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CHAPTER 5

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5.1 Introduction

Sustainability synthesizes the policy goal to reduce the environmental and social imbalances of the world we live in, such as resource depletion, environment degradation, and inequality, amongst others. Traditionally, in economics, such imbalances have been characterized as negative externalities, namely the adverse impact of economic activities on the welfare of individuals and groups uninvolved in these activities. Regulation has policed these externalities by way of taxes or subsidies, regulations, and market-based instruments such as tradable pollution permits. The performance of these legal tools has been questioned on the grounds

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of their limited effectiveness. As a result, policymakers have switched gears and increasingly rely on financial markets to support the control of externalities. This strategy is called sustainable finance.[1]

One way to look at sustainable finance is through the lens of corporate governance. The intuition underlying sustainable finance is that individuals who care for sustainability prefer to invest in sustainable corporations, which results in a lower cost of capital for sustainable investment. In public corporations, the decision to make sustainable investments depends on corporate governance. Most individuals indirectly own shares in the largest corporations of the world as their personal or pension savings. However, they do not decide in which corporations to invest and how to vote on their shares. These are decisions that institutional investors, such as mutual funds and pension funds, make as agents holding shares on their beneficiaries' behalf.

Institutional investors own 41% of public equity worldwide.[2] Their holdings are concentrated.[3] Institutional investors often claim to care about the sustainability of portfolio companies.[4] Whether they actually do is debated. Empirical finance is trying to shed light on this complex issue. Corporate governance, however, also depends on corporate and securities law. For instance, institutional investors have legal duties towards their beneficiaries and legal rights towards portfolio companies. These rights and duties determine the corporate governance behaviour of institutional investors, and therefore also whether sustainable finance can work.

In this essay, I investigate the role that securities law potentially plays in supporting sustainable corporate governance. I ask the following question: Can securities law support ultimate investors' choice as to sustainability by affecting their relationship with institutional investors? This essay will look at EU legislation, which has taken the lead in promoting

[1] European Commission (2018). *Action Plan: Financing Sustainable Growth*. COM(2018) 97 final.

[2] At the end of 2017, there were approximately 41.000 listed companies in the world, worth some $84 trillion in market value, roughly equivalent to the world's GDP. De La Cruz, A., Medina, A., & Tang, Y. (2019). *Owners of the World's Listed Companies*. Paris: OECD Capital Market Series.

[3] Gilson, R.J., & Gordon, J.N. (2013). "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights". *Columbia Law Review*, 113(4), 863–927.

[4] Fink, L. (2020). "Letter to CEOs", Blackrock: https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

sustainable finance.[5] In particular, this essay will discuss disclosure regulations, the transparency of institutional investors' voting and touch upon the debate on fiduciary duties and corporate purpose. Although these are widely debated topics, they haven't been consistently analysed in the perspective of ultimate investors' choice as it concerns sustainability.

In what follows, I will refer to ultimate investors as institutional investors' *beneficiaries*. Moreover, I will confine sustainability to the environmental dimension and specifically, climate change mitigation.[6] The rest of this chapter is as follows. The next section frames sustainable corporate governance as an externalities problem dealt with—in a somewhat Coasian flavour—as investor choice rather than government intervention. Because beneficiaries hold stock indirectly, sustainable corporate governance is complicated by the agency problems of institutional investors and their business models, both of which are analysed in Sect. 5.3. Section 5.4 discusses how securities regulation can foster the incorporation of beneficiaries' preferences into the corporate governance behaviour of institutional investors. Section 5.5 concludes.

5.2 Framing Sustainable Corporate Governance

In economics, negative externalities have been regarded as a matter for corrective taxation, named Pigouvian taxation after Pigou.[7] Taxes, e.g. on CO_2, are supposed to bridge the gap between the private and the social cost of using the environment. Alternatives include command-and-control regulation (e.g. setting maximum pollution standards) or "economic instruments" other than taxes, such as subsidies to "green" investment and tradable emission permits.[8] These strategies reflect a *top-down* public intervention in markets producing negative externalities.[9]

[5] See European Commission (2018). *Action Plan: Financing Sustainable Growth*. COM(2018) 97 final; and European Commission (2019). *The European Green Deal*. COM(2019) 640 final.

[6] See Art. 2 and 10 Taxonomy Regulation (EU) 2020/852.

[7] Pigou, A. (1920). *The Economics of Welfare*. London: Macmillan.

[8] Ogus, A.I. (1994). *Regulation: Legal Form and Economic Theory*. Oxford University Press.

[9] Faure, M.G. (2012), "Environmental Regulation". In R.J. Van den Bergh & A.M. Pacces (eds.), *Regulation and Economics*, Encyclopedia of Law and Economics, Cheltenham: Edward Elgar, 2nd ed., 229–301.

Particularly in the context of climate change, this approach has proven insufficient. The commitment by the signatories of the Paris Agreement 2015 to keep global warming well below 2 degrees Celsius compared to pre-industrial level, along with the best-effort promise to further limit it to 1.5 degrees, seems to require additional *bottom-up* efforts from the private sector.[10]

The ability of governments to police environmental externalities is limited for several reasons.[11] First, large corporations can lobby to influence regulation and taxation considerably. A well-known limitation of emission standards and Pigouvian taxation is that the first is too lax and the second too low to effectively constrain environmental degradation.[12] Second, environmental externalities have an international dimension.[13] Whilst coordinating regulations is hard for states, regulatory arbitrage is easy for multinational corporations especially today because competitive advantage is largely based on intangibles, whereas production facilities (and the externalities thereof) can be relocated to more favourable jurisdictions. Third, some governments may be less concerned with correcting externalities because the more environment-friendly citizens are underrepresented.[14]

In the spirit of Coase,[15] externalities can be tackled in a more decentralized fashion so long as transaction costs are comparatively lower than in the public policy setting. Publicly underrepresented consumers and investors may oppose externalities-generating companies privately, for instance, through boycotts and selloffs, or activism. Differently from regulation, such decentralized behaviours work across borders and are not susceptible to lobbying. Boycotts and selloffs are borne out by the

[10] UNEP, Emissions Gap Report (EGR) 2022: The Closing Window—Climate Crisis Calls for Rapid Transformation of Societies (2022), https://www.unep.org/resources/emissions-gap-report-2022.

[11] Tirole, J. (2017). *Economics for the Common Good*. Princeton University Press.

[12] Gunningham, N., Grabosky, P., & Sinclair, D. (1998). *Smart Regulation: Designing Environmental Policy*. Oxford University Press.

[13] Armour, J., Enriques, L., & Wetzer, T. (2021). "Mandatory Corporate Climate Disclosures: Now, but How?" *Columbia Business Law Review*, 2021(3), 1085–1146.

[14] Bénabou, R., & Tirole, J. (2010). "Individual and Corporate Social Responsibility". *Economica*, 77(305), 1–19.

[15] Coase, R.H. (1960). "The Problem of Social Cost". *Journal of Law and Economics*, 3, 1–44.

empirical evidence, although they seem to have only a limited impact on corporate choice.[16] The challenge of this approach is coordination. Corporate governance may help to overcome this challenge to the extent that a company's decision-making reflects the preferences of investors. If the latter prefer climate change mitigation, corporations will emit less greenhouse gas (GHGs) not because they are compelled to do so by regulation, or induced to do so by taxes or divestment, but because so shareholders decide. This is the role of corporate governance in the broader context of sustainable finance.[17]

Whether sustainable corporate governance can indeed reduce GHGs and mitigate climate change is unclear. The answer depends on the sustainability preferences of shareholders and whether they are reflected by corporate choice. Shareholders typically invest based on the expected rate of return, along with other considerations such as risk and time preferences. If carbon-intensive investments are more profitable than "green" investments, it seems hard for profit-driven financial markets to support sustainability. This reflects the traditional view, in economics, that corporations should maximize profits leaving policing externalities to other institutions. However, shareholders may also base their investment choice on other, prosocial considerations. Following this intuition, Hart and Zingales have recently overturned the traditional economic approach on the grounds that, if externalities such as GHGs cannot be separated from the production process, it is more efficient for prosocial shareholders to make corporations reduce GHGs directly than rely on governments and other charitable institutions to police the externality.[18] The question remains how much profit shareholders are prepared to give up to pursue sustainability.

Bénabou and Tirole distinguish three theories of investor preferences towards Corporate Social Responsibility (CSR).[19] For the purpose of this chapter, I take a somewhat narrow view of CSR as a trade-off between

[16] Gantchev, N., Giannetti, M., & Li, R. (2022). "Does Money Talk? Divestitures and Corporate Environmental and Social Policies". *Review of Finance*, 26(6), 1469–1508.

[17] European Commission (2018). *Action Plan: Financing Sustainable Growth*. COM(2018) 97 final.

[18] Hart, O., & Zingales, L. (2017). "Companies Should Maximize Shareholder Welfare Not Market Value". *Journal of Law, Finance, and Accounting*, 2(2), 247–275.

[19] Bénabou, R., & Tirole, J. (2010). "Individual and Corporate Social Responsibility". *Economica*, 77(305), 1–19.

profit, or financial return, and the prosocial goal to reduce GHGs. The three theories are: (a) "doing-well-by-doing-good"; (b) "delegated philanthropy"; and (c) "corporate philanthropy". I discuss them in turn.

"Doing-well-by-doing-good" is a short-termism theory. According to this theory, long-term investors temporarily accept lower returns on "green" investments to avoid future losses from climate change risk. This risk can be divided into three components. First, there is physical risk of natural disasters affecting supply, demand, or both. Second, there is the technological risk that products and processes will become obsolete undermining the value of the assets involved (stranded assets). Third, there is regulatory risk: regulation can prohibit carbon-intensive productions or make them uneconomical. Short-sighted financial markets fail to incorporate climate change risk into pricing as it is unclear how this risk will materialize and when.[20] Doing-well-by-doing-good investors both avoid an intertemporal loss and reduce externalities.[21] Investors' concern for climate change risk is borne out by survey evidence.[22] Observational data also support the view that, in the long run, CSR correlates with higher firm performance,[23] although the causal effect may be confounded by the overall quality of corporate governance.[24]

A second CSR theory is "delegated philanthropy". According to this theory, investors accept lower long-term returns on "green" investments, to match the preferences of non-shareholder constituencies such as consumers and employees. In the context of climate change, these stakeholders include future generations. Transfers to future generations are complicated by the choice of the appropriate rate of discount. According to Weisbach & Sunstein, cost and benefits of future generations should be discounted, but at a very low rate because the distant future is uncertain

[20] Condon, M. (2022). "Market myopia's climate bubble". *Utah Law Review*, 2022(1), 63–126.

[21] Bénabou, R., & Tirole, J. (2010). "Individual and Corporate Social Responsibility". *Economica*, 77(305), 9.

[22] Ilhan, E. Krueger, P., Sautner, Z. & Starks, L.T. (2020). "Climate Risk Disclosure and Institutional Investors". European Corporate Governance Institute (ECGI)—Finance Working Paper No. 661/2020, http://dx.doi.org/10.2139/ssrn.3353239.

[23] Verheyden, T., Eccles, R.G., & Feiner, A. (2016). "ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification". *Journal of Applied Corporate Finance*, 28(2), 47–55.

[24] Ferrell, A., Liang, H., & Renneboog, L. (2016). "Socially Responsible Firms." *Journal of Financial Economics*, 122(3), 585–606.

and uncertainty magnifies the impact of lower rates.[25] Environment-friendly projects with a positive intertemporal balance increase welfare by a larger amount than they decrease shareholder wealth, because prosocial stakeholders bear part of the cost of reducing negative externalities. In a similar vein, Hart and Zingales have argued that shareholders should be allowed to maximize welfare instead of wealth.[26] But why would shareholders delegate philanthropy to the corporation rather than donating themselves? The reason is transaction cost.[27] If undoing externalities is costlier than preventing them, corporations face lower transaction cost than individuals in transferring resources to current and future stakeholders. From this standpoint, corporations are a substitute for governments and other collective institutions: shareholders who want to police climate change may do so by corporate voting instead of political voting.

The third theory is "corporate philanthropy". According to this theory, corporations should pursue an ethical purpose even though shareholders do not want it. This theory is akin to the stakeholder theory of corporate governance, according to which the corporation *must* balance the interest of all its stakeholders.[28] This approach has been popular amongst European legal scholars,[29] particularly in jurisdictions featuring multiple stakeholders in the corporate purpose. Albeit with exceptions,[30] economists have been more sceptical. Milton Friedman famously argued

[25] Weisbach, D., & Sunstein, C.R. (2009). "Climate Change and Discounting the Future: Guide for the Perplexed". *Yale Law & Policy Review*, 27(2), 433–458.

[26] Hart, O., & Zingales, L. (2017). "Companies Should Maximize Shareholder Welfare Not Market Value". *Journal of Law, Finance, and Accounting*, 2(2), 247–275.

[27] Bénabou, R., & Tirole, J. (2010). "Individual and Corporate Social Responsibility". *Economica*, 77(305), 10.

[28] Blair, M., & Stout, L. (1999). "A Team Production Theory of Corporate Law". *Virginia Law Review*, 85(2), 247–328.

[29] E.g. Sjåfjell, B. (2017). "Achieving Corporate Sustainability: What Is the Role of the Shareholder?". In H. Birkmose (ed.), *Shareholders' Duties in Europe*. Alphen aan den Rijn: Kluwer Law International; Winter, J. (2018). "A Behavioral Perspective on Corporate Law and Corporate governance". In J.N. Gordon and W.-G. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford University Press, 159–183.

[30] Mayer, C. (2018). Prosperity: Better Business Makes the Greater Good. Oxford University Press.

against corporations doing philanthropy with other people's money.[31] As there is no objective criterion to balance different stakeholder interests, corporate philanthropy must give management full discretion over the firm resources. This approach discourages investment as it disenfranchises shareholders, increasing agency cost.[32] The debate on the corporate purpose has recently gained popularity in the U.S. too, with several scholars[33] finding that a commitment to pursuing multiple stakeholder interests would not be enforceable in the U.S. Moreover, as long as shareholders retain the unfettered right to vote, they will always be in the position to overturn such a commitment.[34]

In practice, CSR often reflects a mixture of the three theories, which makes them hard to test empirically. Consider a company switching to carbon-free equipment. This may reflect climate change risk management (theory 1). It may also reflect a genuine shareholder concern for the environment and future generations (theory 2). Finally, it may reflect a management preference for the environment or, more cynically, for the equipment's producer (theory 3). The first two theories are compatible with a notion of corporate governance geared towards shareholder preferences. The third is not. Having framed sustainable corporate governance as shareholder choice, I focus on the first two theories and discuss below how they reflect on shareholder behaviour in theory.

Doing-well-by-doing-good investors care about reducing GHGs because this will eventually improve financial return. Such investors

[31] Friedman, M. (1970). "The Social Responsibility of Business Is to Increase Its Profits". *New York Times Magazine*, September 13.

[32] Jensen, M.C. (2002). "Value Maximization, Stakeholder Theory, and the Corporate Objective Function". *Business Ethics Quarterly*, 235–256.

[33] Fisch, J.E. (2020). "The Uncertain Stewardship Potential of Index Funds". European Corporate governance Institute (ECGI)—Law Working Paper No. 490/2020, http://dx.doi.org/10.2139/ssrn.3525355; Gilson, R. (2019). "Legal and Political Challenges to Corporate Purpose". *Journal of Applied Corporate Finance*, 31(3), 18–21.

[34] Rock, E.B. (2020). "For Whom Is the Corporation Managed in 2020?: The Debate over Corporate Purpose". European Corporate Governance Institute—Law Working Paper No. 515/2020, http://dx.doi.org/10.2139/ssrn.3589951. Recent literature has identified ways in which shareholders could tie their hands. See e.g. Armour, J., Enriques, L., & Wetzer, T. (2023). "Green Pills: Making Corporate Climate Commitments Credible." *Arizona Law Review*, 65(2), 285–336; Pacces, A.M. (2023). Controlling Shareholders and Sustainable Corporate Governance: The Role of Dual-Class Shares. European Corporate Governance Institute—Law Working Paper No. 700/2023, http://dx.doi.org/10.2139/ssrn.4412205.

believe that the market is under-pricing climate risk in the short term, thus they seek to avoid high-GHG companies and rather invest in companies with low GHG emissions, whether direct (Scope 1) or indirect (Scope 2 and Scope 3).[35] These portfolio choices imply a mix of negative and positive screening of the stock market.

Investors may also choose to engage with portfolio companies to reduce GHGs, namely choose voice instead of exit. Investor engagement more typically reflects delegated philanthropy because engagement requires a stronger commitment towards portfolio companies than exit and may imply forgoing profit.[36] As explained by Hirschman,[37] the exercise of voice within an organization presupposes a commitment not to exit, even though exit would be profitable. Investors who aim to reduce externalities are committed to influencing decision-making in corporations that would otherwise degrade the environment and be more profitable. Investors that only aim to manage climate change risk can pursue both sustainability and profit by way of exit, at least until the moment in which negative screening undermines risk diversification.[38]

This framework must be integrated with institutional ownership. Today, institutional investors own the bulk of public equity worldwide. They hold and vote their shares according to a business model, which does not necessarily align with the preferences of their beneficiaries. For example, index funds cannot choose which companies to invest in even though their beneficiaries may have strong views on that. Moreover, index fund managers pursue low-cost strategies and do not have the resources to engage with individual companies, regardless of what beneficiaries expect.

[35] See the Greenhouse gas Protocol, https://ghgprotocol.org/guidance.

[36] Pacces, A.M. (2021). "Will the EU Taxonomy Regulation Foster Sustainable Corporate Governance?" *Sustainability*, 13(21), 12,316.

[37] Hirschman, A.O. (1970). *Exit, Voice and Loyalty*. Cambridge, MA: Harvard University Press.

[38] See Ceccarelli, M., Ramelli, S., & Wagner, A.F. (2023). "Low-Carbon Mutual Funds". European Corporate Governance Institute (ECGI)—Finance Working Paper No. 659/2020, http://dx.doi.org/10.2139/ssrn.3353239, forthcoming in *Review of Finance* (finding that climate-responsible funds experience higher idiosyncratic risk) and Hoepner, A.G., Oikonomou, I., Sautner, Z., Starks, L.T., & Zhou, X. (2020). "ESG Shareholder Engagement and Downside Risk". European Corporate governance Institute (ECGI)—Finance Working Paper No. 671/2020, http://dx.doi.org/10.2139/ssrn.2874252 (finding that shareholder engagement with portfolio companies reduces downside risk).

And yet, there is growing evidence that beneficiaries want institutional investors to invest in sustainable corporations. Two recent studies reveal that the introduction of sustainability labels—such as the Morningstar "5 Globes" Rating and the Low Carbon Designation—significantly affected the inflows into U.S. mutual funds.[39] Both studies find that investor demand for more sustainable funds is motivated by non-pecuniary goals, as beneficiaries give up substantial returns to pursue sustainability.

This evidence on U.S. mutual fund beneficiaries is consistent with delegated philanthropy. However, the presence of institutional investors complicates sustainable corporate governance in at least two ways. First, are the incentives of institutional investors aligned with the preferences of their beneficiaries? Second, can institutional investors better influence corporate choice by way of exit, voice, or both? Answering these questions is crucial to determine whether externalities such as climate change can be controlled by corporate governance rather than government regulation.

5.3 The Challenges of Sustainable Corporate Governance

Whether individual investors in general want delegated philanthropy is hard to say. Even if that was the case, sustainable finance could only succeed in reducing GHGs if investor preferences translated into corporate decisions. This depends on the ability of investors, qua shareholders, to influence decision-making in public corporations. In the developed financial markets, individuals mostly invest in public companies indirectly, as beneficiaries of institutional investors such as mutual funds and pension funds.[40] Such institutional investors are supposed to act on behalf of their beneficiaries when they decide in which companies to invest and how to vote their shares therein. This circumstance provides both an opportunity and a challenge for sustainable finance.

[39] See, respectively, Hartzmark, S.M., & Sussman, A.B. (2019). "Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows". *Journal of Finance*, 74(6), 2789–2837; and Ceccarelli et al., *supra* Footnote 38.

[40] De La Cruz, A., Medina, A., & Tang, Y. (2019). *Owners of the World's Listed Companies*. Paris: OECD Capital Market Series. Notable exceptions include controlling shareholders and state ownership, both of which are prominent worldwide. Particularly controlling shareholders are sufficiently powerful to foster prosocial goals if they so wish. See Pacces, *supra* Footnote 34.

Institutional ownership is an opportunity because it is *big* and *global*. The largest listed companies of the world are responsible for more than half of the CO_2 emissions.[41] In 2017, institutional investors owned collectively 41% of the global stock market capitalization.[42] These two factors imply that institutional investors can have an impact on sustainability. Moreover, differently from governments, institutional investors can influence corporations across borders because their holdings are diversified internationally. Finally, institutional investors are more powerful than individual investors because their holdings of listed companies are concentrated.

Shareholders of public companies used to be too small and dispersed to matter.[43] More recently, the rise of defined-contribution retirement plans and the awareness of the benefits of portfolio diversification have made institutional investors prominent vehicles for private savings. As a result, ownership of publicly held companies has become concentrated.[44] In the U.S. and the UK, the 20 largest investors own a majority of the capital of a typical company. In most of continental Europe, where controlling shareholders are still relatively frequent, they control 15% or more of the votes, on average.[45] Such investors can exercise considerable influence on their portfolio companies. This observation does not only apply to the largest, U.S.-based, institutional investors, such as Blackrock, Vanguard, and State Street (known as the "Big Three"). EU-based institutional investors, which are the second-largest institutional owners in the world, are also potentially influential in all countries in which institutional ownership is large. Institutional investors are influential because they can

[41] Azar, J., Duro, M., Kadach, I., & Ormazabal, G. (2021), "The big three and corporate carbon emissions around the world." *Journal of Financial Economics*, 142(2) (2021): 674–696, 686. See also Bolton, P. & Kacperczyk, M.T. (2023), "Global Pricing of Carbon-Transition Risk", Forthcoming in *Journal of Finance*, Available at SSRN: http://dx.doi.org/10.2139/ssrn.3550233.

[42] De La Cruz et al., *supra* Footnote 40.

[43] Berle, A. & Means, G. (1932). *The Modern Corporation and Private Property*. New York: Macmillan.

[44] Gilson, R.J., & Gordon, J.N. (2013). "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights". *Columbia Law Review*, 113(4), 863–927.

[45] The 20 largest institutional investors own 25% or more, on average, in Canada, the Netherlands, Poland, South Africa, Finland, Japan, Sweden, and Norway. See De La Cruz et al., *supra* Footnote 40.

credibly threaten a company that doesn't meet their requirements in terms of (environmental) sustainability either to divest from it or—as a coalition with other investors—to defeat the management in a voting contest.[46]

The institutional investors' role in corporate governance presents us with a challenge. Do such powerful investors foster the sustainability preferences of their beneficiaries, and if yes, how? The problem is threefold. First, there is an agency cost problem between institutional investors and their beneficiaries because the incentives of the former are not necessarily aligned with the interest of the latter. Secondly, there is another agency cost problem between institutional investors and the managers of portfolio companies.[47] Institutional investors have different business models which lead them to be more or less active monitors in corporate governance and, when they are active, choose exit, voice, or a mix thereof. Thirdly, beneficiaries may have different preferences for sustainability and disagree on how to foster it, which complicates the above-mentioned agency problems. I discuss these issues in turn.

Agency cost is the cost for principals (individual investors) to delegate a task (sustainable corporate governance) to an agent (institutional investors).[48] Because, inter alia, agency cost makes monitoring expensive for beneficiaries, institutional investors may pretend to pursue sustainability, whilst in reality they pursue private interests. There are legal and market mechanisms to cope with this problem. An example of legal mechanism is the investment advisers' obligation to verify that investment advice is in line with the investor preferences. In the EU, this is known

[46] Aguilera, R.V., Bermejo, V.J., Capapé, A.J., & Cuñat, V. (2019). "Firms' Reaction to Changes in the Governance Preferences of Active Institutional Owners". European Corporate Governance Institute—Finance Working Paper No. 625/2019, http://dx.doi.org/10.2139/ssrn.3411566; Brav, A., Jiang, W., Li, T., & Pinnington, J. (2019). "Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests". European Corporate Governance Institute (ECGI)—Finance Working Paper No. 601/2019, http://dx.doi.org/10.2139/ssrn.3101473.

[47] Hart, O., & Zingales, L. (2022). "The New Corporate Governance." *The University of Chicago Business Law Review*, 1(1), 195–216, 205.

[48] Jensen, M.C., & Meckling, W.M. (1976). "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure". *Journal of Financial Economics*, 3(4), 305–360.

as suitability rule.[49] An example of market mechanism is gatekeepers,[50] such as rating agencies, which should help beneficiaries to screen institutional investors based on ESG performance and to choose where to invest depending on their preferences, discussed above, on how much return to give up to pursue sustainability. Both mechanisms are, in general, imperfect ways to cope with the agency cost of retail investment.[51]

The agency cost of institutional investing depends on conflicts of interest. Beneficiaries have a mix of financial and non-financial preferences. To simplify, let us assume that the former is a certain risk/return combination and the latter, as explained earlier, is a prosocial environmental goal that may imply lower short-term financial returns. Institutional investors have incentive to maximize fee income net of management cost. For most investors—notably excluding hedge funds—fee income is based on Assets Under Management (AUM). AUM depends on the value of the investment, but even more so on the inflow of beneficiaries. To attract as many beneficiaries as possible, institutional investors try to offer attractive performance, in different risk classes, combined with a prosocial goal widely supported by beneficiaries. Environmentally sustainable investments are a good example of such a prosocial goal. However, institutional investors may not be entirely honest about pursuing environmental sustainability and, even if they are, the sustainability labels they use to attract beneficiaries may not correspond with what beneficiaries want. This problem is not very different from the pursuit of financial return: there too institutional investor's incentives are imperfectly aligned with the interest of beneficiaries. However, over time, the fiduciaries duties of institutional investors as financial advisers have evolved into a full set of disclosure obligations and conduct of business rules. Both items are well under-developed as far as non-financial goals, such as sustainability, are concerned.

Meanwhile, private markets have provided a full host of sustainability ratings to support the quest of beneficiaries for environment-friendly

[49] Armour, J., Awrey, D., Davies, P.L., Enriques, L., Gordon, J.N., Mayer, C.P., & Payne, J. (2016). *Principles of Financial Regulation*. Oxford University Press. See *infra*, text accompanying notes 99–101, on the recent inclusion of sustainability preferences into the MiFID suitability rule.

[50] Kraakman, R.H. (1986). "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy". *Journal of Law, Economics, & Organization*, 2(1), 53–104.

[51] See Armour et al., *Principles, supra* Footnote 49.

investment. Recent research revealed that these ratings are important for mutual fund beneficiaries. The introduction of Morningstar 1–5 Globes indicator of sustainable investment—a coarse but salient indicator of sustainability—significantly affected inflows and outflows of mutual funds.[52] Moreover, the subsequent introduction of a less discrete rating—Morningstar Low Carbon Designation—has further affected beneficiaries' decision on where to invest, as well as the competition between mutual funds to attract these sustainability-minded beneficiaries.[35] Whilst it is clear that sustainability matters to individual investors, finance studies also reveal that sustainability ratings are unreliable and prone to conflicts of interest.[53] In contrast to a longstanding law & finance literature on financial ratings,[54] the discussion on how legal rules can enhance the reliability of sustainability ratings is still in its infancy. In other words, there is a lot of potential for law to curb greenwashing.[55]

The second agency cost problem of sustainable corporate governance depends on the fact that institutional investors have different business models, resulting in different incentives to monitor managers. Consequently, they may influence the sustainability of portfolio companies in different ways, or not at all. According to a longstanding distinction,[56] institutional investors may "voice" their dissatisfaction, by voting or otherwise engaging with the management, or (threaten to) "exit" the investment. These behaviours correspond with different preferences of beneficiaries regarding sustainability and financial returns. For instance, exit from unsustainable investment is largely compatible with "doing-well-by-doing-good", namely long-term profit maximization. However, "delegated philanthropy" may require a stronger engagement with producers of GHGs and correspondingly accepting lower financial returns to foster

[52] Hartzmark & Sussman, *supra* Footnote 39.

[53] See e.g. Berg, F., Koelbel, J. F., & Rigobon, R. (2022). "Aggregate confusion: The divergence of ESG ratings". *Review of Finance*, 26(6), 1315–1344.

[54] Partnoy, F. (2001). "Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime". *Washington University Law Quarterly*, 79(2), 491–548; Coffee, J.C. (2004). "Partnoy's Complaint: A Response". *Boston University Law Review*, 84(2), 377–382.

[55] See Pacces, *supra* Footnote 36 (defining greenwashing as selective disclosure of positive sustainability information, without full disclosure of negative information).

[56] Hirschman, A.O. (1970). *Exit, Voice and Loyalty*. Cambridge, MA: Harvard University Press.

long-term shareholder welfare. The impact of these corporate governance strategies varies too. Exit tends to depress the stock price of portfolio companies, but because not all investors are committed to sustainability, it may take very long before the price of unsustainable companies incorporates the negative externality.[57] Voice is more immediate, as it affects the sustainability of corporate decision-making directly, but implies forgone profits for both the portfolio companies and the investors engaging with them.

Whether institutional investors pursue exit, voice, both, or neither of them is essential to understand their impact on portfolio companies, hence whether sustainable corporate governance can correct negative externalities. In theory, the optimal strategy of institutional investors depends on the business model. Short-term, transient investors are not interested in corporate governance, apart from activist hedge funds that admittedly do not pursue sustainability.[58] The key difference in corporate governance is between active, dedicated investor, and passive investors that track market indices to a varying degree.[59] Both categories of investors are long-term investors, so they potentially care for sustainability. Active investors have powerful incentives to exit/enter investments based on non-public information,[60] because timely actions boost their performance, which in turn increases AUM and attractiveness for beneficiaries. That applies to ESG investment too. The situation of passive funds is different. Because they track a market index, they cannot exit strategically. Whether they like it or not, they must be loyal to their companies, which in principle commits them to voice. Index funds that want to pursue

[57] Recent research suggests that we are very far away from reaching the tipping point. Berk, J., & van Binsbergen, J. H. (2021). "The impact of impact investing". Law & Economics Center at George Mason University Scalia Law School Research Paper Series No. 22–008, http://dx.doi.org/10.2139/ssrn.3909166.

[58] Pacces, A.M. (2016). "Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance." *Erasmus Law Review*, 9(4), 199–216. An apparent exception is Engine No. 1, the hedge fund that engaged with Exxon in 2021 (see https://www.nytimes.com/2021/06/23/magazine/exxon-mobil-engine-no-1-board.html). For a critical view, see Zohar Goshen & Assaf Hamdani, *Can Systematic Stewardship Reduce Carbon Emissions?* (2022) (unpublished manuscript, on file with author).

[59] Bushee, B.J. (1998). "The Influence of Institutional Investors on Myopic R&D Investment Behavior". *Accounting Review*, 73(3), 305–333.

[60] Edmans, A., & Manso, G. (2011). "Governance Through Trading and Intervention: A Theory of Multiple Blockholders". *Review of Financial Studies*, 24(7), 2395–2428.

ESG Goals must persuade portfolio companies to do so. Pursuing sustainability, however, clashes with another key element of the business model: minimizing cost. Index funds compete on low fees (some of them even offer nominally zero fees), whereas engaging with individual companies is costly. To reduce this cost, most institutional investors rely on proxy advisors such as ISS or Glass Lewis to advise on engagement. However, because proxy advisors are not accountable to the institutional investor's beneficiaries, this solution exacerbates agency costs.

Empirical evidence suggests that institutional ownership increases the sustainability of portfolio companies.[61] However, it is unclear whether they do so by way of exit or voice, which complicates the question whether institutional investor behaviour is in line with what beneficiaries want. Overall, institutional investors seem to have an impact on several ESG ratings of portfolio companies. According to some studies, this depends on exit;[62] according to others, voice plays a prominent role.[63] Most actions by institutional investors are not observable because engagement takes place behind closed doors.[64] This is reflected by the limitations of the extant empirical studies, which either try to identify engagement indirectly or are based on surveys[65] and non-public data from specific investors.[66] Whilst one has to be cautious about the generalizability of these studies, they suggest that active investors tend to participate in

[61] Dyck, A., Lins, K.V., Roth, L., & Wagner, H.F. (2019). "Do Institutional Investors Drive Corporate Social Responsibility? International Evidence". *Journal of Financial Economics*, 131(3), 693–714.

[62] Gantchev et al., *supra* Footnote 16.

[63] Azar et al., *supra* Footnote 41.

[64] McCahery, J.A., Sautner, Z., & Starks, L.T. (2016). "Behind the Scenes: The Corporate governance Preferences of Institutional Investors". *Journal of Finance*, 71(6), 2905–2932.

[65] Krueger, P., Sautner, Z., Starks, L.T. (2019). "The Importance of Climate Risks for Institutional Investors". European Corporate Governance Institute (ECGI)—Finance Working Paper No. 610/2019, http://dx.doi.org/10.2139/ssrn.3235190.

[66] Dimson, E., Karakaş, O., & Li, X. (2019). "Coordinated Engagements". Mimeo, http://dx.doi.org/10.2139/ssrn.3209072; Becht, M., Franks, J.R., & Wagner, H.F. (2019). "Corporate Governance through Exit and Voice". European Corporate Governance Institute (ECGI)—Finance Working Paper No. 633/2019, http://dx.doi.org/10.2139/ssrn.3456626.

corporate governance by way of both voice and exit. In particular, engagement provides information spillovers that potentially benefit the active investment strategies.[67]

Index investors have a potential to engage with portfolio companies on sustainability. As mentioned, index funds cannot exit, which commits them to voice. Moreover, index investors are very large. The Big Three U.S.-based investors (Blackrock, Vanguard, and State Street) have together over $20 trillion of Assets Under Management and the vast majority of the equity funds they operate is indexed. Finally, each of the Big Three has large stakes in the major listed company in the world. In line with this reasoning, a recent finance study found that significant ownership by the Big Three correlates with more environmental engagements with portfolio companies and lower CO_2 emissions.[68]

Theory, however, is divided about institutional investor engagement. Because index funds pursue a low-cost investment strategy, it is questionable whether they can be interested in corporate governance at all.[69] According to some commentators, index fund managers are structurally passive about corporate governance, resulting in an agency problem that regulation should fix by incentivizing expenditures on engagement.[70] Other commentators, in contrast, have argued that index investors have sufficient incentives to engage with companies albeit only on cross-cutting issues, such as sustainability, which apply indistinctively across diversified portfolios and thus have a lower cost per company.[71] Engagements provide benefits too. The sustainability information acquired to engage with the companies in the index funds is useful to decide investments

[67] Fisch, J., Hamdani, A., Solomon, S.D. (2019). "The New Titans of Wall Street: A Theoretical Framework for Passive Investors". *University of Pennsylvania Law Review*, 168, 17–72.

[68] Azar et al., *supra* Footnote 41.

[69] Isaksson, M., & Çelik, S. (2013). "Who Cares? Corporate Governance in Today's Equity Markets". *OECD Corporate Governance Working Papers*, No. 8, OECD Publishing, http://dx.doi.org/10.1787/5k47zw5kdnmp-en.

[70] Bebchuk, L.A., & Hirst, S. (2019). "Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy". *Columbia Law Review*, 119(8), 2029–2146.

[71] Rock, E.B., & Kahan, M. (2019). "Index Funds and Corporate Governance: Let Shareholders Be Shareholders". European Corporate governance Institute (ECGI)—Law Working Paper No. 467/2019, http://dx.doi.org/10.2139/ssrn.3295098.

and divestments of the active funds within the same "fund family" (i.e. sponsored by the same asset managers).[72]

A more fundamental question is why institutional investors would engage on sustainability as opposed to strategies that increase financial return. A group of theories contend that particularly index investors care about sustainability because it implies risks negatively affecting the performance of their portfolio. There are two versions of this Portfolio Value Maximization (PVM) argument. The first is that large index investors are "universal owners" with portfolios mirroring the global economy, hence internalizing the negative externalities imposed by some portfolio firms on others.[73] The second version is that sustainability is systematic risk, which index investors cannot diversify. The business model of index investing, thus, requires pursuing the sustainability of portfolio companies.[74] Both version of PVM reflect a doing-well-by-doing-good strategy and suffer from the limitations of this theory. Yet, a third reason for institutional investors to engage on sustainability is to attract sustainability-minded investors, who are prepared to give up financial return to reduce negative externalities. As I have argued elsewhere,[75] this is potentially a more powerful reason for institution investors to engage on sustainability as such engagements entail forgoing profit, at least in the short term.[76]

If especially index investors hold a promise to engage on sustainability, the third remaining question is whether this will be consistent with the preferences of their beneficiaries. Differently put, why should sustainability-minded beneficiaries prefer to foster sustainability via corporate governance rather than political voting?[77] The main challenge to incorporate the preferences of end-shareholders in corporate governance

[72] Fisch et al., *supra* Footnote 67.

[73] Condon, M. (2020). "Externalities and the Common Owner." *Washington Law Review*, 95(1), 1–81.

[74] Gordon, J.N. (2022). "Systematic Stewardship." *Journal Corporation Law*, 47(3), 627–673.

[75] Pacces, *supra* Footnote 34.

[76] See e.g. Oehmke, M. & Opp, M.M. (2023). "A Theory of Socially Responsible Investment". Swedish House of Finance Research Paper No. 20–2, http://dx.doi.org/10.2139/ssrn.3467644.

[77] Rock, E.B. (2020). "For Whom Is the Corporation Managed in 2020?: The Debate over Corporate Purpose". European Corporate governance Institute—Law Working Paper No. 515/2020, http://dx.doi.org/10.2139/ssrn.3589951.

is that these preferences differ. Some beneficiaries are willing to give up more financial return to foster sustainability; other less, or not at all. For this reason, in the recent debate on corporate purpose, commentators have argued that shareholder wealth maximization is the only norm on which *all* shareholders could agree.[78] However, the picture is more nuanced. In theory, institutional investors who care for sustainability could offer their beneficiaries a sort of "opt-in stewardship" and let the beneficiaries who want sustainability choose a particular voting and engagement strategy that institutional investors commit to.[79] Another possibility is pass-through voting pushing down the decisions to beneficiaries, which is, however, fraught with problems especially in terms of aggregating individual preferences. Although these problems could be overcome, pass-through potentially undermines institutional shareholders' big advantage: concentrated voting power.[80] Finally, and possibly in combination with the other two strategies, institutional investors could elicit beneficiaries' preferences by way of surveys, until more sophisticated techniques are developed.[81]

5.4 The Role of Securities Law

A challenge for sustainable corporate governance is the alignment of institutional investors' behaviour with the sustainability preferences of their beneficiaries. Putting aside the issue of aggregating beneficiaries' preferences, this is an agency problem: institutional investors may fail to pursue the interest of their beneficiaries as it concerns sustainability. This is not conceptually different from the conflicts of interest affecting the delegation of financial investment to intermediaries such as investment

[78] Fisch, J.E., & Davidoff Solomon, S. (2020). "Should Corporations Have a Purpose?". European Corporate Governance Institute—Law Working Paper No. 510/2020, https://ssrn.com/abstract=3561164.

[79] Griffith, S.J. (2020). "Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority". *Texas Law Review*, 98(6), 983–1047 (wondering why private ordering has not yet offered this solution). In previous work (Pacces, *supra* Footnote 36), I have argued that greenwashing undermines credible signalling of sustainability engagement by institutional investors. Regulation could ameliorate this problem.

[80] Fisch, J.E. (2020). "The Uncertain Stewardship Potential of Index Funds". European Corporate Governance Institute (ECGI)—Law Working Paper No. 490/2020, http://dx.doi.org/10.2139/ssrn.3525355.

[81] Hart & Zingales, *supra* Footnote 47, 212–14.

firms, mutual funds, and pension funds. However, there are two complications compared to the pursuit of risk-adjusted financial return. The first is the transparency of institutional investor behaviour as it relates to sustainability, as opposed to financial performance, which affects the ability of beneficiaries to pick the institutional investor they want. The second complication is that, whereas risk and return are well-trotted concepts, what counts as sustainable investment is undefined, particularly in the context of specific economic activities. This undermines a knowledgeable screening of institutional investors by the beneficiaries.[82] Coping with the agency cost of institutional investors in corporate governance, including sustainable corporate governance, contributes to investor protection and market efficiency, which are two key goals of securities regulation.[83] Recently, EU securities regulation has tried to address this problem establishing mandatory disclosure of sustainability performance and of institutional investors' contribution to it.

In 2018, the European Commission published an ambitious Sustainable Finance Action Plan.[84] To tackle the transition of existing activities to more sustainable production processes, finance is crucial. A comprehensive discussion of the Action Plan and its legislative implications is out of the scope of this chapter.[85] Here, I focus on a few aspects of relevance for sustainable corporate governance. First, the Taxonomy Regulation (EU) 2020/852 introduced the first legislative framework in the world defining sustainable economic activities with reference to 6 grand goals, the first and perhaps most important of which being mitigation of GHGs in line with the more ambitious Paris agreement target. Second, the Sustainable Finance Disclosure Regulation (EU) 2019/2088 (hereinafter SFDR) compels all financial market participants (including all categories of institutional investors) and financial advisers to disclose the climate risk exposure and investment sustainability also in terms of the Taxonomy Regulation regime. Another crucial legislative aspect affecting sustainable

[82] Heeb, F., Kölbel, J. F., Paetzold, F., & Zeisberger, S. (2023). "Do investors care about impact?". *Review of Financial Studies*, 36(5), 1737–1787.

[83] Armour et al., *Principles,* supra Footnote 49.

[84] European Commission (2018). *Action Plan: Financing Sustainable Growth.* COM(2018) 97 final.

[85] For an excellent overview, see Siri, M., & Zhu, S. (2019). "Will the EU Commission Successfully Integrate Sustainability Risks and Factors in the Investor Protection Regime? A Research Agenda". *Sustainability*, 11(22), 6292.

corporate governance is not part of the action plan. Only one year earlier, the Revised Shareholder Right Directive (EU) 2017/828 (hereinafter SRD II) established, on a comply-or-explain basis, the transparency of voting policies and voting behaviour of all institutional investors. Importantly, such policies and the consequent voting behaviour must describe social and environmental impact.

With the SRD II Directive, the EU caught up on an important difference with the U.S. Since 2003, U.S.-based institutional investors must be transparent about their voting policies and voting behaviour. Whilst funds managing retirement schemes were long required to vote their shares and be transparent about it, the other mutual funds are only required to have a policy. However, to avoid liability risk, American mutual fund managers routinely cast their vote in a transparent manner.[86] Whereas the largest asset managers, such as the Big Three, have in-house stewardship groups advising voting, smaller asset managers cannot afford this and rely on external proxy advisors.[87] In the EU, similar rules apply since the general meeting season 2020 based on art. 3g of SRD II.[88] Asset managers must disclose annually their voting policy and how they have implemented it by engaging with individual companies, specifying aspects such as social and environmental impact and corporate governance, amongst others. This is an important difference from the U.S., where the voting transparency requirements do not refer to sustainability goals. A second difference is that the EU voting transparency rules can be opted out of, if only the institutional investor explains why these rules should not apply to them.

The comply-or-explain approach of the SRD II reflects the approach of the stewardship codes. However, stewardship means much more than engagement and voting transparency, and the "juridification" of these points has arguably crowed out more ambitious stewardship by EU-based institutional investors.[89] The national transposition of the SRD II has

[86] Griffith, *supra* Footnote 79.

[87] Iliev, P., & Lowry, M. (2015). "Are Mutual Funds Active Voters?". *Review of Financial Studies*, 28(2), 446–485.

[88] Birkmose, H. S. (2021). ARTICLE 3G: ENGAGEMENT POLICY. In Birkmose, H.S., & Sergakis, K. (eds.), *The Shareholder Rights Directive II: A Commentary*, Edward Elgar Publishing, 143–163.

[89] Katelouzou, D., & Puchniak. (eds.). (2022). "Global Shareholder Stewardship: Complexities, Challenges, and Possibilities." In *Global Shareholder Stewardship*, Cambridge University Press, 33–34.

been literal and minimalistic, inviting box-ticking.[90] This is in line with the finding that because institutional investors follow low-cost index-tracking strategies, they do not have incentive to acquire information to support firm-specific engagements.[91] Engagements, however, need not be firm-specific if one takes a market-wide approach to the sustainability problem. From that standpoint, what matters is not so much how individual companies manage the sustainability transition, but rather how a portfolio of companies incorporates sustainability risks. Index investors have a comparative advantage in dealing with sustainability risks.[92] If they care about universal issues, index investors can devise consistent voting policies about these issues and implement them in hundreds of companies, without having to micromanage any of them.[93] Moreover, if institutional investors commit to predetermined positions, or voting policies, on sustainability, beneficiaries can choose the funds that best reflect their sustainability preferences. The remaining challenge is the reliability and the saliency of the information provided by institutional investors about their actual and prospective engagement on sustainability.

Sustainability-minded investors should be able to identify and select the institutional investors that meet their preferences. The first question is whether funds that claim to be sustainable actually pursue sustainability. This is a crucial aspect for beneficiaries to make a knowledgeable choice, which the SFDR has tackled. Amongst other obligations, market participants, which advertise products with sustainable characteristics or that feature sustainable investment, must elaborate on what sustainability means concretely, for instance, in terms of a market index or GHGs reduction. Moreover, they must provide prospective customers with succinct and understandable information in this regard. This mandatory disclosure is a big step to support knowledgeable choice by retail investors, which would otherwise be plagued by the reluctance of companies to

[90] Katelouzou, D., & Sergakis, K. (2021). "When Harmonization is not enough: Shareholder Stewardship in the European Union". *European Business Organization Law Review*, 22(2), 203–240.

[91] Pacces, A.M. (2018). "Shareholder Activism in the Capital Markets Union," In E. Avgouleas, D. Busch, & G. Ferrarini (eds.), *Capital Markets Union in Europe*, Oxford University Press, 507–525.

[92] Condon, *supra* Footnote 73.

[93] Azar, J. (2020). "The common ownership trilemma". *University of Chicago Law Review*, 87(2), 263–296.

provide proprietary information and the lack of standardization of this information.[94]

Mandatory disclosure, however, would not be sufficient if market participants had full discretion to define what is sustainable, and then earmark their products to that definition. The EU Taxonomy Regulation aims to fix this problem. The Taxonomy established a framework that is still being detailed by secondary legislation on technical standards.[95] However, the Regulation already sets the principle that in order for any activity to be labelled as environmentally sustainable, it must fulfil four conditions: (i) contribute significantly to one of the 6 sustainability goals (climate change mitigation; climate change adaptation; sustainable use of water resources; transition to circular economy; pollution prevention; protection of biodiversity); (ii) do not significantly harm any of the other goals; (iii) comply with the relevant technical standards; (iv) respect additional safeguards to be specified by secondary legislation. It is worth noting that the first and most prominent goal is climate change mitigation, which implies that the specific targets of GHG reduction *cannot be undermined* for any activity to be sustainable. Relatedly, power generation by way of solid fossil fuels can never be regarded as a sustainable activity.[96]

The implication of the Taxonomy is that all asset managers offering products in the EU will have to disclose the proportion of their total investment that is "taxonomy-aligned". It is possible for institutional investors to opt out of this requirement, but that implies warning beneficiaries by way of negative disclosure: art. 7 of the Taxonomy Regulation mandates disclosure of the non-sustainable character of products that do not qualify as sustainable according to the Taxonomy and the SFDR.[97] By mandating the disclosure of the degree of taxonomy alignment, the

[94] On these problems and the economic rationale of mandatory disclosure, see Armour et al., *Principles,* supra Footnote 49.

[95] The first technical standards on environmental sustainability are included in the Commission Delegated Regulation (EU) 2021/2139 of 4 June 2021. More Taxonomy delegated acts are forthcoming. See https://finance.ec.europa.eu/publications/sustainable-finance-package_en#taxonomy.

[96] Art. 19(3) Taxonomy Regulation.

[97] See Pacces, A.M. (2000). "Financial Intermediation in the Securities Markets: Law and Economics of Conduct of Business Regulation." *International Review of Law and Economics*, 20(4), 479–510, recommending negative disclosure to flag the lack of suitability of financial investment.

EU regulation of sustainability disclosure aims to reduce greenwashing.[98] However, in order for beneficiaries to choose knowledgeably the institutional investors matching their sustainability preferences, the Taxonomy and its implications must be salient and understandable for beneficiaries.

When choosing a mutual fund, beneficiaries who are prepared to give up financial return in exchange for sustainability are not necessarily alert to regulatory indicators such as the taxonomy alignment, or lack thereof whenever negative disclosure is triggered. A complementary aspect of the Sustainable Finance Action Plan is, therefore, the inclusion of investor sustainability preferences into the conduct of business rules governing the provision of investment services to retail investors, particularly suitability and product governance.

With a recent amendment to the MiFID Delegated Regulation,[99] the EU legislator has integrated the client's "sustainability preferences" into the suitability test. Investment service providers will have to ask their clients whether they request a minimum sustainability threshold—for example, a minimum degree of taxonomy alignment—and only then advise on the suitable mutual fund. The suitability rule only applies to situations in which investors receive personalized recommendations. More often, however, retail investors receive investment advice as marketing communications, which are excluded from the suitability rule and are prone to conflicts of interest.[100] EU securities regulation has responded to this problem with product governance. Product governance has been overhauled, too, to incorporate the sustainability preferences of retail investors.[101] All providers of investment services will have to include

[98] Pacces, *supra* Footnote 36, 10.

[99] Commission Delegated Regulation of 21 April 2021 Amending Delegated Regulation (EU) 2017/565 as Regards the Integration of Sustainability Factors, Risks and Preferences into Certain Organisational Requirements and Operating Conditions for Investment Firms. See also the ESMA guidelines: https://www.esma.europa.eu/document/guidelines-certain-aspects-mifid-ii-suitability-requirements-1.

[100] Enriques, L., & Gargantini, M. (2017). "The Expanding Boundaries of MiFID's Duty to Act in the Client's Best Interest: The Italian Case." *Italian Law Journal*, 3, 485–510.

[101] Commission Delegated Directive of 21 April 2021 Amending Delegated Directive (EU) 2017/593 as Regards the Integration of Sustainability Factors into the Product Governance Obligations. See also the ESMA guidelines: https://www.esma.europa.eu/sites/default/files/2023-03/ESMA35-43-3448_Final_report_on_MiFID_II_guidelines_on_product_governance.pdf.

sustainability factors, as defined by the SFDR and the Taxonomy Regulation, in the definition of their target markets and distribute financial products such as mutual funds according to the expected sustainability preferences of beneficiaries.

Whether and to what extent these reforms will have an impact on the environmental sustainability of publicly held companies will depend on the reaction of institutional investors. Because the EU mandatory disclosure system centred on the Taxonomy has just started being applied, this impact cannot yet be assessed empirically. However, it is hard to imagine that the introduction of the Taxonomy will not have any impact on corporate governance. Index investors who want to improve on their sustainability scores to attract sustainability-minded clients will have no choice but to engage with companies on sustainability matters, because index-trackers cannot simply avoid companies that do not qualify as sustainable under the Taxonomy Regulation.[102] Likewise, active investors catering to sustainability-minded beneficiaries will have to strike an increasingly difficult balance between pursuing sustainability and forgoing the benefits of diversification, or else engage with the companies they are invested in for them to become more sustainable. Not every institutional investor will be concerned with sustainability to the same degree, and some may be not at all, but the introduction of a taxonomy of sustainable activities will enable beneficiaries to understand institutional investors' effective involvement in sustainability—both as engagement and as portfolio choice—and choose accordingly.

Being supported by regulation, the Taxonomy brings back to the forefront the old problems of lobbying and regulatory capture that have plagued environmental regulation during the past decades. I leave this aspect of the comparison between political voting and corporate voting for another day. Yet, in closing, it is worth noting that sustainable corporate governance only adds an additional player to the picture: the institutional investors. Institutional investors are not only subject to sustainable finance regulation, but also contribute to the production of such regulation. Institutional investors' interest is not necessarily aligned with the social welfare, but is also not confined to the interest of any particular sector or national economy, because especially the largest investors invest

[102] I have elaborated on this argument in Pacces, *supra* Footnote 36.

in almost any sector in most parts of the world. Adding this additional player to the production of rules to curb negative externalities is unlikely to decrease social welfare.[103]

5.5 Conclusion

The meaning of sustainability is often in the eye of the beholder. From an economic standpoint, sustainability implies reducing negative externalities. Law has traditionally policed these externalities by way of taxes or regulations. To achieve the ambitious climate change mitigation goals of the Paris Agreement 2015, a more substantial contribution from private investment is needed, which calls for sustainable finance. In this chapter, I have argued that sustainable finance can work depending on the role of institutional investors in corporate governance. Most individuals indirectly own shares in publicly held corporations as beneficiaries of institutional investors, which in turn can influence corporate decision-making. The potential impact of institutional investors on sustainable corporate governance is promising to the extent that individual investors care about sustainability, but also brings in the problem of institutional investors' agency cost. This essay claims that securities law plays a decisive role in reducing this agency cost.

I have discussed the recent EU securities regulation as it relates to sustainable corporate governance. Institutional investors may pursue sustainability in corporate governance, whether by portfolio choices, engagement, or both. However, it is unclear whether they actually pursue sustainability, and if so, how. The incentives of institutional investors are imperfectly aligned with the interest of their beneficiaries as it relates to sustainability. The recent EU legislation on the transparency of shareholder engagement, mandatory sustainability disclosure, taxonomy of environmental sustainability, and the incorporation of sustainability preferences into the conduct of business rules of investment firms is likely to improve this incentive alignment. Institutional investors that aim to attract beneficiaries catering to their preference for sustainability will have to show how they pursue sustainable corporate governance. Whether and

[103] Pursuing sustainability via institutional investors may, however, undermine competition making the overall impact on social welfare indeterminate. See Azar, *supra* Footnote 93.

to what extent sustainable corporate governance is compatible with the business model of different kinds of institutional investors remains to be seen. The first years of application of the EU securities regulation on sustainable finance will provide interesting material to answer this question empirically.