A Fiduciary Duty of Ethical Adequacy and Socially Responsible Investing

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11.02.2021

Content

Introduction

There was and maybe still is sometimes the concern that socially responsible investing (SRI) without explicit consent of the beneficiaries would violate the fiduciary duties of the financial institutions.[1] The argument was that the criteria which are taken into consideration in SRI are of none financial relevance but the integration of them into investment decisions would lead to less diversification in the portfolios, thereby increasing the financial risk for the same or even less returns. Thus, it would be imprudent to invest socially responsibly and violate the fiduciary duty of prudence.

[1] Cf. Boatright 2014, 148ff.; Martin 2009, 549; Sanders 2014, 579.

Under socially responsible investing (SRI) one can understand the inclusion of environmental, social and corporate governance criteria (ESG-criteria) into the analysis of investments and the decision-making process of investment managers and portfolio managers within the concerned financial institutions. Regarding the investments in stocks, some examples for ESG-criteria are whether the companies in question produce a lot of greenhouse gases, facilitate the decline of biodiversity or pollute water (environmental), comply with human rights, benefit from or even promote violent conflicts (social) and whether they engage in tax avoidance, corruption or excessive executive payments (corporate governance).[2]

The line of argumentation above has been displaced over the last years, starting by the Freshfield Report in 2005 and continued by the subsequent reports by Sullivan et al. with the final report in 2019, all of them commissioned by the United Nations Environmental Programme Finance Initiative (UNEP FI).[3] On one hand, these reports examine different jurisdictions and conclude that SRI is not in direct contradiction with the fiduciary duties as formulated in their laws. Moreover, the final report notices that many jurisdictions have already acknowledged the relevance of ESG-criteria on financial performance and have adjusted their policies and regulations in recent years.[4] On the other hand, they argue that not only is SRI permissible but can also be required sometimes because, opposed to the abovementioned view, ESG-criteria do have an impact on the performance of a portfolio. Thus, it would in some cases violate the fiduciary duty of prudence *not* to invest socially responsibly.[5] They recommend explicitly that policymakers and regulators should „clarify that fiduciaries must analyse and take account of ESG issues in their investment processes, in their active ownership activities, and in their public policy engagement“ and that „fiduciary duty requires that investors pay attention to long-term investment value drivers, including ESG issues“.[6]

The main argument by all these reports is an argument of prudence and is based on the premises that ESG-criteria do indeed have a relevant impact on the performance of

[2] A more precise definition of SRI and exact conceptions how these requirements can be implemented in practice is not necessary for my argument. For different practical approaches of different types of institutions one can look at BlackRock 2019; Giese 2019; and PRI 2017. For a condensed theoretical overview over practical approaches see Gary 2019, 736-747. For a general overview see Boatright 2014, 148-154; Camilleri 2017, 61-77.
[3] Freshfield Bruckhaus Deringer 2005; Sullivan et al. 2015; 2019.
[4] Sullivan et al. 2019, 12ff.
[5] Ibid.,17ff.
[6] Sullivan et al. 2015, 21.

portfolios and that it would be imprudent not to take ESG-criteria into consideration for one's investment strategy. Therefore, financial institutions would be required to take ESG-criteria into considerations due to the fiduciary duty of prudence. The argument of prudence has different flaws and it will always depend on the empirical question whether ESG-criteria do have a factual impact on portfolio performance.[7] Furthermore, some of the criteria which we deem socially relevant might turn out to be financially inert and would not have to be taken into account, according to this line of reasoning. Taking ESG-criteria into account is not required because of ethical considerations but because it promises better financial performance.

In this paper I do not want to argue against the argument of prudence and I also do not want to intervene in any empirical debate. Instead, I offer an alternative argument that next to the fiduciary duties that are commonly recognized by the law the ethical considerations which motivate these duties provide the basis for a further fiduciary duty that is still mostly neglected and not represented in law. I call this fiduciary duty the „duty of ethical adequacy". If there is such a basis for a fiduciary duty of ethical adequacy, the implementation of a legal equivalent could be justified which again could lead under certain assumptions to the conclusion that financial institutions are required to invest socially responsibly not only because it may be prudent but also because it is ethically adequate. This is not to undermine the argument of prudence for SRI but to give an additional reason why financial institutions should invest socially responsibly.

In what follows, I will first examine the features of fiduciary relationships and explain how fiduciary duties are ethically based on the moral obligations entailed by the circumstance that fiduciary relationships are trust-relationships. Subsequently, I argue that a further fiduciary duty can be obtained from this ethical basis of trust, namely a fiduciary duty of ethical adequacy which requires the fiduciary to adjust his means to the minimally ethical expectations of the beneficiary. After that, I indicate a possible line of argumentation for legislation that requires financial institutions to provide more services by means of SRI. The last section concludes.

[7] Cf. Sandberg 2011 for some of the flaws of the argumentation. See the following meta-analyses concerning the impact of ESG-criteria on the financial performance of companies or funds: Friede, Busch & Bassen 2015; Kim 2019; Revelli & Viviani 2014; Sinha, Datta & Ziolo 2019. The consensus seems to be that ESG-criteria have a positive or a non-significant impact on financial performance.

Fiduciaries and Trust: The Ethical Basis for Fiduciary Duties

In a legal context, who is a fiduciary and what duties a fiduciary has to fulfill is defined in various different ways. However, from a more general ethical perspective, which is the only perspective I attend to in the following,[8] a fiduciary is a person or an organization that accepts some property of another party in advance (in the financial sector mostly money) and is therefore obliged to do business with that property in order to provide some service to the other party in the future. So, there is a contract that for a payment upfront or on a regular basis (e.g. in insurances) from a party B(eneficiary) to a party F(iduciary), party F gets an assignment to manage the payments in ways that enable F to provide a certain service to B in the future (in the financial sector mostly monetary payments of a certain form and/or under certain conditions) (Condition 1). Another relevant aspect for a fiduciary relationship is that B consults F because B could not generate the outcome of the service by herself but the service to B is individually or socially enormously beneficial or even mandatory or unavoidable in the society in which B lives, while F has some special abilities, resources or knowledge that enable F to fulfill said assignment and provide the service (Condition 2). This distinguishes the fiduciary from a mere debtor, since the debtor's repayment of his debts is not a service that only he could have provided with his specific resources and skills. Furthermore, because of F's expertise and endowment it is to a certain degree up to F's own discretion how to fulfill the assignment and provide the service (Condition 3). This distinguishes F from a mere agent which is commissioned to execute a certain act in a rather strictly determined way (e.g. a bank in its role as a payment service provider or a broker who is told exactly which securities to buy or sell). Condition 2 and 3 also imply that B is on the one hand not able to monitor F and on the other hand also has a strong incentive not to barge in F's business. A last important aspect is that the contract between F and B is bilateral such that F under the terms of the contract with B is particularly under an obligation to B and nobody else (Condition 4). This distinguishes a fiduciary from a public person or organization that gets paid upfront to provide some service for the whole community (e.g. a police officer or a teacher). Indeed, this characterization of a fiduciary is flawlessly compatible with the characterization in the UNEP FI reports.[9]

[8] The following characterization of a fiduciary is composed along the elaborations by Boatright (2014, 40ff.) and Miller (2014, 320f.)
[9] Cf. Sullivan et al. 2019.

Although this characterization is plausible and also compatible with a broad legal understanding of what a fiduciary is, it is noteworthy that the characterization at hand includes financial institutions in their role of providing certain services where it might be controversial whether they should legally count as fiduciaries in that role. While it is quite undisputable that a pension fund is in a fiduciary role towards its customers, it is sometimes disputed that this is the case for a bank when it offers deposits or for an insurance company when it provides insurances.[10] The inclusion of these controversial cases in the characterization above is deliberate.

According to Seumas Miller, a fiduciary relationship is a kind of trust-relationship.[11] In a trust relationship one party B is somehow dependent on another party F and that F performs a certain action or set of actions, thereby party B is making itself vulnerable to F. Moreover, B believes that F has a moral obligation to perform said actions and that F also has this belief.[12] This is, as I want to contend, the ethical foundation of the fiduciary duties as they can be argued for from an ethical stance and as they are implemented in different jurisdictions. They are the legal implementations of moral obligations which are based on trust. Thus, they aim at ensuring that the dependence of B on F is not abused by F and that the trust of B in F is not betrayed.

One might challenge this assertion by suggesting that it is not necessary to trust a financial institution in the role of a fiduciary anymore because the establishment of laws guarantees the adherence of both parties to the contract. However, this is unconvincing for two reasons: First, the average customer of a large bank cannot bring up the resources to afford a litigation of the bank in front of a court. Even if they could, they would not want to end up in such a situation. Therefore, even in the context of a state with laws that determine fiduciary duties of financial institutions, most customers do not have another choice than to trust the powerful financial institutions. Second, the challenge misses the point of the contention. It does not matter so much whether the beneficiary

[10] For a discussion in which matters banks are legally considered fiduciaries in the US see Tuch 2019. For a comparison of different legal interpretations including the Israeli interpretation where a bank is essentially a fiduciary to its customers see Plato-Shinar & Weber 2009. For legal discussions in the US concerning the fiduciary duties of insurance companies see Barker, Glad & Levy 1989; Miller & Tucker 2011; Richmond 1999. Although these are all legal discussions and may not be directly relevant for the ethical conception, that such a broad interpretation of fiduciary duties is also discussed in law may further strengthen the characterization presented in this paper.

[11] Cf. Miller (2014, 315f.; 320f.)

[12] This also fits quite well with the characterization of trust by McLeod (2020), where B has to make herself vulnerable to betrayal by F and needs to rely on F's competence and willingness to perform a certain action.

has a genuine *feeling* of trust towards the fiduciary or not, be it because there are laws to ensure the adherence to the contract or because he does not realize that he is somehow dependent on the fiduciary. Rather, it is the counterfactual circumstance that if there was no law to ensure the adherence to a contract but such an agreement would be made in a state of nature, then B would be completely vulnerable to F and could do nothing else than trust F. Therefore, the fiduciary duties are derived from this trust-relationship and aim at ensuring that the trust from B on F is not betrayed or, to put it differently, that F acts in the interest of B and subordinates his own interest to the interests of B concerning business in relation to his assignment by B.

Fiduciary duties are implemented in various forms in different jurisdictions. While in common law jurisdictions „fiduciary duty“ is an official concept and most significant in determining the extent of discretion of institutional investors, in civil law jurisdictions they are rather found in legal provisions equivalent to the fiduciary duties in common law jurisdictions.[13]

Likewise, they are formulated in different ways in the philosophical literature.[14] However, Sullivan et al. declare that the most widely accepted fiduciary duties are the fiduciary duty of prudence and the fiduciary duty of loyalty. The former amounts to the obligation that the fiduciary should use her skill and be careful in her actions and attend to her task as a prudent investor focusing on maximizing profits. The latter signifies the obligation to act in the interest of the beneficiary, subordinate one's own interest to the interest of the beneficiary, avoid conflicts of interest and handle the conflicts of interest of two or more beneficiaries in a neutral way that is correct in substance.[15]

However, none of these common notions of fiduciary duties encompasses a duty to behave in an ethically adequate manner towards third parties which are not part of the contract that establishes the fiduciary relation. The duties of prudence and loyalty only imply ethical conduct where a different behavior would redound negatively on the beneficiary. If that is not given, nothing within the legal relation between the fiduciary and the beneficiary prevents the fiduciary to act unethically as long as it is to the advantage of the beneficiary unless it is explicitly barred by the beneficiary.

[13] Sullivan et al. 2019, 11.
[14] Boatright 2014, 42f., Koslowski 2011, 11f.
[15] Sullivan et al. 2015, 11; 2019, 12.

Therefore, in the next section I argue for a fiduciary duty of ethical adequacy which turns the tables and obliges the fiduciary to act ethically adequate as long as the assignment by the beneficiary does not necessarily imply unethical conduct or explicitly demands it.

Fiduciary Duty of Ethical Adequacy

The idea for the fiduciary duty of ethical adequacy is mainly based on a moral intuition. The intuition is that if a party X entrusts an assignment to another party Y, X does not ask Y to fulfill the assignment by any means. Rather to the contrary, X usually implies in her assignment that Y should do it within the boundaries of the ethically adequate options. What ethically adequate options are is determined by the minimal expectations of X concerning the ethical integrity of Y. The obligation of Y to act in accordance with the minimally ethical expectations of X follows from the trust-relationship that is established by the assignment of Y through X. This is because X becomes vulnerable to betrayal and relies on the competence and willingness of the assignee.[16] Since a fiduciary relationship is a kind of trust-relationship, as argued above, the same obligation holds for a fiduciary. Therefore, there is an ethical basis for a fiduciary duty of ethical adequacy and the fiduciary should not only fulfill his assignment with prudence and loyalty but additionally with ethical adequacy.

To appreciate said moral intuition one can draw on many examples close to life: When the teacher or professor gives an assignment to a student, when we pass a parcel to the post office and assign them to deliver it to a certain person, when we ask a person to go to the grocery store or the pharmacy to obtain food or medicine for us, when we ask a friend for help in order to apply for a certain position, when we assign an architect and company to build a new house on our land or when we hire a real estate management firm. Although not all these cases are fiduciary relationships, they mostly involve trust on the side of the person who gives the assignment as long as they do not have the resources to supervise the conduct of the assignee. Furthermore, in all these cases, I contend, does the person who gives the assignment (assignor) imply that the assignee accomplishes his assignment not with all available means but only within the ethically adequate range of options i.e., in correspondence with the options that the assignor considers ethically adequate for the fulfillment of the assignment.

[16] Cf. McLeod 2020.

Let us consider an everyday case that is a trust-relationship and modify it moderately such that it at least comes close to a fiduciary relationship. The closeness to everyday life and to a fiduciary relationship hopefully strengthens the intuition. However, it is to notice that even if one would not grant the example to be an example of a fiduciary relationship, it is sufficient if one deems it to be a trust-relationship.

B is sick and entrusts an acquaintance with the assignment to go and procure some groceries and medicine, thereby giving to F $200. B does not have the energy or power to supervise F. Therefore, he can only trust F, becomes vulnerable to betrayal and has to rely on the competence and willingness of F to go and get the right medicine and groceries. Obviously, with the assignment a type of trust-relationship is established between B and F which is a quite common occurrence. However, in a next step the example should be approximated to a fiduciary relationship. By handing over $200 to F condition 1 from above is met, namely the payment or handing over of some property which F has to use to provide a service in the future. Condition 2 requires that F has some special skills, knowledge or resources that enable her to fulfill the task especially well and that B is not able to provide the same outcome. The sickness of B makes it the case that B cannot fulfill the task B assigns to F. Furthermore, we might imagine that B has many allergies and needs a very particular kind of medicine and that F has as one of very few acquaintances of B all the knowledge regarding these facts. Since F has all this knowledge it is not necessary for B to give F an exact purchase list and F is relatively free what groceries she is going to get for B. This meets condition 3. Even more flexibility for F could be achieved in the scenario if the payments of $200 are made every week and the assignment is enduring, thereby F is also free to choose the time in the week to fulfill her assignment. Since the whole arrangement is bilateral between B and F the fulfillment of condition 4 is straightforward. In all this, B does not only trust F to engage in conduct that is prudent and loyal but also ethically adequate. B does not explain explicitly how F should get the groceries and the medicine but therewith he does not imply that F should fulfill the task by any possible means. B does not tell F that she should take the bicycle instead of stealing a car, that F should use the money B gave to her and not rob the store or gamble with the money in order to make more money before she buys the medicine. Furthermore, if she cannot buy the groceries and the medicine because it is a holiday and the stores are closed, B does not imply that F has to break into the store to

get the things B needs. Even if the payments of B would enable F to act as a criminal mastermind who used the money by B to trick some people thereby doubling the money and then pay some accomplices who help her to get the groceries and the medicine for free without any chance of getting caught (prudence) and even if she would be so honest to give the $200 back to B (loyalty), I would argue that if B found out about F's way of conduct, B would be absolutely justified in blaming F for betraying his trust. This is because F did not comply with the minimally ethical expectations of B concerning the fulfillment of the assignment in spite of her being prudent and loyal – for the sake of the example, we might imagine that F restored the money without B's knowledge. If one agrees with my conclusion from this illustration, one should accept the assertion that there is a moral obligation implied in a trust-relationship that justifies a fiduciary duty of ethical adequacy.

However, one might argue that this intuition is highly context sensitive and does not apply in other contexts where trust-relationships are established through an assignment. In the following, I will consider two cases in a rather abstract way in which I assume that the conditions of a trust-relationship are met. One may freely make up the narrative details which yield the trust-relationship.

The first case might be, if person A explicitly assigns a person B to do something unethical, e.g. A assigns B to steal a painting, to rob a bank or to kill a person. In such a case one may intuitively hold that the trust from A in B involved in this assignment does certainly not imply that B has a duty of ethical adequacy. However, this verdict seems shortsighted. Of course, it is easier to imagine that a person like A in one of the suggested scenarios would utter the phrase „By any means necessary!“, thereby stating explicitly that there are no ethical boundaries to the assignment. Nevertheless, this is not necessarily the case and there are several reasons why we should not assume that A always implies this clause of limitlessness, e.g. in dubio pro reo. An assignment to rob a bank does not necessarily imply to shoot people haphazardly or to organize a terror attack some streets away for distraction. So even an unethical assignment can be fulfilled in an ethically adequate manner. This is also the reason why it is called a „duty of ethical adequacy“ and not a „duty of ethical action“.

The second case might be, if the assignment is not explicitly unethical but the context implies the permissibility of unethical means by the standards of the person who gives

the assignment. If one gang member A assigns another member B to scrape up money it seems quite probable that A's assignment does not imply that B should organize the money in an ethical manner. However, the reply to the first case is here applicable too. One might argue that also a criminal context brings along some standards of ethical adequacy. Even if A implies that B can provide the money by robbing or blackmailing others, it seems quite far-fetched that he also implies that B can randomly slaughter some families and steal their possessions.

Furthermore, it seems far-fetched to me to argue that by opening a bank account, effecting an insurance or paying into a pension fund one would find oneself in a situation in which one has to give explicitly or implicitly unethical assignments.

However, there still seems to be an ethical basis for a duty of ethical adequacy as consequence of a trust-relationship in spite of a context that would generally count as unethical or the explicit assignment to an unethical deed. However, what are the ethical adequate means is relative to the person who gives the assignment. A trusts B not only to fulfill the assignment loyally and prudently but also in accordance with her minimally ethical expectations which determine the means that are ethically adequate to fulfill the assignment.

In the next section, I briefly deliberate what such a duty of ethical adequacy might entail for the fiduciary duties of institutional investors and how it could be used for a different approach to argue that they should be required to provide services based on SRI.

The Duty of Ethical Adequacy for Institutional Investors and SRI

If there is such an ethical basis for a duty of ethical adequacy implied in a trust-relationship this duty could also be applied to institutional investors. This is because they are fiduciaries and fiduciary relationships are a kind of trust-relationship. This would entail that institutional investors would have to consider the minimally ethical expectations of their costumers regarding the means that are deployed by the institutions to provide their services. Thus, this also concerns their practice of investing and in the case of a bank also their practice of lending since their ability to provide their services depends on their investment or lending activity. With the definition of a fiduciary applied above banks, insurances and pension funds would have to at least ask their costumers whether investing in socially irresponsible assets is consistent with their expectations. If

it was not, they would have to provide alternative products (deposits, insurances, sub-funds) that are socially responsible or refrain from making a contract with a possible costumer.

Certainly, it is true that a fiduciary duty of ethical adequacy does not necessarily entail a requirement of SRI for financial institutions. A critic may argue that in a free market the costumers can freely choose their financial service contractor and therefore the financial institutions can do business as they please. Rather, it is part of the customer's responsibility to choose the financial institution that offers services in accordance with his minimally ethical expectations.

However, regarding the actual circumstance an argument for a legal regulation that requires financial institutions to proactively offer several alternative services that correspond with different minimally ethical expectations may soundly be construed. Many people are dependent on these institutions. They either are forced by law or by societal compulsions to use them. Therefore, they often agree to the contracts without knowing how their fiduciaries provide the services and trust them that they will not act in considerably unethical ways. If they are not able to comply with the minimally ethical expectations of a potential costumer, the financial institutions should at least not contract with him. Furthermore, it might be argued that when people are regularly forced to make use of these services and enter fiduciary contracts it should be warranted through proper policies that the concerned services are supplied by enough fiduciaries in various different versions such that one can find an appropriate fiduciary for one's minimally ethical standards within an acceptable range of time and costs.

In our time, where many people are concerned with the impact of their deeds in regard of environmental and social issues, a need for a legally acknowledged fiduciary duty of ethical adequacy which requires financial institutions to address these concerns of their costumers is not far-fetched, even if one may dispute whether SRI is ethically better than non-SRI.[17] Probably, many people would choose a socially responsible bank account or insurance when confronted with the question whether their money should be invested or lent socially responsibly or in any way the financial institution pleases.

[17] See for example, Hudson 2005; Irvine 1987; Sugimoto 2018.

Therefore, the duty of ethical adequacy might be an alternative approach to justify legislation that requires financial institutions which occupy the role of a fiduciary to offer services that are based on SRI.

Conclusion

I have argued that the fiduciary relationship is a kind of a trust-relationship which provides an ethical basis for a fiduciary duty of ethical adequacy. If there is such an ethical basis for a fiduciary duty of ethical adequacy it might provide an alternative approach to the argument of prudence to argue for legislation that obliges financial institutions to provide services based on SRI. However, I only indicated a possible argumentation for SRI-based services of concerned financial institutions. How a (legal) fiduciary duty of ethical adequacy should be formulated in detail, how much responsibility lies with the fiduciary and how much with the beneficiary in agreeing on minimally ethical standards and how to handle possible conflicts between the fiduciary duty of ethical adequacy and the fiduciary duty of prudence are question that still need to be addressed. Furthermore, I have only focused on the relationship between the institutional investor as fiduciary and the costumer as beneficiary. I did not discuss the relationship between the institutional investor and the firms that one invests in. Although there is a plausible case made for a fiduciary duty of ethical adequacy, more investigation of the latter relationship is needed to address the problem which ethical expectations of the costumers are legitimate. Especially for the implementation of laws that oblige institutional investors to provide a certain selection of products with different ethical standards. These are questions for a different paper.

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