

## **Stakeholders in Ecological Crises: What role for Financial Institutions?**

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### **Introduction**

Everywhere the call is out for ‘stakeholder’ involvement as a means for improving developmental decisions, particularly those involving complex technology, uncertain risks, and contending values. Everywhere but in funds management, it would seem. Despite the presence of obligations under policy instruments such as the Kyoto Protocol, funds management sectors around the world (comprising pooled investment schemes such as hedge funds, pension funds, insurance companies and mutual funds) have been excluded from ecological crisis management discussions. Moreover, the interests of the ultimate beneficiaries of these fiduciary vehicles have not been factored in climate-change discussions (Lohmann 2008: 362) and have not participated to any material extent in the mechanisms of the UNFCCC.

The Kyoto Protocol of the UNFCCC established three so-called ‘flexible mechanisms’ for reducing GHG emissions: (i) GHG emissions trading systems located in some developed countries including Europe and New Zealand and at a regional level in North America (the Western Climate Initiative consisting of four Canadian provinces and six US states); (ii) the Clean Development Mechanism and (iii) the Joint Implementation (respectively, CDM and JI). The CDM follows Kyoto by allowing developing countries, which are signatories to the Protocol (the so-called non-Annex I countries) to engage in sustainable development by means of GHG abatement projects. Developed (Annex I) countries may purchase the emissions saved (offset) by these projects in order to offset their own emissions and thereby meet their own committed

Kyoto-related emissions reduction target. The JI further allows developed countries to invest in developing country projects to offset their own domestic emissions, which can be also counted towards meeting their Kyoto targets. The private funds under management that might be made available for environmental management efforts warrants attention on the extent to which financing measures designed for environmental management have both facilitated and precluded the involvement of pension schemes, insurance companies and mutual funds. The chapter examines the prevailing financing system of environmental pollution management and, on the basis of a series of interviews with investment-related stakeholders, discusses the institutional realities that impact the participation of the investment sector in financing environmental pollution management. A final section makes a number of policy recommendations.

### **Understanding stakeholder governance**

A consensual ‘new’ governance has emerged which is understood in relational terms that contrast with earlier command/control governance models (for example, Cadman 2011: 20, Fiorini 2010: 578, Foxon and Pearson 2008: 148). This multi-stakeholder view of governance is promoted in some policy circles and, to the extent that the global polity is involved, deserves examination for its applicability. This section looks at the development of a particular version of stakeholder governance relevant to fiduciary investors (as already mentioned, referring to pooled investment funds) that have claimed to be interested in climate and energy-usage policies, climate-related risks and other related issues.

The relational view of governance focuses on the necessary normative elements for collaborative social-political interaction. The relevant dynamic is said to involve a structure/process dialectic based upon participation and deliberation. Participation is

understood in multi-dimensional terms of stakeholder accountability / transparency and inclusive interest representation. An effort is also made, in the interests of integrity, to retain social justice as a type of benchmark by referring to the need for equality and resources. Democracy is treated as a central component of the decision-making processes used in deliberation. Social justice and democratic and participative decision-making are treated as desirable characteristics of behavioural and problem-solving aspects of governance systems (Cadman 2011: 23).

According to this view, the governance of climate change abatement efforts becomes a matter of collaboration between and within the institutional vehicles charged with addressing the relevant problems arising, including the UN regime and the World Bank as initiating and coordinating institutions. Administrative and facilitating programmes are the regime's Adaptation Fund, the Global Environment Facility, the Kyoto Protocol (and national incarnations), the Clean Development Mechanism and the Joint Mechanism, and attempts to create a global cap-and-trade system with appropriate allocation of tradable emissions quotas across countries and time, the most notable example being the EU carbon market.

Table 6 Climate policy measures designed to attract financiers and investors

<b>Research &amp; Technology Development</b>	<b>Legislative &amp; Regulatory Policies</b>	<b>Fiscal Measures</b>	<b>Administrative Measures</b>
Permit trade	Standards	Carbon taxes	Labelling
Energy-usage subsidies	Carbon emissions and other environmental reporting	Feed-in tariff systems	Stakeholder forums
Clean development mechanism	Ambit of fiduciary obligation	Concessional tax status for green-certificated investments	Disclosure of use of ecological considerations in the financing process
Joint implementation			Environmental audits

Note: See Lund (2007: 628-29) for a fuller explication of the connections and disconnections between environmental policy measures.

Certain connections and disconnections can be argued between some of these measures. Those that pertain to a fiduciary investor deserve consideration here. Pension funds in some European countries, Australia and New Zealand have been required to disclose their use of ecological considerations in the investment process (an administrative measure) (see, Haigh and Guthrie 2010). A fiscal measure would be a fiduciary's decision to allocate funds towards companies enjoying concessional tax status for green-certificated investments, such as has been made available in the Netherlands. Fiduciaries interested in forming assessments of the financial implications of climatic risks associated with companies in which they hold investments might find useful regulatory measures such as mandated information disclosures of companies' carbon emissions levels, and research and development measures such as the availability of energy-usage subsidies and utilisation of cap-and-trade allowances (although refer to the outcomes of empirical investigations presented below). Finally, if fiduciary duties were construed in trust law and fiduciary law as including consideration of ecological risks as they pertain to the portfolio, they might become regular issues for discussion at Board levels (Richardson 2011: 17). Present evidence suggests that the connections made above are latent; it is unlikely that most fiduciary investors would consider consideration of climate policy measures as falling within their obligations (Richardson, 2011: 5-10).

Coordination of the regime currently rests on solutions conceived in terms of least-cost mitigation and adaptation terms, which do not permit easily the involvement of different political and economic actors (in particular, the private sector), nor allow for any significant degree of co-operation, decentralisation and competition (Zadek 2011: 1058). According to the constructivist view of governance considered here, the regime would seem to have permitted insufficient interest representation, limiting participation,

while the rigid negotiating tactics used in international negotiations have not been particularly successful. Existing structures and processes have not facilitated collaborative interaction and consequently effective management of the economic, social, and physical outcomes of climatic changes has not been achieved.

Despite the exposure of pooled investment funds to turbulent earth systems and despite the amounts of finance available in these sectors, private sources of finance have not been forthcoming (Zadek 2011: 1058, Andonova et al. 2009: 52). The markets' lack of interest in the regime is related to doubts about the credibility of the system. Various reasons have been put forward for markets' non-involvement in the policy regime. The wavering levels of commitment by signatories and the major exceptions to the regime in the cases of the US and China have contributed to doubts about the likelihood of national governments and the major superpowers effectively tackling climate change (Fiorini 2010: 581). The delegation of procedural elements to national governments has caused permits to be distributed without charge and quotas set at over-generous levels has made for a system of 'carbon credits' not attractive to investment. The absence of an apparent successor to the principal policy instrument and a lack of clarity between adaptation and mitigation efforts have left potential investors uncertain over the basic future architecture of the regime (Bäckstrand and Lövbrand 2007: 123). This has been combined with a series of unclear determinations as to how financing should operate (Haigh 2011: 1367). This has led to a lack of confidence that an appropriate risk-adjusted return will be attached to any of the regime's mechanisms, including cap-and-trade systems (Biermann and Gupta 2011: 1856, Marres 2011: 510). Pooled investment funds have therefore treated such elements of the regime as cap-and-trade, feed-in tariff systems and REDD+ as they might an exotic derivative, and have consequently not included them on their lists of permitted investments (Haigh and Guthie 2010: 195-

199). Moreover, nascent initiatives in financial investments in renewable energy projects are simply not at the scale at which institutional investors would consider (Bowen 2011: 1020). Investors may also be unwilling to engage in politically controversial asset classes like the Clean Development Mechanism (for example, Lohmann 2008).

It should be mentioned that there is no regulatory requirement for pooled investment funds to participate in cap-and-trade systems. Japan, the UK, New Zealand, Belgium, France, Germany and Denmark merely require managers of pooled investments to disclose ‘the extent to which environmental considerations’ are taken into account in portfolio construction (Haigh and Guthrie 2010: 147). Similarly, investor associations in the UK and Australia do not require investment teams to report on the validity of climate investments (Haigh and de Graaf 2009: 413-417). Market-driven regulation has been seen as contributing to the dissolution of responsibility for the negative externalities generated within the global economy (Prakash and Potoski 2005: 350; King and Lenox 2000: 698).

Pooled investment funds are rightfully looked at as major sources of finance yet are excluded from the regime’s architecture. Callon’s recognition of the European Emissions Trading System as a yet unfinished, experimental, process of learning has value (Callon 2009: 548). But in so far as the involvement of stakeholders in opinion-, decision- and policy-making is concerned, the specification of stakeholders, rather than the financing, has not yet commenced. Participatory governance models such as put forward by Cadman (2011) and evolutionary economic geography (Foxon and Pearson 2008) tend to assume that a transition to more climate-resilient and low carbon economies is possible and moreover is path-dependent, meaning it has to somehow find a way through webs of institutions, knowledge networks, cultural values, and

complementary infrastructures. The method appealed to in the usual case is stakeholder participation. Robertson and Choi (2010: 90), in presenting their arguments for embedding governance considerations in ecological management, define organisational ecology as ‘establishing structures and processes that facilitate collaborative dynamic among diverse participants, which, in turn, can enhance the quality of decisions made and implemented’. Robertson and Choi use this definition to identify the stakeholder connections between a triadic form of the global polity: the state; ‘private’, commercial sectors; and natural ecological systems. Cadman (2011: 29) too has argued there is a need to connect resource providers, resource channels (legislators and policy makers), and resource recipients. Yet, it is plain that while the capital markets have been considered a latent policy resource for environmental pollution management (Lund 2007: 629), the communication channels between institutional investors and policy makers are dissipated (Haigh 2011: 1385, Robertson and Choi 2010: 99).

### **The realities of climate finance: what the investors think**

#### ***Interview study***

Interviews were used to provide insights into the ways investors have made sense of ecological crisis management, specifically, their assessment of the UN regime. Thirty-two interviews were conducted in May through August of 2010 with senior executives in managed investment institutions, selected using professional networks of the author and according to the direction of relevant investor networks known to the author, for example, the Carbon Disclosure Project (based in Sydney, New York City and London). Organisations represented by the interviewees were located in the US, Japan, Australia, and Europe.

Interviewees were asked to describe how, if at all, they had participated in carbon trading markets and if they had used data on energy usage levels in their portfolio decisions. Interviewees were provided additional background material to clarify questions, if needed, which typically took the form of a hypothetical investment decision-making scenario. One in three interviewees, at the time of interview, was a provider of research provided to portfolio managers. The next two largest groups were fiduciaries (28 per cent) and portfolio managers (22 per cent).

All interviewees doubted the stability of the regime architecture. A trustee of a European public-sector insurance company explained his reasons for refraining from permits trading:

Carbon trading and all that kind of stuff: that's not an asset class that we are looking at very greedily. We don't understand it. We do not see a fit purpose from a risk perspective for us to go into that kind of asset class.

All interviewees questioned the operationalisation of the regime, and if they were 'expected' to participate. An environmental management analyst working in the London capital markets flagged his doubts on the credibility of the UN regime and pointed at the salience of a short-term perspective for investment processes.

Doubts about the science have a real political impact. You factor in the time it will take to cost carbon, standardise information disclosures, and the right sort of regulation – that's five years. So at the moment, allocations according to carbon don't matter to most [people].

The interviewee above explained that by 'five years' he/she was referring to the industry's common asset allocation planning horizon. Carbon reports were not considered useful for decision-making; a belief held by all interviewees. The reasons are to do with the regular work processes of investors that treat information expected to

impact on share price as relevant, as much as the informational quality issues associated with carbon reports. The following three interview extracts are illustrative.

1. Carbon emission data continues to be calculated and reported in different ways between regions, between companies, and sometimes even with companies. It's the wild west out there... (head of a 'Responsible Investment' advisory unit in a British insurance company)

2. The most critical policy in Australia is a price on carbon emissions. Reporting does not influence investment decisions in and of itself. Companies are generally careful to ensure that material price implications that may be reflected in their disclosures are addressed before they are disclosed [to data collectors and regulatory authorities]. This will change only once there is a price on carbon and [when] current disclosures attract a financial liability. (head of a Europe-based environmental lobby group comprised of institutional investors)

3. Information is not reliable because there is no standard for disclosure. It is difficult to understand materiality and relevance of information to price. (fiduciary of a North American stable of insurance companies and mutual fund trust structures)

The interview data obtained are suggestive of a conclusion that investors' participation in climate change management is contingent on institutional processes. In the financial markets, the subjectivity of participation in ecological crisis management differs from that of civic engagement, where the methods and techniques used in carbon accounting render public engagement visible (Marres 2011: 530). Portfolio managers, belaboured with client mandates, fiduciary obligation, and subject to workplace

conventions, are more likely to use carbon accounting techniques that render their engagement invisible.

### ***Discussion***

Some consideration must be given to the relations between the real-life exigencies of pooled investment funds, and administration of the UN regime. With respect to fiduciary investors, there are very few ‘devices of engagement’ (Marres, 2011: 517) that can help to enact a particular form of environmental participation as a legitimate form of investing practice. While policy makers have been eager to appropriate the discourse of financial services, they are yet to supply guidance on how policies on climate change, energy security, resource scarcity, and so on might best be applied to wealth portfolios. Financial institutions have been left to arrive at determinations without the basic categories that usually accompany their decision-making.

Presenting as issues are the absence of a conceptualisation of transnational governance and a coordinating mechanism linking national regulatory systems. Participation in fiscal mechanisms by pooled investment funds might be frustrated given that central governments in the markets which with this chapter is concerned (with an exception in Norway) do not control the management contracts process of pooled funds (Clark and Hebb 2005: 2015). One might expect that uncertainties associated with derivative trading markets will be frowned upon by most pension funds, and acting as a conduit of firm-level measures such as energy-usage subsidies has not been in their usual remit. The interview extracts provided above suggest that fiduciaries have relegated the ‘trading’ elements of the UN regime at the level of a junk derivative. Certainly, the interviewees had no plans to participate in the major public financing mechanisms constructed to deal with the effects of global climatic changes.

Stakeholder dialogue designed to enable learning appears unlikely in the foreseeable future. A common issue for workers in the ‘Responsible Investment’ units of financial institutions in Europe and North America has been gaining access to and influencing investment teams and governing boards with their various agenda items (Haigh and de Graaf 2009). ‘Influence pathways’ have not in the usual case relied on stakeholder representation but on broad-scale behavioural change (see, Haigh and de Graaf 2009: 409).

The effective exclusion of the capital markets from the climate policy regime is not the fault of policy makers nor of capital markets; it is to do with the interest representation permitted by a legally mandated, fiduciary duty to cater to and protect the economic interests of beneficiaries of vehicles like pension funds and insurance companies. Fiduciary and trust law require that for trustees and governing bodies of fiduciary investment vehicles, the beneficiaries of investment schemes are the relevant and only stakeholders. When a proposal arrives for a remit wider than the interests of immediate beneficiaries, such as a need for deeper and broader forms of climate financing, legal support is left wanting.

These remarks permit only a tentative interpretation of the beneficial impacts of the current programme of the management of climate-change effects based on trading in GHG emissions allowances and rights linked to the creation of industrial projects. The calculation of the economic mitigation potential of emissions trading has been said to involve expected social benefits net of social costs and assuming that existing market barriers are removed by public mitigation policies. The conceptualisation that this entails is at the level of the individual, industrial firm; what would be required, however, is at the level of the global polity. Multilateral management of the effects of climate events depends on having a programmatic approach to ecological crisis

management, which links trading activities in financial derivatives to policy forums, in which financial and investment interests can participate meaningfully, rather than simply acting as the vehicles through which market systems operate.

Yield-maximising, risk-averse investors, based on the outcomes of the interview research presented above, have little incentive to adjust their operations unless required to do so by governments, informed by peer behaviour, or unless treated to economic prospects. The types of ecological crisis management mechanisms that can be considered for pooled investment funds include, following Lund (2007: 628-629): legislative and regulatory policies like standards and reporting; fiscal measures and research and technology development like permit trade, subsidies and taxation; and administrative measures like labelling and stakeholder forums. Available fiscal measures are those that relate to the income and cost levels of pooled investment funds, such as concessional tax status for green-certificated investments (examples are provided by the Netherlands and China (Lund 2007: 628)). Relevant potential administrative instruments are a reconceptualisation of fiduciary obligation to include environmental and energy security risks, including the risk of ignoring energy insecurity; and requirement for pooled funds to disclose their exposure and responses to ecological crises to their beneficiaries (much like statutory financial disclosures).

The intermediated nature of capital market structure conditions investors' participation in measures such as permits trading and strategic investments in energy assets. Several reasons suggest themselves:

- It can be expected that institutional investors subject to fiduciary and trust law will pay short shrift to the values and concerns of those not represented immediately by beneficiaries of pension schemes and insurance companies.

- Commercial relationships imbue and constitute fiduciary capitalism, as the first duty of a pooled fund's board is delegation of investment management to experts. An intermediated structure operates against long-term financial assessment such as suggested by ecological considerations and, as much, 'stakeholder involvement'. Brokerages, custodians, and advisory services used by fiduciaries, for example, are remunerated on the basis of the volumes of transactions.
- Further, while investment firms might be provided fiscal incentives to differentiate themselves from rivals and to signal their environmental commitment, differentiation might not represent a viable strategy for a well-diversified investor, as the portfolios of this type of investor are modelled on averaged benchmarks.

Connections between the ambit of fiduciary responsibility and environmental concerns are considered in the next and final section.

### **Conclusions and recommendations**

Outcomes that can be associated with the United Nations Framework Convention on Climate Control infrastructure have been fewer than might have been hoped for. Extant initiatives (as at July 2011) are non-networked micro-financing at community levels, and variously successful attempts of venture capitalists to launch renewable energy and clean technology financial products.

Unresolved issues have a tendency to turn into stubborn problems. In terms of climate justice, differencing relevancies can be linked to quietism on matters of access of the poor economies to basic services, for example, access to online weather alerts (Kym and Kouzmin 2009: 299-300). The reality of a future ecologically precarious, unjust world is given traction by multiple interlinked and systemic forces directing the policy pronouncements that have followed the Kyoto Protocol. Governments have

tended to make mention of the details of rapidly worsening living conditions in climate-vulnerable regions only so far as to reinforce a division of the rich West (the carbon mitigators) and the poor Other (the carbon adaptors).

Schnaiberg's (1980) treadmill of production theory is a widely recognised theoretical tradition in environmental sociology. Treadmill theory is based on a recognition of the dependence of societies on the natural environment, and the dramatic effects of contemporary societies on natural resources and ecosystems. How that might work out in finance capitalism involves interrelations wider than the state apparatus, financiers, and companies. What is called for is the inter-subjective acknowledgement of responsibility; perhaps akin to what Cadman refers to as organisational responsibility (2011: 24). Only three of the thirty-two individuals interviewed for the research conducted for this chapter, when pressed, could articulate a sophisticated connection between turbulent earth systems and investment risk.

The oddness of the proposition that the funds management sector should participate in environmental financing (Clark and Hebb 2005: 2016) might, by challenging the contingent rationality of financial markets, create spaces for imaginings that will be needed for criticism and transformation. Approaches might be found useful to contextualise the notion of widened stakeholder governance examined above with the worklife exigencies of equity and bond markets. Stakeholder governance is (almost) precluded in the financial markets, with institutional processes such as networked contracts of intermediaries and service providers dispensing with democratic representation.

***Recommendations for financial and intergovernmental policy makers.***

That the UN regime has not articulated with the funds under management in the capital markets suggests, if faintly, potential in networks of state and non-state actors

(Andonova 2010: 25). Examples have appeared in the work of the Coalition for Environmentally Responsible Economies, the Carbon Disclosure Project and the Climate Disclosure Standards Board, organisations which, independently of each other, have brought companies, investors and policymakers in North America, Europe, Asia and Australia together to discuss issues of environmental pollution management and without representation (that is, as non-partisan but connected individuals). Blatter (2009: 109) dispenses with representation requirement on grounds that not all stakeholders are experts, instead seeking a 'coalition' of people who 'share a set of normative and causal beliefs and who often act in concert'. More might be expected from meetings of policy experts, financiers, foresters, biologists, industrialists, philosophers and so on from a wide range of relevant disciplines making no claims to shared values (although their 'interests' might be shared), but a desire to learn something new. It should be noted that discussions on the efficacy of the Kyoto measures have assumed that the market is an appropriate vehicle to bring about efficient and desirable policy outcomes. Reliance on the market is precarious, however, particularly when its regulation is handed to the main market protagonists (Lohmann 2008: 360-264; King and Lenox 2000: 700).

Fiduciary representation deserves consideration if the resources of managed capital are to be accessed for environmental management purposes. At issue is devising ways to widen the scope of interest representation in capital markets to include *all* the recipients of climate finance. The target beneficiaries of climate finance will almost certainly include stakeholders outside the fiduciary remit of trustees and governors. After all, not all those affected by climatic changes are members of pension funds and insurance policy holders. Networks of fiduciary investors (for example, trustees), their service providers (for example, 'asset' consultants and brokerage firms), climate

scientists, environmental engineers, and CEOs of businesses in climate-vulnerable regions might usefully be forged. However, more will be needed to make such networks effective in terms of policy outcomes. Conferences of the Parties to the Kyoto Protocol were designed to achieve the meeting of economic and ‘environmental’ interests, disciplines and knowledge. The outcomes of recent COPs have not given investors reason to rush into carbon trading.

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