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Investor-led Sustainability in Corporate Governance

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Law Working Paper N° 615/2021
November 2021

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Abstract

The transition to a sustainable economy currently involves a fundamental transformation of our capital markets. Lawmakers, in an attempt to overcome this challenge, frequently seek to prescribe and regulate how firms may address environmental, social, and governance (ESG) concerns by formulating conduct standards. Deviating from this conceptual starting point, the present paper makes the case for another path towards achieving greater sustainability in capital markets, namely through the empowerment of investors.

This trust in the market itself is grounded in various recent developments both on the supply side and the demand side of financial markets, and also in the increasing tendency of institutional investors to engage in common ownership. The need to build coalitions among different types of asset managers or institutional investors, and to convince fellow investors of a given initiative, can then act as an in-built filter helping to overcome the pursuit of idiosyncratic motives and supporting only those campaigns that are seconded by a majority of investors. In particular, institutionalized investor platforms have emerged over recent years as a force for investor empowerment, serving to coordinate investor campaigns and to share the costs of engagement.

ESG engagement has the potential to become a very powerful driver towards a more sustainability-oriented future. Indeed, I show that investor-led sustainability has many advantages compared to a more prescriptive, regulatory approach where legislatures are in the driver's seat. For example, a focus on investor-led priorities would follow a more flexible and dynamic pattern rather than complying with inflexible pre-defined criteria. Moreover, investor-promoted assessments are not likely to impair welfare creation in the same way as ill-defined legal standards; they will also not trigger regulatory arbitrage and would avoid deadlock situations in corporate decision-making. Any regulatory activity should then be limited to a facilitative and supportive role

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Keywords: sustainability, ESG, climate change, capital markets, institutional investors, investor coalitions

JEL Classifications: G28, G34, K22

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Investor-led Sustainability in Corporate Governance

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I. Introduction

Conventional wisdom has it that the transition to a more sustainable economy requires the incorporation of environmental, social, and governance (ESG) standards into corporate governance and finance. There is increasingly broad global consensus that the asset management sector has a vital role to play in helping society solve existential challenges such as the current climate crisis by allocating capital sustainably and thereby influencing behavior of investee companies.

The current discussion on this matter frequently revolves around achieving this goal through modifying the legal regime governing the corporate organization. For example, policy makers and courts toy with the idea of expanding the list of directors' duties by making corporate directors legally accountable for the promotion of ESG goals.[1] Another idea here might be to tie executive remuneration to certain sustainability criteria.[2] Furthermore, a third proposal, which has been gaining supporters worldwide, is the promotion of stewardship codes encouraging institutional investors inter alia to pursue ESG criteria in their investment decisions and disclose their engagement policies.[3]

There is, however, another path towards achieving greater sustainability in capital markets, namely through the empowerment of investors. The past several years have seen an unprecedented surge in investor-led initiatives steered toward sustainability. This has been evidenced most prominently by the rise of ESG activists—hedge funds and other specialized investors who have been actively influencing the management of their investee companies to pursue more sustainable decision-making. But, perhaps more surprisingly, passive investment funds, index funds, and exchange-traded funds (ETFs) have also jumped on the bandwagon and

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[1] In the U.S., litigation against corporate boards in increasingly relying on the *Caremark* duty for failing to exercise proper risk oversight. The European Commission even consulted on a proposed legal change in this direction: Public consultation on Sustainable Corporate Governance (Oct. 26, 2020 – Feb. 8, 2021), https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/public-consultation_en.

[2] For example, in Germany, listed companies are required to adopt a remuneration structure which is to be geared 'towards a sustainable and long-term development' of the company (see Aktiengesetz § 87a [AktG; Stock Corporation Act]). Thereby, social and ecological aspects should also be taken into account when adopting remuneration incentives. See generally on the link between ESG and executive pay Jean McGuire et al., *Do Contracts Make Them Care? The Impact of CEO Compensation Design on Corporate Social Performance*, 157 J. BUS. ETHICS 375 (2019).

[3] The paradigm example is the U.K. Code, which in its latest 2020 version also includes ESG criteria. See Financial Reporting Council, THE UK STEWARDSHIP CODE 2020, available at https://www.frc.org.uk/investors/uk-stewardship-code.

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are pushing for more responsible investment strategies, either with independent campaigns or by supporting the activist investors.

Some commentators are skeptical about such investor-led sustainability, possibly due to a general distrust in markets that has dominated the public discourse since the global financial crisis and that has continued into the ongoing Covid-19 pandemic.[4] However, this paper argues that ESG engagement can be a very powerful driver towards a more sustainability-oriented future in corporate governance. Indeed, I show that investor-led sustainability has many advantages compared to a more prescriptive, regulatory approach where legislatures are in the driver's seat.[5] For example, a greater focus on investor initiatives would follow a more flexible and dynamic pattern rather than complying with pre-defined criteria that are slow to change. Moreover, investor-promoted assessments are not likely to impair welfare creation in the same way as ill-defined legal standards; they would also not trigger regulatory arbitrage and would avoid deadlock situations in corporate decision-making. Any regulatory responses should then be limited to a facilitative and supportive role.

This article proceeds as follows: Section II traces the recent trend towards increased ESG and sustainability in corporate governance and finance, and in particular documents the rise of investor-led initiatives in this field. Section III discusses the merits of such shareholder engagement and makes the case that ESG initiatives pursued by investors are consistent with business realities and conform with market logic of both demand and supply, while this section also demonstrates that the market trend towards common ownership holds great promise for such engagement. Section IV turns to the main advantage of ESG engagement, namely that it increasingly relies on coalitions and team-building between different types of institutional investors. I argue that these teaming-up strategies have a dual benefit and a double genius in that they give greater support to campaigns, but also serve as an in-built screening mechanism that would exclude the realization of idiosyncratic benefits for individual investors. Sections V and VI develop some regulatory implications and conclude the analysis.

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[4] For skeptical views, see Paul G. Mahoney & Julia D. Mahoney, *The New Separation of Ownership and Control: Institutional Investors and ESG*, COL. BUS. L. REV. 840 (2021); Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *How Investors Can (and Can't) Create Social Value*, 44 J. CORP. L. 205 (2018); Jonathan R. Macey, *ESG Investing: Why Here? Why Now?*, forthcoming, BERKELEY BUS. L. J. 2022.

[5] I do not, however, argue against any additional regulatory initiative that seeks to curb externalities such as a carbon tax.

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II. The rise of ESG investment

In many ways, the intellectual starting point for a substantial re-direction of the world economy towards greater sustainability was the adoption of the UN's Sustainable Development Goals (SDGs) in 2015, which set out an ambitious agenda to be implemented by 2030.[6] The term "ESG" had first been coined by the United Nations Global Compact itself in its 2004 paper and ensuing conference "Who Cares Wins," which brought together regulators, asset managers, institutional investors, and other market participants.[7] The report that followed the conference outlined that integrating ESG factors into corporate and investor decision-making was critical with respect to security of investments, prosperity, and growing markets.[8] Shortly afterwards, in collaboration with an international group of leading institutional investors, the UN launched its famous "Principles for Responsible Investment" (PRI), promoting the integration of ESG issues within the investment industry.[9]

Reinforced by the ambitious Paris Agreement[10] on climate change mitigation, adaptation, and finance, which came into force in 2016, there was widening recognition that action at all levels was warranted to achieve these ambitious goals. These agendas were supported by the grassroots initiative "Fridays for Future" that dominated the public agenda during 2018-19,[11] and by the subsequent and ongoing Covid-19 pandemic that has caused a fundamental global rethink of our values and goals.[12] Driven by these trends, a consensus grew that traditional policy tools (such as regulation, subsidies, and taxation) would be insufficient

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[6] UN General Assembly, *Resolution 70/1 adopted on 25 September 2015 – Transforming our world: the 2030 Agenda for Sustainable Development*, available at https://undocs.org/A/RES/70/1.

[7] UN Global Compact, *Who Cares Wins: Connecting Financial Markets to a Changing World – Recommendations to better integrate environmental, social and governance issues in financial analysis, asset management and securities brokerage Recommendations by the financial industry to better integrate environmental, social and governance issues in analysis, asset management and securities brokerage* (2004), available at https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf.

[8] UN Global Compact, *Conference Report: Investing for Long-Term Value: Integrating environmental, social and governance value drivers in asset management and financial research — A state-of-the-art assessment* (October 2005), available at https://www.ifc.org/wps/wcm/connect/9d9bb80d-625d-49d5-baad-8e46a0445b12/WhoCaresWins_2005ConferenceReport.pdf?MOD=AJPERES&CACHEID=ROOTWORKSPACE-9d9bb80d-625d-49d5-baad-8e46a0445b12-jkD172p.

[9] See https://www.unpri.org/.

[10] The Paris Agreement was agreed between all member states of the United Nations Framework Convention on Climate Change (UNFCCC) on Dec. 12, 2015 and entered into force on Nov. 4, 2016. See https://unfccc.int/sites/default/files/english_paris_agreement.pdf.

[11] The first 'school strike' by Greta Thunberg was initiated in August 2018. See David Crouch, *The Swedish 15-year-old who's cutting class to fight the climate crisis*, THE GUARDIAN (Sept. 1, 2018), available at https://www.theguardian.com/science/2018/sep/01/swedish-15-year-old-cutting-class-to-fight-the-climate-crisis.

[12] J.P. Morgan, *Why COVID-19 Could Prove to Be a Major Turning Point for ESG Investing* (July 1, 2020), available at https://www.jpmorgan.com/insights/research/covid-19-esg-investing.

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to reach the self-set goals pursuant to a more sustainable economy. It was against this backdrop that new life was breathed into the idea of promoting sustainability goals through the governance of corporations—i.e. do not (only) target particular activities such as carbon emissions directly, but rather encourage structures and purposes of firms and market actors themselves so that markets would intrinsically be geared towards more sustainable development.

To be sure, the idea of encouraging corporations towards more sustainable goals has been around for some time already: under the name of "corporate social responsibility" (CSR), various initiatives and self-governance schemes have been pursued since as early as the 1950s.[13] But it has really been during the past five years or so that the debate in this regard has taken off and penetrated the mainstream thinking.

Policymakers worldwide have seized the idea and developed an array of activities, initiatives, and policy papers, with the European Union spearheading the movement.[14] For example, the 2018 Action Plan entitled "Financing Sustainable Growth" mandated E.U. agencies to report and advise on potential undue short-termism in financial markets.[15] The European Securities and Markets Authority (ESMA) reported back one year later and developed a number of proposals, including a revised disclosure framework for non-financial risk as well as reinforced monitoring of remuneration and engagement standards.[16] Furthermore, a 2020 study on directors' duties and sustainable corporate governance, carried out by EY for the European Commission, explored the need to redefine the legal catalogue of directors' duties and advocated a rethink in this area.[17] Similarly, litigation in the United States is increasingly relying on the board's *Caremark* duty for failing to exercise proper risk oversight when ignoring

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[13] In the 1950s, economist Howard Bowen coined the term "corporate social responsibility" out of a concern for corporate power and its impact on society. See Howard R. Bowen, SOCIAL RESPONSIBILITIES OF THE BUSINESSMAN (1953).

[14] For a helpful review of the academic literature supporting disclosure standards, see Hans B. Christensen, Luzi Hail & Christian Leuz, *Mandatory CSR and sustainability reporting: economic analysis and literature review*, 26 REV. ACCOUNTING STUDIES 1176 (2021).

[15] European Commission, Communication to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions – Action Plan: Financing Sustainable Growth, COM(2018) 97 final, available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN.

[16] ESMA, *Report: Undue short-term pressure on corporations*, ESMA 30-22-762 (Dec. 18, 2019).

[17] EY, *Study on directors' duties and sustainable corporate governance: Final Report* (July 2020).

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climate risks and other ESG factors.[18] Later, both the U.S. Federal Reserve and the Financial Stability Oversight Council (FSOC) have characterized climate change as a "systemic risk" or an "emerging threat" to financial markets, setting the stage for even stronger legislative efforts to prevent climate change from upending the global economy.[19]

These efforts have been paralleled by increased ESG-related engagement throughout the international investor community. The most salient example here has been the increased activism around ESG targets that has been initiated by the "Big Three" institutional investors, BlackRock, Vanguard, and State Street Global Advisors. These leading three asset managers have significant power to influence corporate decisions: they control about 80 percent of all global indexed money, making them a dominant force in the governance of public companies around the world.[20] Together, these three giants now control a staggering 25 percent of the shares of all S&P 500 companies, and this share is growing.[21]

ESG-minded investors use their powers to influence investee firms in a variety of ways. Some will simply focus on, and invest in, companies with high ESG ratings (thereby divesting from firms that have low ratings), while others invest in firms that do not (yet) engage in ESG issues, with a view to actively encouraging them to step up their efforts in the future (for example, through shareholder resolutions).[22] Both strategies have their merits: the former will improve the market position of investee companies that are complying with ESG ratings, while the latter promises to actively change corporate policy to embrace ESG. For example, a broad coalition of institutional investors (including Amundi, Legal & General, and others) recently

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[18] Sarah Barker, Cynthia Williams & Alex Cooper, *Fiduciary Duties and Climate Change in the United States*, CCLI paper (Oct. 2021), available at https://ccli.ubc.ca/wp-content/uploads/2021/12/Fiduciary-duties-and-climate-change-in-the-United-States.pdf.

[19] Board of Governors of the Federal Reserve System, FINANCIAL STABILITY REPORT (Nov. 2020), https://www.federalreserve.gov/publications/2020-november-financial-stability-report-purpose.htm; FSOC, REPORT ON CLIMATE-RELATED FINANCIAL RISK (October 2021), https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf.

[20] John C. Coates IV, *The Future of Corporate Governance Part I: The Problem of Twelve,* https://corpgov.law.harvard.edu/wp-content/uploads/2019/11/John-Coates.pdf. See also David McLaughlin and Annie Massa, *The Hidden Dangers of the Great Index Fund Takeover*, BLOOMBERG BUSINESSWEEK (Jan. 9, 2020), available at https://www.bloomberg.com/news/features/2020-01-09/the-hidden-dangers-of-the-great-index-fund-takeover.

[21] Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2033 (2019).

[22] Each type of ESG investment is associated with different financial performance. See Amir Amel-Zadeh & George Serafeim, *Why and How Investors Use ESG Information: Evidence from a Global Survey*, 74(3) FINANCIAL ANALYSTS JOURNAL 87, 94-96 (2018). On the economic benefits of specific target selection, see Tamas Barko, Martijn Cremers & Luc Renneboog, *Shareholder Engagement on Environmental, Social and Governance Performance*, J. BUS. ETHICS, forthcoming, https://link.springer.com/article/10.1007/s10551-021-04850-z.

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urged large banks to stop financing carbon-intensive projects, to scale-up their green lending, and to ensure that executive pay is linked to net zero targets.[23] In a different context, more on the "S" side of ESG, State Street campaigned in 2017 for more diversity on corporate boards and announced its objection to all-male boards in its portfolio firms. Thereafter, they did live up to their promises and voted against 400 of the 476 firms in its portfolio that did not have any female directors.[24] That drew a significant response from the firms in question: by the end of 2018, more than 300 of these firms had revamped their boards and had added at least one female director.[25]

The "Big Three" also made commitments to racial justice after the controversial killing of George Floyd in 2020 and incorporated that ethos into their voting guidelines. For example, BlackRock stated that it may "vote against directors on the nominating and governance committee" when it considers a board to be "insufficiently diverse."[26] State Street made a similar statement in its 2021 Dear CEO letter.[27] BlackRock and Vanguard were also among the signatories opposing proposed "discriminatory legislation" that would make voting more difficult for certain social groups.[28]

But, equally importantly, a much larger group of institutional investors beyond the Big Three have been subscribing to ESG principles as well. According to a 2021 survey, 49 percent of U.S. institutional investors incorporated ESG factors into their investment decisions, representing a steep rise from just 22 percent in 2019.[29] For large funds, the figure was even higher (72 percent). Moreover, about 40 percent of the respondents who were not yet applying ESG standards were considering doing so; this represented a more than three-fold increase compared to 2019.[30] A 2021 PwC study showed even higher numbers: according to their data

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[23] Attracta Mooney & Stephen Morris, *Big banks urged to defund carbon emitters*, FIN. TIMES (Apr. 19, 2021) at p. 8.

[24] Justin Baer, *State Street Votes Against 400 Companies Citing Gender Diversity*, WALL STREET JOURNAL (July 25, 2017), available at https://www.wsj.com/articles/state-street-votes-against-400-companies-citing-gender-diversity-1501029490.

[25] In July 2019, the last all-male board in the S&P 500 added a woman to its ranks.

[26] BlackRock, *BlackRock Investment Stewardship – Engagement Priorities for 2021* (March 2021), at p. 3. Available at https://www.blackrock.com/corporate/literature/publication/blk-stewardship-priorities-final.pdf.

[27] StateStreet Global Advisors, *CEO's Letter on Our 2021 Proxy Voting Agenda*, available at https://www.ssga.com/us/en/institutional/ic/insights/ceo-letter-2021-proxy-voting-agenda.

[28] David Gelles & Andrew Ross Sorkin, *Hundreds of Companies Unite to Oppose Voting Limits, but Others Abstain*, N.Y. TIMES (Apr. 14, 2021), available at https://www.nytimes.com/2021/04/14/business/ceos-corporate-america-voting-rights.html.

[29] Callan Institute, 2021 ESG SURVEY, available at https://www.callan.com/blog-archive/2021-esg-survey/.

[30] *id*.

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of global fund mangers, almost 80 percent of them consider in their investment decision making how a company manages ESG risks and opportunities as an important factor.[31]

This remarkable development demonstrates some promise that the market may move to incorporate ESG standards of its own accord: in other words, we may expect that institutional investors, when continuing this trend, will ultimately apply sufficient power to steer the entire market towards more sustainability, resulting in a type of "self-regulation" that would force target companies to internalize the externalities that they are causing. Such a scenario, should it materialize, could then make any interventionist steps by regulators less essential.

Growing academic research is now studying the impact of such investor engagement. For example, a number of studies illustrate how engagement actions have increased target firms' ESG/CSR activities and scores.[32] Peer effects appear to be particularly important, where collaboration between different institutional investors becomes the key for successful engagement campaigns.[33] We shall return to this particular point at a later stage.[34]

At this stage, it is still uncertain how strong the impact of ESG engagement will ultimately be and, specifically, whether we will see an impact sufficient to bring public companies in line with the Paris Agreement goals.[35] We shall come back to the exact calibration of institutional stewardship in Section V where we explore how such efforts may be supported.

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[31] PwC, GLOBAL INVESTOR SURVEY: THE ECONOMIC REALITIES OF ESG (December 2021).

[32] Elroy Dimson, Oğuzhan Karakaş & Xi Li, *Active ownership*, 28 REV. FIN. STUD. 3225 (2015); Tamas Barko, Martijn Cremers & Luc Renneboog, *Shareholder Engagement on Environmental, Social and Governance Performance*, J. BUS. ETHICS, forthcoming, https://link.springer.com/article/10.1007/s10551-021-04850-z; Andreas G. F. Hoepner et al., *ESG Shareholder Engagement and Downside Risk* (Working Paper 2021), available at https://ssrn.com/abstract=2874252; S. Lakshmi Naaraayanan, Kunal Sachdeva & Varun Sharma, *The real effects of environmental activist investing* (Working Paper 2020), available at https://ssrn.com/abstract=3483692.

[33] See Elroy Dimson, Oğuzhan Karakaş & Xi Li, *Coordinated Engagements*, ECGI Finance Working Paper No. 721/2021, available at http://ssrn.com/abstract_id=3209072; McCahery, J.A., Sautner, Z., Starks, L., 2016. Behind the scenes: the corporate governance preferences of institutional investors. J. Financ. 71, 2905–2932. See also Cao, J., Liang, H., Zhan, X., 2019. Peer effects of corporate social responsibility. Manag. Sci. 65 (12), 5487–5503.

[34] See below sections IV.2 and V.3.

[35] Especially, as it has been argued, institutional investor stewardship has a lesser chance of promoting sustainability in controlled companies where controlling shareholders want to gain profit by imposing environmental externalities. The fact that most companies around the world are controlled makes this significant. See Alperen Afşin Gözlügöl, *Controlling Shareholders: Missing Link in The Sustainability Debate?*, OXFORD BUS. L. BLOG (July 16, 2021), available at https://www.law.ox.ac.uk/business-law-blog/blog/2021/07/controlling-shareholders-missing-link-sustainability-debate.

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III. The promise of institutional owners

Having explored the potential role that institutional investors could play in fostering a move towards corporate sustainability, this article now turns to evaluate whether this is a realistic prospect and how it may be realized. I take a broadly optimistic perspective on this question and rely on three key principles. These include incentives on both the supply and the demand side of the financial industry, as well as the recent trend towards common ownership.

Before that, it is apt to begin with discussing the opposite, more skeptical viewpoint. A number of eminent scholars have taken the view that institutional investors are unlikely to ultimately steer the economy towards greater sustainability.[36] One common argument here is that index fund managers lack incentives to take on a stronger stewardship role.[37] In its simplest form, the argument is that index funds *de facto* hold shares in a portfolio of very similar firms to that of their competitors. For this reason, any investment in the improvement of the value of their portfolio would not provide them with a competitive advantage over their rivals. On the contrary, any engagement might upset managers of portfolio companies who might then prefer to direct their firm's savings to other funds.[38] In a similar vein, the low fee structure charged by the asset managers of index funds means that they would share only a small portion of the gain potentially brought by any governance engagement in the investee company, which would not justify the cost of the engagement (even if the gain is sufficiently attractive for the beneficiaries of the investment fund).

Others have questioned whether investors would really prefer sustainable instruments when this involves sacrificing profit.[39] Relatedly, some commentators have also questioned whether the market's price mechanism would be able to adequately deal with a challenge as

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[36] See, for example, Mahoney & Mahoney, *supra* note 4; Brest et al., *supra* note 4; see also Giovanni Strampelli, *Can BlackRock Save the Planet? The Institutional Investors' role in Stakeholder Capitalism*, HARV. BUS. L. REV. ONLINE (2021) ("it is illusory to assume that institutional investors can be charged with the task of pursuing objectives of general interest, such as fighting climate change (thus essentially acting in place of the state), where such a task is not aligned with their clients' and their own interest in improving risk-adjusted returns").

[37] Lucian Bebchuk & Scott Hirst, *The Power of the Big Three, and why it Matters*, 102 B.U. L. REV. (forthcoming Sept. 2022), available at http://www.law.harvard.edu/faculty/bebchuk/The_Power_of_the_Big_Three_and_Why_It_Matters.pdf.

[38] Marcel Kahan & Edward Rock, *Hedge funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1066-1068 (2007).

[39] Brest, Gilson & Wolfson, *supra* note 4.

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momentous as climate change.[40] With these views in mind, it would seem ill-advised to put too much faith in the hands of market investors to address sustainability concerns.

There is empirical support for this skeptical view. For example, it has been shown that index funds frequently take a rather passive stance on governance matters such as challenging executives, putting forward shareholder proposals, or the active promotion of best practice standards in corporate governance.[41] Rather, skeptics have argued that fund managers would comfortably side with the incumbent management in any contested decision.[42] In addition, as Bebchuk and Hirst have argued, the Big Three and other large institutional investors have only very small-sized teams, relative to their overall manpower, that are dedicated to engagement policies.[43] That in itself, it has been argued, precludes any meaningful ESG impact.

Other commentators have argued that an investor-led shift towards ESG may be conceivable, but would only succeed if framed in a certain pro-shareholder guise.[44]

Given these important points of criticism, it may appear challenging to argue in favor of the opposite – in favor of investor empowerment. Nevertheless, there are at least three emerging phenomena, related to very recent developments, that make us more optimistic about the case for ESG promotion through investors.

1. The supply side: the attractiveness of ESG funds

The first argument that would support greater ESG inclination comes from the *supply side* of the market. In particular, offering ESG products may be motivated by purely financial reasons. Promoting sustainable indices is a particularly lucrative business for many fund managers, especially index fund managers, as it simply allows them to charge higher fees. It is crucial here

[40] Katharina Pistor, *Green Markets Won't Save Us*, PROJECT SYNDICATE (Mar. 16, 2021), available at https://www.project-syndicate.org/commentary/green-markets-esg-investments-risky-bet-on-climate-change-by-katharina-pistor-2021-03

[41] Leo E. Strine, Jr., *Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending*, 97 WASH. U. L. REV. 1007, 1025 (2020) (highlighting index funds' passivity in monitoring management political spending); Bebchuk & Hirst, *supra* note 21, at 2040 (arguing that the Big Three do not submit shareholder proposals).

[42] Bebchuk & Hirst, *supra* note 21, at 2094; see also Alon Brav, Wei Jiang, Tao Li & James Pinnington, *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests*, ECGI Finance Working Paper No 601/2019 (Mar. 2019), at 18–19 (finding index funds more likely than other funds to vote against hedge fund nominees in contested elections).

[43] Bebchuk & Hirst, *supra* note 21, at 2076 ff.

[44] Dorothy Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563 (2021).

Electronic copy available at: https://ssrn.com/abstract=3958960

to understand that the entire trend towards index investing was originally driven by the exact opposite consideration: the selling point of fees being significantly lower has always been the main argument for the success of index funds over their actively-managed rivals.[45] When index investing turned mainstream, it became a victim of its own success: when low fees are ubiquitous, profit margins shrink and index investing becomes intensely competitive. In the hunt for new business opportunities, specialized ESG indices provide an exit from this difficult situation in that they allow fund managers to charge higher fees that drive up revenues.[46] Rather than charging higher fees for their traditional, passive index fund (which might deter investors), a second, alternative market segment allows fund managers to cater for both fee-sensitive customers and those who are environmentally conscious.[47]

For example, BlackRock's "iShares Global Clean Energy ETF," one of the largest ESG funds in the world, carries an expense ratio of more than 11 times that of BlackRock's plain vanilla S&P500 ETF.[48] As a side effect, the broad index funds may see an emphasis on ESG and a wide choice of different products as beneficial when it comes to attracting new customers by differentiating the firm from other, typically smaller index-portfolio specialists. Large institutional investors would thereby benefit from economies of scale in the course of bearing the costs of introducing such new products. This could give them a certain comparative advantage as first movers.

It is certainly true that not all of these funds and asset managers are equally impactful. ESG funds come in different varieties, and not all of them care equally about promoting sustainability in investee companies. Even funds that apply only negative screening—i.e. not investing in certain companies such as tobacco firms—may be classified as ESG funds, and much of the emphasis is on marketing the fund and framing it towards investors, and not necessarily its substance and content.[49] But these concerns do not undermine the merit of the

[45] Edwin J. Elton, Martin J. Gruber & Christopher R. Blake, *Incentive Fees and Mutual Funds*, 58 J. FIN. 779 (2003); Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B. U. L. REV. 1771, 1781-1801 (2020).

[46] These higher fees are partly necessary due to the costs of in-house research or licensing third-party sustainability research. See Harrison Hong, *The Sustainable Investing Proposition*, 2 NBER REPORTER 23-26 (2019).

[47] In a way, this strategy is reminiscent of so-called "regulatory dualism": see Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 STAN. L. REV. 475 (2011).

[48] Christopher Bancroft Burnham, *BlackRock's ESG Strategy Plays Politics with Public Pensions*, BARRON'S (May 28, 2020), available at https://www.barrons.com/articles/blackrock-is-playing-politics-with-public-pensions-51590661589.

[49] Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921 (2020). See also Margaret Giles, *Not All Sustainable Funds Are Equally Sustainable*,

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argument that investors have an incentive, from the supply side, to offer products for this particular market segment. Comparability and standardization may be issues that regulators may have to address.[50]

As a whole, the supply-side argument is an important reason behind many firms not only offering alternative investment funds now, and are also actively advertising them. Moreover, they are supporting the ESG movement more generally to signal and support awareness for a broad sustainability agenda, thereby increasing the demand even further. Following this logic, there is a clear rationale behind the expansion of green products.

2. The demand side: the preferences of millennials

A second related point can be found looking at the *demand side*. The number of investors seeking to actually purchase ESG-oriented financial products is dramatically increasing.

There is considerable evidence that investors' preferences are shifting in that they become increasingly attracted to ESG investments over the recent several years.[51] Two key drivers stand out: to hedge against downside risk, and to pursue non-pecuniary goals for sustainable investment.

First, one of the greatest motivations for investors is to hedge social and, in particular, climate change related long-term risk, which has been widely documented as a significant risk factor, as perceived particularly by large and sophisticated institutional investors.[52] Seen from this perspective, climate change is viewed as a significant source of financial risk, reflected in a return premium on assets with high climate risk exposure. It is for this reason that investors are interested in strategies to hedge against such risk.[53] Crucially, such strategic considerations go beyond climate risk. Indeed, studies have demonstrated that investment in other

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Morningstar Briefing (Apr. 14, 2021), available at https://www.morningstar.com/articles/1033389/not-all-sustainable-funds-are-equally-sustainable.

[50] See below section V.1.

[51] Samuel M. Hartzmark & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, 74 J. FIN. 2789 (2019); Marco Ceccarelli, Stefano Ramelli & Alexander F. Wagner, *Low-carbon Mutual Funds*, ECGI Finance Working Paper N° 659/2020, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3353239.

[52] Philipp Krueger, Zacharias Sautner & Laura Starks, *The Importance of Climate Risks for Institutional Investors*, 33 REV. FIN. STUD. 1067 (2020).

[53] Robert F. Engle et al., *Hedging Climate Change News*, 33 REV. FIN. STUD. 1184 (2020); Stefano Giglio, Bryan Kelly & Johannes Stroebel, *Climate Finance*, 13 ANNUAL REV. FIN. ECON. 15 (2021).

Electronic copy available at: https://ssrn.com/abstract=3958960

sustainability and social-oriented products proves a useful hedge against downside risk in general.[54] For example, when a company suffers a reputational or economic shock, prior corporate investments in socially responsible goals may ensure customer and employee loyalty or signal differentiation against competitors, protecting the firm against such shocks.[55]

A second driver behind the strong demand for ESG products is the increasing focus of mostly retail investors seeking to obtain non-pecuniary utility from pursuing their social, not necessarily profit-driven preferences. This phenomenon is best illustrated by the new set of values that dominate the investment interests of the so-called "millennial generation" (i.e. the cohort of the population born during the 1980s and 1990s, reaching young adulthood in the early 21st century).[56] The millennial population is projected to peak in size and importance during the early 2030s.[57] This generation is currently entering its wealth accumulation phase. In the coming years, staggering amounts of wealth will pass from "Generation X" parents to their millennial children, estimated by one account to amount to $24 trillion.[58] Crucially, this new powerful generation markedly differs in its values from previous generations, or is at least perceived to do so.[59] In a Deloitte survey, 63 percent of millennials stated that they would understand the primary purpose of a business to be "improving society" rather than "generating profit."[60] Most of them identified climate change and environmental issues as the world's greatest concerns, even above healthcare during the pandemic.[61] A recent Fidelity report found

[54] Karl V. Lins, Henri Servaes & Ane Tamayo *Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility during the Financial Crisis*, 72 J. FIN. 1785 (2017); Rui Albuquerque, Yrjö Koskinen & Chendi Zhang, *Corporate Social Responsibility and Firm Risk: Theory and Empirical Evidence*, 65 MANAGEMENT SCIENCE 4451 (2019).

[55] For example, research has shown that the stock prices of firms that had high ESG performance suffered much less during the 2020 Covid-19 crisis: Rui Albuquerque et al., *Resiliency of Environmental and Social Stocks: An Analysis of the Exogenous COVID-19 Market Crash*, 9 REV. CORP. FIN. STUD. 593 (2020); Luboš Pástor & M. Blair Vorsatz, *Mutual Fund Performance and Flows During the COVID-19 Crisis*, 10 REV. ASSET PRICING STUD. 791 (2020); Wenzhi Ding et al., *Corporate Immunity to the COVID-19 Pandemic*, 141 J. FIN. ECON. 802 (2021).

[56] See William Strauss & Neil Howe, MILLENNIALS RISING: THE NEXT GREAT GENERATION (Random House, 2000).

[57] Richard Fry, *Millennials Overtake Baby Boomers as America's Largest Generation*, PEW RESEARCH CENTER (Apr. 28, 2020), https://www.pewresearch.org/fact-tank/2020/04/28/millennials-overtake-baby-boomers-as-americas-largest-generation/ ("[T]he Millennial population is projected to peak in 2033, at 74.9 million. […] The Census Bureau estimates that the Gen X population peaked at 65.6 million in 2015.").

[58] BlackRock CEO Larry Fink has called this trend "the largest transfer of wealth in history." See Larry Fink, *2019 Letter to CEOs: Purpose & Profit*, https://www.blackrock.com/corporate/investor-relations/2019-larry-fink-ceo-letter.

[59] Gillian Tett, *Millennials may forever change investing*, FIN. TIMES (May 7, 2021) at 19.

[60] Fink, *supra* note 58.

[61] Deloitte, THE DELOITTE GLOBAL MILLENNIAL SURVEY 2020 (2020), at 9. Available at https://www2.deloitte.com/global/en/pages/about-deloitte/articles/millennialsurvey.html.

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that almost 75 percent of millennials described themselves as "philanthropists"—a figure that is much higher when compared to the older generations usually referred to as "baby boomers" (35 percent) and "Generation X" (48 percent).[62]

Recent research has demonstrated that investors who behave more socially in everyday life and donate more to charity also hold more socially responsible equity funds, which is consistent with pro-social preferences driving ESG investment.[63] This reflects millennials' changed investment preferences, which are also very different compared to their preceding generations. A recent Morgan Stanley study reports that 99 percent of millennials expressed interest in sustainable investing, in comparison to 79 percent of regular investors.[64] Generally speaking, it has long been documented that millennials are less interested in investment returns and more interested in investments reflecting their social values.[65] According to Fidelity, 43 percent of millennials are engaged in impact investing, compared to just 12 percent of baby boomers, and 22 percent of Generation X.[66] Meanwhile, a study by Natixis revealed that 74 percent of millennials wanted to "make a positive social impact" with their investments, a substantially higher percentage compared to other, older age cohorts.[67] Numerous other studies have confirmed this general trend.[68]

As these business purpose preferences are undergoing profound changes, it is understandable that the financial services sector would be offering products sought by the demand side.[69] In this light, many index funds have been strengthening their efforts to redefine corporate valuations from an ESG perspective, and offering new instruments and index products that focus on principles other than just shareholder returns. Furthermore, a wave of

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[62] Fidelity Charitable, THE FUTURE OF PHILANTHROPY: THE EVOLUTION FROM CHARITABLE GIVING TO CHARITABLE LIVING (2021), available at https://www.fidelitycharitable.org/insights/2021-future-of-philanthropy.html.

[63] Arno Riedl & Paul Smeets, *Why Do Investors Hold Socially Responsible Mutual Funds?*, 72 J. FIN. 2505 (2017).

[64] Morgan Stanley Institute for Sustainable Investing, SUSTAINABLE SIGNALS: INDIVIDUAL INVESTORS AND THE COVID-19 PANDEMIC (2021). They attribute this figure in part to the economic uncertainty and market volatility during the pandemic.

[65] Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1283 ff. (part III.) (2020); Amy Bell, *Young Voices Grow Louder in Company Strategies and Values*, FIN. TIMES (May 24, 2021) FTReports 10.

[66] Fidelity Charitable, *supra* note 62.

[67] The figure was 71 percent for Generation X, 68 percent for the Baby Boomers, and 65 percent for the Silent Generation. See Natixis, *2021 ESG Investor Insight Report*, https://www.im.natixis.com/us/research/esg-investing-survey-insight-report.

[68] See Tett, *supra* note 59.

[69] Richard Henderson, *Funds prepare for future with pitch to millennials*, FIN. TIMES (July 25, 2019) at 19.

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ESG activism has led funds to use their voting power to promote ESG values as well as widely reporting their efforts publicly to catch the attention of this new crop of wealthy investors.[70] Likewise, there is evidence that portfolio companies have strong incentives to do "good" by serving a beneficial purpose and to attract financially sophisticated and dedicated investors.[71]

Another important consequence flows from this trend. If the demand side—represented partly, but not exclusively, by the millennial generation—cares more about sustainability goals than previous generations, in other words if investors are increasingly seeking "purpose" in financial markets, then financial performance itself becomes simultaneously less important. It would certainly be ideal if both could coincide, but the question of whether ESG investments lead to higher long-term financial returns is controversial and has not yet been settled in research. For the reasons outlined above, this question is of lower importance in the present inquiry. The success story of ESG products at higher fees despite possibly non-superior financial performance results from an increasing demand on the part of retail investors with better access to financial markets (due to better financial literacy and greater knowledge of online investment platforms) and non-financial preferences (in the sense of wealth maximization). This is where the supply-side argument and the demand-side argument overlap.

3. Index funds and common ownership

The third argument that supports the case for investor-led sustainability relies on the phenomenon of *common ownership*. Over the past several years, this term has come to describe the phenomenon where a number of large diversified institutional investors dominating today's corporate landscape, such as the Big Three, are holding significant stakes in the vast majority of firms in many economies.[72] While this trend has been criticized for having anti-competitive effects,[73] it does have some *positive* implications in terms of its penchant for favoring policies

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[70] Barzuza et al., *supra* note 65, at 1250.

[71] Claire Economidou et al., *Does Sustainable Investing Matter to the Market?*, Working Paper (2021), available at https://ssrn.com/abstract=3965134.

[72] See, *e.g.*, Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B. U. L. REV. 721, 735, fig. 1 (2019) ("The average combined stake in S&P 500 companies held by the Big Three essentially quadrupled over the past two decades, from 5.2% in 1998 to 20.5% in 2017").

[73] See the seminal paper by José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018). For a contrasting view, see Patrick Dennis, Kristopher Gerardi & Carola Schenone, *Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry*, FEDERAL RESERVE BANK OF ATLANTA WORKING PAPER 2019-5, available at https://doi.org/10.29338/wp2019-15. A vibrant discourse on this research is still ongoing. See further José Azar, Martin C. Schmalz & Isabel Tecu, *Reply to: Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry* (2018), available at https://ssrn.com/abstract=3168095; José Azar, Martin C. Schmalz & Isabel Tecu, *Research on the Competitive*

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and initiatives that support ESG values. This is because funds to have invested in virtually every firm in the market are less concerned with the performance of individual portfolio companies, and more interested in the state of whole economies, if not the world economy. Against this backdrop, scholars have argued that the trend towards common ownership would increase their incentives to push for greater ESG commitment in investee firms, or at least favor general policies that support such efforts.[74] Seen in this light, funds that "own the market" appear to be the ideal conduits for the internalization of a large fraction of the negative externalities caused by environmental damage and social disparities. This prospect is even more promising in the ESG field than in the context of traditional corporate governance engagement, which predominantly relies on firm-specific analysis.[75]

This argument is in line with the so-called "universal owner" hypothesis, which has long argued that shareholder engagement is becoming a powerful weapon for sustainability.[76] This was recognized well before the current ESG movement first emerged.[77] The reasons are twofold. First, institutional investors, in particular the long-term ones like pension funds, recognized that sustainability (both of their portfolio companies and of society more generally) was a precondition for being able to honor their pension promises which would be due decades

Consequences of Common Ownership: A Methodological Critique, 66 ANTITRUST BULLETIN 113 (2021), Mohammad Torshizi & Jennifer Clapp, *Price Effects of Common Ownership in the Seed Sector*, 66 ANTITRUST BULLETIN 39 (2021); José Azar, Sahil Raina & Martin C. Schmalz, *Ultimate Ownership and Bank Competition*, 51 FIN. MGMT. 227 (2022). But see also Jacob Gramlich, & Serafin J. Grundl, *Estimating the Competitive Effects of Common Ownership* (2017), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=294013.

[74] See, for example, Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 17-18 (2020) (arguing that "[f]or indexers and quasi-indexers whose investment strategy is to match the market […] this ability to influence the market beta itself is unprecedented. This uniqueness can explain why institutional investors have taken on the role of proactive overseers of management and undertaken many of the climate-related corporate engagements discussed in the following section").

[75] See Barzuza et al., *supra* note 65.

[76] See Frederick Alexander, *An Honorable Harvest: Universal Owners Must Take Responsibility for Their Portfolios*, 32(2) J. APPL. CORP. FIN. 24 (2020).

[77] See ROBERT MONKS & NELL MINOW, WATCHING THE WATCHERS: CORPORATE GOVERNANCE IN THE 21ST CENTURY (Blackwell Business 1996); Robert A.G. Monks & Nell Minow, *Ownership-Based Governance: Corporate Governance for the New Millennium* (Sept. 1999), available at https://ssrn.com/abstract=6148; JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC (University of Pennsylvania Press, 2000); STEPHEN DAVIS, JON LUKOMNIK & DAVID PITT-WATSON, THE NEW CAPITALISTS: HOW CITIZEN INVESTORS ARE RESHAPING THE CORPORATE AGENDA (Harvard Business School Press, 2006); Simon Deakin & Richard Hobbs, *False Dawn for CSR? Shifts in regulatory policy and the response of the corporate and financial sectors in Britain*, 15 CORPORATE GOVERNANCE 68 (2007).

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into the future. Therefore, institutional investors became persuadable with regard to the virtues of taking a long-term view of their holdings.[78]

Secondly, the extent of institutional holdings is crucial. Institutional investors are considered "universal owners" in a double sense. On the one hand, large pension funds and index funds collectively represent a large majority of employees and savers in many countries, particularly in those jurisdictions that rely on private sector pensions and insurance provision (such as the U.K. and the U.S.). On the other hand, such investors tend to hold a small but significant stake in nearly all listed companies of the country (and beyond) as a way of diversifying their investment risk. This dual "universalization" of the role of the shareholder means that institutional investors have strong incentives to encourage companies to avoid strategies that create negative externalities (i.e. the shifting of costs to third parties or society at large), since whatever the short-term benefit for the company and its investors may be, over the longer term these costs will inevitably be borne by the same institutions and their own "principals" in some form or another.[79]

More recently, Jeffrey Gordon convincingly argued that large, diversified investors' foremost duty should be to address "systematic" risk, as opposed to idiosyncratic, firm-level risk.[80] Coining the term "systematic stewardship," he noted that most asset managers' business model drives them to pursue policies to mitigate portfolio-wide risk, which most notably would include factors such as climate change, financial stability, and social stability. In a similar vein, John Coffee has shown that common owners should rationally concentrate on systematic risk and generally disregard the idiosyncratic risk of individual firms.[81] Indeed, the best evidence that these diversified investors are following economic logic lies in a new pattern under which such investors are actively voting and lobbying public companies in common, primarily on ESG-related issues.[82]

[78] Zacharias Sautner & Laura T. Starks, *ESG and Downside Risks: Implications for Pension Funds*, Wharton Pension Research Council Working Paper No. 2021-10 (2021), available at https://repository.upenn.edu/prc_papers/708/.

[79] For example, pension fund beneficiaries and savers are also employees with an interest in a high quality of employment, and individuals who would like to breathe unpolluted air.

[80] Jeffrey N. Gordon, *Systematic Stewardship*, ECGI Law Working Paper no 566/2021, available at https://privpapers.ssrn.com/sol3/papers.cfm?abstract_id=3782814.

[81] John C. Coffee, Jr., *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk*, COL. BUS. L. REV. 602 (2021).

[82] Elroy Dimson, Oğuzhan Karakaş & Xi Li, *Coordinated Engagements* (ECGI Working Paper January 21, 2021), see https://ssrn.com/abstract=3209072 (11 November 2020) (finding an "international network of long-term shareholders cooperating to influence firms on environmental and social issues").

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In fact, index investors rarely engage in company-specific initiatives – their incentives, cost structures, and benchmarking effects with respect to peers do not allow for such costly firm-level engagement. Rather, the Big Three and others tend to promote generic standards for the market as a whole. They vocally outline their corporate governance priorities in "Dear CEO letters" and public policy statements, openly threatening to use their influence to force change where companies are not being proactive.[83] In particular, they increasingly support calls for board diversity and expansion of shareholder powers, such as proxy access, annual director elections, and other shareholder-friendly governance changes.[84] Recently, they have urged firms to publicly disclose a plan for how their business model will be compatible with a net zero economy.[85] Given their share of the market, winning the voting blocks of passive investors in proxy situations is often pivotal to a voting outcome. Some activist investors recognize this and have begun to structure issues such as governance into their campaigns, in order to appeal to the core issues of concern to large passive voting blocks.

To be sure, the Big Three have been accused of "greenwashing" (i.e. claiming to pursue climate-oriented policies for marketing reasons).[86] But there is now evidence emerging to suggest that large institutions have genuinely encouraged their investee firms to reduce carbon emissions,[87] and even that their efforts have been successful in changing the behavior of portfolio companies in this direction.[88] A recent study confirmed that, at least outside of the

[83] Blackrock's CEO Larry Fink's annual CEO letters have become famous and are widely reported in the investment community. See Andrew Ross Sorkin, *BlackRock Chief Pushes a Big New Climate Goal for the Corporate World*, New York Times (Jan. 26, 2021).

[84] JP Morgan, 2020 PROXY SEASON REVIEW, available at https://www.jpmorgan.com/content/dam/jpm/cib/complex/content/investment-banking/2020-proxy-season/pdf-0.pdf

[85] Blackrock, Larry Fink's 2021 Letter to CEOs, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

[86] Anna L. Christie, *The Agency Costs of Sustainable Capitalism*, 55 U.C. DAVIS L. REV. 875 (2021); Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921 (2020). The accusation of greenwashing extends beyond the Big Three. For corporate greenwashing, see Ellen Pei-yi Yu, Bac Van Luu & Catherine Huirong Chen, *Greenwashing in environmental, social and governance disclosures*, 52 RESEARCH IN INT'L BUS. & FIN. 101192 (2020). For hedge fund greenwashing, see Hao Liang, Lin Sun & Melvyn Teo, *Greenwashing: Evidence from Hedge Funds*, Working Paper (2020), available at https://ssrn.com/abstract=3610627; for greenwashing from PRI signatories, see Rajna Gibson Brandon, Simon Glossner, Philipp Krueger, Pedro Matos & Tom Steffen, *Do Responsible Investors Invest Responsibly?*, ECGI Finance Working Paper Series No 712/2020, available at https://ecgi.global/working-paper/do-responsible-investors-invest-responsibly, pp. 27-29.

[87] See Gillian Tett, *Passive Investing goes Active*, FIN. TIMES (Feb. 2, 2018), at 9.

[88] See José Azar, Miguel Duro, Igor Kadach & Gaizka Ormazabal, *The Big Three and Corporate Carbon Emissions Around the World*, 142 J. FIN. ECON. 674 (2021) ("we observe a strong and robust negative association between Big Three ownership and subsequent carbon emissions among MSCI index constituents, a pattern that becomes stronger in the later years of the sample period as the three institutions publicly commit to tackle ESG issues"). See also Alexander Dyck, Karl V. Lins, Lukas Roth & Hannes F. Wagner, *Do Institutional Investors Drive Corporate Social Responsibility? International Evidence*, 131 J. FIN. ECON. 639 (2019) ("We

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U.S., institutional investors who publicly commit to responsible investing principles do in fact exhibit better ESG performance.[89]

Recent surveys go even further. A 2020 study, investigating the effects of carbon emissions in a cross-section of stock returns, found a "carbon premium" charged on U.S. and other capital markets, which conventional risk factors could not fully explain.[90] The carbon premium has been shown to have increased in the years after the adoption of the Paris Agreement, suggesting that investor awareness of climate issues is playing an ever more significant role, and that climate risk is generally impounded into asset prices at the firm level.[91] Another study has shown that the presence of socially oriented investors can amplify the impact of any formal enforcement activity taken by the U.S. Environmental Protection Agency.[92]

Certainly, free-rider effects are present in generic rulemaking activity too. But three factors make this a more effective means of intervention than attempting to improve individual companies' governance. First, while exit is a rational strategy with regard to particular investment objects, it is not rational with respect to market-wide rules. Hence, the choice is simply between intervention and free-riding (but not exit). Exerting influence over the content of ESG rules may yield positive returns, even in the presence of free-riding activity. Brocardo, Hart and Zingales have recently shown that, in competitive markets, voice is more effective

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find that greater institutional ownership is associated with higher firm-level E&S scores. Not only is this result statistically significant, but it is also economically meaningful"); Condon, *supra* note 74, at 1 (describing how a coalition of institutional investors persuaded Royal Dutch Shell to embark on a massive program to reduce its net carbon footprint that had been defined by the CEO "cumbersome and onerous").

[89] Gibson Brandon et al., *supra* note 86. See also Anne Lafarre, *Do Institutional Investors Vote Responsibly?*, TILEC Discussion Paper No 2022-001 (April 2022), available at https://ssrn.com/abstract=4042907 (finding that EU institutional investors, unlike their U.S. counterparts, do indeed pursue sustainable agendas); Krueger, Sautner & Starks, *supra* note 52 (finding that many investors, especially the long-term, larger, and ESG-oriented ones, consider risk management and engagement, rather than divestment, to be the better approach for addressing climate risks).

[90] Patrick Bolton & Marcin Kacperczyk, *Do Investors Care about Carbon Risk?*, 142 J. FIN. ECON. 517 (2021) (analyzing the effect of corporate emissions on the cross-section of stock returns in the U.S. between 2005 and 2017); for a worldwide analysis, see Patrick Bolton & Marcin Kacperczyk, *Global Pricing of Carbon-Transition Risk*, J. FIN., forthcoming; NBER Working Paper No 28510 (2021), available at https://www.nber.org/system/files/working_papers/w28510/w28510.pdf.

[91] Darwin Choi, Zhenyu Gao & Wenxi Jiang, *Attention to Global Warming*, 33 REV. FIN. STUD. 1112 (2020) (finding that in times of hot temperatures, high-emitting stocks underperform low-emitting stocks); Irene Monasterolo & Luca de Angelis, *Blind to carbon risk? An analysis of stock market reaction to the Paris Agreement*, 170 ECOLOGICAL ECONOMICS 106571 (2020) (showing a decrease in the correlation on indices comprising high carbon emitting issuers on the one hand and low carbon emitting issuers on the other with a significant decrease of systematic risk for low-carbon intensive indices after the conclusion of the Paris Agreement).

[92] Sudipto Dasgupta, Thanh Huynh & Ying Xia, *Joining forces: The spillover effects of EPA enforcement actions and the role of socially responsible investors*, CEPR Discussion Paper 16584 (2021), https://cepr.org/active/publications/discussion_papers/dp.php?dpno=16584.

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than exit in pushing firms to act in a socially responsible manner: in other words, engagement trumps divestment.[93] Secondly, given that common owners cannot easily exit the market, each institution recognizes that if it is not involved in influencing a change, others might do so in a way that harms its interests. Hence, a prevalent strategy is one of coordinated lobbying for rules that were expected to maximize the joint welfare of institutional investors. Finally, coordinated efforts by the investor community may fend off any more interventionist government activity that might eventually entail hardcore regulation;[94] thus, self-regulatory standards and ESG campaigns are especially attractive for investors.[95]

As the influence of large index funds has been growing in recent years, their role is also evolving from being mere passive investors. The largest passive investors are now responding to calls for more active engagement with management. BlackRock, Vanguard, and State Street recently expanded their corporate governance teams and made their interactions with management more transparent,[96] while investment stewardship teams at large active and passive funds have significantly grown, with some doubling in size over the past 10 years.[97] A 2021 survey found that 85 percent of index funds were giving ESG more attention when exercising their right to vote.[98] In this way, the lines between what is passive and what is active engagement are blurring, and traditionally reticent investors are increasingly embracing activist tactics and engaging in activist campaigns.[99]

IV. Team-building

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[93] Eleonora Broccardo, Oliver Hart & Luigi Zingales, *Exit vs. Voice*, Working Paper (December 2020), available at https://scholar.harvard.edu/files/hart/files/exit_vs_voice_1230.pdf.

[94] John L. Campbell, *Why would corporations behave in socially responsible ways? An institutional theory of corporate social responsibility*, 32 ACAD. OF MGMT. REV. 946 (2007); David Vogel, *The Private Regulation of Global Corporate Conduct*, 49 BUS. & SOC'Y 68 (2010).

[95] Barzuza et al., *supra* note 65, at 1272. See also Gillian Tett, *Passive investing goes active*, FIN. TIMES (Feb. 2, 2018) at 9.

[96] Madison Marriage, *BlackRock, Vanguard and State Street bulk up governance staff*, FIN. TIMES (Jan. 28, 2017), available at https://www.ft.com/content/657b243c-e492-11e6-9645-c9357a75844a.

[97] Morrow Sodali, INSTITUTIONAL INVESTOR SURVEY 2021 (2021), available at https://morrowsodali.com/insights/institutional-investor-survey-2021.

[98] *ibid*.

[99] Richard J. Grossman & Neil P. Stronski, *New Tactics and ESG Themes Take Shareholder Activism in New Directions*, Skadden, Arps, Slate, Meagher & Flom LLP memo (Feb. 3, 2021), available at https://www.skadden.com/insights/publications/2021/02/the-informed-board/new-tactics-and-esg-themes; Gillian Tett, *Passive investing goes active*, FIN. TIMES (Feb. 2, 2018), at 9.

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The final and most prominent phenomenon in favor of investor-led sustainability relates to greater *collaboration* between different types of ESG-oriented investors, thereby supporting engagement and activism.[100] First observed in the context of traditional shareholder activism, the collaboration model is becoming increasingly important in the context of green activism.[101] Board-oriented practitioners may sometimes refer to this trend as "pincer attacks."[102] But coalition-building, as we shall see below, has become a very valuable component of ESG activism, not least through institutionalized platforms of collaboration.[103]

1. Traditional collaboration for shareholder engagement

By way of background, greater collaboration between institutional investors has been observed in traditional corporate governance for several years already, and it is seen as one of the most promising trends in enhancing shareholder engagement, as it sets out to improve the accountability of management and to overcome traditional free-rider problems and concerns about the rational apathy of shareholders.[104] The peculiar incentive structure of activist hedge funds promises to ultimately overcome these collective action problems, yet hedge funds have been accused of pursing idiosyncratic goals and serving their own profit-making goals.[105] As I have explained elsewhere, the fact that such hedge funds need the support of larger, traditionally

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[100] William McNabb, Vanguard Chairman and CEO, stated that "To understand the full picture, we often also engage with other investors, including activists and shareholder proponents": see Vanguard, *An open letter to directors of public companies worldwide* (Aug. 31, 2017), available at https://global.vanguard.com/documents/investment-stewardship-mcnabb-letter.pdf.

[101] For shareholder proposals with a focus on environmental issues, see Robert Monks, Anthony Miller & Jacqueline Cook, *Shareholder activism on environmental issues: A study of proposals at large US corporations (2000-2003)*, 28 NAT. RESOURCES F. 317 (2004); Giovanna Michelon & Michelle Rodrigue, *Demand for CSR: Insights from Shareholder Proposals*', 35 SOC. & ENVTL. ACCOUNTABILITY J. 157 (2015); Erwin Eding & Bert Scholtens, 'Corporate Social Responsibility and Shareholder Proposals', 24 CORP. SOC. RESP. & ENVTL. MGMT. 648 (2017); Viju Raghupathi, Jie Ren, Wullianallur Raghupathi, *Identifying Corporate Sustainability Issues by Analyzing Shareholder Resolutions: A Machine-Learning Text Analytics Approach*, 12 SUSTAINABILITY 4753 (2020).

[102] Andrew R. Brownstein, Steven A. Rosenblum & Trevor S. Norwitz, *The ESG/TSR Activist "Pincer Attack"*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Jan. 26, 2021), available at https://corpgov.law.harvard.edu/2021/01/26/the-esg-tsr-activist-pincer-attack/.

[103] See below.

[104] Marcel Kahan & Edward B. Rock, 'Embattled CEOs', 88 TEX. L. REV. 987 (2010); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Wolf-Georg Ringe, *Shareholder Activism: A Renaissance*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 387 (Jeffrey N. Gordon & Wolf-Georg Ringe, eds., 2018). See also recent evidence provided by Simi Kedia, Laura T. Starks & Xianjue Wang, *Institutional Investors and Hedge Fund Activism*, 10 REV. CORP. FIN. STUD. 1 (2021).

[105] Former German SPD party chairman Franz Müntefering famously likened hedge funds to locusts, who "fall on companies, stripping them bare before moving on". See THE ECONOMIST, *Locust, pocus*, May 5, 2005, https://www.economist.com/special-report/2005/05/05/locust-pocus.

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passive institutional investors (such as pension funds or mutual funds) may operate as a "vetting process," where asset managers would only lend their support if they can be sure that the proposed action would be beneficial for the body of shareholders as a whole.[106] Traditional investors such as pension funds, foundations, and sovereign wealth funds would then act as guardians of long-term value creation.[107] Indeed, many cases have shown their voting behavior to be more orientated towards the long term than was previously the case.[108] This influence has helped to protect companies from controversial practices, such as excessive executive compensation or investments.[109] In this way, the "teaming-up" of activist funds and larger institutional investors creates a system of checks and balances, which gives greater credibility and legitimacy to shareholder activism and serves as a filter to ensure support is only given to campaigns that are value-creating for all shareholders.[110]

2. Collaboration for ESG

This phenomenon of coalition-building is now also increasingly being observed in ESG activism, which is a promising sign for credible investor-led sustainability.

The most prominent story of recent times in terms of ESG activism was that of Engine No. 1, an "impact-focused fund" who launched an activist campaign at U.S. oil giant ExxonMobil. Starting in December 2020, the tiny hedge fund initiated a proxy contest at ExxonMobil for its alleged failure to adequately respond to evolving energy needs and emissions standards. The following months saw increasingly strong pressure from Engine

[106] Ringe, *supra* note 104.

[107] Frank A.J. Wagemans, C.S.A. (Kris) van Koppen & Arthur P.J. Mol, *Engagement on ESG issues by Dutch pension funds: is it reaching its full potential?*, 8 J. OF SUSTAINABLE FIN. & INVESTMENT 301 (2018); Natalia Semenova & Lars G. Hassel, *Private engagement by Nordic institutional investors on environmental, social, and governance risks in global companies*, 27 CORP. GOV.: AN INT'L REV. 144 (2019); Hao Liang & Luc Renneboog, *The global sustainability footprint of sovereign wealth funds*, 36 OXFORD REV. OF ECON. POL'Y 380 (2020).

[108] Laura Starks, Parth Venkat & Qifei Zhu, *Corporate ESG Profiles and Investor Horizons* (2017), available at https://ssrn.com/abstract=3049943; Ioannis Oikonomou, Chao Yin & Lei Zhao, *Investment horizon and corporate social performance: the virtuous circle of long-term institutional ownership and responsible firm conduct*, 26 EUR. J. FIN. 14 (2020).

[109] Dominik Breitinger, *What is shareholder activism and how should businesses respond?*, WORLD ECONOMIC FORUM (August 2017), available at https://www.weforum.org/agenda/2017/08/shareholder-activism-business-response-explainer.

[110] See Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015); Alon Brav, Wei Jiang & Hyunseob Kim, *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes*, 28 REV. FIN. STUD. 2723 (2015); Ed de Haan, David Larcker & Charles McClure, *Long-term economic consequences of hedge fund activist interventions*, 24 REV. ACCT. STUD. 1573 (2019).

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No. 1, which had urged Exxon to cut capital spending and to focus on accelerating rather than on deferring the transition to cleaner energy. This culminated in an epic shareholder meeting on May 26, 2021, where Engine No. 1 successfully convinced fellow shareholders to support three of its director nominees – which, in effect, was a major defeat for the incumbent management.[111]

Interestingly, the hedge fund held a stake of only $54m in a company with $248bn in market capitalization (i.e. equal to just 0.02 percent). Key to its success was therefore coalition-building. Engine No. 1 partnered from the beginning of its campaign with the U.S.'s second-largest pension fund, California State Teachers' Retirement System (CalSTRS).[112] Shortly afterwards, none other than the Church of England joined forces with both investors, lending further support to the campaign.[113] In the run-up to the shareholder vote, the team was also successful in convincing other important funds such as the California Public Employees' Retirement System (CalPERS) and New York state's pension fund New York State Common.[114] It was reported that Blackrock and Vanguard, two of the largest Exxon shareholders, also voted to support at least three of the four director nominees on Engine No. 1's slate.[115] Together, this alliance proved critical in the campaign's victory and may herald a new era for shareholder activism.[116] The coalition of investors was therefore not only successful

[111] Derek Brower, *ExxonMobil shareholders hand board seats to activist nominees*, FIN. TIMES (May 26, 2021), https://www.ft.com/content/da6dec6a-6c58-427f-a012-9c1efb71fddf.

[112] *id*.

[113] Ortenca Aliaj, Derek Brower & Myles McCormick, *ExxonMobil under pressure as Church of England joins investor campaign*, FIN. TIMES (Dec. 10, 2020) https://www.ft.com/content/c0639fb0-d81f-4ee9-8d58-d8e8da05c454.

[114] Jennifer Hiller & Svea Herbst-Bayliss, *CalPERS to back activist's four director nominees in Exxon board fight*, REUTERS (Apr. 27, 2021), https://www.reuters.com/business/energy/calpers-back-activists-four-director-nominees-exxon-board-fight-2021-04-26/. See also Businesswire, *Leading Pension Funds CalPERS, CalSTRS, and New York State Common Support Engine No. 1's Campaign to Reenergize ExxonMobil by Voting the WHITE Proxy Card "FOR ALL" of Engine No. 1's Director Candidates* (Apr. 27, 2021), https://www.businesswire.com/news/home/20210427005386/en/Leading-Pension-Funds-CalPERS-CalSTRS-and-New-York-State-Common-Support-Engine-No.-1%E2%80%99s-Campaign-to-Reenergize-ExxonMobil-by-Voting-the-WHITE-Proxy-Card-%E2%80%9CFOR-ALL%E2%80%9D-of-Engine-No.-1%E2%80%99s-Director-Candidates.

[115] Alastair Marsh & Saijel Kishan. *Engine No. 1's Exxon Win Provides Boost for ESG Advocates*, BLOOMBERG (May 27, 2021), https://www.bloomberg.com/news/articles/2021-05-27/engine-no-1-s-exxon-win-signals-turning-point-for-esg-investors; Bernice Napach, *BlackRock and Vanguard Played Key Roles in Exxon's Shareholder Proxy Vote*, THINKADVISOR (May 27, 2021), https://www.thinkadvisor.com/2021/05/27/blackrock-and-vanguard-played-key-roles-in-exxons-shareholder-proxy-vote/.

[116] Matt Phillips, *Exxon's Board Defeat Signals the Rise of Social-Good Activists*, N.Y. TIMES (June 11, 2021).

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in shaking up Exxon Mobil, but it also handed a major victory to the ESG movement as a whole.[117]

Other pertinent examples abound.[118] In January 2020, activist hedge fund Elliott Management sent a letter to the board of Evergy, an American utility company. Among other things, Elliott criticized the company's insufficient carbon reduction targets, stating that Evergy ought to be a leader in decarburization system investments, which, in turn, would help transition the company's coal fleet to renewable resources. One year later, both sides announced a settlement whereby Evergy committed to maintaining a focus on its Sustainability Transformation Plan, with Elliott agreeing to support management until the 2022 annual shareholder meeting.[119] Again, the backing from other institutional firms was of paramount importance, especially that of Bluescape Energy Partners who supported the deal.[120]

The formerly aggressive hedge fund TCI (The Children's Investment Fund) has also shifted its attention to ESG in recent years. In 2020, TCI launched a "say on climate" campaign, calling for a shareholder vote on climate policy.[121] They filed resolutions at seven U.S.-listed issuers, including Moody's, S&P Global, Union Pacific Railroad, Charter Communications, Alphabet, Canadian Pacific Railway, and Canadian National. The resolutions called for these companies to disclose annually their greenhouse gas emissions, to produce a plan to manage those emissions, and to hold an annual advisory vote on the plan. In the case of Spanish airport operator Aena, TCI was successful in pushing for the introduction of the world's first "say on climate" vote.[122] Once more, the push for an advisory vote on the climate plan was supported

[117] It emerged in October 2021 that Engine No. 1 has now taken a stake in carmaker General Motors, this time however to support that firm's move towards producing more environmentally friendly electric vehicles. See Press Release, *Engine No. 1 Announces Support for General Motors Co.'s Transformative Electric Vehicle Plan in Advance of Automaker's Investment Day* (Oct. 4, 2021), https://www.businesswire.com/news/home/20211004005876/en/Engine-No.-1-Announces-Support-for-General-Motors-Co.%E2%80%99s-Transformative-Electric-Vehicle-Plan-in-Advance-of-Automaker%E2%80%99s-Investment-Day.

[118] See several examples discussed by Brownstein, Rosenblum & Norwitz, *supra* note 102.

[119] David French, *U.S. utility Evergy adds directors in new agreement with activist firm Elliott*, REUTERS (Feb. 26, 2021), available at https://www.reuters.com/article/us-evergy-elliott-idUSKBN2AQ294.

[120] *id*.

[121] Tim Human, *TCI goes global with "say on climate" campaign* (Dec. 2, 2020), available at https://www.corporatesecretary.com/articles/esg/32358/tci-goes-global-%E2%80%98say-climate%E2%80%99-campaign.

[122] Tim Human, *Aena adopts annual advisory vote on climate plan*, IR MAGAZINE (Nov. 5, 2020), https://www.irmagazine.com/reporting/aena-adopts-annual-advisory-vote-climate-plan.

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by BlackRock, which said in a voting bulletin it would be "beneficial at Aena given the material risk to its business model and its need to accelerate its efforts."[123]

In October 2020, shareholders in consumer goods firm Procter & Gamble (P&G) were successful in a vote urging stronger efforts to prevent supply chain deforestation. A landslide 67 percent of P&G's shareholders voted in favor of a resolution put forward by Green Century Equity Fund calling on the company to report on how and whether it could eliminate deforestation and the degradation of intact forests from its supply chain.[124] Again, this vote received critical support from all "Big Three" asset management companies.[125] Similarly, the management of software giant Oracle was defeated by a shareholder vote on racial- and gender-pay gap reporting, which was also supported by BlackRock, Vanguard, and State Street.[126]

Another somewhat different example has been the widely reported campaign of hedge fund Jana Partners targeting IT giant Apple and demanding more features on the latter's devices to better enable parents to control and limit their children's screen time. Jana enlisted the help of social activists and rock star Sting. Most importantly, the campaign was conducted in partnership, once again, with ESG-oriented pension fund CalSTRS, and this was crucial in its success.[127] The campaign convinced Apple to respond; the company unveiled a new 'screen time' feature on its devices several months later.[128]

An even more recent phenomenon is that ESG campaigns may not only be initiated by activist funds or halo funds, but may instead be prompted or encouraged by more passive asset managers themselves. For example, it was recently reported that the New York State Common Retirement Fund is reaching out to shareholders of the world's six largest banks, seeking to

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[123] BlackRock Investment Stewardship Group, VOTING BULLETIN: AENA S.M.E. SA, available at https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-aena-oct-2020.pdf.

[124] Alistair Gray & Patrick Temple-West, *Investor rebellion at Procter & Gamble over environmental concerns*, FIN. TIMES (Oct. 14, 2020), https://www.ft.com/content/1dd92502-e95b-4c21-be1c-c18a598acf1a.

[125] Jackie Cook & Lauren Solberg, *Hints of Sea Change in Big Fund Company ESG Proxy Votes*, MORNINGSTAR (May 12, 2021), https://www.morningstar.com/articles/1039244/hints-of-sea-change-in-big-fund-company-esg-proxy-votes.

[126] Jackie Cook & Lauren Solberg, *The 2021 Proxy Voting Season in 7 Charts*, MORNINGSTAR (Aug. 5, 2021), https://www.morningstar.com/articles/1052234/the-2021-proxy-voting-season-in-7-charts.

[127] Robert G. Eccles, *Why an Activist Hedge Fund Cares Whether Apple's Devices Are Bad for Kids*, HARV. BUS. REV. (January 2018), https://hbr.org/2018/01/why-an-activist-hedge-fund-cares-whether-apples-devices-are-bad-for-kids.

[128] Sarah Perez, *Apple unveils new screen time controls for children*, TECHCRUNCH (June 4, 2018) https://techcrunch.com/2018/06/04/apple-unveils-new-screen-time-controls-for-children/.

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convince them to back plans that would force the banks to align their policy with the 2050 net zero goal.[129]

3. Institutionalized platforms

Such coalitions between different investors may either be built for individual campaigns or may become more institutionalized themselves. At the one extreme end of the spectrum, the initiative Climate Change 100+ brings together more than 570 investors, responsible for over $54 trillion in assets under management.[130] The goal of the initiative is to engage firms on improving climate change governance, cutting emissions, and strengthening climate-related financial disclosures. Launched in December 2017, Climate Action 100+ garnered immediate worldwide attention. Apparently, it not only coordinates actions but also distributes leadership roles for individual campaigns and geographical areas of specialization, thereby sharing the cost of activism.[131] In January 2020, BlackRock joined Climate Action 100+, adding itself to a long list of other prominent signatories (including CalPERS, CalSTRS, Fidelity, J.P. Morgan Asset Management, and the pension funds of the City and State of New York). The United Nations has identified Climate Action 100+ as one of the "most consequential global initiatives to combat global warming."[132]

But coalitions do not always need large numbers of participants to have a meaningful impact. In April 2021, two investor groups, BlackRock and Singaporean sovereign wealth fund Temasek, agreed on an institutionalized partnership called "Decarbonization Partners," which committed $600 million to advancing decarbonization solutions.[133] Furthermore, a broad range of international investor advocacy groups, like As You Sow, Follow This, Majority Action, the Shareholder Association for Research and Education, the Shareholder Commons, ShareAction, and Investor Advocates for Social Justice, represent both individual and institutional investors

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[129] Camilla Hodgson, *New York State pension fund urges bank shareholders to back climate demands*, FIN. TIMES (Apr. 13, 2022) at p. 8.

[130] https://www.climateaction100.org/about/.

[131] See *e.g.* Condon, *supra* note 47, at 64; Christie, *supra* note 86, at 22.

[132] Matteo Tonello, *2021 Proxy Season Preview and Shareholder Voting Trends*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Feb. 11, 2021), available at https://corpgov.law.harvard.edu/2021/02/11/2021-proxy-season-preview-and-shareholder-voting-trends-2017-2020/.

[133] Jonathan Shieber, *Temasek and BlackRock form Decarbonization Partners with $600 million to create a zero-emission economy*, TechCrunch (Apr. 13, 2021), https://techcrunch.com/2021/04/13/temasek-and-blackrock-form-decarbonization-partners-with-600-million-to-create-a-zero-emission-economy/.

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by filing shareholder resolutions on their behalf, tracking campaigns, and defending them against legal challenges that typically come from the corporate management of the investee company.[134] There is also a growing trend several institutions simultaneously „co-filing" shareholder resolutions.[135]

As an example of how platforms operate and interact with shareholder activists, consider the 2021 shareholder resolutions passed at some major oil and gas companies. At U.S. big oil firms Chevron, ConocoPhillips, and Phillips 66, shareholders supported resolutions seeking substantial greenhouse gas emissions reduction targets.[136] These resolutions were filed by the pressure group "Follow This," and obtained majority shareholder approval, as did a vote at Phillips 66 requesting that the company issue a report on how its lobbying activities are consistent with the goals of the Paris Climate Agreement. Crucially, the lobbying resolution votes were supported by the Climate Action 100+ initiative.[137] Proxy advisory group ISS also lent its support to the vote at Phillips 66, recommending that shareholders vote "For" the proposal and noting that the company's reports on year-over-year emissions were lagging behind those of its peers.[138]

Already, several academic studies have looked into the evolving practice of such coalition-building between different types of institutional investor; and all of them have confirmed a notable increase in such collaborations.

A recent study by Elroy Dimson and co-authors documented a large number of coordinated engagements, conducted by a prominent international network of long-term shareholders who cooperate to influence target firms on ESG issues.[139] In particular, they showed that investors tended to choose a two-tier engagement strategy, combining a lead investor (who spearheads the dialogue) with several supporting investors (typically major

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[134] Cook & Solberg, *supra* note 126.

[135] *Id*.

[136] Pinsent Masons, *Institutional shareholders push for climate change commitments* (June 18, 2021), https://www.pinsentmasons.com/out-law/analysis/institutional-shareholders-push-for-climate-change-commitments.

[137] ClimateAction 100+, *In Historic Votes, Shareholders Demand Strong Climate Action from the U.S. Oil and Gas Industry* (May 12, 2021), https://www.climateaction100.org/news/in-historic-votes-shareholders-demand-strong-climate-action-from-the-u-s-oil-and-gas-industry/.

[138] See on the role of proxy advisors below IV.4.

[139] Elroy Dimson, Oğuzhan Karakaş & Xi Li, *Coordinated Engagements*, ECGI Finance Working Paper No. 721/2021, available at http://ssrn.com/abstract_id=3209072.

Electronic copy available at: https://ssrn.com/abstract=3958960

investment institutions). This strategy has proved highly effective in achieving the stated engagement goals and has also led to improved target performance. This particular study was based mostly on data from a collaboration platform provided by the UN's Principles for Responsible Investment (PRI). The PRI is a leading network and the largest initiative of its kind in the world for investors committed to responsible ownership and long-term, sustainable returns.[140]

Other researchers have confirmed the importance of established networks to further ESG campaigns. Indeed, several studies have illustrated the role of "investor-driven governance networks" (IGNs) as a key component of the infrastructure for private environmental governance: IGNs are coalitions or alliances led by investors, formed around a specific public good or issue such as climate, in which investors are the primary actors.[141] Such IGNs include the Carbon Disclosure Project (CDP), the Interfaith Center for Corporate Responsibility (ICCR), the Coalition for Environmentally Responsible Economies (Ceres), Investors Against Genocide, the Network for Sustainable Financial Markets, and the Institutional Investors Group on Climate Change (IIGCC). Such purpose-driven networks are designed for advocacy following a particular mission, with varying rigor, and many tend to partner with classic institutional investors such as pension funds and mutual funds.[142] Others have emphasized in greater detail the function that coalitions play in fostering shareholder engagement on ESG issues.[143] Pertinently, they disseminate information relating to their mission and propose strategies and tactics for action, while they also serve as rallying points for individual and institutional shareholders seeking to influence companies and facilitate cost-sharing for campaigns.[144]

Another emerging trend is collaboration between existing shareholder coalitions.[145] Thus, the recently launched "Net Zero Asset Managers Initiative" is a "network of networks"

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[140] See on the PRI platform also below XXX.

[141] Michael MacLeod & Jacob Park, *Financial Activism and Global Climate Change: The Rise of Investor-Driven Governance Networks*, 11(2) GLOBAL ENVTL. POL. 54 (2011); Aimei Yang, Nur Uysal & Maureen Taylor, *Unleashing the Power of Networks: Shareholder Activism, Sustainable Development and Corporate Environmental Policy*, 27 BUS. STRATEGY AND THE ENV'T 712 (2018).

[142] *id*.

[143] Gary J. Cundill, Palie Smart & Hugh N. Wilson, *Non-financial Shareholder Activism: A Process Model for Influencing Corporate Environmental and Social Performance*, 20 INT'L J. MGMT. REV. 606 (2018).

[144] *id*. at 615.

[145] David Grayson & Jane Nelson, CORPORATE RESPONSIBILITY COALITIONS: THE PAST, PRESENT, AND FUTURE OF ALLIANCES FOR SUSTAINABLE CAPITALISM (Stanford University Press 2020), available at https://www.degruyter.com/document/doi/10.1515/9780804787109/html.

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bringing together platforms such as Ceres, the PRI, and the IIGCC, who share a commitment to push the companies they invest in towards reducing their net greenhouse gas emissions to zero by 2050.[146] Among the signatories of this initiative are the Big Three and many other asset management firms from across the globe.

4. Ratings, indexes and proxy advisors

Collaboration, however, is not only happening at a bilateral level. Intermediaries are playing an increasingly prominent role in facilitating ESG engagement and investment, by helping investors to better evaluate their portfolio companies' ESG performance. As we saw above, firms have strong incentives to do "good" by engaging in ESG activities; however, in order to attract investors, their practices need to be visible to the market, through outside rating procedures.[147] Therefore, it is unsurprising that ESG ratings and ESG indexes have recently expanded in quantity, quality, complexity, and variety.[148] This is unsurprising given the soaring investor demand, as well as heightened regulatory pressure.

An ESG rating is a scoring framework through which a target firm's performance on ESG factors is evaluated and measured in a systematic way to create a combined ESG score for that company. In contrast, an ESG index describes an investable index, usually a market capitalization-weighted index value which is calculated by aggregating the individual company scores assessed for the ESG performance of each member in the group of companies that form the index.[149] Crucially, neither of these two evaluations include any indicators of financial performance.

The industry providing services to better inform investors about companies' ESG activity is mushrooming. There are now many rating agencies that specialize in evaluating companies based on ESG criteria. Among the leading providers at present are MSCI ESG Research, Sustainalytics, Institutional Shareholder Services (ISS), RobecoSAM, and Refinitiv.

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[146] https://www.iigcc.org/.

[147] Claire Economidou et al., *Does Sustainable Investing Matter to the Market?*, Working Paper (2021), available at https://ssrn.com/abstract=3965134.

[148] Michael S. Pagano et al., *Understanding ESG ratings and ESG indexes*, in: RESEARCH HANDBOOK OF FINANCE AND SUSTAINABILITY 339 (Sabri Boubaker, Douglas Cumming & Duc K. Nguyen, eds., 2018).

[149] Well-known examples include the Dow Jones Sustainability Index and the FTSE4Good Index.

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However, there has been considerable movement in this market in recent years. For example, sustainability specialist RobecoSAM sold its ESG ratings to S&P Global in 2019, and Sustainalytics has been a part of fund specialist Morningstar since 2020. The major traditional rating agencies do not want to miss out on this trend either. Indeed, S&P launched its own ESG rating department in 2019, and Moody's assumed a majority position in the established sustainability agency Vigeo Eiris. Fitch, on the other hand, relies on an ESG score that is integrated into the company's credit ratings, while ISS is now part of Deutsche Börse.

The key problem here is obvious: the lack of a standardized methodology. As there is no common definition of "ESG" or "sustainability," different results can be obtained depending on the methodology used by the data provider, rating agency, or index designer. Some ESG rating agencies do not even disclose what criteria they use to determine their rating in the first place. This may create significant uncertainty for investors. A recent study found correlation of only an average of 0.54 for ESG ratings of six different providers.[150] In stark contrast, for traditional credit ratings, the correlation is 0.99. Meanwhile, further research has documented widespread retroactive changes to the historical ESG ratings provided by Refinitiv.[151]

A related problem is that rating agencies obtain their data either from the companies' self-reporting efforts or from algorithms that evaluate ESG reports and company websites. Self-reporting is, for obvious reasons, not necessarily the most reliable source for ratings. A recent study by Hargreaves Lansdown, a British financial services company, ranked the five companies in the FTSE 100 that were deemed the most environmentally friendly and socially responsible, based on data from Refinitiv. Much to their surprise, the top five companies included firms such as British American Tobacco, a supplier of over 200 brands of cigarettes, Coca-Cola, renowned for its sugary soft drinks, and Glencore, a global mining company.[152]

As a side note, ESG ratings are not to be confused with so-called second-party opinions (SPOs). These refer to opinions from an independent party to evaluate the merits of a green bond or green promissory note. An SPO evaluates whether the projects that a company seeks to finance using such a green instrument are indeed sustainable. In contrast to the ESG rating,

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[150] Florian Berg, Julian F. Kölbel & Roberto Rigobon, *Aggregate Confusion: The Divergence of ESG Ratings*, Working Paper 2020, https://ssrn.com/abstract=3438533. See also Elroy Dimson, Paul Marsh & Mike Staunton, *Divergent ESG Ratings*, 47 J. PORTFOLIO MGMT. 75 (finding widely diverging ratings across agencies, and questioning their utility for investors).

[151] Florian Berg, Kornelia Fabisik & Zacharias Sautner, *Is History Repeating Itself? The (Un)Predictable Past of ESG Ratings*, ECGI Finance Working Paper No. 708/2020, https://ssrn.com/abstract=3722087.

[152] Sophie Lund-Yates, *FTSE 100 – the 5 highest ESG rated companies* (March 3, 2021), https://www.hl.co.uk/news/articles/ftse-100-the-5-highest-esg-rated-companies.

Electronic copy available at: https://ssrn.com/abstract=3958960

the agency does not necessarily take the entire of the company's activities into consideration. In addition, an SPO certifies that the issuer complies with the current standards for sustainable financing. From a legal point of view, there are no binding rules, but in this market segment at least, the ICMA Green Bond Principles have established a *de facto* market standard.[153]

Finally, proxy advisors have emerged as powerful players on the capital market, serving as intermediaries to further responsible investment. Proxy advisory firms are independent service providers who help institutional investors to execute their voting decision on shareholder matters and to advise them on how to vote their shares. The market is dominated by two relatively small proxy advisory firms, namely Institutional Shareholder Services (ISS) and Glass Lewis, who together control more than 90 percent of the proxy advisory market. In the past, that dominance and corresponding influence over corporate voting matters has given rise to concerns, going hand-in-hand with concerns over asset managers' blind overreliance on proxy advisors' recommendations.[154]

More recently, scholarly attention has turned to consider the role that proxy advisors play in promoting ESG objectives.[155] It has emerged that proxy advisors such as ISS, the dominant player, is even more supportive of environmental and social resolutions than most traditional asset managers.[156] For example, ISS have adopted a new voting policy relating to so-called "significant greenhouse gas emitters", a set of companies that are accounting for over 80 percent of corporate industrial greenhouse gas emissions and are thus perceived as key to driving the global net-zero emissions transition.[157] Focusing on these companies, ISS guidelines say that it will recommend voting against the incumbent chair of the responsible board committee if it determines the company is not taking the "minimum steps" needed to

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[153] International Capital Markets Association (ICMA), GREEN BOND PRINCIPLES: VOLUNTARY PROCESS GUIDELINES FOR ISSUING GREEN BONDS (June 2021), https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/.

[154] The SEC adopted new rules governing proxy advisors over those concerns in 2020: SEC, *Exemptions from the Proxy Rules for Proxy Voting Advice*, 85 FR 55082, Sept. 3, 2020 (Release No. 34-89372, July 22, 2020).

[155] See, e.g., John G. Matsusaka & Chong Shu, *A Theory of Proxy Advice When Investors Have Social Goals*, USC Marshall School of Business Research Paper (Oct. 26, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3547880; Paul Rose, *Proxy Advisors and Market Power: A Review of Institutional Investor Robovoting*, Report for the Manhattan Institute (April 2021), https://ssrn.com/abstract=3851233.

[156] Kevin Chuah, Isobel Mitchell & Lily Tomson, ANOTHER LINK IN THE CHAIN: UNCOVERING THE ROLE OF PROXY ADVISORS IN INVESTOR VOTING, ShareAction Report (2021), https://api.shareaction.org/resources/reports/Another-Link-in-the-Chain_Uncovering-the-role-of-proxy-advisors-in-investor-voting.pdf.

[157] These companies are the 167 companies that currently identified as part of the "Climate Action 100+ Focus Group". The list is available at https://www.climateaction100.org/whos-involved/companies/.

Electronic copy available at: https://ssrn.com/abstract=3958960

understand, assess and mitigate climate risks, both for the company and larger economy.[158] What it considers as "minimum steps" will sharpen over the course of the next year as ISS seeks detailed disclosure about climate risks, including board governance, corporate strategy, risk management analyses and metrics/targets, and reduction targets for greenhouse gas emissions that cover at least a significant portion of the company's direct emissions.[159] Further, they will generally recommend voting against proposed directors where the board has no apparent racially or ethnically diverse members or women.[160]

ISS has also been found to be more supportive on ESG matters than the second-largest proxy firm, Glass Lewis.[161] While the problem of overreliance on proxy advisory recommendations has certainly not yet been resolved, their influence on voting decisions still represents additional support for a reliable investor-driven move towards responsible investing.

V. Implications

What are the lessons that lawmakers and regulators should draw from this? Two main implications flow from the main argument that investors are increasingly promoting sustainable policies purely on account of their own interests.

The first of these lessons is negative. As investors are providing strong and sensible pressure in pursuit of the achievement of ESG goals, additional modifications of the regime governing corporate *boards* appear unwarranted. Worse still, modifying directors' duties may prove counterproductive in terms of investor-led sustainability. For example, corporate management may hide behind the guise of protecting stakeholders' interests by opposing institutional shareholders and their efforts, thereby becoming more entrenched.[162]

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[158] Institutional Shareholder Services, *U.S. Proxy Voting Guidelines* 16 (Dec. 13, 2021), available at https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.

[159] See also Marc S. Gerber & Raquel Fox, *Investors Press for Progress on ESG Matters, and SEC Prepares To Join the Fray*, SKADDEN INSIGHTS (Jan. 19, 2022), https://www.skadden.com/insights/publications/2022/01/2022-insights/corporate/investors-press-for-progress.

[160] ISS, *supra* note 158, at 11-12.

[161] Chuah et al., *supra* note 156. ISS recommended that investors vote "For" a shareholder resolution 79 percent of the time, which was much higher than the 53 percent of votes supported by Glass Lewis.

[162] Bebchuk et al.

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Efforts by rule-makers, in particular the European Commission,[163] to reform the regulatory regime governing corporate directors should therefore not be pursued further. As noted in a recent submission in response to E.U. proposals, these efforts need to be reconsidered in light of economic evidence and in light of the "self-regulation" approach presented here.[164] The Commission's initiative as well as the underlying EY report[165] have also drawn fierce criticism from different academic quarters.[166] The same is true for other, mostly mandatory attempts at prescribing sustainability criteria.[167]

Instead of pursuing an overly prescriptive approach, this paper offers an alternative. The more positive message is that investor pressure, ideally filtered and vetted through the "teaming-up" model, will push firms to pursue sustainability initiatives out of intrinsic motivation. We have seen, however, that collaborative efforts also face challenges here. For example, the famous free-rider problem applies: costs may be borne by a small group of committed and resourceful investors, while benefits are shared by all investors in the firm. Furthermore, competition and rivalry between institutional investors makes collaboration difficult and frequently requires independent or mutual trust. Also, coordination is costly and time-consuming: it needs to overcome language and cultural barriers, so achieving agreement among many investors from diverse jurisdictions may prove difficult. Finally, some regulatory barriers persist. If anything, the regulatory framework should then address these concerns: its

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[163] European Commission, *Public consultation on Sustainable Corporate Governance* (Oct. 26, 2020 – Feb. 8, 2021), https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/public-consultation_en.

[164] Alexander Bassen, Kerstin Lopatta & Wolf-Georg Ringe, *Feedback Statement on the Sustainable Corporate Governance Initiative* (October 2020), available at https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/F594615_en. A summary has featured on the Oxford Business Law Blog at https://www.law.ox.ac.uk/business-law-blog/blog/2020/10/ec-corporate-governance-initiative-series-eu-sustainable-corporate.

[165] EY, STUDY ON DIRECTORS' DUTIES AND SUSTAINABLE CORPORATE GOVERNANCE: FINAL REPORT (July 2020), available at https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en.

[166] Mark J. Roe, Holger Spamann, Jesse Fried & Charles Wang, *The European Commission's Sustainable Corporate Governance Report: A Critique*, 38 YALE J. ON REG. BULL. 133 (2021); The European Company Law Experts Group, *A Critique of the Study on Directors' Duties and Sustainable Corporate Governance Prepared by Ernst & Young for the European Commission*, OXFORD BUS. L. BLOG (Oct. 14, 2020), available at https://www.law.ox.ac.uk/business-law-blog/blog/2020/10/ec-corporate-governance-initiative-series-critique-study-directors; Marcello Bianchi & Mateja Milič, *European Companies are Short-Term Oriented: The Unconvincing Analysis and Conclusions of the Ernst & Young Study*, OXFORD BUS. L. BLOG (Oct. 13, 2020), available at https://www.law.ox.ac.uk/business-law-blog/blog/2020/10/ec-corporate-governance-initiative-series-european-companies-are.

[167] *See* Dirk A. Zetzsche & Linn Anker-Sørensen, *Regulating sustainable finance in the dark*, 23 EUR. BUS. ORG. L. REV. 47 (2022).

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role should be to take a supportive and facilitative role to *enable* ESG engagement. There are several tools that may be usefully employed to this end.

1. Facilitation and clarification

Rather than *mandating* sustainability goals, the present analysis has identified the role of regulation, if anything, to *facilitate* and allow ESG investments. A good example on what regulation can sensibly do is exemplified by currently proposed rules by the U.S. Department of Labor (DOL). They concern the ability of retirement plan fiduciaries to invest in ESG funds in the retirement plans that they sponsor under the U.S. ERISA framework.[168]

Prior to the current reform process, the Trump administration had caused some considerable regulatory uncertainty regarding fiduciaries' ability to use ESG funds in their retirement plans. In October 2021, the DOL released a proposal that would roll back some of the restraints on ESG investing rules.[169] If adopted, this means that retirement plan sponsors can more confidently incorporate ESG funds into their plans. Although the fiduciary responsibilities of ERISA plan sponsors have remained consistent in previous ESG guidance documents, the continual issuance of guidance under different administrations had led to uncertainty for plan sponsors, resulting in a certain reluctance to include ESG funds broadly in retirement plans.[170] This meant that ERISA-regulated fiduciaries were not able to follow common market practice.[171] Different from previous rules, however, the new DOL rules now propose to treat ESG funds no differently than any other investment fund. Although the core principles underlying ERISA—the duties of prudence and loyalty—remain of paramount importance, the proposed regulation recognizes that ESG factors in investment selection can be "financially material" and clarifies that the impact of an ESG factor may be an appropriate consideration when evaluating particular investment options.[172] The use of ESG considerations as a "tie-breaker" is also clarified, when choosing between investment alternatives that are otherwise equal with respect to return and risk over the appropriate time horizon.

[168] ERISA stands for the Employee Retirement Income Security Act of 1974 but here refers to entire regulatory framework that govern employee benefit plans.

[169] Department of Labor, Employee Benefits Security Administration, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 FED. REG. 57,272 (Oct. 14, 2021).

[170] Melissa Kahn, *The New DOL Proposal May Change the ESG Game*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Dec. 8, 2021), available at https://corpgov.law.harvard.edu/2021/12/08/the-new-dol-proposal-may-change-the-esg-game/.

[171] PRI, *Consultation Response – U.S. Department of Labor: Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights* (Dec. 13, 2021), https://www.unpri.org/download?ac=15663.

[172] Department of Labor, *supra* note 168.

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These changes, technical as they may seem, have the potential to "change the ESG game",[173] as they will (re-)open up the ESG market for the vast funds of ERISA retirement plans. Crucially, however, the proposed rules are not prescriptive in mandating ESG investment; they simply clarify the position that fiduciaries *may* invest into ESG products if they wish to do so. Once these rules are adopted, ESG factors may be considered material, depending on the individual facts and circumstances, and that not only fiduciaries may properly consider them, but that in some instances and evaluation of those factors may even be warranted.[174]

2. Disclosure and standardization

Any attempt at self-regulation faces the difficulty of information asymmetry and of a lack of market standardization. At the moment, a patchwork of standards exists around the globe, accompanied by poor data quality, which makes compliance challenging and undermines the efficacy of investor engagement, both for investors that invest directly and for those relying on ratings.[175] For companies operating in multiple jurisdictions, the widely varying rules and guidelines may impose extensive but differing disclosures, and make it harder for investors to compare and ascertain reliable and verifiable information.[176] At the same time, they invite regulatory arbitrage and "greenwashing."[177] What is worse is that diverging standards may ultimately result in a race to the bottom.[178] On a more practical level, the opacity of products, data, and standards makes it challenging for ultimate investors to put their funds to the most appropriate use, thus undermining the force of the investor-led model for sustainability.[179] It is

[173] Kahn, *supra* note 170.

[174] Thoms P. DiNapoli, State Comptroller of New York, *Consultation Response: Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights* (Dec. 9, 2021).

[175] Silvia Pavoni, *The search for the Meaning of Green*, FIN. TIMES (May 24, 2021), FTfm 5.

[176] Sara Bernow et al., *More than values: The value-based sustainability reporting that investors want*, McKinsey & Company (Aug. 7, 2019), available at https://www.mckinsey.com/businessfunctions/sustainability/our-insights/more-than-values-the-value-based-sustainability-reporting-thatinvestors-want.

[177] Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921 (2020). See further the references at *supra* note 86.

[178] Jean Raby, *Responsible investment should improve and outperform the market, not become the market*, FIN. NEWS (Jan. 5, 2021), https://www.fnlondon.com/articles/responsible-investment-should-improve-and-outperform-the-market-not-become-the-market-20210105.

[179] On the role of disclosure regulation for empowering the shift towards green finance, see Tobias Tröger & Sebastian Steuer, *The Role of Disclosure in Green Finance*, ECGI Law Working Paper No. 604/2021, available at https://ssrn.com/abstract=3908617.

Electronic copy available at: https://ssrn.com/abstract=3958960

therefore no surprise that institutional investors are increasingly calling for the adoption of more standardized and comparable reporting standards.[180]

Over the past several years, a number of ESG reporting frameworks have been adopted worldwide, such as the Sustainability Accounting Standards Board (SASB),[181] the Global Reporting Initiative (GRI),[182] the World Economic Forum's (WEF) Metrics on Sustainable Capitalism,[183] and a framework adopted by the Task Force on Climate-related Financial Disclosures (TCFD),[184] which was established by the G20 Financial Stability Board.[185] According to a recent survey, investors recommend the SASB (75 percent) and the TCFD (53 percent) as the best standards when it comes to communicating ESG information.[186]

At present, national and regional approaches differ significantly. In the U.S., the Big Three asset managers and others currently encourage companies to follow the SASB reporting standards and the TCFD regime. The Securities and Exchange Commission (SEC) is currently considering the adoption of new rules that would require specific ESG disclosures.[187] In June 2021, the House of Representatives adopted legislation that would require the SEC to issue new rules on ESG disclosure.[188] While this is unlikely to get a majority in the Senate, it still certainly bolsters the SEC's own efforts. In October 2021, SEC Chair Gary Gensler announced a public consultation on non-financial disclosure policies.[189] In parallel to these efforts, the Financial

[180] PwC, GLOBAL INVESTOR SURVEY: THE ECONOMIC REALITIES OF ESG 5 (December 2021).

[181] The SASB standards are available for sector-specific download at https://www.sasb.org/standards/download/.

[182] Global Reporting Initiative, Consolidated Set of GRI Sustainability Reporting Standards 2020 (2020), available at https://www.globalreporting.org/standards/download-the-standards/.

[183] World Economic Forum, Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation (Sept. 22, 2020), available at https://www.weforum.org/reports/measuring-stakeholder-capitalism-towards-common-metrics-and-consistent-reporting-of-sustainable-value-creation.

[184] TCFD, RECOMMENDATIONS OF THE TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES (June 2017), available at https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf.

[185] For an overview and comprehensive discussion, see Virginia Harper Ho, *Modernizing ESG Disclosure*, Working Paper 2021, available at https://ssrn.com/abstract=3845145.

[186] Morrow Sodali, INSTITUTIONAL INVESTOR SURVEY 2021 (2021), available at https://morrowsodali.com/insights/institutional-investor-survey-2021.

[187] In March 2021, the SEC released a request for public comment on climate change disclosures and announced the creation of a Climate and ESG Task Force in the Division of Enforcement (more information at https://www.sec.gov/news/public-statement/lee-climate-change-disclosures). See David A. Katz & Laura A. McIntosh, *SEC Regulation of ESG Disclosures*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (May 28, 2021), available at https://corpgov.law.harvard.edu/2021/05/28/sec-regulation-of-esg-disclosures/; Harper Ho, *supra* note 185.

[188] CORPORATE GOVERNANCE IMPROVEMENT AND INVESTOR PROTECTION ACT, H.R. 1187.

[189] Gary Gensler, *Testimony Before the United States House of Representatives Committee on Financial Services* (Oct. 5, 2021), https://www.sec.gov/news/testimony/gensler-2021-10-05.

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Accounting Standards Board (FASB) has issued guidance to staff on the incorporation of ESG matters, including climate change, into financial statements.[190] At the same time, private institutions are pursuing their separate agendas. For example, Nasdaq has introduced changes to its listing standards that will require its listed companies as of 2022 to enhance their disclosures regarding board diversity and require them to have, or to disclose why they do not have, a minimum of two "diverse" board members.[191]

The E.U. regime is more advanced, yet still at an emerging stage. Most recently, the Sustainable Finance Disclosure Regulation (SFDR) came into effect in March 2021 and is currently being implemented across the Union. It imposes sustainability-related disclosure requirements on financial services institutions including banks and investment firms. The European Commission has also published a proposal for a revised Corporate Sustainability Reporting Directive (CSRD)[192] as part of its Sustainable Finance Package.[193] This Directive, if adopted, would significantly upgrade and expand the existing Non-Financial Reporting Directive (NFRD)[194]. The CSRD plans, inter alia, to extend the scope of application to most large companies and all companies listed on regulated markets, except listed micro-enterprises. It introduces more detailed and more stringent reporting requirements, and a requirement to report according to mandatory E.U. sustainability reporting standards. It would also mandate companies to digitally "tag" the reported information in a machine-readable form, feeding into the planned European single access point for corporate information.

Finally, the E.U.'s Taxonomy Regulation is an important pillar of the E.U. regime in that it categorizes and classifies types of investment, and provides common definitions and

[190] FASB, FASB Staff Educational Paper: Intersection of Environmental, Social, and Governance Matters with Financial Accounting Standards (Mar. 19, 2021).

[191] Nasdaq, *Nasdaq to Advance Diversity through New Proposed Listing Requirements*, (Dec. 1, 2020), available at https://www.nasdaq.com/press-release/nasdaq-to-advance-diversity-through-new-proposed-listing-requirements-2020-12-01. The proposal was amended in February 2021 and approved by the SEC in August 2021. *See* Securities and Exchange Commission, Release No. 34-92590 (August 6, 2021), available at https://www.sec.gov/rules/sro/nasdaq/2021/34-92590.pdf.

[192] European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (Apr. 21, 2021), COM(2021) 189 final.

[193] See European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal (Apr. 21, 2021), COM(2021) 188.

[194] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups [2014] OJ L330/1.

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standards for what constitutes 'green' investment activities.[195] It thus has the clear objective of addressing the problem of greenwashing. Moreover, it obliges firms to disclose the ratio of their turnover that qualifies as environmentally sustainable.[196] The Taxonomy Regulation entered into force in July 2020 and was expected to create legal certainty for investors, to protect private investors from greenwashing, to help companies to plan their transition, to mitigate market fragmentation, and eventually to help shift investments toward where they are most needed.[197] The European Commission is currently adopting a number of delegated acts to put flesh on the Taxonomy Regulation's bones.

In the U.K., the Financial Conduct Authority has adopted a new listing rule requiring premium-listed issuers to disclose, as part of their annual reports beginning in 2021, on a comply-or-explain basis with regard to whether their climate-related disclosures are in line with TCFD recommendations.[198] Moreover, a government proposal that is currently pending would make climate-related financial disclosures mandatory for publicly listed companies, large private companies, and limited liability partnerships, also in line with TCFD standards.[199] Both instruments build on the Government's 2019 Green Finance Strategy[200] and will become fully operational by 2023.

This short overview demonstrates that the jungle of different regulatory instruments, standards, and obligations is hardly conducive to a transparent, global investment market seeking to promote investor-led sustainability. What is needed here is a truly global standard that makes investments and activities comparable. On the positive side, the ESG movement has already triggered the establishment of multiple initiatives and disclosure frameworks, albeit

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[195] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, [2020] OJ L198/13.

[196] Taxonomy Regulation, Article 8.

[197] European Commission, *What is the EU taxonomy*, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en.

[198] Financial Conduct Authority, Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations, Policy Statement PS20/17 (Dec. 2020), available at https://www.fca.org.uk/publication/policy/ps20-17.pdf.

[199] Department for Business, Energy & Industrial Strategy, Consultation on requiring mandatory climate-related financial disclosures by publicly quoted companies, large private companies and Limited Liability Partnerships (LLPs) (March 2021), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/972422/Consultation_on_BEIS_mandatory_climate-related_disclosure_requirements.pdf.

[200] HM Government, GREEN FINANCE STRATEGY: TRANSFORMING FINANCE FOR A GREENER FUTURE (July 2019), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf.

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these are lacking coordination and consistency.[201] A laudable initiative is the Corporate Reporting Dialogue (CRD), essentially a platform that is set up by the International Integrated Reporting Council to promote greater coherence, consistency, and comparability between international corporate reporting frameworks, standards, and related requirements.[202] Likewise, the International Accounting Standards Board (IASB) recently announced the development of an ambitious global standard for ESG reporting.[203] Key in this is the new International Sustainability Standards Board (ISSB), which is to establish a singular, global ESG disclosure framework for companies.[204] Whichever standards will play the leading role globally in the future would require the backing of a strong, independent, and, most importantly, credible institution.[205]

3. Removing barriers to collaboration

We have seen above that the "teaming-up" concept holds great promise for the future development of ESG activism, namely in that coalition-building gives engaged shareholders greater clout, and also limits possibilities for abuse.[206]

Yet there are a number of regulatory barriers in place that limit the possibility of investor collaboration. For example, U.S. proxy solicitation rules make it very costly to initiate an investor campaign.[207] During the Trump administration, the SEC further toughened those requirements. Specifically, in 2019, the SEC adopted guidance on proxy advisors and proxy

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[201] See also Patrick de Cambourg, Ensuring the relevance and reliability of non-financial corporate information: an ambition and a competitive advantage for a sustainable Europe (May 2019), available at https://www.responsible-investor.com/reports/multiple-authors-ensuring-the-relevance-and-reliability-of-non-financial-co.

[202] https://corporatereportingdialogue.com/.

[203] IFRS, *IFRS Foundation Trustees Announce Next Steps in Response to Broad Demand for Global Sustainability Standards* (Feb. 2, 2021), https://www.ifrs.org/news-and-events/2021/02/trustees-announce-nextsteps-in-response-to-broad-demand-for-global-sustainability-standards/; IFRS, *IFRS Foundation Trustees Announce Strategic Direction and Further Steps Based on Feedback to Sustainability Reporting Consultation* (Mar. 8, 2021), available at https://www.ifrs.org/news-and-events/news/2021/03/trustees-announce-strategic-directionbased-on-feedback-to-sustainability-reporting-consultation/.

[204] For more information, see https://www.ifrs.org/groups/international-sustainability-standards-board/. See also Martha Carter et al., *Towards a Global ESG Disclosure Framework*, Harvard Law School Forum on Corporate Governance (Jan. 9, 2022), https://corpgov.law.harvard.edu/2022/01/09/towards-a-global-esg-disclosure-framework/.

[205] Paul Brest & Colleen Honigsberg, *Measuring Corporate Virtue—And Vice: Making ESG Metrics Trustworthy*, in: FRONTIERS IN SOCIAL INNOVATION: THE ESSENTIAL HANDBOOK FOR CREATING, DEPLOYING, AND SUSTAINING CREATIVE SOLUTIONS TO SYSTEMIC PROBLEMS 79 (Neil Malhotra, ed., 2022).

[206] See above XXX.

[207] SEC Regulation 14A, Rules 14a 1 to 14a 7.

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solicitation that made it more difficult and costly for investment advisers to exercise shareholder voting rights on behalf of their clients relying on independent proxy voting advice.[208] One year later, the SEC adopted new rules and additional guidance related to proxy advisors that imposed further cost and complexity into the voting process, and mandated greater issuer involvement in proxy voting decisions.[209] And most recently, regulatory reform of Rule 14a-8 has raised the thresholds and made it even more difficult for shareholders to adopt shareholder proposals for corporate general meetings.[210] This trend in policy making has been severely criticized, even from within the SEC, for obstructing shareholder engagement and in particular ESG initiatives.[211]

European and other jurisdictions' rules on "acting in concert" limit the possibility of coalition-building: under E.U. disclosure rules, blocks of shares held by concerted parties would have to be counted together, which would require earlier disclosure.[212] In the U.S., investors informally acting together on an issue without disclosure may be regarded as being in violation of Regulation "Fair Disclosure."[213] Further, investors acting in concert might have to make a mandatory bid under the E.U. Takeover Directive if they together are in "control" of the company.[214] These rules have long been seen as a large barrier to more effective shareholder engagement as they trigger large financial consequences.[215] Finally, there is a certain tension

[208] See Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Rel. No. IA-5325 (Aug. 21, 2019); Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Rel. No. 34-86721 (Aug. 21, 2019).

[209] Exemptions from the Proxy Rules for Proxy Voting Advice, Rel. No. 34-89372 (July 22, 2020); Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release No. IA-5547 (July 22, 2020).

[210] Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8, Rel. No. 34-89964 (Sept. 23, 2020).

[211] Allison Herren Lee, *Statement by Commissioner Lee on the Amendments to Rule 14a-8*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Sept. 24, 2020), available at https://corpgov.law.harvard.edu/2020/09/24/statement-by-commissioner-lee-on-the-amendments-to-rule-14a-8/.

[212] Transparency Directive 2004/109/EC, Articles 9, 10(a).

[213] Reg FD, 17 CFR Part 243.

[214] Takeover Directive 2004/25/EC, Article 5(1).

[215] See, e.g. the survey data reported by Joseph A. McCahery, Zacharias Sautner & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2923 (2016). See also ESMA, *Report: Undue short-term pressure on corporations*, ESMA 30-22-762 (December 2019) at 64; PRI, *Addressing System Barriers* (2022): "Acting in concert is often perceived as a key regulatory barrier when institutional investors seek to engage collaboratively with companies."

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and vast legal uncertainty concerning shareholder activism under existing insider dealing laws, which needs to be resolved.[216]

Regulators are beginning to realize that investor engagement should be facilitated, and not restricted, particularly when pushing for sustainability. For example, former SEC Commissioner Allison Lee heavily criticized the 2020 regulatory changes and argued that the Commission should seek to facilitate greater ESG engagement rather than stifling it.[217] Also, the European Securities and Markets Authority (ESMA) maintains a White List of activities that would not count as "acting in concert."[218] It recently proposed a review of this list and explored whether it should include an explicit reference to coordination activities among institutional investors in the area of ESG, to stimulate engagement in this field.[219] Such initiatives are to be welcomed.

4. Facilitating investor platforms

We saw above that investor platforms, where they exist, greatly facilitate investor engagement.[220] Studies have revealed that such platforms—also referred to as investor collective action organizations (ICAOs)—allow for easier interaction between investors, identifying lead investors, spreading information, and helping to share the costs of engagement.

One example is the PRI Collaboration Platform established by investors in partnership with the UNEP's Finance Initiative and the UN's Global Compact.[221] The PRI platform is the leading network and the largest initiative worldwide for investors with a commitment to responsible ownership and long-term, sustainable returns. It provides a significant database with records on ESG engagements worldwide. The platform allows lead investors to launch and

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[216] See Ana Taleska, *European Insider Trading Theory Revisited: The Limits of the Parity-of-Information Theory and the Application of the Property Rights in Information Theory to Activist Investment Strategies*, 17 EUR. COMPANY & FIN. L. REV. 558, 580 ff. (2020).

[217] Lee, *supra* note 211.

[218] ESMA, Public statement Information on shareholder cooperation and acting in concert under the Takeover Bids Directive (Feb. 8, 2019), ESMA31-65-682.

[219] ESMA, *Report: Undue short-term pressure on corporations*, ESMA 30-22-762 (Dec. 2019), at pp. 69, 70.

[220] See above XX.

[221] The PRI platform is available at https://collaborate.unpri.org/.

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market campaigns, with supporting investors either invited by the PRI or the leader to join an engagement, or allowed to join via the PRI's Collaboration Platform online.[222]

We have seen that several other specialized ESG-related platforms exist and play a vital role in facilitating investor engagements.[223] Successful examples here are the initiative Climate Action 100+ and the NGO entitled Ceres, among others.[224]

Outside of the ESG realm, investor platforms exist in various shapes and forms. An example is the Dutch corporate governance platform Eumedion, which represents the interests of institutional investors worldwide to have invested in Dutch listed companies. The platform seeks to promote good corporate governance and sustainability policies at Dutch listed companies and to promote engaged and responsible share ownership by its members. Eumedion, inter alia, supports its members by facilitating dialogue among them, and between the members and Dutch listed companies.[225] A similar institution is the Canadian Coalition for Good Governance (CCGG), which bundles together institutional shareholders that invest in Canadian public equities.[226] The CCGG aims to promote good governance practices at Canadian public companies and coordinates engagement activities. It also claims to focus on topics related to the governance of environmental and social risks.[227]

These and other networks and platforms are crucial in facilitating investor engagement, as well as overcoming free-rider incentives and collective action problems. Dimson and colleagues argued that they are paramount in helping investors to exploit the advantages and overcome the challenges of jointly pursuing shared objectives.[228] Related research has documented that institutional investors use such platforms to improve governance outcomes through collective action.[229] To be sure, such platforms may also be set up by business associations themselves and these evolve by way of self-regulatory initiatives. However, the UN's PRI platform, considered as the most effective platform promoting ESG objectives, draws

[222] Dimson et al., *supra* note 139, at 14 ff.

[223] See above section IV.

[224] See above section IV.

[225] Eumedion Corporate Governance Forum, *About Eumedion*, https://en.eumedion.nl/About-Eumedion.html.

[226] On CCGG, see the important study by Craig Doidge, Alexander Dyck, Hamed Mahmudi & Aazam Virani, *Collective Action and Governance Activism*, 23 REV. FIN. 893 (2019).

[227] Canadian Coalition for Good Governance, 2020 Annual Report: Engagement through a Governance Lens – Connecting boards and investors through principles of good governance (2021), available at https://ccgg.ca/wp-content/uploads/dlm_uploads/2021/06/CCGG-2020-Annual-Report_Final.pdf.

[228] Dimson et al., *supra* note 139, at 2.

[229] *See* Doidge et al., *supra* note 226.

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a considerable part of its strength from the financial and reputational support stemming from the United Nations. Regulators may therefore be inclined to consider establishing or sponsoring further platform solutions in the field. The German Sustainable Finance Expert Group, in its final report, recommended the establishment of such a platform to facilitate collective engagement.[230]

VI. Conclusion

This paper shifts the focus of ESG away from regulatory intervention to instead favor a market-led approach in ESG investments. I have argued that investors' initiatives and engagement are and should be the primary tool to promote sustainability orientation in the market. This trust in the market is grounded in recent developments on the supply side and the demand side of the financial market, and the move towards common ownership. The need to build coalitions and to convince fellow investors of an initiative can then act as an in-built safety check, which would help to control for idiosyncratic motives and would further support only those campaigns that are supported by a majority of investors. In particular, institutionalized investor platforms have emerged over recent years that serve to coordinate investor campaigns and to share costs. This paper concludes with the policy implication that lawmakers should take a supportive and facilitative approach that supports investor engagement and private ordering. By doing so, static and interventionist legal policies would become unnecessary.

[230] Sustainable Finance Beirat der Bundesregierung, *Shifting the Trillions: Ein nachhaltiges Finanzsystem für die Große Transformation* 36 (2021), available at https://sustainable-finance-beirat.de/wp-content/uploads/2021/02/210224_SFB_-Abschlussbericht-2021.pdf.

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