Chapter Four

Ethics in Investment

The importance of financial services for our personal well-being is obvious, but investment decisions by institutional investors, which manage large volumes of capital, profoundly affect the quality of life in our communities and the nation—indeed, the world. These decisions are critical to society because they select from the opportunities that are available and determine the direction of future growth. Some of this investment involves the management of individuals' assets, especially in mutual funds and pension funds, and thus affects people directly as retail customers. However, investment by other institutional investors, such as endowments, insurance companies, trust departments of banks, hedge funds, and sovereign wealth funds, affects everyone indirectly and, ideally, promotes the welfare of all by allocating capital to its most productive uses.

Investment decisions are typically based on objective calculations of risk and return, not on considerations of the public good or social welfare. According to Adam Smith's famous metaphor, though, an "invisible hand" hovers over the marketplace and promotes an end that is not a part of anyone's intention. So sound investment decisions tend to benefit everyone. However, the marketplace is prone to many well-known failures, and the market mechanism is not intended to promote some ends, such as equality in society. Thus, it is questionable whether an ethical economy, as well as a prosperous one, can permit investment decisions to be made without some attention to their impact on the public good or social welfare.

Institutional investors, especially the managers of large pension funds, face ethical challenges in exercising their responsibility as shareholders on behalf of the people whose assets they manage. One response to these problems has

Ethics in Finance, Third Edition. John R. Boatright.

been the development of *relationship investing*, whereby institutional investors take an active role in improving corporate performance. Their immediate aim is typically to obtain a return, but in so doing they may also increase social welfare. Some investors seek to make a positive social impact through the investment process itself. This phenomenon, known as *socially responsible investing*, raises some important ethical issues about how such investing should be done and what benefit it can bring. A movement known as *microfinance* sees a potential in investment to alleviate poverty, especially in less-developed countries. Whether microfinance can achieve this worthy goal and constitutes a viable approach to poverty alleviation are important questions to answer.

Mutual Funds

In 2011, mutual funds managed over $11 trillion for more than 53 million or 44 percent of American households, and the median of mutual fund assets for these families was $120 000.[1] These figures show that mutual funds are largely the domain of individual investors of modest net worth who do not want to manage a portfolio actively but seek returns that exceed bank savings accounts. These funds combine convenience and flexibility with low levels of risk and cost that would be difficult to achieve in relatively small portfolios.

Customer satisfaction with mutual funds is generally high, perhaps because few opportunities exist for abuse or neglect, and also because dissatisfied customers can so easily switch. Great care is taken by the industry to attract and retain investors. However, some ethical issues have arisen in recent years about certain practices within the industry, which fund shareholders may not notice but which still have an impact on their returns. Most notable has been a scandal involving market timing and late trading, which rocked the industry beginning in 2003. A perennial ethical issue in mutual funds is the conflict of interest that occurs when fund managers also invest for their own accounts. Although it may be difficult, as well as undesirable, to prevent such trading, it is a conflict that requires careful management. Finally, the practice of soft-dollar brokerage is a practice that may be ethical, indeed even beneficial, but that has nevertheless received considerable criticism. These three topics are considered in this section on mutual funds.

Market timing

In 2003, reports surfaced that many mutual funds were allowing a few favored clients, mostly investment funds, to engage in *market timing*. In this practice, large investments are made for short periods of time in order to benefit from temporary changes in securities prices. Typically, it involves rapid "in-and-out" trades (also called "round trips") with purchases and redemptions within a few days of each other. Although market timing of individual stocks is common—indeed it is the main tactic of day traders—brokerage fees tend to limit the gain, and market timing of individual stocks is not suitable for capitalizing on broad market movements. Rapid in-and-out trading in mutual funds solves both of these problems: brokerage fees are avoided if the fund has no up-front or back-end fees, and diversified funds generally reflect the broader market. Market timing is especially attractive in international funds due to the time lag in distant markets. When an international fund closes for the day in New York, for example, the prices of Japanese stocks were set half a day earlier, and European stock prices have been known for a few hours. The resulting "stale" prices create opportunities for market timing (also called "stale price arbitrage").

The other practice that came to light in 2003 is *late trading*, in which orders are placed after the close of trading in the United States, which is four o'clock New York time. Late trading, which is strictly illegal in the US, enables investors to utilize information about the day's activities and announcements made after the markets' close. In some instances, offsetting trades are entered during the day, and then, after closing time, one trade is cancelled, leaving the desired one to be executed. Whereas market timing still involves some judgment and risk, late trading is a sure bet, rather like betting on a horse race after the outcome is known.

In a 2003 SEC survey of the 88 largest mutual fund companies, more than half admitted that they allowed market timing, and 25 percent admitted to allowing late trading.[2] According to another estimate, between 2001 and 2003, over 90 percent of fund companies permitted market timing in at least one fund, and late trading was permitted by 30 percent of them.[3] During the same period, market timing is estimated to have cost investors $5 billion per year[4] and late trading $400 million.[5] Although these amounts may be small for each investor, the overall sums constitute a significant loss in returns.

Unlike late trading, which violates established trading rules, market timing is legal as long as it is permitted by the mutual fund sponsor. Market timing is ethically questionable, though, and possibly illegal when only a few favored clients are permitted to engage in the practice to the detriment of others who are discouraged or forbidden from trading on the same terms. Such disparate treatment of a majority of investors is arguably a violation of a fund sponsor's fiduciary duty to serve the interests of all investors in accord with stated policies. Thus, it might be ethical for a fund to openly permit market timing for all shareholders, but not to secretly allow only a favored few in defiance of policies against this practice. The main ethical questions, then, are what, if anything, is wrong with these two mutual fund trading practices, and if they are wrong, what should be done to prevent them. Before these questions are considered, more needs to be said about how market timing works.

How timing works

The abuses in mutual fund trading first became public in 2003 with an investigation by Eliot Spitzer, the New York State attorney general, into the activities of Canary Capital, headed by Edward J. (Eddie) Stern, which had market-timing agreements with 30 mutual fund companies, including, most notoriously, Bank of America and its Nations Funds family.[6] Canary Capital managed the Stern family fortune, which was based on the Hartz Mountain pet food empire that was founded by the grandfather of Eddie Stern, who arrived in the United States in 1926 with 5000 canaries to sell (hence the name Canary Capital). Founded in 1998, Canary engaged in market timing from the beginning, earning returns that greatly outpaced the market. In 1999, when the S&P 500 index rose 20 percent, Canary earned 110 percent, and the returns in 2000 and 2001 were 50 percent and almost 29 percent respectively, when the market averages were down 9 percent and 13 percent in those same years.

During the 1990s, market timing, which was practiced on a large scale by perhaps a few hundred investors, was a mild irritant to mutual fund companies, which usually discouraged or, in some cases, banned the practice. The prospectuses for most funds emphasized that they were intended as long-term investment vehicles, and investors were restricted to a few rapid trades a year (most commonly four) and, in many cases, redemption fees were imposed for short-term trades. Most fund companies had "timing police," who identified market timers and enforced the rules. By 2000, market timers, who had previously managed to avoid detection by keeping a low profile and moving from one fund to another, now found it more difficult to operate without the cooperation of the mutual fund companies. Also, the increasingly large investments (often tens of millions of dollars) made it more difficult to operate undetected.

Although many mutual fund companies spurned the overtures of the market timers—Fidelity, for example, firmly declined to do business with any of them—others were receptive. This willingness of fund companies to permit market timing of their funds to the detriment of ordinary investors was prompted by the bear market that began in 2000, which reduced the assets under management and the management fees that these assets generated. Mutual fund companies were desperately looking for ways to maintain the income levels of better times. Thus, some companies were interested when market timers like Eddie Stern offered to share some of the gains to be made from rapid trading.

How did it work? As one writer explained:

> Market-timing hedge funds—as well as brokers and other middlemen—negotiated secret "capacity" arrangements in which they gained the right to run a predetermined amount of money in and out of a fund and were exempted from short-term redemption fees. In return, the market timer handled over a second predetermined amount to the fund company—"sticky assets," which sat quietly and generated extra management fees for the fund complex. Often, the sticky assets were placed in low-risk money-market or government bond funds. But sometimes they'd end up in a hedge fund run by the fund managers, generating much juicier fees for both the portfolio managers and their firm.[7]

Canary Capital and some other market-timing funds also figured out how to engage in short-selling with mutual funds. (Short-selling is profiting from declining prices by selling borrowed shares and returning them later by buying them back in the market after the price has dropped.) The method consisted of developing a market instrument replicating holdings of a mutual fund that could be shorted. However, developing this instrument required knowledge of the holdings of the fund in question, which is information that is ordinarily released only twice a year. Canary was able to strike deals in which fund companies would provide a list of holdings at any given time, thus permitting market timers, but not other investors, to short mutual funds.

Between 2000 and 2003, Canary Capital had market-timing agreements with some of the major mutual fund companies, including Strong Capital Management, Pimco Advisors, Janus Capital, Alliance Capital Management, Bank One (now part of JPMorgan Chase), and Invesco. The reputation of Putnam Investments was also badly tarnished for permitting other market timers to trade in its funds. However, no mutual fund company went to greater lengths to accommodate Canary than Bank of America, the sponsor of Nations Funds (now a part of Columbia Management). In 2001, Bank of America provided Canary with its own electronic trading terminal, installed in Canary's office, so that trades could be entered as late as 6:30 p.m. With direct access to Bank of America's trading system, Canary could disguise the origin of the trades by mixing them with the bank's own trading flow. Bank of America provided Canary with a \$300 million credit line to finance market timing in its own funds, and the bank also revealed the portfolio holdings of funds so that Canary could engage in short-selling.

Eventually, Bank of America settled all charges by agreeing to pay \$125 million in penalties and \$250 million in restitution to investors. Canary Capital paid a fine of \$40 million, and Eddie Stern agreed to cooperate with prosecutors in providing information about the mutual fund companies with which he had market-timing agreements. Most of the other offending mutual fund companies have entered into legal settlements and taken steps to compensate investors for their losses and restore their deeply tarnished reputations. In addition, a few individuals at the mutual fund companies have faced criminal charges for their involvement in this scandal.

One individual, in particular, provides a striking example of the abuse in mutual fund trading. Richard S. Strong was the founder, chairman, and chief investment officer of Strong Capital Management (SCM), as well as chairman of the board of directors of the 27 investment companies that managed the 71 SCM funds. When Mr Strong founded Strong Capital Management in 1974, he wanted it to be "the Nordstrom's of the financial industry," believing that this store provided the very best customer service. With this goal in mind, he built SCM into an investment company that by 2004 managed $33.8 billion in mutual fund and pension investments. In that year, though, SCM and Richard Strong came under scrutiny for market timing, not only by outside investors but by Mr Strong himself.

Despite the company's policy on market timing, Richard Strong engaged in market timing in SCM mutual funds, making 1400 quick trades between 1998 and 2003, including 22 round trips in 1998 in a fund for which he was also a portfolio manager. In 2000, SCM's timing police detected the chairman's trading activity, and the general counsel spoke to him, noting that his trading was inconsistent with the company's stated position on market timing and its treatment of other market timers. After agreeing to quit, he increased his activity, making a record 510 trades in 2001. In total, he netted $1.8 million and obtained much higher returns than ordinary investors in the same SCM funds. Richard Strong's market timing was costly not only to SCM but also to Mr Strong personally. The company agreed to pay $40 million in fines and an additional $40 million in restitution, as well as reducing the fees on SCM funds by a total of approximately $35 million over the next five years. Mr Strong personally agreed to pay $30 million in fines and the same amount in restitution, and to accept a lifetime ban from the financial services industry.[8]

It was SCM's involvement with Canary that eventually led to the downfall of both companies. In 2001 and 2002, Canary was making so much money and attracting so many new investors that it became more difficult to obtain sufficient "capacity" in mutual funds that would permit market-timing trades. In an effort to get the attention of Goldman Sachs, Canary hired a former employee, Noreen Harrington. Goldman Sachs was uninterested, and Harriman left in dismay when she discovered how Canary's money was made. She was not intending to blow the whistle until her sister complained about how much money she was losing in her mutual fund and how she would never be able to retire. "I didn't think about this from the bottom up until then," Harrington said.[9] A telephone call to the New York State attorney general's office started the investigation that led not only to Canary but also to Richard Strong.

What is wrong with timing?

Although market timing, unlike late trading, does not violate an explicit legal prohibition, it is morally objectionable and arguably illegal for several reasons.

First, it allows a few favored clients to trade under terms that are unavailable to the vast majority of ordinary investors. If a fund openly offers the opportunity to engage in rapid in-and-out trading with few, if any, restrictions, so that all investors can take equal advantage of market-timing opportunities, then no one would be treated unfairly. Such a market-timing fund would have *transparency*—that is, all investors would know the rules—and it would provide *equal treatment*—that is, the same rules would apply to all. Market timing under these conditions would be morally unobjectionable and perfectly legal. However, very few funds openly permit market timing, although a few do. Most funds actively discourage short-term trading by advising against it, placing restrictions on the number of round trips, and imposing redemption fees on short-term investments. The objection to market timing in most mutual funds, then, is that that some investors are subject to different, more favorable rules (unequal treatment) of which other investors are not aware (transparency).

For example, Strong Capital Management, like most mutual fund companies, encouraged long-term holding of five years or more and advised that market timing does not work. Beginning in 1997, SCM warned shareholders that frequent traders could be banned: "Since an excessive number of exchanges may be detrimental to the Funds, each Fund reserves the right to discontinue the exchange privilege of any shareholder who makes more than five exchanges in a year or three exchanges in a calendar quarter." Like most other mutual fund companies, SCM also had timing police, who monitored trading activity for frequent activity, and from 1998 through 2003, hundreds of market timers were identified and barred from investing in Strong funds. When it was discovered that some SCM employees were market-timing in their own accounts, the company issued a clear directive that the Strong funds were not to be used for short-term trading and that violators could have their trading privileges restricted. From these facts, a reasonable investor could assume that marketing timing does not take place in SCM mutual funds.

Second, allowing marketing timing hurts long-term mutual fund investors by increasing a fund's expense and reducing its returns. Large inflows and outflows in short time periods add trading and other overhead costs. In addition, the manager of a fund with active market timers may have to keep a more liquid position in order to meet redemption orders or otherwise make different investment decisions. The result may be the adoption of trading strategies that are less than optimal for long-term investors. Also, frequent sales of securities to meet redemption orders by market timers may produce capital gains that result in higher taxes for all fund investors. Moreover, if the value of a fund rises after a market timer's investment was made, and if the trader cashes out quickly before the fund purchases any new securities, the effect is to dilute the earnings of a fund. Under such conditions, the earnings are due entirely to money provided by other investors and yet the market timer shares in the returns. All of these possibilities involve losses to investors without any corresponding gains—except for the market timers. In short, market timers are able to impose costs on every fund investor for trading activity from which only they benefit.

Third, insofar as market timing is unfair and harmful to ordinary investors, it can be argued that the directors and executives of mutual fund companies are violating a fiduciary duty to serve investors' interests. Each mutual fund is, legally, an independent company with a board of directors and a chairman (although the same persons may be directors and chairmen of dozens, if not hundreds, of funds offered by a single mutual fund company). The investors are the shareholders of a mutual fund and the fund itself purchases and owns the securities that comprise the fund's assets. Although mutual funds are sponsored by a mutual fund company, legally the board of directors selects and contracts with the fund's sponsor. A mutual fund company is simply an agent hired by the directors of a fund to administer or advise the fund. Accordingly, the directors and executives of a mutual fund have the same kind of fiduciary duty to its investors as the directors and executives of a publicly held company have to its shareholders.

Indeed, all company personnel have an obligation to refrain from actions that would harm a fund's investors. In the SCM code of ethics, which was distributed to all employees, Richard Strong summed up the "three most important principles" for dealing with clients:

- You must deal with our clients fairly and in good faith.
- You must never put the interests of our firm ahead of the interests of our clients.
- You must never compromise your personal ethics or integrity, or give the appearance that you may have done so.

Thus, because of the fiduciary duty imposed by law on the directors and executives of mutual funds, as well the codes of ethics that mutual fund companies adopt and publish, investors have a right to expect that their interests will not be harmed by capacity agreements with market timers, and especially not by market timing by a company's own personnel.

The wrongness of market timing, then, does not lie in the practice itself, whether it is done by investors making frequent trades or by mutual fund companies in allowing such trading. The wrongness consists rather in the inconsistency of presenting mutual funds as safe, reliable investment vehicles for relatively unsophisticated investors and at the same time collecting additional revenue from market timers who are allowed to benefit at the expense of ordinary investors. By allowing market timers, mutual fund companies are professing to play by one set of rules while secretly playing by another, which is a kind of fraud. At bottom, mutual fund companies are betraying a trust that is the cornerstone of their industry, and market timers are inducing fund personnel to betray that trust.

What should be done

If market timing is wrong, then the obvious remedy is for all parties to refrain from doing it. This solution overlooks the conditions that led to the scandal in the first place. The failure is not a simple lack of recognition about what is right and wrong but rather the result of a number of converging forces. When an unethical practice occurs simultaneously in such a large number of financial institutions, including some of the most respected and successful mutual fund companies, the underlying causes are likely to be complex.

In this case, the factors are easily recognized. The mutual fund industry is relatively young, coming into existence after the passage of the Investment Company Act of 1940. Only in recent years has institutional investing by mutual funds, as well as pension funds, exceeded individual stock ownership. The popularity of mutual funds increased significantly with the bull market of the 1990s. Because of the small size of the industry through much of its short history and its reputation for trust and integrity, it has been lightly regulated. Although mutual fund companies are not recognized as self-regulating organizations like the major exchanges, such as the New York Stock Exchange or NASDAQ, and are formally under the jurisdiction of the SEC, they operate with little oversight, and neither Congress nor the SEC has seen a need for extensive regulation. The mutual fund industry is supported by a large national trade association, the Investment Company Institute, founded in 1940, which aggressively advances the interest of its member companies and generally opposes proposed additional regulation.

The market-timing scandal occurred between 2000 and 2003, which was a difficult period of reduced returns due to the piercing of a bubble in the economy. The decade prior saw a bull market in which the mutual fund industry experienced tremendous growth and record-setting revenues. However, a few large mutual fund companies, including Fidelity and Vanguard, had captured a large market share, leaving a multitude of small firms to compete for the rest of the market. In 2001, the combination of too many mutual fund companies and fewer, more wary investors created great pressure on mutual fund companies to maintain the expected high earnings. Conditions in the mutual fund industry made for a disaster waiting to happen.

In the wake of the mutual fund scandal, the following reforms have been proposed:

1. *Governance.* Where were the directors of mutual funds when market timers were allowed to engage in rapid in-and-out trading? Ultimately, the board of directors of a fund is responsible for ensuring that investors' interests are served. However, directors typically serve on dozens, if not hundreds, of boards. In some mutual fund companies, every fund has the same directors and chairman. Many of the directors and chairmen are also company executives or else have close ties to the company, so that they are not truly independent. Thus, they face a conflict of interest. Various proposals have been advanced to limit the number of boards on which directors serve, to increase the percentage of independent directors, and to require that the chairman of the board be an independent party who is not otherwise connected with the mutual fund company.
2. *Disclosure.* If market timing harms investors, then the losses should be reflected in the form of reduced returns, which, if detected, would enable investors to avoid market-timing funds. In a market with perfect information, investors would be adequately protected. However, the lack of disclosure makes it difficult for investors to detect such losses or to assess the costs of a fund and compare the returns with competing funds. Proposals have been advanced to require the disclosure of information about a fund's expenses that would enable investors to determine whether they are receiving adequate value for the fees they pay and whether their return is being reduced by market timing and other abuses in mutual fund trading.
3. *Pricing.* Market timing, especially in international funds, is possible because of the problem of stale prices. If the net value of a fund that is reported at four o'clock New York time does not accurately reflect the current prices of the securities in the fund's portfolio, then an opportunity for stale price arbitrage exists. Rather than prohibit or otherwise try to protect against this practice—by changes in governance or disclosure rules, for example—another strategy is to eliminate the opportunity. There have been various proposals for mutual funds to implement what is called

> "fair-value pricing," in which the net values of funds that are reported each day at the close of the market incorporate any market-moving developments. Some critics of fair-value pricing argue, though, that it gives too much discretion to fund managers and that uneven use could affect the reporting of fund returns.[10]

Whatever reforms are eventually implemented, the mutual fund industry, which had a relatively blemish-free reputation prior to 2003, has shown that it is not immune to scandal and that greater oversight of some form—whether it be industry self-regulation or government regulation—is necessary.

Personal trading

The explosive growth in mutual funds has brought Wall Street to Main Street. The stock market, which was once the province of the very rich, is now easily accessible to millions of ordinary investors. This revolutionary development has drawn attention to the men and women who manage billion dollar portfolios and has even made celebrities of a few. When Jeffrey Vinik, the idolized manager of Fidelity's $54 billion Magellan Fund, touted Silicon Graphics in 1995, people took note and the share price rose—before it suddenly collapsed. The financial writer Michael Lewis, who bought 500 shares of Silicon Graphics on the way up, recalled, "As my money disappeared, my warm feelings toward Jeff Vinik went with it."[11] This fund manager's stock picks turned into an ethics case when, as Lewis reports, "Vinik was quoted by journalists singing the praises of two companies—Micron Technologies and Goodyear Tire and Rubber—at virtually the same time that he was selling his own stake in these companies."[12]

Concern about personal trading was also sparked by John Kaweske, a former money manager for Invesco Funds Group, who in 1995 paid $115 000 to settle an SEC complaint that he had not reported 57 personal trades for himself and his wife, as required by the company's rules. Although it is not illegal for fund managers to trade, the SEC holds that they should not abuse their position for personal gain. Mutual fund companies are required by law to have policies and procedures on personal trading, although the details are left to each company. Cases like this remind us that mutual fund managers wear two hats: they manage money for others, but they often trade for their own account. Even though most fund managers toil in obscurity and refrain from giving stock tips, they still have immense opportunities to benefit personally from their privileged position.

The potential for abuse was recognized in 1940 by the drafters of the Investment Company Act (ICA), which governs mutual funds. In 1970, Congress added Section 17(j) to the original legislation, which gave the SEC the power to set rules that require each investment company to adopt a code of ethics and develop procedures for detecting and preventing abuse, including the collection of information on employees' personal trading activities. Because of this long-standing regulation, personal trading in the mutual fund industry has involved very little abuse, and the occasional instances have drawn a vigorous response.

News stories about Mr Kaweske's failure to disclose personal trades as required prompted Congress to ask the SEC to study the problem, and a report, *Personal Investment Activities of Investment Company Personnel*, was released in September 1994.[13] In anticipation of the SEC report, the Investment Company Institute (ICI), the trade association of the mutual fund industry, issued its own report by a special Advisory Group on Personal Investing on May 9, 1994.[14] The two reports reach similar conclusions: that personal trading should not be banned and that the current system of regulation works well but can be improved.

There is very little controversy over personal trading except for the recognition of the potential for abuse and the need for regulation to prevent it. The main ethical issues, therefore, concern the rationale for regulation and the details of the appropriate regulatory system. The section examines, first, the potential for abuse and the current regulatory framework; second, the debate over whether personal trading should be banned; and, third, remaining questions that need a closer look.

Scope of the problem

Investment companies, of which mutual funds are the best-known type, invest their capital in other companies, usually by purchasing stock or other securities. Closed-end mutual funds have a fixed number of shares, which are commonly traded on a market, while open-ended mutual funds sell new shares to the public and stand ready to redeem shares at any time. Like the managers of a corporation, mutual fund managers have a fiduciary duty to act in all matters solely in the interest of the shareholder-investors. Specifically, the managers of mutual funds have an obligation to avoid conflicts of interest that would lead them to put their own interests ahead of those they are duty bound to serve. In addition, mutual funds serve the role of an investment adviser, which also carries with it a fiduciary duty.

One aim of government regulation of investment companies is to ensure that managers fulfill their fiduciary duty. Investment companies themselves also have a strong interest in maintaining investor confidence. The SEC report on personal trading notes:

> The success of the investment company industry is in no small measure the result of the industry's excellent record. . . . The industry's continued health, however, depends on its meeting the expectation of American investors, many of whom are new to the market. The industry will continue to be trusted by investors only if it demonstrates that it maintains the highest possible ethical standards and that it operates free from abusive and fraudulent practices.[15]

Hence the concern in Congress and the industry when the Kaweske case raised even the suggestion of improper personal trading by a fund manager.

Conflict of interest from personal trading is possible for so-called "access people," that is, investment company personnel such as portfolio managers, analysts, and traders who have access to proprietary research and information about pending transactions.[16] Access people are in a position to use this information to trade ahead of a fund's purchase (called *frontrunning*) and benefit from any upward price movement. If frontrunning raises the price of a stock, then the fund pays more for a security than it would otherwise. Similarly, an access person with advance knowledge of a fund's sale of a stock could capitalize on the information by selling the stock short. An access person might be in a position to influence transactions that serve primarily to protect or promote that person's investment in a security. Conflicts of interest also arise when a fund manager allocates a security that is in short supply, such as shares in a "hot" initial public offering, or distributes gains and losses between different funds in ways that benefit the manager at the expense of some investors. In addition, a fund manager who takes advantage of an opportunity, such as a special placement, for his or her own portfolio rather than investing for the fund is in a conflict of interest.

The SEC study, which examined data on personal and fund trading in 30 companies, found that relatively few managers actively buy and sell securities for their own account. In 1993, 56.5 percent of the fund managers in the groups studied engaged in any personal trading, and the median number of personal transactions was two. Fewer than 5 percent of the personal transactions took place in a 10-day period prior to a transaction in the same security held by another fund in the company, and only 2 percent of personal transactions were made within 10 days before a transaction in a fund for which the manager selected securities.

The data analyzed in the SEC study may understate or overstate the frequency of matching transactions. Trading in the shares of large corporations, for example, is unlikely to have any market moving effect, whereas the price of thinly traded stock of small capitalization companies is easily moved. Of course, the amount of personal trading and the number of matching trades reflects close regulatory oversight. No one can predict the consequences if the current system of regulation were relaxed.

Several studies in the 1960s revealed substantial personal trading that posed conflicts of interest, and so in 1970, Congress added Section 17(j) to the 1940 ICA. This addition granted rule-making power to the SEC in order to prohibit any fraudulent, deceptive, or manipulative act by an access person in the purchase or sale of any security. Using its power, the SEC promulgated Rule 17j-1 in 1980. In brief, the rule:

1. Prohibits directors, officers, and employees of investment companies (and the investment advisers and principal underwriters) from engaging in fraudulent, manipulative or deceptive conduct in connection with their personal trading of securities held or to be acquired by the investment company.
2. Requires investment companies (and their investment advisers and principal underwriters) to adopt codes of ethics and procedures reasonably designed to prevent trading prohibited by the rule.
3. Requires every "access person" to file reports with the firm concerning his or her personal securities transactions, within ten days of the end of the quarter in which the transaction was effected.
4. Requires investment companies (and their investment advisers and principal underwriters) to maintain records related to the implementation of their procedures.[17]

Section 17(j) and Rule 17j-l reflect three important points in the approach of Congress and the SEC toward personal trading.[18] First, the regulation of personal trading by investment company personnel is best done by the companies themselves. That is, an employee's own firm provides a strong first line of oversight. Second, every mutual fund is different, and they can provide better oversight if they are given flexibility to develop a code of ethics and specific procedures that fit their individual circumstances. Third, there is the recognition that not all personal trading poses a conflict of interest and that judgment is required for carefully evaluating each case. Thus, both a complete ban on personal trading and rigid rules are inappropriate forms of regulation.

Banning personal trading

Both the SEC and ICI reports contain lengthy sections on the question of a complete ban on personal trading. This attention suggests that the issue is not closed, despite the firm rejection of a ban in each report. Two points should be noted at the outset. First, the question addressed in both reports is whether personal trading by access people in mutual fund companies ought to be banned industry wide, not whether any given company should impose such a ban on its own employees. The reports reject a *mandatory* ban for the industry but leaves open a *voluntary* ban by individual mutual fund companies. Second, personal trading by access people is already subject to considerable restrictions, and a complete ban is merely one end of a long continuum. As a debate proposition, a complete ban is a red herring that diverts attention from the critical question of how restrictive the regulation of personal trading should be. Thus, the arguments for and against a complete ban are worth examining, even if a complete ban is rejected, because the same considerations enable us to determine the appropriate level of restrictiveness.

The arguments for a complete ban can be summarized as follows:

1. *The image of the industry.* Regardless of the seriousness of the actual problem (which may be slight), the success of the mutual fund industry depends on a "squeaky-clean" image that reassures investors, especially those new to the market. Personal trading creates a perception of conflict of interest that may be worse than the reality, and an unequivocal policy is the only effective means for countering this perception.
2. *The heavy responsibility of managing funds.* The sheer volume of assets under management by mutual funds and the importance of mutual funds to the savings plans of so many people create a responsibility to adhere to the highest level of ethics and to avoid even the remote possibility of harm to investors from mismanagement. Aside from any direct loss to investors due to personal trading, there is a possible indirect loss if fund managers devote their time and energies to their own portfolios rather than attending to the work at hand.
3. *The (in)effectiveness of regulation.* Any regulation short of a complete ban creates too many opportunities to take advantage of loopholes and fuzzy lines. Fund managers, analysts, and other access people who are intent on benefiting from their positions may be tempted to skirt the edge of ethical and legal trading without overstepping the line. A simple complete ban can be better understood and more easily enforced than complicated rules and regulations.
4. *Fairness to other investors.* Access people are insiders who are privy to information that other investors lack, so that personal trading may constitute insider trading and be objectionable for this reason. Like proprietary corporate information, information about pending transactions is provided to access people in order for them to perform a job. Trading on the basis of this information is thus a misappropriation of company property for personal use.

The arguments against a complete ban include the following:

1. *The lack of need.* A complete ban is unnecessary for several reasons. First, a multitude of funds compete fiercely with each other on the basis of performance, and in this environment no company can succeed if it does not put the interests of the customer first. In short, the market is a powerful force for motivating companies to protect investors against abuses from personal trading. Second, fund managers compete against each other and are judged by the returns that they achieve. Third, personal trading is already stringently regulated, and the lack of apparent abuse indicates that the current regulatory system works well.
2. *No benefit to investors.* A ban on personal trading would make it difficult for mutual fund companies to attract and retain the best analysts, traders, and fund managers. Competition for the most talented people is already stiff, and a complete ban would put investment companies at a disadvantage with other financial institutions that permit personal trading. Mutual fund customers would lose the benefit that they now derive from the skills of top-performing professionals if a complete ban were imposed.
3. *Unfairness to fund personnel.* The opportunity to invest is vital to people's economic well-being, and so a ban on personal trading that would limit people's freedom on such an important matter requires weighty justification. In general, people's freedom should not be restricted any more than is necessary to achieve the desired ends. If the current regulatory system works reasonably well, then would more stringent regulation compensate for the loss of freedom?

In evaluating these arguments, the SEC considers three factors: "the prevalence of abusive securities transactions by access persons; the potential harm to fund shareholders caused by access persons' personal investment activities; and the likelihood that a ban would curb abusive trading by access persons."[19] The available data suggest that abusive personal trading is not prevalent, that it is not harmful to investors, and that any gains to investors from a complete ban would be slight. The SEC also questions whether a complete ban would deter more determined wrongdoers, some of whom are not deterred by current regulation. Banning all personal trading in an attempt to prevent the last vestiges of abuse is a misguided enterprise. The SEC report concludes that, even though an industry-wide ban on personal trading is not warranted at this time, the directors of mutual funds have a responsibility to assess the benefits of personal trading for shareholders and adopt more effective rules and procedures, or even a complete ban, if such steps are in the shareholders' interests.

Remaining questions

The current regulatory system on personal trading allows mutual fund companies great flexibility, and the rules and regulations of individual companies vary widely. Any given question, therefore, may have already been answered by one company and be completely unaddressed by another. The answers that different companies give to these questions may be justifiably different. However, some questions are at the forefront of discussion and have yet to be firmly settled industry wide. Chief among these are questions concerning codes of ethics and trading practices.

Although Rule 17j-1 requires investment companies to adopt a code of ethics, the content of these codes is not legally mandated. The ICI Advisory Group on Personal Investing recommends that every code of ethics incorporates certain general principles, which should, at a minimum, reflect the following: "(1) the duty at all times to place the interests of shareholders first; (2) the requirement that all personal securities transactions be conducted consistent with the code of ethics and in such a manner as to avoid any actual or potential conflict of interest or any abuse of an individual's position of trust and responsibility; and (3) the fundamental standard that investment company personnel should not take inappropriate advantage of their positions."[20]

The implementation of these general principles in specific rules and procedures raises many questions, including who is covered, what transactions are prohibited, and what transactions must be reported. The term *access people* covers a range of personnel who may not be easily identified, and some distinctions among them may be appropriate. Some codes of ethics employ a tiered structure in which employees on different tiers are subject to different regulations. The securities in question may need to be distinguished. Generally, codes of ethics exempt money market instruments, Treasury securities, shares of mutual funds, or small blocks of stocks in large, actively traded corporations on the grounds that fund trading in these securities is unlikely to affect the price. Some argue that the definition of a security should be broadened because of the development of new financial instruments such as options, derivatives, and commodities futures.

Rule 17j-1 mandates that employees disclose all personal trading in quarterly reports. One loophole is that access people are not required by law to disclose their portfolio holdings when they begin employment. Thus, quarterly transactions may not reveal a conflict of interest that involves an undisclosed pre-employment securities holding. Also, there is no legal obligation to disclose a fund's code of ethics to the public. The SEC and ICI reports each recommend that mutual fund companies disclose their policy on personal trading and provide an overview of their rules and procedures in the prospectus for each fund. The SEC has further proposed that investment companies be legally required to include the full text of the code of ethics as an attachment to the company's registration statement so that it will be publicly available, while the ICI Advisory Group's only recommendation is that a company may elect to include it at its discretion.

Generally, conflicts of interest are created by matching transactions in which an access person makes personal trades in conjunction with fund trades. Matching transactions can be addressed not only by disclosure—which enables a company to analyze the pattern of trades—but also by *blackout* periods during which all trading in a security is prohibited. Questions still arise, however, about the length of the blackout period, whether it applies before or after a fund transaction, or both, and whether there are different blackout periods for different types of securities transactions. For example, some codes of ethics create a longer blackout period for transactions over which a fund manager has decision-making power. Other remaining questions about trading practices are: (1) the personal purchase of initial public offerings (IPOs) and private placements; (2) short-term trading; and (3) short-selling stocks that are held by a company's funds. Should any of these be permitted?

IPOs raise the possibility of a conflict of interest because the intense interest in certain "hot" new issues limits the number of investors who can participate. Fund shareholders may rightly ask why a fund manager who had the opportunity to purchase shares did so for his or her personal account and not for the fund. Private placements do not raise this concern because they generally do not involve securities that could be purchased by a fund. Still, the opportunity to participate in a private placement may be regarded by fund shareholders as a conflict of interest if, for example, it was offered by a start-up firm as an incentive for the manager to invest for the fund should the venture go public in an IPO. Both IPOs and special placements are potentially profitable opportunities that raise questions about the ability of a fund manager to exercise unbiased judgment in future transactions.

Short-term trading—which is generally interpreted as holding securities for less than 90 days—is prohibited by some mutual fund companies for the reason that quick profit taking is more likely to utilize information about fund transactions. A rule against short-term trading is an especially effective precaution against frontrunning that, at the same time, does not prevent employees from realizing long-term gain in the stock market. Thus, the benefits to the company and its shareholders are likely to outweigh any small losses to fund managers and other access people.

Neither the SEC nor the ICI report addresses short-selling—which is the practice of borrowing a stock and selling it in the hopes of replacing it later at a lower price—although shorting might fall under the category of short-term trading. Short-selling is practiced by investors who believe that the price of a stock will decline, which raises the question of why a prudent fund manager does not reduce the fund's holdings. Shorting evades restrictions on matching transactions because there is no sale by the fund, and the conflict of interest arises when a fund manager makes a biased decision *not* to sell in order to short the stock for personal gain. Few companies have addressed the issue of short-selling, although Fidelity Investments has announced a ban on the shorting of stock held by its funds, saying that the practice could create an appearance of a conflict of interest.[21]

Soft-dollar brokerage

Institutional investors, such as mutual funds and pension funds, pay a commission to brokerage firms to execute trades of securities. These commissions are a highly valued source of revenue for brokerage firms, which lead them to compete in gaining favor with funds to obtain and retain this lucrative trade-execution business. One means for competing for this business is offering rebates to institutional investors in the form of products and services other than the execution of trades. These rebates, which are usually expressed in dollar amounts of products and services, are called *soft-dollar brokerage*, or simply soft dollars. The most common form of soft dollars are noncash credits for propriety research offered by the brokerage firm itself or provided by third party research firms.

Another means for obtaining and retaining the business of mutual funds is for brokers to promote these funds to their own clients. This practice, which was prohibited by the SEC in 1994, is known as *directed brokerage*. Brokerage firms, which typically offer mutual funds to clients, can direct them to certain funds through advising or prominent display. Such direction is a valuable benefit to mutual funds in their competition for investors, which may lead a fund to pay an above-market rate in commissions. With directed brokerage, a brokerage firm becomes, in effect, a selling agent for a mutual fund, which is a benefit worth paying for. However, in the SEC's view, directed brokerage creates an unacceptable conflict of interest since it might interfere with the fiduciary duty of brokerage firms to recommend the best investment for a client.[22] The SEC rule still permitted brokerage firms to promote one mutual fund over another as long as there was no *quid pro quo* arrangement in which the promotion was offered in return for a fund's trade-execution business.

Soft dollars and directed brokerage began in the 1950s with the growth of institutional investors during a period of fixed commissions for securities traded on the New York Stock Exchange. Barred from competing for volume customers by offering lower commissions, brokerage firms offered various noncash benefits, including research services, in lieu of lower commission rates. After the system of fixed commissions was abolished in May 1975, the practices of soft dollars and directed brokerage continued. Although commission rates declined after that date and customers could pay for only the execution of trades, soft-dollar arrangements and directed brokerage continued to be important forms of competition among brokerage firms and significant resources for institutional investment funds.

The legislation ending fixed commissions, the Securities Act Amendments of 1975,[23] reiterated that fund managers have a fiduciary duty to secure the "best execution" of trades, which includes paying low commissions. However, Section 28(e) created a "safe harbor" that allows soft-dollar arrangements as long as the managers believe in good faith that a higher-than-market commissions are "reasonable in relation to the value of the brokerage and research services provided." Thus, soft-dollar payments could continue as long as mutual fund shareholders received benefits in the form of products and services that offset the higher commissions that fund managers were paying for the execution of trades.

For such a little-known practice, soft dollars has received a surprising amount of moral concern, with one observer claiming that it did not pass "the smell test."[24] Soft dollars was the subject of a 1998 report by the Securities and Exchange Commission,[25] and in the same year the Association for Investment Management Research issued extensive guidelines for soft-dollar arrangements.[26]

Moral criticism of soft dollars has two sources. First, soft dollars is a virtually invisible process that appears to depart from the ideal of arm's-length economic transactions. In soft-dollar arrangements, the managers of institutional investment funds seem to be paying brokers more than is necessary for the execution of trades and receiving other benefits in return. The costs of execution and research are bundled together in ways that mutual fund investors may not be aware of and cannot easily evaluate. Expressed in the terms of agency theory, investors (the principals) have the task of monitoring fund managers (their agents). The lack of transparency and market forces makes the monitoring of fund managers by investors more difficult. As a result, investors either suffer the agency costs of inadequate monitoring or else are forced to incur additional monitoring costs. That transactions should be unbundled and made transparent are key elements not only of sound financial practice but of effective monitoring.

Second, investment fund managers, as fiduciaries, have a fiduciary duty to act in the best interests of a fund's investors. This duty includes obtaining "best execution" and using any soft dollars solely for the benefit of a fund's investors. However, soft dollars appear to create incentives for fund managers to advance their own interests or the interests of a fund's sponsor to the detriment of investors. This advancement of the manager's interests would be not only a violation of fiduciary duty but also an unacceptable conflict of interest. Fund managers might unjustly enrich themselves through soft-dollar arrangements by engaging in excessive trading or churning designed merely to generate more soft dollars. They might also use soft dollars for purposes other than research that benefits a fund's investors. Finally, the benefit from soft dollars may make managers less careful about monitoring the quality of a brokerage firm's execution. All of these possibilities would violate the safe harbor provision of Section 28(e).

Defenders of soft dollars argue that these moral concerns are misplaced and that soft-dollar brokerage is not only morally justified but even economically sound.[27] First, with regard to the difficulty that soft dollars may create in monitoring fund manager performance, defenders contend that soft dollars, in fact, align the interests of investors and fund managers because fund managers are in a better position than investors to monitor the execution of trades by brokerage firms. Thus, instead of increasing the monitoring costs of investors, soft dollars reduce them.[28] Second, to the criticism that the practice tempts fund managers to violate their fiduciary duty to seek "best execution" and to use any soft dollars in the investors' interest, defenders respond that the intense competition in institutional investing would punish fund managers who did not use all resources for the benefit of investors. This argument suggests that funds using soft dollars would produce superior returns to those that do not, and the evidence to date is that soft dollars have a slight positive correlation with fund performance.[29]

Critics of soft dollars generally favor two measures: restricting the scope of Section 28(e), thus giving fund managers less of a safe harbor, and mandating greater disclosure of soft dollar practices. In particular, some critics urge that the safe harbor provision be limited to research-related services provided by the brokerage firm that are not readily available commercially, which would exclude ordinary overhead expenses. Defenders of soft dollars would expand the scope of Section 28(e), thus giving fund managers greater discretion in making arrangements with brokerage firms. Although they are not opposed to greater disclosure in principle, some defenders question the usefulness of this information for investors and whether the cost would exceed the benefit.

A persistent problem with both soft dollars and directed brokerage is that the regulations rely heavily on the judgment of fund managers—about the reasonableness of the commissions paid in relation to the value of the soft dollars received, and about the absence of any *quid pro quo* in a broker's promotion of a company's mutual funds. How can the soundness of a fund manager's judgment in these matters be determined? The recommendation of the ICI is that these questions should be answered in terms of the adequacy of rules and policies that mutual funds have in place about soft dollars and directed brokerage.[30]

Relationship Investing

Within the past 50 years, a profound shift has occurred in the ownership of stock in American corporations. In 1970, individuals held more than 72 percent of shares, while institutional investors (pensions, mutual funds, insurance companies, and private trusts and endowments) accounted for about 16 percent.[31] By 1990, the holdings of institutions had risen to almost 50 percent, and in 2009 the figure was 73 percent.[32] This transformation has implications not only for the responsibilities of institutional investors toward their beneficiaries but also for the role of institutional investors as shareholders in the American system of corporate governance. In this changed environment, the concept of *relationship investing* (RI) has emerged as one answer to the many questions that institutional investors now face.

Because of the size of their holdings, institutional investors cannot behave like individuals. They cannot easily sell an underperforming stock, for example, but are generally locked into their investments. Instead of active portfolio management that seeks out undervalued stocks, institutional investors passively manage large portions of their portfolios by indexing them to broad market measures, such as the S&P 500. Because institutional investors are so diversified, they can be said to "own the market" rather than specific companies. As such "universal owners," they may have different interests than the owners of single stocks, which may lead them to oppose, for example, corporate actions that impose externalities on society or impair long-term growth in the whole economy.[33] Institutions also have some opportunities that individual investors lack. In particular, they are in a position to pressure managers of corporations for changes, and some argue that fund managers are not fulfilling their fiduciary duty if they do not exert this power. Individual investors do not often take an active role in corporate governance, with the result that some corporate managers have gotten by with lackluster performance.

In addition, taking an active role in corporate governance has also been pursued as an investment strategy by some institutional investors, especially hedge funds, as an effective way of increasing returns. By investing in underperforming companies and then pressing for changes designed to improve corporate performance, these investors hope to realize a boost in stock price. The ultimate cause of underperformance is usually a faulty strategy, but the immediate target of activist investors is more commonly a change in top management or board composition or the correction of mistaken practices or policies. Unlike traditional raiders in hostile takeovers, these investors do not aim to take control of a company. However, they are also not mere critics, who sometimes wage proxy fights; they want to be partners, who will work closely with a company over a long period of time and offer valuable expertise.

Relationship investing is undertaken by institutional investors for diverse reasons. Broadly speaking, the advocates of relationship investing cite three grounds for engaging in it. First, relationship investing is an effective investment strategy that prudent investors may choose to adopt. Indeed, some individual investors, most notably Warren Buffett, have used relationship investing with great success. Second, the fiduciary duties of fund managers may require them to take advantage of the opportunities offered by relationship investing. Third, relationship investing is a solution to a number of critical problems in corporate governance, so that this approach ought to be encouraged. Each of these reasons is examined in turn.

RI as an investment strategy

Relationship investing may be defined as a situation in which an investor takes an active interest in a corporation and attempts to influence the corporation's operations. As such, RI is not a new idea. It harks back to an earlier time when stockholding was more concentrated and a few large investors exercised close oversight. Today, venture capitalists and lenders to small businesses, who watch their investments closely, could be called relationship investors. Similarly, the concept of relationship investing has been used to describe the close working relation in Germany and Japan between corporations and large banks, which are the major holders of corporate equity in those countries. Among individual investors, Warren Buffett is known for his strategy of taking large stakes in a few, well-chosen firms and working with them to increase earnings when necessary. Other individual investors seek out troubled firms with poor performance and seek to increase the value of their investment by pressing for changes in leadership or strategic direction. In some instances, the investors believe that they have expertise that can increase the value of the firm.

Large institutional investors do not have the resources to establish a relationship with every corporation in their portfolio. For many years, CalPERS, the pension fund for California state employees, compiled an annual "hit list" of companies which had underperformed over the previous five-year period.[34] CalPERS executives met with the CEOs of these companies in order to analyze the causes of lagging performance and to develop plans for improvement. In situations where these efforts failed, CalPERS resorted to shareholder resolutions and even litigation. CalPERS's efforts have borne fruit. One study reported that 42 companies targeted by CalPERS for aggressive action between 1987 and 1994 lagged the S&P 500 by an average of 66 percent. After some interventions, the returns of these companies averaged more than 41 percent *above* the S&P 500.[35] More recently, CalPERS and many other pension funds have lobbied aggressively for regulation that improves corporate governance and market operations.[36]

The ability of institutional investors to influence corporate managers is enhanced when they can combine forces. In the past, SEC proxy rules have made such concerted action difficult by requiring shareholders to file cumbersome statements, but in 1992 the SEC relaxed these rules, thereby increasing the ease of communication among institutional investors. Traditional proxy fights have required dissidents to educate large numbers of relatively uninformed shareholders about the issues, whereas, today, a handful of highly sophisticated institutional investors are able to confer easily and agree on changes quickly. Activist investors have formed several organizations in order to exert joint pressure more effectively. One of these organizations, the Council of Institutional Investors, currently represents 125 institutional investors with assets that exceed $3 trillion. Its mission is "to educate its members, policymakers and the public about corporate governance, shareowner rights and related investment issues."

Generally, institutional investors have focused on major issues in corporate governance and strategic direction and have avoided social issues. This choice has been dictated both by a fiduciary duty to increase bottom-line value for the funds' beneficiaries and by the difficulty of articulating a position on social issues that reflects the interests of all beneficiaries. Institutional investors have pressured corporations to include more outside directors on boards, establish independent compensation committees, separate the roles of CEO and chair of the board of directors, and avoid poison pills and other defenses against takeovers. In addition, institutional investors have supported regulatory reforms, such as the changes in SEC proxy rules that facilitate communication, promote greater transparency, and increase shareholder voice.

As an investment strategy, RI is forced upon institutional investors by the size of their holdings. Institutional investors are not like traditional investors, who can move in and out of the market freely; they are more like owners, who are stuck with a stock. A former CalPERS CEO Dale M. Hanson used the analogy: "If we buy an office building and the property manager isn't properly maintaining it, we don't sell the building—we change the property manager."[37] The largest pension and mutual funds hold between 1 and 3 percent of the largest American corporations. Positions of that size cannot be sold in the open market without depressing prices, and the only buyers are other institutional investors, who are apt to hold a similar evaluation of a stock.

Although the costs of relationship investing are high, they are typically less than the expense involved in selling one stock and buying another. Albert O. Hirschman, in his book *Exit, Voice, and Loyalty*, observes that dissatisfied members of an organization who can easily leave (exit) do not attempt to speak up for change (voice), but that members who cannot use the exit option have no choice but to use voice.[38] Thus, RI is a rational choice for institutional investors who are locked in and have only the voice option to express their dissatisfaction.

Many advocates of RI argue that not only shareholders but also managers themselves benefit from more active, informed involvement. Institutional investors provide patient capital, which is cited as a feature of the German and Japanese systems that enables firms to develop long-term plans. Outsiders also provide specialized skills and fresh perspectives that can help solve problems and prevent costly mistakes. Corporate managers are advised to view relationship investors as a valuable resource. On the downside, more cautious critics argue that relationship investing can lead to meddling by outsiders that distracts managers and diverts their focus. Institutional shareholders may be pursuing agendas that run counter to the interests of the corporation and other shareholders.

In particular, the change in the SEC rules that permits greater communication among institutional investors has been criticized for shifting the balance of power away from individual shareholders.[39] Although activist investors are at a disadvantage when incumbent managers and board members can use corporate resources to fight unwanted attention, the costs for a company to fight activists may exceed the benefits and thus lead to unwise accommodation. Uncertainty about the fiduciary duty of managers and directors may also cause them to accede to investors, even when they doubt the wisdom of their demands.

RI and fiduciary duty

Individual shareholders are responsible to no one. Hence, they can pursue investment strategies and exercise their shareholder rights as they choose. However, institutional investors are typically both shareholders and fiduciaries, which creates the potential for conflicts between these two roles.

First, if RI is an effective investment strategy that is suited to the special circumstances of institutional investors, then they may fail as fiduciaries if they do not take advantage of the opportunity. Some have argued that the decision to index a fund creates a fiduciary duty of active involvement with management, given the commitment not to sell an underperforming stock.[40] As fiduciaries, institutional investors may also face conflicts of interest. For example, investment management companies, which manage portions of portfolios for large pension plans, are reluctant to offend corporations on whom they depend for other business. Similarly, the managers of corporate pension funds face numerous conflicts of interest. Should they invest heavily in the company's own stock or seek better diversification? How should they vote when a management-sponsored proxy proposal is not in the employees' interests? Managers of company pension funds often refrain from pressuring the management of other corporations for fear of reciprocal action.[41] In order to avoid conflicts of interest, the managers of corporate pension funds must be given greater independence to serve the interests of the employees exclusively, which might include the use of RI.

Second, since shareholders have a role to play in corporate governance, institutional investors must decide how they will serve in this role. In particular, they are called upon to take positions on proxy proposals in every corporation in their portfolio. To do nothing or to vote routinely with management is still to take a position. In the interpretation of the Employee Retirement Income Security Act (ERISA) of 1974, which covers private pension plans, the right to vote proxies is considered to be a plan asset and thus is subject to the same strict fiduciary duties that apply to any other asset. Accordingly, pension funds subject to ERISA are legally obligated to develop policies on the voting of proxies that serve to promote the interests of a fund's beneficiaries. A number of proxy voting services provide analyses and recommendations on proxy proposals and handle the mechanics of submitting proxy votes. The most prominent of these organizations is Institutional Shareholder Services (ISS), which advises more than 1700 clients worldwide.

Third, the interests of the beneficiaries of pension funds and other institutional investments depend on the performance of the total portfolio. Because these portfolios contain a cross-section of corporations and are heavily indexed, their performance depends more on the health of the American economy than on the success of any particular company. Consequently, a fund manager with a fiduciary duty to serve the beneficiaries' interests has a broader perspective than an individual investor. For example, a merger or acquisition that benefits the shareholders of one company but harms those of another, or that benefits shareholders but harms bondholders, may be opposed by an institutional investor that holds both stocks and bonds in each company.

Furthermore, a pension fund manager might best provide for the secure retirement of a fund's beneficiaries by making investments that create good jobs, affordable housing, and an improved infrastructure. In 1989, the New York State Pension Investment Task Force recommended that the state pension funds use their assets to promote long-term economic growth rather than strict profit maximization. State pension funds have been urged to engage in economically targeted investment (ETI) on the grounds that retirement security depends on the health of the state's economy.[42]

A problem with ETI is that if it leads to reduced rates of return, then private pension fund managers would violate their fiduciary duty under ERISA. To meet this problem, the Clinton administration, which supported ETI, held that this kind of investment is permissible under ERISA if it produces "collateral benefits" while also providing "commensurate returns."[43] Under this ruling, an investment must produce at least a competitive rate of return, but the choice among alternative investment may involve a consideration of the social benefits. However, critics argue that ETI almost always offers a lesser return adjusted for risk, because otherwise the investment would be made without the need for special consideration.[44] So the question becomes how much return can rightly be sacrificed for the collateral benefits, especially when the value of the collateral benefits is difficult to judge. Moreover, the collateral benefits of an investment are difficult to identify, and, further, they cannot easily be separated from the strictly financial return. Indeed, it has been argued that investing for collateral benefits is little different from traditional investing, which considers all benefits.[45]

Public pension funds, which are not subject to ERISA, are especially vulnerable to political influence, and so managers must exercise considerable care to resist unwise uses of fund assets. Experience shows that the managers of public pension funds do not always make wise choices. For example, the Connecticut state pension fund lost $25 million in an unsuccessful attempt to save the jobs provided by Colt Industries, a manufacturer of firearms that eventually declared bankruptcy.[46] The Kansas pension fund invested in a local steel mill and a savings and loan association in order to save jobs and lost more than $100 million when both went bankrupt.[47] Some consider any use of public pension fund money for ETIs to be unsound public policy. If a project benefits the people of a state, then it is worth supporting through the political system with tax dollars that everyone provides. If the investments lower the returns for retirees, then, in effect, they have been taxed to provide a benefit for others.[48]

Improving corporate governance

One of the roles of shareholders in corporate governance is to exercise oversight and ensure accountability. In short, shareholders are important *monitors* of corporations. In corporations without a separation of ownership and control, shareholders are also the managers of an enterprise, and so their monitoring role is taken for granted. However, in large, publicly held corporations that have many shareholders with small holdings, the power of individual shareholders is diluted, and they have a decreased incentive to take any action. The result has been the imperial CEO, backed by a complacent board of directors. Without effective monitoring, corporations have engaged in unwise expansion, avoided difficult but necessary changes, and provided lavish compensation and other perquisites. Some companies languish because of operational problems or mistaken strategic plans. The hostile takeover wave of the 1980s was a financial remedy for excesses that were permitted, in part, by inadequate monitoring. Relationship investing has been hailed by some advocates as a political alternative that replaced hostile takeovers in the 1990s. John Pound proclaimed, "This new form of governance based on politics rather than finance will provide a means of oversight that is both far more effective and far less expensive than the takeovers of the 1980s."[49]

Traditionally, shareholders have monitored corporations by electing the board of directors and voting on proposals for major changes that have been submitted by management. For companies in distress, the main corrective has been the board of directors, which has the authority to replace management and set a new strategic direction. When boards do their job, this form of corporate governance can be very effective. Shareholders have little recourse, however, against an inattentive or incompetent board of directors since board elections and proxy battles are generally too slow and unwieldy to bring about the needed changes. In the 1980s, hostile takeovers provided a quick, albeit ruthless, method for bringing about change. This form of corporate governance involves high transaction costs, however, because of the enormous fees to investment bankers and lawyers, and it also imposes social costs as a result of the dislocation that typically follows in takeovers.

Relationship investing enables present shareholders to bring about the same kind of changes that a raider in a hostile takeover might make. Nell Minow calls relationship investing a "nontakeover takeover." She explains, "Like the raiders, we [relationship investors] hope to realize value that's buried there. We've found a better, easier way to do it."[50] A number of factors limited the use of hostile takeovers in the 1990s and beyond, including a lack of ready financing and the advent of state antitakeover laws. At the same time, developments have been favorable to concerted action by institutional investors. John Pound cites the further advantages that corporate governance through relationship investing is politically acceptable and consonant with basic American values. He writes:

> Americans have always had a deep distrust and political intolerance for pure finance, and the transactions of the 1980s stirred the populist pot of suspicions

> to an unprecedented degree. LBOs [leveraged buyouts] and other takeover transactions were based on secrecy, speed, and surprise. They eschewed due process and public debate. . . . The new politics of corporate governance stands in sharp contrast to the old ways of doing business. At the core of the new movement is a substantive discussion and debate over corporate policies. The new initiatives embrace due process and demand public debate. . . . [T]hey create a system that holds corporate management accountable to the same kinds of rules to which Americans hold their public officials accountable.[51]

RI raises some fears about its impact on corporate governance. Critics predict that institutional investor demands for quarterly performance will lead to more short-term emphasis instead of the patient capital that some have predicted. Others warn that in a politicized environment, every corporate decision will become a matter of public debate and that segments of the public will attempt to influence corporate decision making. In addition, the relentless effort to satisfy institutional investors has already led to restructurings and other changes that have caused dislocation in the workforce. Some critics contend that employees and other constituencies will lose additional power to institutional investors as corporations continue to become "mean and lean." The danger is that greater accountability might be achieved by reducing the responsiveness of corporations to social concerns. Thus, the question of whether relationship investing is a beneficial reform in corporate governance or a pernicious successor to hostile takeovers of the 1980s remains to be decided.

Socially Responsible Investing

In picking stocks, some individuals consider values to be as important as *P*/*E* ratios. These virtuous souls want to make sure that their dollars do not support objectionable business activities. Similarly, charities, foundations, religious groups, universities, and other nonprofit organizations have long sought stocks that are compatible with their institutional values. By contrast, some investors avidly pursue so-called "sin stocks." Morgan Funshares, for example, specializes in alcohol, tobacco, and gambling companies and finds support among folks who take delight in profiting from the folly of others.[52] The only trouble with tainted profits, they say, is "there 'taint enough of them." For most people, however, the stock market is merely a place to invest with no thought to the uses that others make of their money. The advice of financial experts is that if you care about the environment, civil rights, or public health, contribute your gains to worthy causes or engage in political activity—but don't mix money and morals.[53]

In recent years, investors who care about where their money goes have been aided by mutual funds and pension funds that screen for social responsibility factors. These funds identify themselves by many names: socially responsible investing (SRI), ethical investing, sustainable investing, triple bottom-line investing (financial, environmental, and social), and environment, social issues, and governance investing (ESG).[54] SRI is both a *product* and a *practice*.[55] Therefore, in addition to SRI mutual and pension funds (products), which appeal to socially concerned investors, the means employed by these funds to be socially responsible are utilized by many other investment funds to seek some of the same ends (practice). In addition, a whole industry of support services has developed to aid funds that offer SRI products and engage in SRI practices.

Because of the broad range of activities that might be characterized as SRI, statistics are difficult to compile. However, a study by the Forum for Sustainable and Responsible Investment in 2012 found that in the United States $3.74 trillion is currently being managed according to SRI principles, which is approximately 11 percent of investment assets under management and a 22 percent increase since 2009.[56] In Europe, the corresponding figure for SRI assets under management is in excess of 2.3 trillion euros.[57] In both the US and Europe, the increase in SRI funds has been quite rapid, with almost a fivefold increase between 1995 and 2012.

Despite the admirable intent of socially responsible investors, some troubling questions surround the movement. In addition to the practical difficulty of identifying socially responsible and irresponsible companies, critics challenge whether the effort makes any difference. Investors engage in SRI for different reasons—some to feel good about making money in stocks, others to bring about changes in corporate behavior—and whether SRI makes any difference depends on the aim. Individual investors are free to buy stocks for any reason they please and to pay the price if SRI produces lower returns. Likewise, mutual fund and pension companies are at liberty to attract investors by offering to screen their holdings, as long as the commitment to SRI is clearly stated and the investment is voluntary. More debatable, however, is whether portfolio managers who have a fiduciary duty to seek the highest return for investors have a right to consider nonfinancial factors in the selection of stocks—especially if SRI reduces overall results.

Defining SRI

SRI takes many forms. It can be as simple as a policy to avoid "sin stocks" or companies engaged in unpopular causes or as complex as seeking out socially responsible companies for investment and working with them to achieve socially worthy ends. Many active members of the SRI movement are motivated merely by a desire to feel good about their own investments, while others are seeking to change the world through their investing activity.

The roots of SRI reach back to the eighteenth century in England, when religious groups, especially Quakers and Methodists, believed that investing was a value-laden activity with a religious dimension. However, the movement really began in the 1960s as part of the political struggles against apartheid in South Africa and the war in Vietnam. Frustrated activists used protests at annual meetings, shareholder resolutions, and pressure on institutional investors, such as university endowment funds, to advance their causes. Similar tactics were used by the activist Ralph Nader in his campaign against General Motors to improve automobile safety, which spawned a larger consumer protection movement. In 1969, the Council on Economic Priorities was formed, and their work resulted in a series of guides for investors and consumers with such titles as *Rating America's Corporate Conscience: A Provocative Guide to the Companies behind the Products You Buy Every Day*[58] and *The Better World Investment Guide*. Religious groups eventually joined this movement, most notably with the founding of the Interfaith Center for Corporate Responsibility in 1971. Further impetus was provided by the explosion of environmental concerns in the 1990s.

Today, SRI has ceased to be the province of activists and has become mainstream, as well as global. Most SRI practitioners believe that screened funds serve primarily to provide competitive returns, with the achievement of some beneficial results as a secondary aim. SRI, they claim, is a viable investment approach that takes advantage of the superior long-term performance of socially responsible corporations. Corporations that pass SRI screens are generally well run and unlikely to face major crises and scandals. SRI may also contribute to improved performance by increasing communication between corporations and investors about social issues, and prompting corporations to undertake socially responsible initiatives.

In this mainstream form, SRI has become prominent in Europe as well as North America. European interest in SRI has been fostered by government mandates for responsible investment by state pension funds (which are more common in Europe than the US). The Oil Fund of Norway, which is the largest holder of stock in Europe, with assets in 2012 of $654 billion, has been guided since 2004 by an Advisory Council on Ethics, which enforces ethical guidelines for investments. The globalization of SRI has been facilitated by innovations in the reporting of social performance, as represented by the Global Reporting Initiative, whose accounting standards for sustainability are used worldwide. SRI practices have also been fostered by the Principles of Responsible Investment, which is an initiative launched by the United Nations in 2005. By 2012, its six basic principles have been subscribed to by more than

1000 investment companies (not all SRI funds), which manage more than $30 trillion in assets.

Screened funds employ negative screens to exclude the stock of companies that are engaged in particular businesses or that have objectionable records of performance. Some also use positive screens that identify companies with notable achievements in such areas as environmental protection, the promotion of women and minorities, family-friendly programs, charitable giving, community outreach, customer and supplier relations, product quality and safety, political activity, and responsiveness to public concerns. Many mainstream mutual fund and pension fund companies offer one or more SRI fund. Support for SRI is provided by socially responsible investment advisory and portfolio management companies and by organizations, most notably The Forum for Sustainable and Responsible Investment in the US and the European Sustainable Investment Forum (Eurosif).

Proponents of SRI have diverse aims. Some investors apparently feel a personal responsibility for the use that is made of their money. Many would no doubt refuse to invest in a brothel in Nevada (where prostitution is legal) on the grounds that they would be participating in an immoral activity, enabling others to act immorally or profiting from the immorality of others. However, it is not evident that a shareholder in a brothel enterprise would actually be participating in this activity or enabling others to do so. Obviously, the responsibility of investors for the activities of the firms in which they invest is a perplexing ethical issue. Much depends on whether investors' decisions have any substantial impact on corporate behavior, a question that is discussed below.

The research to date has failed to find any statistically significant difference in the returns of SRI funds.[59] Their performance is, on the whole, no better and no worse than comparable stock portfolios. However, these studies cover a relatively brief period of time in which the stock market has risen steadily. The returns must be adjusted for risk, and some researchers suggest that SRI funds may be riskier, on the whole, because of less diversification and greater holdings of small capitalization stocks.[60] In addition, successful firms are able to invest more in social responsibility, so that SRI screens may introduce a bias in favor of corporations with strong past earnings records. Such a bias would explain competitive short-term results but would be a poor predictor of performance in the long run.

Can SRI make a difference?

Is socially responsible investing capable of producing superior results while making the world a better place? If so, then the case for SRI could not be stronger. Even if the returns are competitive or only slightly lower, then the beneficial consequences would still make SRI an attractive alternative for investors who want to do good as they do well. Unfortunately, the prospects for making the world a better place and making a profit at the same time are not very bright. First, finance theory and, in particular, the efficient market hypothesis challenge the claim that SRI can produce superior returns. Second, the claim that SRI can change corporate investment policy lacks a basis in finance theory.

SRI and fund performance

Finance theory suggests that screened funds should have a lower return because of a lack of diversification and higher transaction costs. That is, reducing the universe of available stocks and adding the cost of screening are self-imposed restrictions that should hamper rather than enhance a fund's performance. The greatest theoretical challenge to the claimed benefits of SRI is posed by the Efficient Market Hypothesis.[61] The semi-strong form of the hypothesis holds that all publicly available information is already reflected in the price of stocks. As a result, the stock market is efficiently priced, and no investor can expect to beat the market on a risk-adjusted basis. That is, investors can achieve superior returns only if they assume more risk (in which case their risk-adjusted returns are still the same), or else they must possess information that has not yet been registered in stock prices (which requires that the market be inefficient). The Efficient Market Hypothesis suggests, further, that actively evaluating individual stocks by any criteria, financial or social, is a waste of resources, and that investors should passively select a balanced portfolio that mirrors the broader market.

The stock market is not perfectly efficient, however, and research can yield some gains for any fund.[62] However, this state of affairs provides little support for SRI unless the information that is not reflected in prices involves a firm's *social* performance. The case for SRI, then, must be based on the claims that the market is inefficient and that the source of this inefficiency is a failure to recognize the significance of socially responsible activity in the evaluation of stock price. The argument, in short, is that there is a link between social performance and financial performance that is generally ignored in the market, and so SRI funds can beat the market by taking advantage of information that other investors ignore.

That social and financial performance are linked is a reasonable claim that has received some empirical support.[63] That the market ignores information about social responsibility is a more dubious proposition. A firm that has a strong record on the environment, for example, may outperform less environmentally responsible firms because they are more likely to avoid the costs of meeting new regulation and settling legal claims for environmental damage.

The reason for this superior performance, however, may be due to a rational calculation that an ounce of prevention is worth a pound of cure. If so, then a higher stock price reflects the fact that the company has made an investment in order to avoid future liabilities, and the lower stock price of a less responsible rival results from the lack of such an investment and a greater potential for future liabilities.

The vulnerability of a corporation to adversity of any kind is information that is ordinarily registered in the market and is not detected solely by social responsibility screens. SRI funds avoid tobacco stocks for ethical reasons, but these stocks are already discounted in the market because of uncertainty over the industry's potential liability. If tobacco companies were ever to collapse from catastrophic liability judgments, then SRI firms would appear to be vindicated in their exclusion of such a "sin" stock, but the long-term returns of balanced portfolios that include tobacco stocks might be the same as the returns of SRI funds because of the discounting. That is, tobacco stocks now produce superior earnings relative to their (discounted) price, and so the losses to possible future holders of worthless tobacco stocks would be offset by these superior earnings.

The challenge of the Efficient Market Hypothesis, therefore, is that if the market is efficient, then any information about socially responsible practices that is relevant to financial performance will already be registered in the market. SRI funds act on this information by excluding (negative screens) or including (positive screens) the stock. By contrast, the market operates by discounting the price of a stock on the basis of negative information and placing a premium on a stock in the case of positive information. The difference between SRI and ordinary investing is the manner in which each responds to information. SRI funds can produce superior returns, then, only if their screens consistently reflect information that the market has somehow missed, which is unlikely but still possible.

SRI and investment policy

Whether socially responsible investing is capable of making a better world depends on the ability of investors to change corporate behavior by their investment decisions. The law of supply and demand suggests that if the demand for a stock is increased by socially concerned investors, then the price of a stock in fixed supply will rise. Thus, socially responsible companies will be rewarded by SRI investors with a higher stock price. However, if the price of a stock rises above a level that is supported by its fundamentals, then other investors will sell stock that they own or else cease their demand for the stock. As a result, supply and demand will return to an equilibrium state and the price of the stock will fall to its market value. In the long run, the price of the stock will be unaffected. The only difference will be that the stock of socially responsible companies will be in the hands of socially concerned investors. Since the price of the stock would be unaffected, under this analysis, there is no reason to believe that SRI could affect corporate behavior.

This argument assumes that supply and demand are perfectly elastic, which is true for larger, heavily traded stocks. SRI investors are more likely to affect the stock price of smaller, relatively unknown firms, for whose stock the demand is somewhat inelastic. However, can the willingness of SRI investors to bid up the price of a stock influence the investment policy of a company? Theoretically, the answer is yes.[64] If a firm makes investment decisions by selecting the opportunity with the highest net present value (NPV), then the increased stock price that results from socially responsible investments would lower the cost of equity for the firm and increase the expected rate of return. In practical terms, however, the shareholders are subsidizing socially responsible activities through their willingness to pay a higher price for the company's stock and accept lower financial performance, which runs counter to the claim that SRI can produce superior returns.

Alternatively, SRI provides an opportunity for smaller companies to compete in the crowded, noisy market for equity capital. Firms that operate in a socially responsible manner have an opportunity to attract capital from SRI funds. Much socially responsible activity is low-cost or cost-free, and a reputation for social responsibility can be an asset, especially in marketing. Smaller companies that market products like soaps and lotions (The Body Shop), toothpaste (Tom's of Maine), and ice cream (Ben & Jerry's) are able to compete in the mass market with industry giants by offering natural, environmentally friendly products to socially concerned consumers. Such socially responsible companies are usually founded and led by value-driven entrepreneurs who want to do business in a different way. Although they might successfully raise capital in the general market on the basis of their balance sheets, the existence of supportive, understanding SRI investors facilitates the task.

The conclusion to be drawn, then, is that SRI is unlikely to have any impact on large, heavily traded corporations. It can alter the investment policy of a firm only by raising the price of the firm's stock significantly over a long period of time, but the resulting increase in stock price represents a willingness of investors to subsidize investment in social responsibility. Perhaps the most enduring contribution of SRI is to provide a ready capital market for socially responsible companies that would have difficulty raising capital otherwise. These companies are often highly profitable, so that SRI investors need not necessarily pay a price, but investors need to understand these companies and seek them out in the first place. Socially responsible companies have an impact on American business by pioneering practices that are later adopted by mainstream corporations. Because of this impact, then, socially concerned investors can perhaps, in the end, make a difference indirectly.

Microfinance

Investment is commonly made to obtain a return. However, this return usually has some further aims, such as to secure one's retirement (a pension fund), support an institution (a university endowment, for example) or enable economic growth (such as development loans made by the World Bank). Socially responsible investment seeks to promote good corporate behavior. Can investment also be used to alleviate poverty? Development loans to promote economic growth achieve this end indirectly by creating jobs and increasing productivity, but a more direct form of investment aimed at poverty alleviation consists of putting money into the hands of the poor themselves for the purpose of starting or expanding a small enterprise. Loans in small amounts—as low as $50 to $100—might enable budding entrepreneurs to escape grinding poverty and begin a climb toward modest prosperity.

This is the idea behind *microfinance*, which is also called microcredit and microlending. This innovation in investment may be defined as the provision of financial services—not only lending but also savings, insurance, and payment systems—to low-income people who otherwise would not have access to them. These are the "unbankables"—human beings whose needs for credit and other financial services are not met by conventional financial institutions. This neglect is due mainly to the low income of the poor, which makes servicing them unprofitable for existing banks, but other factors include their distance from urban centers where banks are located, their lack of collateral for ensuring loans, and the absence of any credit history, which makes creditworthiness difficult to assess. In addition, the poor can pay back loans only if the funds are used productively and not merely for current consumption, and the potential for productive use by the poor is open to question. How much return can a poverty-stricken villager in Bangladesh, for example, obtain from a small loan?

The answer turns out to be, quite a bit. In 2006, Muhammad Yunus, a former Bangladeshi economics professor, and his creation, the Grameen Bank, were awarded the Nobel Peace Prize for developing microfinance into "an ever more important instrument in the struggle against poverty."[65] In his search for the causes of the extreme privation that afflicts Bangladesh, Yunus discovered that women who made bamboo stools cleared barely two cents a day, since much of their income went to the middlemen who loaned them money to buy the necessary bamboo and managed the sale of their products. Recognizing that the cause of the women's poverty was not effort or skill but lack of credit, he gave $27 of his own money to 42 women. These small amounts enabled them to break free from the moneylenders and realize the full value of their labors. After much experimentation, Yunus was ready in 1983 to found a bank with the purpose of making small loans to the poor of Bangladesh, and the bank has grown to serve more than 8.3 million members, almost all women, in villages nationwide.[66] Appropriately, the name Grameen means "of the village."

Lending small amounts to the poor is not a novel idea, and it can even be profitable—as loan sharks and payday lenders have discovered. Subsidized loans have long been a favored way for governments to help the poor. An early practitioner of microfinance was Jonathan Swift, the noted Irish satirist and dean of St Patrick's cathedral in Dublin. In the 1720s, he developed a system for making small interest-free loans to the poor, which led to numerous charitable societies that followed the Swift system. The first savings bank in England developed from a Penny Bank for the poor that was founded in 1798 by Priscilla Wakefield, an English Quaker reformer. In slums and villages around the world, communal mutual benefit associations, whereby members make contributions that they can draw upon as needs arise, have long been common.[67]

The challenge of microfinance is how to achieve three aims together: (1) assuring high rates of repayment; (2) becoming self-sustaining, thereby avoiding a reliance on subsidies or contributions; and (3) actually alleviating poverty or otherwise improving people's lives. The real innovation in microfinance that earned Muhammad Yunus and Grameen Bank the Nobel Peace Prize consists in the means that were discovered by experimentation and keen insights for achieving these three seemingly incompatible aims.

The first task in this section is to understand how microfinance, as developed at Grameen Bank and elsewhere, works. The keys of microfinance's success also raise some difficult ethical questions, including the justification of the high interest rates that typically prevail and the pressure that is applied to secure repayments. Some critics find a "dark side" to microfinance.[68] The field of microfinance is also riven by controversy over the conflict between being self-sustaining and even profitable and achieving the aim of alleviating poverty. Finally, does microfinance actually work to alleviate poverty? Anecdotes of successful stories are now giving way to hard empirical evidence, and measuring the impact of microfinance has proved to be complex and elusive.

How microfinance works

The poor have traditionally been unlikely candidates for loans due to a general lack of creditworthiness. Creditworthiness, in turn, consists of both an ability to pay and a willingness to do so. The ability to make payments requires that borrowers have the skill and knowledge to use money productively in some enterprise that generates income. Creditworthy borrowers must also have the discipline to set aside a portion of this income for loan payments and not spend it on current consumption (moral hazard). This complex of personal attributes is difficult, especially for an outsider, to judge (information asymmetry), and less creditworthy borrowers have the opportunity to take advantage of a lender's lack of knowledge by falsely presenting themselves as reliable (adverse selection). Fortunately, the willingness to pay depends not only on one's character (which is relatively fixed and difficult to judge) but also on incentives (which can be created and reliably known by outsiders). With sufficient incentives to repay, the character of the borrower becomes less relevant.

The poor borrower's lack of collateral presents a different kind of problem but one that can also be overcome with incentives. Since collateral in a traditional loan is an asset that can be seized in the event of default to offset the loss to the lender, it must have some market value. However, any possession that has value to the borrower—even if it is of little worth in a market—provides a strong incentive to the borrower to avoid seizure. Microfinance often involves collateral of this kind, which provides an incentive to repay but not the kind of offsetting compensation afforded by collateral in a traditional loan. Moreover, the use of collateral in a traditional loan assumes that a borrower makes a rational calculation that repayment is preferable to the loss of the asset (again, moral hazard). Typically, the lender's right to seize collateral is based on a legally enforceable contract, which fosters a legalistic mindset. Microfinance seeks to instill a different attitude toward repayment in which one pays the debt not in order to avoid some legal penalty, such as loss of the collateral, but out of a sense of moral obligation. The use of collateral can be eschewed entirely if this kind of attitude is successfully instilled.

The secret of microfinance, which was discovered by trial and error in the creation of Grameen Bank, is *group lending*. Potential borrowers present themselves in groups of five. Two members of a group each receive a small loan with an initial payment due quickly, followed by a frequent repayment schedule. If these members make the payments, the next two receive small loans some time later, followed last of all by a loan to the fifth member (this is called *dynamic incentives*). When the first round is complete, members are eligible for successively larger loans (*progressive lending*). If any member defaults on a loan, then all others in the group are denied future credit. In addition, eight groups are brought together in a public place to make payments that all can witness. Although all transactions are recorded, no contracts are signed; obligations are based instead on social relationships.

The quick initial payments and frequent payments thereafter (*regular repayment schedules*) enable the lender to discover any lack of ability or willingness to repay at an early stage, and the progressive increases in the amounts of loans minimize any losses. Staggering the loans among group members, withdrawing credit from all members if any one defaults, and accepting unconventional collateral (*collateral substitutes*) create powerful peer pressure to make payments. Progressively increasing the size of loans also ensures that borrowers who are eligible to obtain larger amounts have developed a credit history. Villagers themselves know better than an outsider who is trustworthy and who is not, and they will use this knowledge in the formation of groups. Thus, more trustworthy villagers will likely select each other, and less trustworthy people will be left to form their own groups if, indeed, they are able to do so at all. The public forum in which payments are made also inspires trust since any irregularity is exposed for all to witness.

Microfinance thus surmounts the first challenge of achieving a high rate of repayment—which is typically 95 percent or better—by the method of group lending, which overcomes the problems of traditional, individual lending, largely by providing strong incentives for making payments and by utilizing the knowledge of villagers themselves to monitor and motivate each other. This result is achieved without the use of conventional collateral or legally enforceable contracts, by basing the whole system on a high level of trust. The Grameen Bank has achieved a high repayment rate also by lending almost exclusively to women, who are considered to be more reliable and enterprising than men and more likely to use funds for their family's benefit. Group lending as a method is supplemented, moreover, with a deeper change in people's attitudes about borrowing and their relationships with each other. Borrowing is not merely a financial transaction but a means of collective self-help and community development, and, in borrowing, people are engaging in a communal activity that strengthens their bonds with others and promotes prosperity in the whole society.

Ethical issues in microfinance

The success of Grameen Bank in Bangladesh, Banco Solidario in Bolivia, Bank Rakyat Indonesia, and similar institutions elsewhere seem to indicate the financial soundness, as well as the social benefit, of microfinance. However, the controversy over the high profitability of Compartamos in Mexico, which richly rewarded its founder when it went public in 2007, and the 2010 collapse of Banex in Nicaragua, the largest microfinance institution to fail, have brought a new level of scrutiny to this branch of the investment industry. Many critical voices have emerged in recent years to question the movement on many fronts.[69] The Grameen model has been duplicated, cookie-cutter fashion, in countries where a different approach may be warranted, and the rapid growth of microfinance may have outstripped the useful employment of loan funds. Worse, the practice may not even be a very effective instrument for alleviating poverty in the world.

The ethical criticism of microfinance may be divided into three areas of inquiry. First are questions about how well microfinance actually addresses the financial needs of the poor and brings genuine benefits. Group lending, which constitutes the real innovation in microfinance that makes it possible, has some possibly deleterious consequences, including intense peer pressure that may be socially disruptive. Although high interest rates may be justified by the costs of administration and the risks taken, they still constitute a burden that reduces the economic return to the intended beneficiaries and perhaps enriches investors in some for-profit ventures. More serious are concerns that small loans for business enterprises are not really what the poor need and that, in any event, many loans are not used for this purpose. Other kinds of financial products might fit the needs of the poor better, and investment aimed at reducing poverty might be better directed to larger enterprises that create new jobs instead of merely helping the self-employed.

Second, there is controversy in the microfinance industry over the question of whether lending institutions should be not-for-profit and rely mainly on donors' contributions for funds or should aim to become self-sustaining and be operated for profit. Not-for-profit status allows institutions to focus on their mission of alleviating poverty, and aid funds produce greater benefits if loans to the poor are, in effect, subsidized by development resources. A great deal of money is contributed by individuals, governments, and private organizations to alleviate poverty, and if microfinance is an effective means of achieving this end, then these aid funds should be used in this way. However, dependence on aid funds brings some uncertainty and constraints and, in any event, such funds are limited, so forgoing for-profit opportunities might endanger the viability of microfinance institutions and limit their growth. This split in thought has been called "the microfinance schism."[70]

Effectiveness of microfinance

Whether microfinance benefits the poor is a complex of questions, each with no easy answer. First, does microfinance increase the income of the poor? Second, in the process of increasing income for some, are other people further impoverished by crushing debt loads? That is, for every success story that is told about microfinance, is there also a cautionary tale of failure? Third, should alleviating poverty be defined as merely an increase in income or should a definition of poverty alleviation include other forms of wealth as well? Fourth, are small loans for a business enterprise the extent of the financial services needed by the poor or are some other service needs more urgent and unmet? And finally, are aid funds best spent on loans for self-employed individuals who create no new jobs but only improve their own or is poverty alleviation best achieved by the support of small and medium enterprises that increase total employment?

Whether microfinance actually increases the income of the poor is seemingly a straightforward empirical question to be answered by careful data collection and analysis. Despite numerous studies, however, the results to date are inconclusive and unreliable.[71] To quantify any gains with assurance, it would be necessary to undertake the impossible task of comparing the world as it is with the world as it would have been without microfinance and attribute the difference to this one factor. The studies that have been undertaken use suspect data, apply different statistical methods, make different assumptions, and attempt to draw unbiased conclusions. One source of bias in these studies is that microfinance might attract borrowers who are better off to begin with and would have succeeded even without a loan. The progressive loan system eliminates those who are poorer credit risks and produces possibly skewed samples. Less successful borrowers might drop out of the programs and leave the more successful ones to be counted. If loan programs are established and expanded in geographical areas where small entrepreneurs are more successful and are provided with other support services, as seems likely, then another source of bias is introduced. Finally researchers may be drawn to study only the most successful programs. The consensus, even among supporters of microfinance, is that microfinance probably alleviates poverty to some extent but that definitive evidence of its effectiveness is lacking.[72]

Increased income is not the only or even the major need of the poor. The poor survive not merely as self-employed entrepreneurs but also as members of an informal economy built on strong family ties and social networks. Not only do they rely on financial capital but on social capital as well. Consequently, wealth for the poor, as for all people, consists, in part, of developing their capabilities and gaining control over certain aspects of their lives. Amartya Sen argues that this state of realizing capabilities and gaining control, which he calls freedom, should be the end of development, rather than a mere increase in income.[73] Freedom, for Sen, is not merely the proper end of development, but it is also the best means for achieving it. It follows from this view that aid funds should be used to increase the freedom, and not just the income, of the poor.[74]

Given the importance of social capital to the poor, as well as Sen's concept of development as freedom, it may be that the group lending method, while effective in securing repayment, is destructive of social capital. When group lending is successful, it builds social capital, but the peer pressure that occurs and the discord that results from nonpayment are likely to break down whatever social bonds have been created. One study finds evidence that social relationships deteriorate after some members of a group default.[75] Little is gained for the poor if financial capital is increased at the expense of social capital. Freedom is further enhanced by microfinance, though, insofar as loans made to women empower them in family and community relationships. This alleged nonincome benefit is questionable, however, since studies show that although women are typically the recipients of the loans, men still control the small businesses that the funds support.[76] The potential of microfinance to change the deeply embedded inferior status of women in traditional societies by empowering them is definitely limited.

Microfinance assumes that the main financial service needed by the poor is credit and that the demand for it is largely unlimited and relatively unaffected by high interest rates. The idea that the poor are all budding entrepreneurs who need only a small loan to start or expand a business not only inflates expectations of what is possible but also ignores other, equally crucial, financial needs. Indeed, studies of how loans are actually used reflect some of these other needs. Often loan funds are used to meet urgent financial obligations, such as school fees, medical bills, and house repairs, which cannot be met from current income due to unforeseen circumstances. Like the wealthy everywhere, the poor use credit to smooth variations between income and expenses. Given the precariousness of their lives and resources, the financial services of greatest value to the poor are savings and insurance, rather than credit.[77] Without savings or insurance, credit is more likely to be used as a substitute for resources rather than for production. This point is not an argument against the effectiveness of microfinance but one for changing its aims and creating new products in order to be more effective in meeting the financial needs of the poor. Indeed, the Grameen Bank requires enrollment in a savings program as a requirement for obtaining a loan, and many microfinance institutions offer a broad range of financial services.[78]

The focus of microfinance on individual enterprises as the key to alleviating poverty is fundamentally misguided, in the view of many people involved in economic development. Not only are the poor limited in their ability to start or expand a business, but the most effective means for raising people's incomes is creating employment, which is to say real jobs. Jonathan Morduch writes, "The best evidence to date suggests that making a real dent in poverty rates will require increasing overall levels of economic growth and employment generation. Microfinance may be able to help some households take advantage of these processes, but nothing so far suggests that it will ever drive them."[79] This point has been expressed as the problem of the "missing middle."

In developed countries, small and medium enterprises (SMEs) account for around 60 percent of gross domestic product (GDP), while in less-developed countries the figure for SMEs is 17 percent.[80] Graphs of employment in less-developed countries show that employment is clustered at the two ends of the self-employed and large enterprises, whereas developed economies peak at the mid-point of small and medium enterprises. The problem of the "missing middle"—that is, a relative lack of jobs at this mid-point—suggests that the key to turning less-developed countries into developed ones, and thereby alleviating poverty, lies with correcting what the graphs show to be missing and creating more employment in SMEs. Thus, more poverty may be alleviated by loaning $100 000 to build a medium-sized factory that will employ 1000 people than to make 1000 $100 loans.

The microfinance schism

Microfinance is appealing to many supporters not only because it appears to offer the best results for donors who want to make some contribution to poverty alleviation, but because it also holds out the prospect of being self-sustaining, and even profitable. This outcome would be a win for both the poor and those who seek to help them—and it would also attract profit-minded investors. Profitable microfinance would be an example of "marketing to the bottom of the pyramid," which holds that selling products and services to the poor provide good business opportunities.[81]

That microfinance can be done profitably is shown by the few large institutions that have successfully gone public, such as Compartamos in Mexico and SKS Microfinance in India, which conducted successful IPOs in 2007 and 2011 respectively. In the process, the transformations of these formerly not-for-profit lenders generated huge windfalls for insiders. One question is how many microfinance institutions could be profitable; by one estimate, the answer is about 5 percent, with most institutions covering only about 70 percent of their costs.[82] The more pertinent question is whether becoming self-sustaining or working toward this goal is desirable. Many donors willingly support microfinance as pure philanthropy but still expect or hope that these institutions will eventually be able to survive without donations. For these donors, sustainability is at least a goal worth pursuing. Achieving this goal, however, may also change both the operations and the mission of microfinance institutions in ways that many would consider undesirable.

In 2011, Muhammad Yunus wrote, in the *New York Times*, that when he founded the Grameen Bank, seeking to thwart the loan sharks who preyed on the poor, he never imagined that "one day microcredit would give rise to its own breed of loan sharks."[83] His opinion that commercialization has been a "terrible wrong turn" for microfinance is based, in part, on principle: "Poverty should be eradicated, not seen as a money-making opportunity." However, he also cites the practical consequences that for-profit microfinance leads to higher interest rates, more aggressive loan origination and collection practices, and a focus on higher-income borrowers. In his view, the inevitable neglect of the very poor leads to "mission drift." Furthermore, by obtaining loan funds from capital markets, for-profit microfinance transfers more of the risk of this volatile source to borrowers. More crucially, the Grameen Bank model, which is built on trust rather than contracts, is threatened when borrowers no longer feel a strong moral obligation to repay. Indeed, Yunus notes, borrowers in India stopped making payments when they came to believe that lenders were taking advantage of them. The collapse of Banex in Nicaragua was caused, in part, by the rise of the "no pago" or "no pay" movement, which was encouraged by the government.

Supporters on the other side of the microfinance schism argue, first, that profitable lenders can tap world credit markets for funds and thereby increase the volume of loans for the benefit of the poor. Generating loan funds from donors, along with interest from borrowers and a bank's own depositors, places sharp limits on the amounts available. With greater scale, for-profit institutions can make a greater impact on poverty. This argument assumes, however, that the demand for credit is virtually unlimited and is not reduced by the high rates of interest that may be necessary to lend profitably. Further, the impact on poverty is limited if the focus shifts away from serving the very poor. The volume of loans is not a good indicator of their impact if the recipients are not well chosen.

Second, by reducing or eliminating reliance on donors, which includes governments, for-profit microfinance institutions avoid not only the limited supply of funds but also the uncertainty of this source of funding and the other demands that donors make. In particular, government subsidies of loans often have the result that well-off, politically connected insiders obtain loans instead of the intended recipients. More broadly, alleviating poverty is a long-term project that requires enduring, substantial institutions. Self-sustaining institutions are more likely to attain sufficient stability and capability for this difficult task. However, the experience of the Grameen Bank shows that not-for-profit institutions can achieve considerable scale and longevity. Moreover, both governments and institutional donors (such as foundations, aid organizations, and world bodies) can be reliable, long-term partners.

Third, it is argued that for-profit microfinance institutions are better able to offer the poor savings programs and the other financial services that are crucial to alleviating poverty. The call for microfinance to serve as a platform for a wide variety of financial products has been largely ignored by smaller lending institutions with a narrow focus. However, this situation is changing, and there is no reason why a subsidized lending institution might not find it feasible to offer, say, savings accounts along with loans. Indeed, deposits from savings accounts can be a source of loan funds for a microfinance lender. Although institutions that accept deposits must be more carefully regulated than mere lenders, the obstacles are not insurmountable.

The schism between subsidized and sustainable microfinance continues to divide supporters of this movement, and much experience and research will be needed to resolve it. Although some institutions continue to focus on financial sustainability while others measure success in terms of social impact, both kinds bring great benefit to the poor of this world. Moreover, there is room in the movement for both kinds of institutions, and differences between countries and constituencies demand that the movement contain great variety. As many writers stress, the important point is to address this schism and the other issues in microfinance without damaging the motivating commitment to alleviate poverty.

Conclusion

Investment is a core financial activity that enables individuals to obtain a return on funds that are not needed for immediate consumption. These funds and those of organizations—for example, university endowments or corporate pension funds—are the raw material for a major industry, the investment industry, which consists of investment banks, mutual and pension funds, hedge funds, sovereign wealth funds, and the like. Most investment is a straightforward search for returns, which are obtained by discovering the most productive use for the funds under management. As in any industry that turns raw materials into finished products, ethical issues arise in its operations. Investment banks raise many such issues, which are not considered here directly; the focus is instead on mutual funds, which have encountered criticism for allowing market timing and personal trading by fund managers, and on hedge funds and other investment forms that practice relationship investing. In addition, some investment funds seek more than a return; they seek to do good by promoting corporate social responsibility in the case of SRI funds or alleviating poverty in the case of microfinance. Although the aims of these kinds of investment are generally admirable, the actual practices of SRI investing and microlending and the results obtained need to be carefully understood and evaluated.

Notes

1. Investment Company Institute, *2012 Investment Company Fact Book*, 2012.
2. Paula Dwyer and Amy Borrus, "The Coming Reforms," *BusinessWeek*, November 10, 2003.
3. Testimony of Eric W. Zitzewitz before the United States House of Representatives, Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, November 6, 2003.
4. Eric W. Zitzewitz, "Who Cares about Shareholders? Arbitrage-Proofing Mutual Funds," *Journal of Law, Economics, and Organization*, 19 (2006), 245–280.
5. Eric W. Zitzewitz, "How Widespread Was Late Trading in Mutual Funds," *AEA Papers and Proceedings*, May 2006.
6. Peter Elkind, "The Secrets of Eddie Stern," *Fortune*, April 19, 2004.
7. Elkind, "The Secrets of Eddie Stern."
8. Riva D. Atlas, "Fund Executive Accepts Life Ban in Trading Case," *New York Times*, May 21, 2004.
9. Elkind, "The Secrets of Eddie Stern."
10. Andrew Caffrey, "Critics Decry Uneven Use of 'Fair-Value Pricing'," *Boston Globe*, September 12, 2003.
11. Michael Lewis, "Fidelities Revisited," *New York Times Magazine*, January 21, 1996.
12. Lewis, "Fidelities Revisited." See also Robert McGough and Jeffrey Taylor, "SEC Boosts Its Scrutiny of Magellan Fund," *Wall Street Journal*, December 11, 1995; Jeffrey Taylor, "SEC Has Array of Tools in Magellan Probe," *Wall Street Journal*, December 26, 1995; and Jeffrey Taylor, "SEC Action Is Unlikely on Vinik," *Wall Street Journal*, May 9, 1996.
13. *Personal Investment Activities of Investment Company Personnel*, Report of the Division of Investment Management, United States Securities and Exchange Commission, September 1994.
14. *Report of the Advisory Group on Personal Investing*, Investment Company Institute, May 9, 1994.
15. *Personal Investment Activities of Investment Company Personnel*, p. 1.
16. For convenience, the terms *fund manager* and *access people* are used here interchangeably, and apply to portfolio managers, analysts, traders, and all others for whom personal trading is an issue.
17. This summary is taken from *Report of the Advisory Group on Personal Investing*, p. 10.
18. These points are developed in *Personal Investment Activities of Investment Company Personnel*, p. 4.
19. *Personal Investment Activities of Investment Company Personnel*, p. 28.
20. *Report of the Advisory Group on Personal Investing*, p. 27.
21. Robert McGough, "Few Mutual Funds Ban Personal Shorting," *Wall Street Journal*, June 24, 1996.

22. Securities and Exchange Commission, "Prohibition on the Use of Brokerage Commissions to Finance Distribution," 17 CFR Part 270, *Federal Register*, Vol. 69, No. 174, September 9, 2004.
23. The Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).
24. Remark by Peter Rawlins, then chairman of the London Stock Exchange, *Times Business News*, February 29, 1992.
25. Office of Compliance, Inspections and Examinations, Securities and Exchange Commission, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds*, September 22, 1998.
26. Association for Investment Management and Research, *CFA Institute Soft Dollar Standards: Guidance for Ethical Practices Involving Client Brokerage*, 1998.
27. D. Bruce Johnsen, "Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage," *Yale Law Journal on Regulation*, 11 (1994), 75–113.
28. Johnsen, "Property Rights to Investment Research." See also D. Bruce Johnsen, "Mutual Funds," in John R. Boatright (ed.), *Finance Ethics: Critical Issues in Theory and Practice* (New York: John Wiley & Sons, Inc. 2010).
29. D. Bruce Johnsen and Stephen M. Horan, *The Welfare Effects of Soft Dollar Brokerage: Law and Economics*, monograph from the Association for Investment Management and Research, 2000.
30. Investment Company Institute, "Request for Rulemaking concerning Soft Dollars and Directed Brokerage," Petition No. 4-49, December 16, 2003, Securities and Exchange Commission.
31. *The Brancato Report on Institutional Investment* (Fairfax, VA: The Victoria Group, 1993), 1994.
32. Matteo Tonello and Stephan Rabimov, *The 2010 Institutional Investment Report* (New York: The Conference Board, 2010). Figures are for institutional ownership of the 1000 largest US corporations.
33. On the concept of "universal ownership," see James P. Hawley and Andrew Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate American More Democratic* (Philadelphia, PA: University of Pennsylvania Press, 2000).
34. Dale M. Hanson, "Much, Much More than Investors," *Financial Executive*, March–Apri1 1993, pp. 48–51.
35. The study by Stephen Nesbitt of Wilshire Associates is reported in Ed McCarthy, "Pension Funds Flex Shareholder Muscle," *Pension Management*, January 1996, pp. 16–19.
36. Marc Lifsher, "CalPERS to Seek Improved Governance, Stricter Wall Street Rules," *Los Angeles Times*, February 9, 2009.
37. Quoted in Hanson, "Much, Much More than Investors," p. 48.
38. Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA: Harvard University Press, 1970).
39. See Nell Minow, "Proxy Reform: The Case for Increased Shareholder Communication," *Journal of Corporation Law*, 17 (1991), 149–162.

40. "Indexing Fingered," *The Economist*, April 30, 1994.
41. John Brook, "Corporate Pension Fund Asset Management," in *Abuse on Wall Street: Conflicts of Interest in the Securities Industry* (Westport, CT: Quorum Books 1980).
42. "The Politically Correct Pension Fund," *BusinessWeek*, March 21, 1994; and "Clinton Administration Official Advocates Relationship Investing," *Pension World*, July 1994.
43. Department of Labor Interpretive Bulletin 94-1 on Economically Targeted Investments, 59 Fed. Reg. 32,606 (June 23, 1994), codified at 29 C.F.R. § 2509.94-1. See Diane E. Burkley and Shari A. Wynne, "The Clinton Administration Is Attempting to Persuade Pension Plans to Invest Their Vast Resources in Projects that Offer Benefits to Low-Income Communities," *National Law Journal*, September 5, 1994.
44. Edward Zalinsky, "ETI, Phone the Department of Labor: Economically Targeted Investments and the Reincarnation of Industrial Policy," *Berkeley Journal of Employment and Labor Law*, 16 (1995), 333–355.
45. Zalinsky, "ETI, Phone the Department of Labor," p. 341. For criticism, see Jayne Elizabeth Zanglein, "Protecting Retirees While Encouraging Economically Targeted Investment," *Kansas Journal of Law and Public Policy*, 5 (1995–1996), 47–58; and a response, Edward A. Zelinsky, "Economically Targeted Investments: A Critical Analysis," *Kansas Journal of Law and Public Policy*, 6 (1996–1997), 39–48.
46. Adam Bryant, "Colt's in Bankruptcy Court Filing," *New York Times*, March 20, 1992.
47. Richard W. Stevenson, "Pension Funds Becoming a Tool for Growth," *New York Times*, March 17, 1992.
48. Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review*, 93 (1993), 795–853. Romano notes that the alternative is to make up the shortfall by taking tax dollars away from some other state services.
49. John Pound, "Beyond Takeovers: Politics Comes to Corporate Control," *Harvard Business Review*, March–April 1992, p. 83.
50. Quoted in Judith H. Dobrzynski, *Business Week*, March 15, 1993. Nell Minow was a founder and principal of Lens, a relational investment firm that operated between 1992 and 2000.
51. Pound, "Beyond Takeovers," p. 88.
52. Michele Galen, "Sin Does a Number on Saintliness," *BusinessWeek*, December 26, 1994; John Rothchild, "Why I Invest with Sinners," *Fortune*, May 13, 1996; and Ann Brocklehurst, "Banking on the Wages of Sin," *New York Times*, February 18, 1995.
53. Ritchie P. Lowry, *Good Money: A Guide to Profitable Social Investing in the '90s* (New York: W.W. Norton, 1991), p. 19.
54. For a short history of social investing, see Mayra Alperson, Alice Tepper Marlin, Jonathan Schorsch, and Rosalyn Will, *The Better World Investment Guide* (New

York: Prentice Hall, 1991). See also Elizabeth Judd, *Investing with a Conscience* (New York: Pharos Books, 1990); Peter D. Kinder, Steven D. Lydenberg, and Amy L. Domini, *The Social Investment Almanac: A Comprehensive Guide to Socially Responsible Investing* (New York: Henry Holt, 1992); Jack A. Brill and Alan Reder, *Investing from the Heart* (New York: Crown, 1992); and Amy L. Domini, *Socially Responsible Investing: Making a Difference in Making Money* (Chicago: Dearborn Trade, 2001).

55. Céline Louche and Steven Lydenberg, "Responsble Investing," in John R. Boatright (ed.), *Finance Ethics: Critical Issues in Theory and Practice* (New York: John Wiley & Sons, Inc., 2010).
56. *2012 Report on Sustainable and Responsible Investing Trends in the United States* (Washington, DC: The Forum for Sustainable and Responsible Investment, 2012).
57. Eurosif, *European SRI Study 2012*.
58. Steven D. Lydenberg, Alice Tepper Marlin, and Sean O'Brien Strub, *Rating America's Corporate Conscience: A Provocative Guide to the Companies behind the Products You Buy Everyday* (Reading, MA: Addison-Wesley, 1986).
59. Sally Hamilton, Hoje Jo, and Meir Statman, "Doing Well While Doing Good?" *Financial Analysts Journal*, November–December 1993, pp. 62–66; J. David Diltz, "The Private Cost of Socially Responsible Investing," *Applied Financial Economics*, 5 (1995), 69–77; and C. Mallin, B. Saadouni, and R. J. Briston, "The Financial Performance of Ethical Investment Funds," *Journal of Business Finance and Accounting*, 22 (1995), 483–496.
60. D. J. Ashton, "A Problem in the Detection of Superior Investment Performance," *Journal of Business Finance and Accounting*, 17 (1990), 337–350; and John H. Langbein and Richard A. Posner, "Social Investing and the Law of Trusts," *Michigan Law Review*, 79 (1980), 72–112.
61. For a discussion of the implications of finance theory for social investing, see Larry D. Wall, "Some Lessons from Basic Finance for Effective Socially Responsible Investing," *Economic Review*, 8 (1995), 1–12.
62. Maria O'Brien Hylton, "'Socially Responsible' Investing: Doing Good versus Doing Well in an Inefficient Market," *American University Law Review*, 42 (1992), 1–52.
63. Attempts to measure the relation between social and financial performance have been marred by problems of definition and measurement, and the results of the many studies have been contradictory and inconclusive. For an overview of the available studies, see Joshua Margolis and James P. Walsh, *People and Profits? The Search for a Link between a Company's Social and Financial Performance* (Mahwah, NJ: Lawrence Erlbaum, 2001).
64. Wall, "Some Lessons from Basic Finance for Effective Socially Responsible Investing," p. 4.
65. http://www.nobelprize.org/nobel_prizes/peace/laureates/2006/press.html
66. http://www.grameeninfo.org/index.php?option=com_content&task=view&id=26&Itemid=175

67. For a history of microfinance initiatives, see David Roodman, *Due Diligence: An Impertinent Inquiry into Microfinance* (Washington, DC: Center for Global Development, 2012), Chapter 3.
68. David Hulme, “Is Microdebt Good for Poor People? A Note on the Dark Side of Microfinance,” *Small Enterprise Development*, 11 (2000), 26–28. See also Keith Epstein and Geri Smith, “The Ugly Side of Microlending,” *Newsweek*, November 12, 2007.
69. See, for example, Roodman, *Due Diligence*; Hugh Sinclair, *Confessions of a Microfinance Heretic* (San Francisco, CA: Berrett-Koehler, 2012); and Milford Batemen, *Confronting Microfinance: Undermining Sustainable Development* (Sterling, VA: Kumarian Press, 2011).
70. Jonathan Morduch, “The Microfinance Schism,” *World Development*, 28 (2000), 617–629.
71. One of the most often cited studies is Mark M. Pitt and Shahidur Khandker, “The Impact of Group-Based Credit Programs on Poor Households in Bangladesh: Does Gender Participation Matter,” *Journal of Political Economy*, 106 (1998), 958–996. A subsequent analysis of the data by Jonathan Morduch failed to yield the same positive conclusions. Jonathan Morduch, “The Microfinance Promise,” *Journal of Economic Literature*, 37 (1999), 1569–1614. An extended exchange between these researchers did not produce a decisive conclusion. See also Beatriz Armendariz and Jonathan Morduch, *The Economics of Microfinance* (Cambridge, MA: MIT Press, 2005); and Roodman, *Due Diligence*, pp. 160–165.
72. Jonathan Morduch and Barbara Haley, “Analysis of the Effects of Microfinance on Poverty Reduction,” NYU Wagner Working Papers No. 1014, June 28, 2002; and Manohar Sharma and Gertrud Buchenrieder, “Impact of Microfinance on Food Security and Poverty Alleviation: A Review and Synthesis of the Empirical Evidence,” in Manfred Zeller and Richard L. Meyer (eds), *The Triangle of Microfinance: Financial Sustainability, Outreach and Impact* (Baltimore, MD: The Johns Hopkins University Press, 2002).
73. Amartya Sen, *Development as Freedom* (New York: Knopf, 1999).
74. See Roodman, *Due Diligence*, Chapter 7.
75. Dean S. Karlan, “Social Connections and Group Banking,” *The Economic Journal*, 117 (2007), F52–F84. See also Annabel Vanroose, “Is Microfinance an Ethical Way to Provide Financial Services to the Poor?” *Ethics and Economics*, 5 (2007), 1–8.
76. Anne Marie Goetz and Rina Sen Gupta, “Who Takes the Credit? Gender, Power, and Control over Loan Use in Rural Credit Programs in Bangladesh,” *World Development*, 24 (1996), 45–63.
77. Timothy H. Nourse, “The Missing Parts of Microfinance: Services for Consumption and Insurance,” *SAIS Review*, 21 (2002), 61–69. See also Hulme, “Is Microdebt Good for Poor People?”
78. Alex Counts, “Reimagining Microfinance,” *Stanford Social Innovation Review*, 6 (Summer 2008), 46–53.
79. Morduch, “The Microfinance Promise,” p. 1610.

80. Meghana Ayyagari, Thorsten Beck, and Asli Demirgüç-Kunt, "Small and Medium Enterprises across the Globe: A New Database," World Bank Policy Research Working Paper 3127, August 2003.
81. C. K. Prahalad, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits*, 5th edition (Upper Saddle River, NJ: Wharton School Publishing, 2010).
82. Morduch, "The Microfinance Schism," p. 618.
83. Muhammad Yunus, "Sacrificing Microcredit for Megaprofits," *New York Times*, January 14, 2011.