. The underlying policies, and the list of companies and countries excluded as a result, are published on the pension funds' websites.

### **French asset owners**

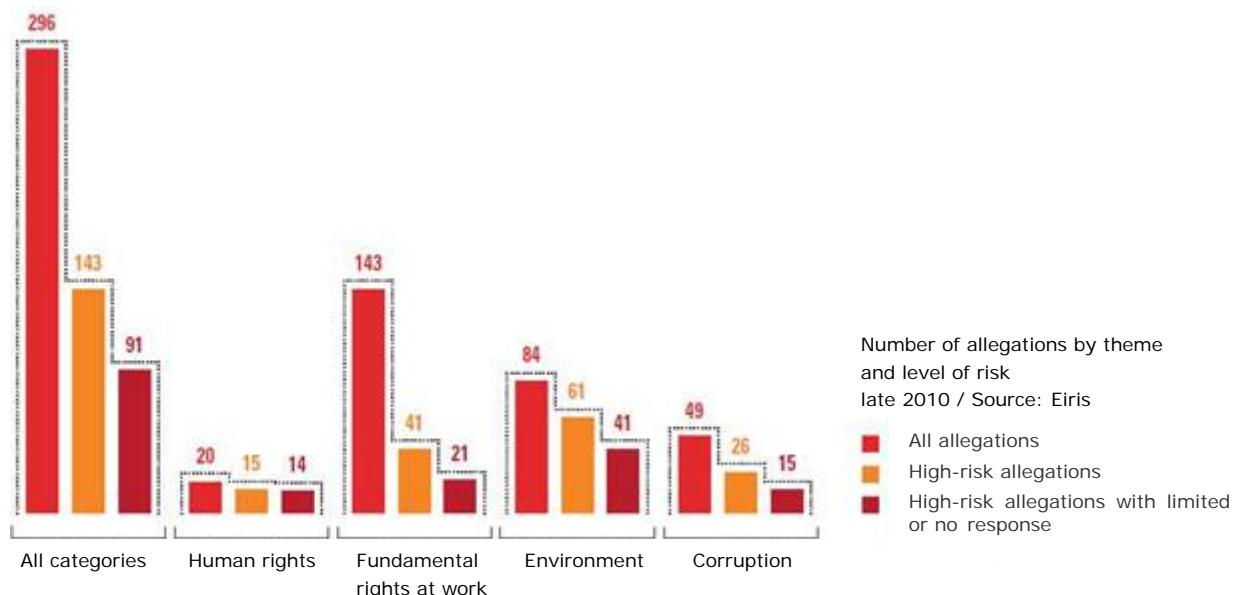
In France, some asset owners have been gradually going down the path of responsible investment over the past decade, primarily in order to meet the expectations of trade unions within bodies that are managed on a joint basis (Agirc Arrco, FRR, etc.), or where the management depends on the civil service (ERAfp, Ircantec, etc.). However, few of them have ultimately adopted norm-based exclusion processes to protect their reputation. In particular, among the nine French asset owners who signed the Principles for Responsible Investment (PRI), only four players have implemented this type of approach: the FRR used it for companies, while the ERAfp (French public service additional pension scheme), CNP Assurances, and the MAIF used it for countries (see box below).

The FRR is therefore the only French asset owner to have adopted a norm-based approach for an international corporate universe, but without systematic exclusions from its portfolios that are managed by proxy. The Fund has relied on EIRIS' Convention Watch tool, and on its controversial weapons screening service since 2007. As the FRR commented in a release published when the Fund was launched, this approach was drawn

up "in order to identify and minimise extra-financial risks that could have an impact on its reputation". To that end, the FRR intends to enter into a dialogue with companies that are the subject of controversy, and reserves the option to exclude them from its investment management mandates if no corrective action is taken.

According to its 2010 annual report, 91 allegations described as "serious, and regarding which the company took no measures, or only limited measures", were identified among the companies in which FRR invests thanks to the Convention Watch tool. These allegations involve 67 companies (one company can be the subject of several allegations) out of around 2,600 companies in the portfolio analysed by EIRIS, i.e. 2.5% of the companies analysed.

### Number of allegations by topic and level of risk identified by EIRIS in the FRR portfolio



(Source: FRR, 2010 Annual Report)

In fact, despite their stakeholders' rising expectations, French investors are lagging behind their Dutch and Scandinavian counterparts. Do they need a media controversy to change their investment policies?

### Applying norm-based screening to countries

Norm-based exclusions of countries, which are less widespread than norm-based exclusions of companies, are nonetheless a worthwhile process, primarily due to the political dimension that they imply.

The ERAFP, which chose to implement a comprehensive SRI policy based on the best-in-class principle as soon as it was launched, rounded out that policy with several exclusion criteria for government bonds, covering the death penalty, the use of child soldiers, and the practice of torture. Countries like Japan or the United States, for instance, which have not abolished the death penalty, could see themselves excluded from the ERAFP bond portfolio if they were part of its investment universe (which currently covers issuers of bonds denominated in euros).

Apart from its best-in-class approach, CNP Assurances does not apply norm-based exclusion policies either, except where anti-personnel mines and cluster bombs are involved in the case of companies, and where food products are involved in the case of UCITS. Conversely, the insurance company has applied an exclusion policy for countries with the highest scores in the Transparency International and Freedom House indices (high level of perceived corruption and few civil and political freedoms). This has led the company to exclude a country that is not a member of the OECD.

Lastly, at the MAIF, it is the ILO norms, the Kyoto Protocol and the UN Millennium Development Goals that provide the foundation for norm-based assessments, which have been performed on government bonds since 2009.

Outside France, the Dutch ABP pension fund published a list of excluded countries in January 2012. That list includes countries subject to a United Nations embargo on weapons sales, namely the Democratic Republic of Congo, North Korea, the Ivory Coast, Eritrea, Iraq, Iran, Liberia, Libya, Somalia, and Sudan. Meanwhile, PGGM has drawn up a list of seven countries that are the subject of sanctions from the United Nations Security Council, or where the ILO recommends their exclusion, namely: North Korea, the Ivory Coast, Eritrea, Iran, Libya, Myanmar, Somalia, and Sudan. However, since these countries issue few or no bonds, their exclusion has no impact on the investment management process; it has therefore been implemented in order to protect their reputation.

### Measures implemented by asset managers

An increasing number of asset managers, who listen to their institutional clients, especially the international ones, are developing norm-based approaches, either as an addition to existing processes for their SRI funds, or to meet the specific demands of investors as part of investment management mandates.

Investment management companies also understand the reputational dimension that these exclusions may embody, and are sometimes led to apply them to all their financial assets, including non-SRI assets. This is especially the case for the exclusion of so-called controversial weapons.

#### Meeting institutional demand

Allianz Global Investors is one of the first asset managers in France to have adopted a norm-based screening approach for its SRI funds. Since 2002, the "Human Rights" criterion has become a screening criterion for SRI equity funds. This approach, which predates the ESG selection process, aims to have a dual effect. When a warning relating to

human rights arises, investments are frozen and SRI analysts enter into a dialogue with the company in the portfolio. They have one month after the warning to issue an opinion, namely to retain the company in, or exclude it from the investment universe. For instance, this approach led Allianz GI to exclude Unilever in 2011, due to evidence of poor human rights practices in its supply chain, despite the fact that the company is highly rated by extra-financial agencies for its global CSR policy. According to Allianz GI, several asset owners are interested in this approach, some of whom expect an even more stringent approach under the terms of their investment tenders.

Moreover, if we believe Eric Van Labeck from the OFI Group, the human rights criterion is the one to which investors pay most attention. The asset manager does not apply any exclusion processes in its open-ended UCITS, but does so on request for investment mandates, where once again expectations often focus on human rights<sup>6</sup>.

Meanwhile, AXA Investment Managers' strategy demonstrates the influence of foreign demand on this type of approach. Indeed, except for exclusions linked to anti-personnel mines, cluster bombs and depleted uranium weapons, which are applied to the whole group in order to meet civil society's expectations, and the systematic exclusion of the tobacco and defence sectors for SRI funds, AXA IM has adopted a systematic norm-based exclusion process only for the fund distributed in the United Kingdom, while a positive (best-in-class) approach is used for the funds distributed in France.

The aim of BNP Paribas Investment Partners' approach is to implement its undertakings as a signatory of the Principles for Responsible Investment (PRI) in a manner that is consistent with the BNP Paribas Group's CSR policy, while meeting the requirements of certain clients. Its policy consists in excluding companies that do not comply with the ten Global Compact principles from its funds. To that end, BNPP IP relies on research from Sustainalytics, the extra-financial rating agency, and with final approval for exclusion decisions being given internally. This approach, which was originally implemented for BNPP IP's SRI and theme-based funds, will be applied soon more broadly to all BNPP IP's assets under management, except for the index-linked and multi-management businesses.

As a result, BNPP IP is expected to follow Amundi's lead; this company now applies norm-based exclusions in its investment management business, in order to anticipate clients' expectations, and prevent any risks to its reputation. In fact, a few securities have been entered on a non-investment blacklist since 2011 in the group's active investment management business, which amounts to over €600 billion.

Two converging trends are emerging: on the one hand, asset managers that are increasingly identifying a demand from asset owners that focuses on compliance with international norms, or in addition to best-in-class approaches, the results of which are not always sufficiently visible, and on the other, asset managers that are gradually rolling out norm-based exclusions, in order to preserve their reputation, without necessarily disclosing that they are doing so.

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<sup>6</sup> Source: Interview with Eric Van Labeck, Head of Research and Development, OFI Group – Macif Gestion, January 9<sup>th</sup> 2012. [www.newsmanagers.com](http://www.newsmanagers.com)

## The main asset managers that operate in the French market and use norm-based exclusions

Asset manager	Description used	Benchmarks used	Scope of application	
			SRI funds	Other
AGICAM	Monitoring extreme risk	Global Compact	x	
Allianz GI France	Exclusion	Universal Declaration of Human Rights (UDHR)	x	
Amundi	Exclusion of companies that are in serious and repeated breach of the Global Compact	Global Compact		All assets under management*
AXA IM	Ethical Policies	Human rights violations, serious water pollution, etc.	AXA Ethical Distribution Fund (UK)	
BNP Paribas IP	Application of the Global Compact	Global Compact	x	All assets under management (2012)*
Dexia AM	Norm-based analysis	Global Compact	x	
Federal Finance	Responsible screening	Global Compact	x	
La Banque Postale AM	Assessing the application of international human rights norms	Human rights and fundamental employments rights	Libertés et solidarité fund	
La Financière Responsable	Exclusion	UDHR, ILO, OECD guidelines	x	
Petercam	Exclusion	Norwegian Government Pension Fund list	x	
Pictet AM	Exclusion of worst practices	Not disclosed		Theme-based funds
Sparinvest	Norm-based screening	OECD guidelines, Global Compact, UN norms on the Human Rights Responsibilities of Transnational and other Companies, UN Human Rights norms	x	
Triodos Investment Management	Minimum standards	ILO, OECD, etc.	x	

\*excluding index-linked management

Given that some players do not disclose their norm-based exclusion processes, this list cannot be considered as exhaustive. For instance, the OFI Group has implemented this type of approach for some SRI mandates, without any details being disclosed.

### **Norm-based exclusions applied on a case-by-case basis**

Two kinds of norm-based exclusion approaches co-exist: some players duplicate the processes used as part of ESG selection approaches, with violation rating systems. The most serious violations automatically lead to exclusion. Others work on a case-by-case basis, using ad hoc assessments that are generally discussed at an ethics committee before deciding on exclusion.

For instance, for each identified violation, several criteria enable Dexia AM to rank the seriousness of the violation involved: its temporal proximity, its extent (financial and ecological impact, etc.), the credibility of the information source, its repetitiveness, as well as the solutions provided by the company in order to ensure that such a violation does not reoccur. Dexia AM ranks violations under three categories, depending on their seriousness and their extent, namely green, orange, and red. All companies that receive at least one "red flag" in one of the four areas represented by human rights, labour standards, environment, and anti-corruption are excluded from the SRI investment universe.

Federal Finance's approach combines two factors that may lead to exclusion based on the Global Compact principles, i.e. either an evidence of a violation of its principles, or very high exposure to fundamental issues, where there is no visibility on measures that could prevent future violations.

Another example is that applied by the Sparinvest investment management company, which adheres fully to the green, amber and red signal system suggested by Ethix, the Swedish agency.

Amundi, meanwhile, has chosen a more qualitative process. This process is based on a two-step approach, which involves the extra-financial research team identifying problematic companies, and a rating committee that includes members from the research, investment and risk management teams taking exclusion decisions on a case-by-case basis. Although the exclusion system is based on a rating – the excluded companies are those rated G on a scale of A to G -, the choice of a G rating is made by the rating committee on a case-by-case basis for every company that is in serious and repeated breach of the Global Compact, and therefore represents a reputational risk for the asset manager.

### **The issue of regulatory compliance**

Where anti-personnel mines and cluster bombs are concerned, the implementation of norm-based exclusions was initially a response to legal. In this case, asset owners and asset managers commit to complying with the conventions ratified by their country. Nowadays, most institutional investors in France, Belgium or the Netherlands, for example, have such policies, which comply with the texts ratified by their respective countries. According to the annual survey conducted by Novethic in 2010, 67% of investment management companies that are active in the French SRI market state that they have implemented such exclusions.

However, although the application of the Ottawa Treaty and of the Convention on Cluster Munitions now represents a "reduced service" for an increasing number of investors where norm-based exclusions are concerned, this has not always been the case. In addition to the introduction of domestic legislation, it is the pressure exercised by civil society, especially the NGOs and the media, which has driven, and is still driving

investors to exclude companies involved in the manufacturing of these weapons from their portfolios.

In fact, the New Zealand Superannuation Fund was called to order by the Green Party in August 2011, because of its investments in companies that did not comply with the treaties ratified by New Zealand. The Green Party primarily accused the New Zealand pension fund, which has, however, excluded cluster bomb manufacturers since 2008, of investing in five companies involved in this business, namely GenCorp, Kaman, Saab AB, Tata Power and Zodiac Aerospace.

Even more recently, in September 2011, RBS, the British bank, agreed to withdraw from any new agreements with cluster bomb manufacturers, after *The Independent* newspaper and NGO groups revealed its investments in companies that manufacture such weapons, most likely Alliant Techsystems and Lockheed Martin, according to the paper<sup>7</sup>. A campaign conducted by Amnesty International resulted in over 10,000 people emailing the bank's Chief Executive within less than two weeks, asking him to put an end to the bank's investments in cluster bomb manufacturers.

Conversely, there is no law explicitly banning the financing of companies that are guilty of breaching the international norms ratified in their own country. Belgium is the first country to discuss the adoption of such a law for SRI funds.

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<sup>7</sup><http://www.independent.co.uk/news/uk/home-news/rbs-severs-ties-with-makers-of-cluster-bombs-6128753.html>

### **Belgium: towards generalising norm-based exclusion in SRI funds?**

Belgium has been thinking about introducing a legal definition of SRI for several years; this definition would primarily cover the exclusion of companies that are guilty of violating the international treaties ratified by Belgium.

At the request of Marie Arena, a Belgian senator who was the Federal Minister for Social Integration, Pensions and Major Cities at the time, the Belgian Réseau Financement Alternatif (RFA) published a *"Report on a Proposed Definition of a Legal Standard for Socially Responsible Investment"*. Faced with a plethora of SRI funds, all extremely different, the RFA is suggesting drawing up minimum criteria that funds distributed in Belgium should apply in order to qualify as SRI funds. They specifically include negative criteria according to which "in order to enjoy SRI certification, the investment product cannot invest in companies where there is significant evidence that they are guilty of, either as perpetrators, co-perpetrators or accomplices, or that they are benefiting from actions that are prohibited by the international treaties ratified by Belgium<sup>8</sup>".

A "draft bill aimed at promoting responsible investment" covering the key elements of this report was therefore tabled by two senators, Philippe Mahoux and Marie Arena, in February 2011. This draft bill primarily provides for the compiling of a company blacklist, arising from the application of norm-based exclusion criteria. This list would not be left to investors' discretion, but would be drawn up by the Government, through the Banking, Finance and Insurance Commission (CBFA).

Aside from the political crisis experienced by Belgium, which has delayed the continuation of discussions on this proposal, the list of companies concerned still needs to be drawn up. Given the diversity of the existing lists applied by investors in the same country, this stage could represent an obstacle for applying the law. For the Belgian Asset Managers Association (BEAMA), which is opposing the proposal, the application of such strict exclusion criteria would lead to only around ten of over 200 so-called SRI funds currently identified in Belgium qualifying as SRI funds.

Now that a new Belgian government has been formed, discussions around this draft bill should begin again in the near future.

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<sup>8</sup> [http://www.financite.be/s-in-former/bibliotheque\\_fr\\_11\\_3\\_1\\_3.html](http://www.financite.be/s-in-former/bibliotheque_fr_11_3_1_3.html)

### III.

## The impact of norm-based exclusions

### A statistical study on companies excluded by 32 investors

This research provided the opportunity to combine the lists of companies that are currently excluded by about thirty asset owners or asset managers, in order to identify those that appear mostly on exclusion lists.

This data cannot be considered as exhaustive given that some investors do not disclose this information. However, regardless of whether are involved lists that have been made public or lists disclosed directly to Novethic, they enable statistics to be drawn up regarding norm-based exclusion practices, and the most controversial companies to be highlighted.

#### Exclusion lists (excluding anti-personnel mines and cluster bombs)

The exclusion lists (excluding anti-personnel mines and cluster bombs) of 15 investors (nine asset managers and six asset owners) have been gathered, either from data published on their websites (60%), or from data directly forwarded to Novethic (40%). Foreign investors are over-represented (67%), and are the only ones to disclose information about their exclusions.

#### Investor panel

ABP (Netherlands)  
Amundi (France)\*  
AP7 (Sweden)  
BNP Paribas IP (France)\*  
Dexia AM (France)\*  
Ethias (Belgium)  
Federal Finance (France)\*  
KLP (Norway)  
La Financière Responsable (France)\*  
PFA Pension (Denmark)  
PGGM (Netherlands)  
PNO Media (Netherlands)  
SNS AM (Netherlands)  
Sparinvest (Denmark)\*  
The Government Pension Fund Global (Norway)

\*Non-public lists

The 16 companies excluded most frequently for norm violations (excluding anti-personnel mines and cluster bombs)

	Business sector	Country	% of investors who exclude this security	% of asset managers	% of asset owners	% of French investors	% of foreign investors	Exclusion criteria
<b>Vedanta Resources</b>	Mining	United Kingdom	67%	78%	50%	80%	60%	Environment, human rights
<b>Wal-Mart</b>	Retailing	United States	53%	33%	83%	40%	60%	Labour rights
<b>Freeport-McMoRan</b>	Mining	United States	40%	33%	50%	40%	40%	Environment
<b>Barrick Gold</b>	Mining	Canada	33%	33%	33%	40%	30%	Environment
<b>Chevron</b>	Oil & gas	United States	27%	11%	50%	20%	30%	Environment, human rights
<b>Dongfeng Motor Group</b>	Automobile	China	27%	11%	50%	20%	30%	Human rights, weapons and military equipment sales to the Myanmar regime
<b>PetroChina</b>	Oil & gas	China	27%	22%	33%	20%	30%	Environment, human rights
<b>Sterlite Industries (a Vedanta subsidiary)</b>	Mining	India	27%	22%	33%	20%	30%	Human rights
<b>Alpha Natural Resources</b>	Mining	United States	20%	22%	17%	40%	10%	Human rights
<b>BAE Systems</b>	Aerospace & defence	United Kingdom	20%	33%	0%	60%	0%	Corruption
<b>Halliburton</b>	Oil & gas	United States	20%	33%	0%	40%	10%	Labour rights
<b>Norilsk Nickel</b>	Mining	Russia	20%	11%	33%	20%	20%	Environment
<b>Potash Corporation</b>	Chemicals	Canada	20%	0%	50%	0%	30%	Human rights
<b>Rio Tinto</b>	Mining	United Kingdom	20%	11%	33%	0%	30%	Environment
<b>Samling Global</b>	Forestry	Malaysia	20%	11%	33%	20%	20%	Environment
<b>Total</b>	Oil & gas	France	20%	22%	17%	20%	20%	Operation in Myanmar, Labour rights

## Exclusion lists involving anti-personnel mines and cluster bombs

Where anti-personnel mines and cluster bombs are concerned, the lists of companies excluded by 28 investors (13 investment management companies and 15 institutional investors) were virtually all compiled from public data (93%). The panel mostly includes foreign investors (86%), who all publish their exclusion list on their website. Indeed, only two French players, La Banque Postale Asset Management (LBPAM) and the Fonds de Réserve pour les Retraites (French Pension Reserve Fund) make their lists public.

### Investor panel

ABP (Netherlands)  
AEGON (Netherlands)  
Amundi (France)\*  
AP 1-4 (Sweden)  
AP7 (Sweden)  
ATP (Denmark)  
Aviva (United Kingdom)  
BNP Paribas IP (France)\*  
Danske Bank (Denmark)  
Ethias (Belgium)  
Fonds de Réserve pour les Retraites (France)  
KBC (Belgium)  
KLP (Norway)  
La Banque Postale AM (France)  
National Pensions Reserve Fund (Ireland)  
New Zealand Superannuation Fund (New Zealand)  
Nordea (Sweden)  
Nykredit (Denmark)  
Pensioenfonds Horeca & Catering (Netherlands)  
Pensioenfonds Vervoer (Netherlands)  
PFA Pension (Denmark)  
PGGM (Netherlands)  
PNO Media (Netherlands)  
Robeco (Netherlands)  
SEB (Sweden)  
SNS AM (Netherlands)  
Spoorwegpensioenfonds (Netherlands)  
The Government Pension Fund Global (Norway)

\*Non-public lists

**The 15 companies that are most frequently excluded due to their involvement in the manufacturing of anti-personnel mines or cluster bombs**

	Country	% of investors who exclude this security	% of asset managers	% of asset owners	% of French investors	% of foreign investors
<b>Lockheed Martin</b>	United States	100%	100%	100%	100%	100%
<b>Textron</b>	United States	93%	92%	93%	100%	92%
<b>Alliant Techsystems</b>	United States	89%	85%	93%	75%	92%
<b>General Dynamics</b>	United States	89%	85%	93%	75%	92%
<b>Poongsan</b>	South Korea	89%	92%	87%	75%	92%
<b>Hanwha</b>	South Korea	82%	85%	80%	75%	83%
<b>L-3 Communications</b>	United States	82%	85%	80%	100%	79%
<b>Singapore Technologies Engineering</b>	Singapore	82%	100%	67%	100%	79%
<b>GenCorp</b>	United States	50%	69%	33%	50%	50%
<b>Raytheon</b>	United States	50%	31%	67%	25%	54%
<b>Aerostar</b>	Romania	36%	46%	27%	50%	33%
<b>Aerotech</b>	Romania	29%	38%	20%	50%	25%
<b>Aryt Industries</b>	Israel	29%	54%	7%	50%	25%
<b>China North Industries (Norinco)</b>	China	25%	38%	13%	50%	21%
<b>Goodrich</b>	United States	25%	23%	27%	25%	25%

**A limited impact on portfolios**

Among the panel of investors who exclude controversial weapons, the number of excluded companies stands at 13 on average. For those who exclude companies on the basis of other criteria, the average number of companies excluded also stands at 13. Basically, norm-based assessment leads investors to identify a very limited number of companies guilty of serious and proven violations, and that have not implemented the appropriate measures. Norm-based exclusion approaches have a limited impact on investment universes, which usually consist of over 1,000 securities, and therefore on the management process. In this context, it could facilitate the extension of norm-based screening to all assets under management. For comparison purposes, the norm-based exclusion process introduced by Dexia AM for its SRI funds, resulted in the elimination of 5% of the companies analysed, while its SRI best-in-class screen only retains 35% of the companies among its SRI investment universe. Meanwhile, the Norwegian Fund's norm-based screening process excludes about 0.3% of its investment universe.

In proportional terms, the extra-financial rating agencies yield similar results, if we consider companies that are guilty of serious violations and have not taken the appropriate measures. For instance, EIRIS' *Convention Watch* tool has identified around

sixty companies (excluding anti-personnel mine and cluster bomb manufacturers) that did not provide any solution, or provided only a limited response to a violation with a high level of risk in a universe of around 3,000 companies world-wide (excluding emerging countries), i.e. a rate of 2%. The rate was significantly higher among the 700 companies assessed in emerging countries, where it reached 10%. Likewise, the research that MSCI conducted for its *ESG Impact Monitor* tool led to a "red" light being awarded to around 50 companies (out of an international universe of 2,350 companies, including around 750 in emerging countries). In contrast, if we consider companies that are the subject of proven norm violation allegations (but not repeated, systematic, or for which corrective measures have been taken), over 700 companies fall into that category according to MSCI ("yellow" light).

### **Limited convergence among the exclusion lists**

A compilation of the exclusion lists of the fifteen investors from our panel, not including anti-personnel mines and cluster bombs, leads us to identify no fewer than 120 different companies. Almost three quarters of them are excluded by only one member of the panel, and only the 16 companies listed on page 24 are excluded by at least 20% of them. Nonetheless, most investors who use a norm-based exclusion process rely on the same body of international norms, and the exclusions practiced by some of them, like the Norwegian Fund, are very high-profile. However, companies where exclusion creates consensus among investors are rare.

Investors are more united regarding companies involved in manufacturing anti-personnel mines and cluster bombs (page 26): eight of these companies are excluded by at least 80% of the panel. However, the list of excluded companies is not universal: the Norwegian Fund excludes eight companies for these reasons, while PGGM, the Dutch investment manager excludes 17, and KBC, the Belgian bank, excludes 48! The compilation of our panel's exclusions therefore results in a list of over 70 different companies. There are several reasons for these disparities. First of all, a few players include unlisted companies in their exclusion list, which results in a significant widening of the range of companies concerned, and is the main explanation for the large number of companies identified. In addition, where some investors consider that a subsidiary is involved in the manufacturing of controversial weapons, others consider that the whole group is involved, or that both entities are, when they are listed. In fact, the financial participation threshold according to which people consider that a company is involved in this kind of weapons appears to vary between one investor and another. Lastly, when a company ends its involvement in the manufacturing of controversial weapons, the frequency of updating lists or the application of a precaution principle by investors, may explain why the company disappears from a certain number of exclusion lists but still features on others.

### **Extractive industries are the main excluded sector**

Among the sixteen companies that investors exclude the most (aside from anti-personnel mine and cluster bomb manufacturers), seven are part of the mining sector. The high exposure to ESG risks of this sector explain its strong representation in excluded

companies<sup>9</sup>. Indeed, over 60% of the investors surveyed exclude Vedanta Resources, on the grounds of human rights violations or environmental damage. Barrick Gold and Freeport McMoRan are excluded by 40% and 33% of the panel respectively on the grounds of environmental damage.

In contrast, the list of companies that are most frequently excluded by the panel includes relatively few companies in the oil and gas sector, which are nonetheless the subject of a high number of controversies. In fact, oil and gas producers are particularly concerned by the EIRIS *Convention Watch* tool, not only in terms of the number of companies involved, but also in terms of the number of serious violations to which the company has not responded. The companies are mainly accused of pollution and human rights violations.

PetroChina and Chevron, which are excluded by 27% of investors on the panel, and Total which is excluded by 20% of them, feature most regularly. In contrast, oil and gas companies like BP, Exxon Mobil, and Royal Dutch Shell are only excluded by one or two members of the panel. For instance, Sparinvest, the Danish investment management company, is the only investor on the panel to exclude Royal Dutch Shell from its SRI funds. In its reports, Sparinvest explains that it sold its holdings in late 2010, in accordance with the recommendations of Ethix, the extra-financial rating agency. Ethix put Royal Dutch Shell under a "red light", primarily because of the environmental damage caused by oil leaks, and for its gas flaring practices in Nigeria. In addition, Ethix also gave the "orange light" status to Eni Spa, due to its 5% investment in the Nigerian joint venture managed by Royal Dutch Shell.

Moreover, aside from Wal-Mart, which is excluded by over 50% of the panel for non-compliance with employment laws, mass retailing, like the food processing industry, is virtually absent from the exclusion lists. Even though some companies in these sectors are often accused of non-compliance with employment laws.

We further note that there are a number of reasons for excluding a company. Indeed, BAE Systems appears in both tables, and is excluded either because it manufactures cluster bombs, or because of corruption.

## What is the leverage over companies?

The direct impact of norm-based exclusion processes on the CSR policies of the targeted companies appears to be low. Indeed, although an increasing number of institutional investors applies norm-based exclusions to all their assets, which represent a substantial amount of capital (over €2,000 billion), these approaches have not lead to a reduction of capital flows for controversial companies. On the one hand, this is because investors who adopt this type of approach do not represent sufficient funds on a global scale for a company to see its sources of funding drying up. On the other, it is because these investors do not all exclude the same companies. The case of Wal-Mart, the giant US retailer, which is excluded by several investors because of its anti-union or discriminatory practices, shows that a company can see its share price rise even at the height of the financial downturn, no matter how controversial it is.

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<sup>9</sup> For more information, please refer to the [Listed mining sector and ESG risks](#) report, Novethic, September 2011

Nonetheless, when these approaches are public, they can put the company in an uncomfortable position by threatening its image, and encourage it to pay particular attention to investors' demands. Norm-based exclusion may therefore represent a way to question the company and to initiate a dialogue, or may even drive investors to engage with the company, so that it improves its social and environmental practices, or its anti-corruption policy. For instance, the Ethos Foundation's public announcement of Glencore exclusion in July 2011, and the media impact of that decision, made the company react. Glencore entered into a dialogue with Ethos, published its first sustainable development report, and announced that it was joining the Extractive Industries Transparency Initiative (EITI) in September 2011!

However, this is only possible if the move to exclude a company is made public, or if it is disclosed to the company targeted by the investor, at the very least.

### **Anti-personnel mines and cluster bomb manufacturers**

Although it is not possible at this stage, to establish a direct link with the exclusion processes implemented by major international investors, we note that some companies, including those in countries that have not ratified the treaties on controversial weapons, have withdrawn from any business linked to anti-personnel mines and cluster bombs.

For example, in March 2011, the Norwegian Fund announced that it had received confirmation that L-3 Communications, the US company that markets electronic equipment primarily for military purposes, was no longer producing components intended for the manufacture of cluster bombs. The company, which had been excluded from the Fund since 2005, was therefore reinstated in its investment universe. ABP, the largest Dutch civil service pension fund, behaved in the same way when it updated its exclusion list, which was published in January 2012. On the same occasion, the pension fund also announced that it had removed General Dynamics, Magellan Aerospace, Valente Systems and Zodiac Aerospace from its exclusion list.

### **A response from investors that is consistent with civil society's expectations**

The lists of companies excluded for standard violations by investors highlight a certain convergence with companies that have been stigmatised by NGOs because of their practices, which are deemed unacceptable. For instance BankTrack, the NGO, publishes a "non-exhaustive" list of major international projects and companies that it considers guilty of human rights violations. It is interesting to note that 12 out of the 27 "dodgy companies" identified by the NGO are excluded by at least one of the investors on the panel described above.

Primarily, investors rely on reports or warnings from NGOs when conducting research ahead of norm-based exclusions, or explicitly choose to rely on the work of well-known NGOs in order to identify the companies to exclude. For instance, LBPAM mentions the reports that two NGOs, Handicap International and Human Rights Watch published in 2005 on its website, in order to justify its selection of companies excluded because of their involvement in the manufacture of anti-personnel mines and cluster bombs.

Secondly, some investors draw up their own norm-based exclusion approach, by involving representatives from civil society. Allianz GI, for example, was one of the first investment management companies in France to start excluding companies from its SRI

funds on human rights grounds, from 2002 onwards. To this end, Allianz relies on a "SRI Steering Committee", which consists of representatives from civil society. The same applies to LBPAM's "*Libertés et Solidarité* (Freedoms and Solidarity)" SRI fund: non-compliance with the assessment criteria arising from EIRIS' *Convention Watch* tool is validated by the International Federation for Human Rights (FIDH). These criteria, which initially focused on human rights compliance in connection with the NGO's activities, have gradually been extended to the combat against corruption and environmental damage.

In fact, when applied to SRI funds, norm-based exclusion is a means of responding to criticisms of the best-in-class selection process, which is accused of "smoothing" issuers' ESG practices to a certain degree, by offsetting very poor practices in respect of some rating criteria against high scores in respect of others. The implementation of norm-based exclusions therefore represents not only an addition to the best-in-class approach, but a minimum guarantee of the credibility of an SRI approach. The Alternative Financing Network (RFA) puts forward this argument, among others, in Belgium in order to encourage the government to introduce a minimum requirement for a fund to qualify as an SRI fund (see box on page 23). In this case, norm-based assessment will enable unacceptable ESG practices to be isolated, and therefore, perhaps, the expectations of retail customers, and more broadly of civil society, for whom best-in-class approaches are still not very convincing, to be met.

## IV.

# The limits of the process

### A limited scope

Although investors usually apply norm-based exclusions to the whole asset management business, there is nonetheless one exception: index-linked management. Actually, not only an increasing share of institutional assets is allocated to index-linked management, but in addition, most companies that are excluded according to norm-based criteria are part of the main global stock market indices, given the size of their market capitalisation.

For instance, among the top twenty companies excluded for human rights violations, damage to the environment, or corruption, identified in this report, seven (BAE Systems, Chevron, Freeport, Halliburton, Rio Tinto, Vedanta and Wal-Mart,) are included in the S&P 100 or FTSE 100 indices, while PetroChina is included in the regional S&P Asia 50 and MSCI Asia indices. Moreover, as far as companies related to controversial weapons are concerned, three (General Dynamics, Lockheed Martin and Raytheon) are part of the S&P 100 or FTSE 100, while Singapore Technologies Engineering is included in the STI and Stoxx Asia/Pacific 600 indices.

Furthermore, even laws that prohibit the financing of businesses related to anti-personnel mines and cluster bombs, like in Belgium and Ireland, specifically exclude index-linked management. This exclusion therefore highlights a material restriction on norm-based exclusion processes, either in terms of reputational risk for investors or in terms of pressure upon companies. IKV Pax Christi, and Netwerk Vlaanderen, the Dutch and Belgian NGOs, tackle this limit in their third research report on the financing of cluster bombs, which was published in May 2011 and entitled "*Worldwide Investments in Cluster Munitions: a Shared Responsibility*"<sup>10</sup>. They explain that norm-based exclusion would be efficient only if it is also applied to index-linked funds, which do not pose technical issue.

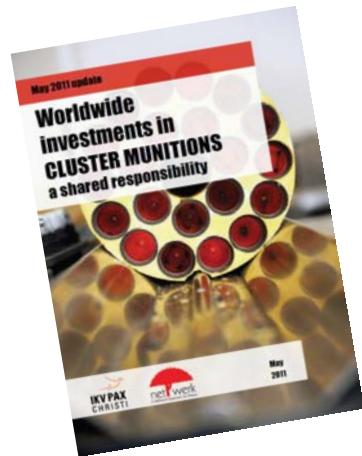
Major index providers currently offer suitable products: in June 2011, MSCI launched a series of nine indices excluding controversial weapons (anti-personnel mines, cluster bombs, chemical weapons, biological and depleted uranium weapons), and established a partnership with BlackRock, the asset management company, which is one of the world's leading providers of ETFs, under the *iShares* brand. MSCI is also offering a custom index, which excludes companies that are guilty of human rights violations. The index is based on the MSCI ESG Impact Monitor service, and on the screening of the operations carried out in oppressive regimes, targeted of divestment campaigns in the United States (Iran, Myanmar and Sudan). Previously, the FTSE had already created an index excluding

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<sup>10</sup> [http://www.ikvpaxchristi.nl/UK/below\\_thematic\\_security\\_and\\_disarmament\\_cluster\\_munition\\_home\\_stop\\_explensive\\_investments.htm](http://www.ikvpaxchristi.nl/UK/below_thematic_security_and_disarmament_cluster_munition_home_stop_explensive_investments.htm)

controversial weapons in 2009, at the request of F&C Investments, the asset management company.

The development of indices taking into account exclusions, especially if they impact companies operating in countries that have not ratified the main international norms, will enable investors to be offered the opportunity to extend their norm-based exclusion policy to all their assets. At the same time, asset managers are expected to gradually extend their norm-based processes from their SRI funds to all their assets under management. Apart from index-linked management, other financial business areas are sometimes ignored by norm-based exclusion policies, namely specialised asset management subsidiaries, and corporate and investment banking. Indeed, the IKV Pax Christi and Netwerk Vlaanderen report highlights 166 institutions that were still financing in different ways in 2011 one of the eight cluster bomb manufacturers targeted in the study. A number of French banks are on this "wall of shame", although they have committed to comply with the Ottawa Convention and the Oslo Treaty, and despite the efforts made by some of them to adopt ad hoc policies. Actually, AXA, BNP Paribas, Crédit Agricole, Natixis and Société Générale are accused of financing cluster bomb manufacturers, mainly via equities or bonds held by one of their subsidiaries, or via their involvement in financial operations through their corporate and investment banking branch. Therefore, the question of cross-divisional policies which would apply to their entire business arises for banking or insurance groups: why excluding Textron from your investment universe while granting a loan to it through your corporate banking branch? There are already initiatives that suggest better practices for the future: for example, BNP Paribas Group has defined sector policies (controversial weapons, palm oil, etc.) that are supposed to be followed by all its businesses, corporate banking and asset management first.



Étude d'IKV Pax Christi et Netwerk Vlaanderen sur l'investissement dans les armes controversées

## Significant research needs

Exclusions set up by the Norwegian Fund are the results from a deep research process: for each exclusion, the Ethics Council takes a decision after reading a ten-page report, based on the research performed by many agencies and consultants. Other investors confirm that the use of specialised databases such as RepRisk or Factiva requires a substantial amount of work. Indeed, these databases list many controversies that affect more or less directly all major listed companies.

Although it is actually crucial that exclusions should be based on specific and proven facts, particularly when they are disclosed and initiated by a major international investor, it undoubtedly limits the number of exclusion files that can be opened by each investor.

## A lack of public disclosure

Once the decision to exclude a company because of norm violations has been taken, investors agree or do not agree, depending on countries, to make public that decision. Although Nordic investors (KLP, the Norwegian Fund, etc.), and KBC in Belgium do not

mind disclosing the list of excluded companies, and even companies that are put on watch-list. This is far from being a standard rule among French investors. The lack of disclosure is usually justified by two arguments: either the process is too young, or only aims to avoid controversial risk, and therefore does not require public communication.

However, the expected impact of norm-based exclusions on companies is directly linked to its disclosure. If the investor's goal is simply for to safeguard its reputation, which is the case for the FRR, then disclosure may not seem essential. On the other hand, the impact of "name and shame" processes on companies, like those adopted by the Norwegian Fund, assumes public disclosure, or at least disclosure to the company concerned. However, this kind of initiative is very unusual among French SRI investors. On this point, the issue of conflicts of interest can also be raised, as asset owners are more likely to disclose their exclusions than asset management companies, which very rarely do so.

Things are different for anti-personnel mines and cluster bombs manufacturers since a number of asset owners (the Norwegian Fund, KLP, etc.) and asset managers (KBC, PGGM, Robeco, etc.) have formalised their exclusion policy, and disclose the list of companies concerned. French asset management companies are an exception, since only two of them (Fonds de Réserve des Retraites and La Banque Postale Asset Management) disclose their exclusion list.

# Conclusion

Norm-based exclusions, which are implemented by an increasing number of European financial companies, are first and foremost due to asset owners' concerns about safeguarding their reputation. They can also be used as a means of identifying extreme risk, without reducing the investment universe significantly. Finally, norm-based exclusions, often applied by investors to all their assets, offer the advantage of meeting civil society's expectations for a responsible investment process which displays its differences.

Nonetheless, there are still a few gaps in current norm-based exclusion policies. First, their scope is limited, because only few companies have practices that are considered as serious enough to be excluded from international investment universes. Moreover, the definition of a common norm-based framework does not lead investors to exclude the same companies. This situation therefore limits the impact of such blacklists for the companies concerned. In addition, a number of investors do not release their exclusion process, and do not even disclose it to the companies concerned, which therefore creates no pressure for the excluded company, and gives it no warning! At last, index-linked management, which represents an increasing share of European investors' asset allocation, is very rarely included in the scope of application of norm-based exclusion policies.

This being said, changes can occur quickly. The exclusion of investments in controversial weapons manufacturers, which was **inconceivable** ten years ago, and rejected by a large number of investors even five years ago, is now becoming widespread. Supported by civil society, as well as by texts ratified by a large number of countries, the exclusion of those weapons has now created a relatively broad consensus, even though a unique blacklist is not on the agenda.

As far as SRI funds are concerned, norm-based exclusions are a good addition to other approaches, such as best-in-class selection or shareholder engagement. By excluding the most controversial companies, norm-based processes could help to make SRI more credible among those who are deceived by the presence of such companies in these portfolios. However, unless there is a more substantial impact on investment universes and companies, it seems hard to consider norm-based exclusions as an SRI approach in itself.

# Norm-based Exclusions

How responsible investors  
handle  
controversial companies

A report prepared by  
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Novethic, a subsidiary of Caisse des Dépôts, is a research centre on Socially Responsible Investment (SRI) and a media expert in sustainable development. Founded in 2001, Novethic is now the exclusive source of statistics on the French SRI market. The SRI research centre analyses, both qualitatively and quantitatively, the progression of the integration of Environmental, Social and Governance (ESG) criteria in asset management, and publishes thematic studies on this subject. In 2009, Novethic launched a label for the SRI funds available on the French market.



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