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Sustainable Corporate Governance: The Role of the Law

Law Working Paper N° 550/2020

October 2020

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Abstract

The debate on sustainable finance seldom includes the perspective of shareholders. However, shareholders are important for the governance of publicly held corporations today, because their holdings are concentrated in the hands of few institutional investors. Institutional investors can therefore have an impact on the sustainability of the largest companies in the world, as they often claim they do – particularly in communications with their beneficiaries.

Whether institutional investors actually have such an impact is an open question. Recent changes in EU financial regulation will bring more clarity on this matter. For instance, the revised Shareholder Rights Directive requires companies, on a comply-or-explain basis, to disclose voting policies and behaviours concerning sustainability. Moreover, the EU soon will be the first jurisdiction in the world to supply standard definitions of sustainable investment, to be used in institutional investors' mandatory disclosure to their beneficiaries. This essay discusses whether this legislation can align the incentives of institutional investors to pursue sustainable corporate governance with the prosocial preferences of their beneficiaries.

Keywords: negative externalities, corporate governance, institutional investors, exit v. voice, sustainable finance, investor preferences, disclosure, EU Taxonomy Regulation

JEL Classifications: G38; K22; L21; Q56

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SUSTAINABLE CORPORATE GOVERNANCE: THE ROLE OF THE LAW

Alessio M. Paces

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Sustainable Corporate Governance: The Role of the Law

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Draft 30 September 2020

Abstract

The debate on sustainable finance seldom includes the perspective of shareholders. However, shareholders are important for the governance of publicly held corporations today, because their holdings are concentrated in the hands of few institutional investors. Institutional investors can therefore have an impact on the sustainability of the largest companies in the world, as they often claim they do – particularly in communications with their beneficiaries.

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1. Introduction

Sustainability is a buzzword and a policy goal. It synthesizes the aim to reduce the environmental and social imbalances of the world we live in, such as resource depletion, environment degradation, and inequality, among 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 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 (European Commission 2018).

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 firms and, eventually, unsustainable firms exiting the market. In public

corporations, the decision whether to invest in sustainability 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.¹ Their holdings are concentrated (Gilson & Gordon 2013). Institutional investors often claim to care about the sustainability of portfolio companies (Fink 2020). 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 financial 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 law potentially plays in supporting sustainable corporate governance. I ask the following question: Can legal tools 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 sustainable finance.² 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. The rest of this chapter is as follows. The next section frames sustainable corporate governance as an externalities problem death with – in a somewhat Coasian flavour – as investors 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 section 3. Section 4 discusses how legal rules may foster the incorporation of beneficiaries' preferences into voting by institutional investors. Section 5 concludes.

2. Framing Sustainable Corporate Governance

In economics, negative externalities have been regarded as a matter for corrective taxation, named Pigouvian taxation after Pigou (1920). Taxes e.g. on CO₂ 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 (Ogus 1994). These strategies reflect a *top-down* public intervention in markets producing negative externalities (Faure 2012). Particularly in the context of climate change, this approach has proven insufficient. The commitment by the signatories of the

¹ 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 et al 2019).

² See the Action Plan on Financing Sustainable Growth (European Commission 2018); and The European Green Deal (European Commission 2019).

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 (Andersson, Bolton, & Samama 2016).³

The ability of governments to police environmental externalities is limited for several reasons (Tirole 2017). 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 are too lax and the second too low to effectively constrain environmental degradation (Gunningham et al 1998). Second, environmental externalities have an international dimension. While 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 (Kraakman et al 2017). Third, some governments may be less concerned with correcting externalities because the more environment-friendly citizens are underrepresented (Bénabu & Tirole 2010).

In the spirit of Coase (1960), 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, selloffs and activism. Differently from regulation, such decentralized behaviours work across borders and are not susceptible to lobbying. These behaviours are borne out by the empirical evidence and seem to have an impact on corporate choice (Gantchev et al 2019). Intuitively, 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 indeed 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, but because so they choose. This is the role of corporate governance in the broader context of sustainable finance (European Commission 2018).

Whether sustainable corporate governance can actually reduce GHGs and mitigate climate change is unclear. The answer depends on the sustainability preferences of investors and whether they are reflected by corporate choice. Investors typically select investment 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. Investors, however, particularly shareholders, may also base their investment choice on other, prosocial considerations. Following this intuition, Hart and Zingales (2017) 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. The question remains how much profit shareholders are prepared to give up to pursue sustainability.

Bénabu & Tirole (2010) distinguish three theories of investor preferences towards Corporate Social Responsibility (CSR). For the purpose of this article, I take a somewhat

³ In this essay, I take this policy goal as a given assuming it reflects the effort to maximize global social welfare.

narrow view of CSR as a trade-off between profit, or financial returns, and the prosocial goal to reduce GHGs. On this perspective, different CSR theories can be framed as the opportunity cost of increasing levels of sustainability preferences. 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 in 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. Doing-well-by-doing-good investors both avoid an intertemporal loss and reduce externalities (Bénabu & Tirole 2010: 9). Investors’ concern for climate change risk is borne out by survey evidence (Ilhan et al, 2020). Empirical evidence also supports the view that CSR correlates with higher firm performance in the long term (Verheyden et al 2016), although this may rather reflect better corporate governance (Ferrel et al 2016).

A second CSR theory is “delegated philanthropy.” According to this theory, investors *permanently* accept to earn less on ‘green’ investments for ethical reasons, effectively requesting corporations to transfer resources to non-shareholder constituencies such as consumer, employees, etc. 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 (2009), cost and benefits of future generations should be discounted, but at a very low rate because the distant future is uncertain and uncertainty magnifies the impact of lower rates. Environment-friendly projects with a positive intertemporal balance increase welfare, even though they decrease shareholder wealth. In a similar vein, Hart and Zingales (2017) have argued that shareholders should be allowed to maximize welfare instead of wealth. But why should shareholder delegate philanthropy to the corporation rather than donating themselves? The reason is transaction cost (Bénabu & Tirole 2010: 10). Undoing externalities is costlier than preventing them, whereas corporations may enjoy transaction cost savings in transferring resources to current and future stakeholders. From this perspective, corporations are regarded as 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 ethical goals *at any cost*, even though a majority of investors 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 (Blair & Stout 1999). This approach has been popular among European legal scholars (e.g. Sjøfjell 2017; Winter 2018), particularly in jurisdictions featuring multiple stakeholders in the corporate purpose. Albeit with exceptions (Mayer 2018), economists have been more sceptical. Milton Friedman (1970) famously argued against corporations doing philanthropy with other people’s money. 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 (Jensen 2002). The debate on the corporate purpose has recently gained popularity in the

U.S. too, with many scholars (Fisch 2020; Gilson 2019) finding that a commitment to pursuing multiple stakeholder interests would be unenforceable under U.S. state laws. Moreover, shareholders, who retain the exclusive right to vote, would always be in the position to overturn such a commitment (Rock 2020).

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, which is so popular these days. 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 investor choice, I focus on the first two theories and discuss below how they reflect on investor behaviour in theory.

Doing-well-by-doing-good investors are mindful about financial returns. As they believe that the market is under-pricing climate risk in the short term, such investors naturally 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).⁴ These portfolio choices imply a mix of negative and positive screening of the stock market. Climate-risk minded investors may also choose to steer the management of portfolio companies towards GHGs reduction. However, engagement in corporate governance reflects a longer-term commitment towards portfolio companies, which is more compatible with delegated philanthropy. As explained by Hirschman (1970), the exercise of voice within an organization implies a commitment not to exit. Investors who want to reduce externalities, also for the benefit of future generations, are committed to voice – i.e. influencing decision-making in corporations that would otherwise degrade the environment. Investors that only aim to manage climate change risk benefit more from exit, in principle, at least until the moment in which negative screening undermines risk diversification.⁵

This breakdown neglects a crucial aspect of modern investing, namely institutional ownership. 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 really choose which companies to invest in even though their beneficiaries may have strong views on that. Some fund managers do not have the resources to engage with individual companies, regardless of what beneficiaries expect. And yet, empirical evidence that beneficiaries want institutional investors to invest in sustainable corporations is mounting. 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 US mutual funds.⁶ Both studies find that investor demand for more sustainable funds is motivated by non-pecuniary goals, as investors 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 brings in two fundamental questions for sustainable corporate governance. First, are the incentives of institutional

⁴ See the Greenhouse Gas Protocol, <https://ghgprotocol.org/guidance>.

⁵ Recent research suggests that this moment may have already arrived. See Ceccarelli et al 2020 (finding that climate-responsible funds experience higher idiosyncratic risk) and Hoepner et al 2020 (finding that shareholder engagement with portfolio companies reduces downside risk).

⁶ See, respectively, Hartzmark & Sussman (2019) and Ceccarelli et al (2020).

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.

3. Questions and Challenges

Whether delegated philanthropy is what investors want *in general* is hard to say. Even if that was the case, sustainable finance could only succeed in reducing GHGs if investor preferences translated into sustainable corporate choices. This depends on the ability of investors, qua shareholders, to influence decision-making in public corporations. In the most developed financial markets worldwide, however, individual shareholding is a phenomenon of the past. Today, individuals mainly invest in public companies indirectly, as beneficiaries of institutional investors such as mutual funds and pension funds.⁷ 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.

It is an opportunity because institutional ownership of public companies is *big* and *global*. According to a 2017 research, 100 corporations worldwide are responsible for 71% of global GHG emissions; almost one-third of these companies are publicly held.⁸ In 2017 institutional investors owned collectively 41% of the world stock market capitalization, namely almost \$35 trillion (De La Cruz et al 2019). This is big and, given the role of publicly held companies in GHGs, potentially impactful. Moreover, differently from governments, institutional investors can influence corporations across borders because their holdings are diversified internationally. Finally, and most importantly, institutional investors have a crucial advantage over individual investors: their holdings in individual companies are concentrated.

Shareholders of public companies used to be too small and dispersed to matter (Berle & Means 1932). But 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 (Gilson & Gordon 2013). In the US 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.⁹ Such investors can exercise a 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 – and, as I will discuss shortly, are subject to a different regulation as it relates

⁷ De La Cruz et al (2019). Notable exceptions include controlling shareholders and state ownership, both of which are prominent worldwide. These are large investors who are sufficiently powerful to foster prosocial goals, if they so wish.

⁸ <https://www.cdp.net/en/articles/media/new-report-shows-just-100-companies-are-source-of-over-70-of-emissions>. 59% of the top-100 GHGs producers are state-owned companies and 9% are private companies.

⁹ The 20 largest institutional investors own 25% or more, on average, in Canada, the Netherlands, Poland, South Africa, Finland, Japan, Sweden and Norway (De La Cruz et al 2019).

to sustainability – are also potentially influential in all the countries in which institutional ownership is large. Institutional investors are influential because they can credibly threaten to divest from a company that doesn't meet their requirements in terms of Environmental, Social or Governance (ESG) goals, or – as a coalition with other investors – to defeat the management in a voting contest (Aguilera et al 2019; Brav et al 2019).

The key role played by institutional investors 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 as the incentives of institutional investors are not aligned with the interest of the beneficiaries. Secondly, and relatedly, institutional investors have different business models which prompt them to be active or inactive 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. 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) (Jensen & Meckling 1976). Because, inter alia, agency cost makes monitoring expensive for beneficiaries, institutional investors may pretend to pursue ESG goals while in reality they pursue private interests. Fortunately, there are legal and market mechanisms to cope with this problem. Example of legal rules include the investment advisers' fiduciary duties, and the corresponding obligation to verify that investment advice is in line with the investor preferences – that is, investment suitability (Armour et al 2016). Example of market mechanism are gatekeepers (Kraakman 1986), 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 in order to pursue sustainability. Both mechanisms are, in general, imperfect ways to cope with the agency cost of retail investment (Amour et al 2016).

The agency cost of institutional investment stems from 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 is affected by the value of the investment, but even more so by 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. Environment-friendly investments are a good example of such a prosocial goal. However, institutional investors may not be entirely honest in pursuing ESG investment and, even if they are, their ESG labels may not correspond with what beneficiaries actually want. The problem is akin to the pursuit of financial performance: there too institutional investor's choices may not reflect the interest of beneficiaries. However, over time, the fiduciaries duties of institutional investors as financial advisors have evolved into a full set of disclosure obligations and conduct of business rules. Both items are well under-developed as far as sustainable investments are concerned.

Meanwhile, private markets have provided a full host of sustainability ratings to support the quest of beneficiaries for environment-friendly investment. According to recent research, these ratings have a significant impact on mutual fund's 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 (Hartzmark & Sussman 2019). 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. While it is clear that sustainability matters to retail investors, finance studies also show that ESG ratings are unreliable and prone to conflicts of interest (Daines et al 2010; Shackleton et al 2019). In contrast to a longstanding law & finance literature on financial ratings (Partnoy 2001; Coffee 2004), the discussion on how legal rules can enhance the reliability of ESG ratings is still in its infancy (Siri & Zhu 2019).

The second problem with the role of institutional investors in sustainable corporate governance is that they have different business models. Consequently, they may influence the sustainability of portfolio companies in different ways, or not at all. According to a longstanding distinction (Hirschman 1970), 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 long-term shareholder welfare. The impact of these corporate governance strategies differs, too. Exit tends to depress the stock price of portfolio companies, but because not all investors are committed to sustainability, it may take a while before the price of unsustainable companies incorporates the negative externality. Voice is more immediate, as it affects the sustainability of corporate decision-making directly, but implies foregone 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. As I argued in previous work (Pacces 2016), short-term, transient investors are not interested in corporate governance, apart from activist hedge funds that admittedly do not pursue sustainability. The key difference in corporate governance is between active, dedicated investor and passive investors that track market indices to a varying degree (Bushee 1998). Both categories of investors are long-term investors, so they potentially care for sustainability. However, active investors have powerful incentives to exit/enter investments based on non-public information (Edmans & Manso 2011), 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 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 investors foster the sustainability of portfolio companies. However, it is unclear whether they do so by way of exit or voice, which makes it impossible to say whether institutional investor behaviour is in line with what beneficiaries want. Overall, institutional investors have an impact on several ESG ratings of portfolio companies. According to some studies (Gantchev et al 2019), this depends on exit; according to others, voice plays the main role (Dyck et al 2019). Most actions by institutional investors are not observable because engagement takes place behind closed doors (McCahery et al 2016). This is reflected by the limitations of the extant empirical studies, which either try to identify engagement indirectly or are based on surveys (Krueger et al 2019) and non-public data from specific investors (Dimson et al 2019; Becht et al 2019). While one has to be cautious about the generalizability of these studies, they suggest that active investors tend to participate in corporate governance by way of both voice and exit. In particular, engagement provides information spillovers that benefit the exit strategy.

There isn't much evidence about the impact of index investors on sustainability, which is unfortunate because such investors have a huge potential to engage portfolio companies on sustainability. First of all, index investors are very large. The "Big Three" U.S.-based investors (Blackrock, Vanguard and State Street) have together \$15,5 trillion of assets under management and the vast majority of the equity funds they operate is indexed. Moreover, each of the Big Three has large stakes in virtually every listed company in the world. Finally, as mentioned, index funds cannot exit, which commits them to voice. However, because they pursue a low-cost investment strategy, it is questionable that they care about corporate governance at all (Isaksson & Çelik 2013). According to some commentators (Bebchuk & Hirst 2019), this reflects a severe agency problem that regulation should fix by incentivizing index investors' expenditures on engagement. In contrast, Rock & Kahn (2019) have argued that index investors have sufficient incentives to engage companies particularly on universal issues, such as ESG, which apply indistinctively across diversified portfolios and thus have a lower cost per company. Their argument is twofold. First, particularly the Big Three invest on a very large scale, which implies a substantial interest in the long-term performance of their portfolio companies. Engaging any of these on sustainability and other long-term issues will affect the investor's fee income as a proportion of AUM. Secondly, not all the funds operated by the Big Three are indexed. The sustainability information acquired to engage the companies in the index funds will be also useful to decide investments and divestments of the active funds.

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 climate-change minded beneficiaries prefer to foster sustainability via corporate governance rather than political voting (Rock 2020)? The main challenge to incorporate the preferences of end-shareholders in corporate governance 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, several commentators have argued that shareholder wealth maximization is the only norm on which *all* shareholders could agree (Fisch & Davidoff 2020). 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 them.¹⁰ Another possibility is pass-through voting, which is, however, fraught with problems – most notably the risk for large institutional investors to disband their biggest advantage: concentrated voting power (Fisch 2020).

To address the comparison between corporate voting and political voting, institutional investors may be framed as parties in a political spectrum. Like parties, institutional investors can reflect the varying sustainability preferences of beneficiaries so long as their behaviour is consistent over time. Both economists (Bolton et al, 2019) and legal scholars (Bubb & Catan 2019) have recently studied the voting behaviour of U.S. institutional investors in this fashion. The result, albeit preliminary, are interesting as they suggest that the voting behaviour of large institutional investors (e.g. the Big Three) or proxy advisors (e.g. ISS) is predictable in a comparable way as political parties in a parliament. If institutional investors and their advisors behave predictably, beneficiaries might choose the investors depending on their stance on sustainability. Beneficiaries, however, may be completely unaware of how institutional investor cast their vote and, even more so, that they follow a “political” patterns in exercising corporate governance.

Here the law has an important role to play.

4. The Role of the Law

The challenge for sustainable corporate governance is the alignment of institutional investors’ behaviour with the environment-friendly preferences of their beneficiaries. This is not conceptually different from the conflicts of interest affecting the delegation of investment to intermediaries such as investment firms, mutual funds, and pension funds. However, as the foregoing discussion reveals, there are at least two complications. One is the transparency of institutional investor behaviour as it relates to sustainability, as opposed to financial performance, which affects the coordination of beneficiaries’ preferences in corporate governance. The second complication is that, whereas risk and return are well-trodden concepts, what counts as sustainable investment is undefined, particularly in the context of specific economic activities. This potentially undermines the knowledgeable screening of institutional investors by the beneficiaries. The recent EU regulatory framework tries to address both problems.

In 2018, the European Commission (2018) published an ambitious Action Plan to support sustainable finance. 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 paper.¹¹ I will focus on two major aspects. First, the Taxonomy Regulation (EU) 2020/852 introduces 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 Disclosure Regulation (EU) 2019/2088 compels all financial market participants (including all categories of institutional investors) and financial advisors to disclose the climate risk exposure and investment

¹⁰ See Griffith (2020), wondering why private ordering has not yet offered this solution. Hart & Zingales (2017) discuss the same question, assuming incorrectly that fiduciary duties in the U.S. would prevent such arrangement. On why this is not the case, see e.g. Williams (2018).

¹¹ See Siri & Zhu (2019) for an excellent overview.

sustainability in terms of the Taxonomy Regulation regime. A third, crucial legislative aspect affecting sustainable 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.

Let me start with SRD II. With this 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. While 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 funds routinely cast their vote in a transparent manner (Griffith 2020: 998-1000). Whereas the largest asset managers (e.g. the Big Three) have in-house stewardship groups advising voting, smaller institutional investors cannot afford this and rely on proxy advisors (Iliev & Lowry 2015). In the EU, similar rules apply since the general meeting season 2020 based on art. 3g of SRD II. Institutional investors 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, among others. This is an important difference from the U.S., where the voting transparency requirements do not refer to ESG 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.

Although it is too early to evaluate the first year of application of SRD II, it is hard to imagine that institutional investors will opt out of transparency of voting on this particular aspect, given the momentum of sustainability in Europe. As argued by Paccès (2018), the question is rather the quality of engagement and the individual company's decision-making on sustainability, because particularly institutional investors which follow a low-cost index tracking strategy hardly have any company-specific information. This question is, however, superseded if one takes a market-wide approach to the sustainability problem. From that standpoint, what matters is not so much how the individual company manages the transition to more sustainable production processes, but rather how a portfolio of companies integrates investment in sustainable activities. This perspective confers upon index investors a comparative advantage. As 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. Moreover, the positioning of institutional investors on these issues, particularly ESG, allows beneficiaries to choose the funds that best reflect their sustainability preferences. The remaining challenge is the reliability and the saliency of the information provided by institutional investor about their engagement on sustainability.

Establishing how sustainability-minded institutional investors really are is a problem transcending voting and engagement with portfolio companies. The first question is whether funds that claim to make sustainable investments actually do so. This is a crucial aspect for a knowledgeable choice by beneficiaries, which the EU Disclosure Regulation has tackled. Among 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, and 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 provide proprietary information and the lack of standardization of this information.¹² This step, 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. Having come into force on 12 July 2020, it only establishes a framework that will have to be detailed by secondary legislation on technical standards. However, the Taxonomy Regulation already sets the principle that in order for any activity to be labelled as 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 no 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 fossil fuels can never be regarded as a sustainable activity.¹³

It is too early to predict the impact of this monumental EU legislation on the sustainability of beneficiaries' choices and institutional investors' behaviour, also considering that this regime will only start becoming effective in 2022 or 2023, depending on the goal.¹⁴ However, because financial markets are forward-looking, some effects will start materializing earlier, as soon as the technical standards applying to specific activities will become known. The immediate impact will be most likely on the portfolio choices of institutional investors. An increasing alignment of equity investment with the EU Taxonomy will be necessary to appease to environment-friendly beneficiaries who will immediately see what is sustainable and what is not. Revealing a good understanding of the functional meaning of investment suitability for retail investors, art. 7 of the Taxonomy Regulation mandates explicit disclosure of the non-sustainable character of products that do not qualify as sustainable according to the Taxonomy and the Disclosure Regulation.¹⁵

Moreover, it is hard to imagine that the introduction of the Taxonomy will not have an impact on corporate governance. Index investors who want to improve on their sustainability scores will have no choice but to engage with companies on ESG matters, because they cannot simply avoid companies that do not qualify as sustainable under the Taxonomy Regulation. Active investors, too, 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

¹² On these problems and the economic rationale of mandatory disclosure, see Armour et al (2016).

¹³ Art. 19(3) Taxonomy Regulation.

¹⁴ The Taxonomy Regulation prioritizes climate change mitigation and adaptation. The relevant technical standards will apply from 1 January 2022. The technical standards relating to the other goals will apply from 1 January 2023.

¹⁵ See Paces (2000) recommending this approach to flag the lack of suitability of financial investment.

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 in virtually every sector in every part of the world. Adding this additional player to the production of rules to curb negative externalities is unlikely to decrease social welfare.

5. Conclusion

The meaning of sustainability is often in the eye of the beholder. From an economic standpoint, sustainability implies *inter alia* reducing the negative externalities of production on the environment. 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. Whether sustainable finance can work notably depends on the role of institutional investors in corporate governance. Most individuals indirectly own shares in the world's largest corporations via institutional investors, which are big and influential on corporate decision-making. This holds a considerable promise to the extent that these individuals care for sustainability, but also brings the question whether their preferences are reflected by institutional investors' actions and impact. A major claim of this essay is that law plays a decisive role in this respect.

In this essay, I have analysed the recent EU legislation as it relates to sustainable corporate governance. Institutional investors may pursue sustainability in corporate governance, whether by portfolio choices, voting power, or both. However, it is unclear whether they actually do this, 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 and upcoming EU law on standard sustainability indicators, transparency of voting behaviour, and disclosure of sustainable investment by institutional investors is likely to improve this incentive alignment, making institutional investors increasingly cater to the preferences of their beneficiaries for sustainability. Whether and 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 legislation on sustainable finance and corporate governance will provide interesting material to answer this question empirically.

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