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Publication date
2022

Document Version
Final published version

Published in
Festschrift in honour of Rolf Skog

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Abstract

This paper discusses the potential of the EU rules mandating sustainability disclosure to support a sustainable corporate governance.

The EU has uniquely established a regulatory taxonomy of environmentally sustainable activities to elicit investors' preferences towards sustainable investments. It is potentially efficient to channel these preferences thorough corporate governance, as opposed to the political process, because the concentration of institutional shareholding has lowered the transaction costs of shareholder action. However, institutional investors' incentives are not aligned with the interest of their beneficiaries, which may lead to greenwashing and insufficient corporate governance engagement.

This paper argues that the new system of EU sustainability disclosure, centred in the EU taxonomy, will foster a sustainable corporate governance. Firstly, the mandatory disclosure of the degree of taxonomy alignment will establish a credible signal of environmental sustainability. Secondly, the inclusion of sustainability preferences into the suitability and product governance rules will make this information salient for the beneficiaries of institutional investors. Thirdly, in the competition for sustainability-minded beneficiaries, large index investors cannot avoid less sustainable companies whereas negative screening undermines risk diversification by active investors. Therefore, institutional investors will increasingly cater to beneficiaries' preferences for more environmentally sustainable portfolios by way of voice, instead of exit.

1 Introduction

In the work by Rolf Skog, ownership is the driving force of corporate governance. As residual claimants, shareholders have the right to control the allocation of resources by corporations. Corporate governance is ultimately about how shareholders exercise this right.[1] The focus on ownership brought us together as in the study of comparative corporate governance Sweden stood out as puzzle: a concentrated ownership system with

* Professor of Law & Finance, Amsterdam Center for Law & Economics, University of Amsterdam, and ECGI. I wish to thank Marcello Bianchi, Luca Enriques and Erik Lidman for comments, and Luís A. Mendes for research assistance. All errors are mine. Keywords: Sustainability, Disclosure, EU Taxonomy, Securities Regulation, Corporate Governance, Institutional Investors, Exit and Voice. JEL classification: G38, K22, Q56.

1. Skog, R. (2005). "A Remarkable Decade: The Awakening of Swedish Institutional Investors". *European Business Organisation Law Review*, 16, 1017.

a vibrant market for corporate control and hardly any minority shareholder expropriation.[2] Fuelled by a rather unique combination of legal rules, social norms, and ownership patterns, Sweden continues to highlight the virtues of a controlling shareholder system. However, in Sweden as elsewhere, another category of owners – the institutional investors – have changed the way we think about corporate governance.

Institutional investors are the largest owners of the world.[3] In this essay, I am going to discuss institutional investors' role in supporting a sustainable corporate governance. In line with Rolf Skog's approach, I am looking at the concept of sustainable corporate governance from the perspective of ownership. This is not how this topic is always understood, particularly in the language of the EU institutions. The European Commission and the European Parliament have recently put forward a proposal to establish a sustainable corporate governance framework by way of director duties and other constraints on corporate decision-making.[4] This approach to sustainable corporate governance is based on the idea that corporations need a commitment device, such as regulation, to have a purpose different from profit maximization and to stick to it.

This essay's approach to sustainable corporate governance is based on the idea that corporations pursue whatever goals their shareholders choose. Traditionally, business corporations pursue profit to maximize the joint utility of their investors, and in this way, they contribute to the efficient allocation of resources.[5] However, this is not a foregone conclusion. Profit maximization does not imply maximization of social welfare if investor preferences also include a concern for a common good that is undermined by profit maximization and whose damage is costlier to repair than to avoid, as with climate change.

In economics, the undermining of a common good is a negative externality. As in previous work,[6] I define sustainability in corporate governance as the correction of negative externalities, such as the adverse impact of corporate actions on the well-being of individuals having no contractual relation with the corporation, including future generations. Sustainability is otherwise an elusive concept. It confuses two already ill-defined notions: the corporation's concern for stakeholders other than shareholders, without explaining how to balance the interest of these constituencies; and a preference for long-term, as opposed to short-term, decision-making without specifying what counts as long or short and what interest is at stake in the computation. Focusing on shareholders' concern for negative externalities clarifies that sustainable corporate governance means limiting some specific, adverse impact of profit maximization on the society *to the extent that shareholders want this*.

2. Pacces, A.M. (2012). Rethinking corporate governance: The law and economics of control powers. Routledge, 295–298, 391–395.

3. De La Cruz, A., Medina, A., & Tang, Y. (2019). "Owners of the World's Listed Companies". *OECD Capital Markets Series*, Paris.

4. European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)) – Draft Directive on Corporate due diligence and corporate accountability. For a word of caution against this approach, see Edmans, A., Enriques, L., Fried, J., Roe, M., & Thomsen S. (2021). "Call for Reflection on Sustainable Corporate Governance", *European Corporate Governance Institute* (ECGI).

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

6. Pacces, A.M. (2021). "Sustainable Corporate Governance: The Role of the Law." In D. Busch, G. Ferrarini & S. Gruenewald (eds.), *Sustainable Finance in Europe*, Palgrave MacMillan, 151-174.

Institutional investors are prominent shareholders of publicly held corporations worldwide, but the real owners – meaning, the corporations' residual claimants – are the beneficiaries of these investors. Clients of mutual funds, pension funds, and of comparable collective investment schemes are those bearing the financial consequences of what corporations do, and thus those who can decide to trade these consequences for negative externalities. The beneficiaries' concern for the externalities of public corporations is ultimately what matters for a sustainable corporate governance. This provides an opportunity and a challenge. The opportunity is that, compared to traditionally atomistic shareholders, the owners of the modern public companies are no longer too dispersed to matter. They hold shares through institutional investors which, in turn, are large shareholders that can influence corporate management. The challenge is that institutional investors are also profit-maximizing entities. Their incentives are not necessarily aligned with the interest of their beneficiaries. As a result, institutional investors may fail to pursue sustainable corporate governance even though their beneficiaries want it or pursue sustainable corporate governance when beneficiaries do not want this. More subtly, institutional investors may pretend to pursue sustainability taking advantage of the ambiguity of its definition, as explained before.

The law, in particular securities law, can align the incentives of institutional investors with the interest of their beneficiaries. EU securities regulation has specifically taken this stance in the context of the Sustainable Finance Action Plan.[7] Aiming to encourage private investment in sustainable activities, the EU legislator has created a system of disclosure rules designed to communicate unambiguously whether and to what extent an investment is sustainable. This system is based on a unique regulatory taxonomy of sustainable activities and investments therein, which is being completed and will be applied from 2022. In this way, the beneficiaries of institutional investors will be prompted to decide how much they want to invest in sustainable economic activities, as defined by the EU. Short of the unavoidable imperfections of such a system, it purports to elicit investors' preferences towards sustainability. This, in turn, will have consequences on the behaviour of institutional investors, which must cater to these preferences to attract their clients.

In this article, I will explore the consequences of the EU Taxonomy on the corporate governance behaviour of institutional investors. Because the EU Taxonomy currently includes only environmental sustainability, I will also focus on this and particularly on climate change. The advantage of limiting the analysis to climate change is that the strategies to cope with it are measurable, if only in terms of Greenhouse Gas emissions (GHGs), which again reduces the ambiguity about sustainability and allows learning more about the behaviour of institutional investors and their beneficiaries. The remainder of this article is as follows. In the next Section, I will discuss the theory of investor preferences towards prosocial goals, such as environmental sustainability, and how these can be efficiently channelled through corporate governance as opposed to the political process. In Section 3, I will analyse the recent changes in EU securities regulation focusing on how they bring the EU Taxonomy of sustainable investment in the decision set of retail investors. In Section 4, I will move on to the implications for institutional investor

7. Commission Communication COM(2018)97 Action Plan: Financing Sustainable Growth.

behaviour. Because the EU Taxonomy is not yet in force, it is impossible to study its impact empirically. Nevertheless, looking at the theory and the existing evidence, I will discuss how institutional investors are expected to react to the introduction of the EU Taxonomy. I will pay particular attention to the question whether institutional investors will respond to the increased saliency of sustainability for beneficiaries by way of voice or exit.[8] Section 5 will conclude.

2 The Theory

In this Section, I discuss the theory behind the control of negative externalities through corporate governance as opposed to government regulation.

In economics, firms such as corporations are assumed to maximize profit and, in doing so, to contribute to the optimal allocation of scarce resources, short of market failure. As a prominent example of the latter, firms produce negative externalities, such as GHGs, when their private cost is lower than the social cost. Governments try to correct externalities by increasing the price of input, by way of Pigouvian taxes, or limiting the quantity of input/output, by way of command-and-control regulation. Ronald Coase famously argued that externalities would self-correct in a world without transaction costs,[9] and more importantly, that to correct market failure in a world of positive transaction cost one should compare how different institutional arrangements score in terms of transaction costs.[10] I will return to the transaction costs argument momentarily.

In the traditional economic framework, corporations should maximize shareholder utility by providing them with the highest possible profit, within the limits of regulation, taxation, and ethical norms.[11] This isn't because all shareholders are selfish, but because the shareholders who care for other members of society are supposedly better off giving (a part of) their share of maximum profit to charity instead of getting a lower profit net of charity decided by someone else. Thus, governments should take care of aligning private cost with social cost whereas individuals should manage their non-monetary preferences. This approach, which dominated economics (and law & economics) for decades, has two limitations. First, governments have proved not so good at policing externalities after all. Second, charity is insufficient to support individuals' concern for the well-being of society when negative externalities are costly to reverse.

As explained by Bénabou and Tirole, governments face shortcomings in policing externalities.[12] Governments' ability to align private cost with social cost is affected by lobbying. This problem is exacerbated by interjurisdictional externalities, for which governments face higher cost of coordination than multinational firms. Finally, governments respond, albeit imperfectly, to the preferences of the median voter, which due to the ageing western population underweights the interest of younger generations. The

8. Hirschman, A.0. (1970). *Exit, Voice and Loyalty.* Cambridge, MA: Harvard University Press.

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

10. Coase, R.H. (1991). "Nobel Prize Lecture: The Institutional Structure of Production". *The Nobel Foundation*: https://www.nobelprize.org/prizes/economic-sciences/1991/coase/lecture/.

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

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

second problem, highlighted by Hart and Zingales, is that externalities are not always separable from the production process.[13] If Walmart sells firearms that can be used in mass shootings of children, correcting this externality, for instance by patrolling schools and playgrounds, would cost shareholders more than stopping selling firearms in the first place. A similar reasoning applies to climate change. Although investors may pay to offset CO2 individually, this isn't a solution in the aggregate at least to the extent that the technology to capture and store CO2 is not sufficient to avert the climate change problem.

There is therefore an economic case for investors trying and stopping companies from producing externalities. However, because investors face coordination problems like those of voters, if not more severe, one might doubt whether investors can fare any better in the control of externalities than citizens electing governments. This is a relevant question for policymakers deciding whether to focus on improving the regulatory process as opposed to corporate governance, to cope with negative externalities. In the spirit of Coase, I posit that the answer depends on comparative institutional analysis. Corporate governance is a good approach to correct externalities to the extent that the transaction costs are lower compared to correcting externalities via the political system or by way of charity.

The transaction cost of an individual investor's action in corporate governance used to be huge, due to extremely small stakes and the collective action problems of retail investors. Things have changed considerably with the institutionalization of savings. The bulk of retail investors hold shares in the largest publicly held companies indirectly, via institutional investors. Large publicly held companies account for one-third of the top-100 CO2 producers, which in turn are responsible for 71% of GHGs.[14] The 'Big Three' world-largest institutional investors – Blackrock, Vanguard, and State Street – hold significant stakes in all these companies, as in thousands of smaller contributors to GHGs. The holdings of other institutional investors are similarly concentrated.[15] Therefore, institutional investors can influence the abatement of negative externalities, such as GHGs. Moreover, because they manage the savings of retail investors, it is plausible to consider them as a vehicle for retail investors' preferences for environmental sustainability.

The transaction costs of a sustainable corporate governance may have become lower because of institutional investors. Whether this is the case depends on two issues. First, there is a question about what the preferences of retail investors are and to what extent they include a concern for environmental sustainability. Second, there is an agency cost problem. For institutional investors to channel the preferences of their beneficiaries to

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

14. CDP (2017). "New report shows just 100 companies are source of over 70% of emissions". Retrieved from: https://www.cdp.net/en/articles/media/new-report-shows-just-100-companies-are-source-of-over-70-of-emissions.

15. In 2018, the firms included in the MSCI World index accounted for 56% of GHGs. In these MSCI firms, the average institutional ownership is 45% and the Big Three hold on average 4.8%. See Azar, J., Duro, M., Kadach, I., & Ormazabal, G. (2020). "The Big Three and Corporate Carbon Emissions Around the World". European Corporate Governance Institute (ECGI) – Finance Working Paper No. 715/2020, https://dx.doi.org/10.2139/ssrn.3553258 (forthcoming in *Journal of Financial Economics*).

the portfolio companies, their incentives must be aligned with the beneficiaries' interest. I am discussing these issues in turn.

There are three theories on how investors may want corporations to incorporate concerns about environmental sustainability.[16] The first is "Doing Well by Doing Good": a corporation incorporating climate risk (including 3 components: physical risk, regulatory risk, and technological risk)[17] will eventually outperform competitors as soon as this risk is priced correctly. This is effectively a short-termism theory that implies no trade-off between a prosocial goal and financial performance. Following it, corporations reduce externalities anticipating a future in which these will be curbed more effectively. The second theory, "Delegated Philanthropy", is more ambitious. It posits that investors expect corporations to pursue a prosocial goal, such as reduction of GHGs, even though this results in lower long-term returns. This theory implies curbing externalities more than needed to cope with future risks. The third theory, "Corporate Philanthropy", posits that corporations should pursue a prosocial goal whether investors want it or not. As it disenfranchises shareholders, this theory results in potentially extreme agency costs that could undermine the goal of pursing sustainability via corporate governance as opposed to public regulation. I am therefore not considering it further.

These theories are hard to distinguish empirically. As explained by Bénabou and Tirole, the same corporate action may be interpreted as evidence of any of these theories. However, a few considerations are in order. First, the incentives of institutional shareholders who own well-diversified portfolios, like the Big Three, are aligned with a Doing Well by Doing Good strategy. Institutional investors that do not actively manage their portfolios track market indexes and thus hold stock in virtually any company in the world. As diversified, universal owners, they are going to take the hit of climate risk in one way or another, so minimizing climate and other cross-cutting risks is unambiguously profitable for them. Index investors should thus incorporate climate risk in their decision-making and prompt portfolio companies to do the same.[18] Borrowing from the language of portfolio theory, this universal ownership argument has been framed as 'Systematic Stewardship' as it echoes the systematic risk of a diversified portfolio.[19] This approach is naturally in line with the financial goal of beneficiaries of diversified investors, namely maximizing the risk-adjusted return of their portfolio.

A second consideration is that beneficiaries of institutional investors may want more than financial return, namely Delegated Philanthropy. As framed by Hart and Zingales, it is plausible to assume that investors also have ethical concerns for which they feel responsible – such as the investee corporation's GHGs – and are willing to accept lower

16. This is based on Bénabou & Tirole (2010), *supra* note 12. For a more detailed discussion, *see also* Pacces, (2020), *supra* note 6.

17. *See* 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, https://dx.doi.org/10.2139/ssrn.3235190 for illustration of different aspects of climate risk and how investors care for them.

18. Passive index-tracker funds have a limited ability to bear the cost of climate risk management, a point to which I will return in Section 4.

19. Gordon, J. (2021). "Systematic Stewardship". Columbia Law and Economics – Working Paper No. 640, European Corporate Governance Institute (ECGI) – Law Working Paper No. 566/2021, https://dx.doi.org/10.2139/ssrn.3782814.

returns on this basis. Short of practical difficulties, featuring the non-financial preferences of shareholders in corporate governance is consistent with the basic legal principle that corporations should pursue whichever goal the majority of their shareholders want – sometimes referred to as "fiduciary duties".[20] Finally, there is indirect evidence that at least some beneficiaries are prepared to give up financial return to reduce climate change externalities.

Using the introduction of the Morningstar Globes rating – a synthetic, visual indicator of Environmental-Social-Governance (ESG) sustainability – as a natural experiment, a finance study found that beneficiaries switched away from actively managed funds with the lowest ratings towards funds with the highest ratings.[21] Moreover, the authors were able to attribute the choice by beneficiaries to nonpecuniary motives. Another finance study found that the introduction of the Morningstar Low Carbon Designation – a label of environmental sustainability based on GHGs – not only had an even stronger impact than Globes on fund flows, but also triggered a reaction by fund managers who altered their portfolio composition to obtain the designation in the next period.[22] Also in this study, the motivation of fund switch by beneficiaries is nonpecuniary. While the jury is still out to decide how much beneficiaries care about sustainability, and whether they care enough to outweigh the preferences of those who focus on financial returns,[23] it seems undeniable that a significant proportion of retail investors support Delegated Philanthropy, particularly in the context of climate change.

Coming to the agency problem, the attractiveness of ESG labels for retail investors is not necessarily good news for climate change. Because mutual funds compete aggressively on fund flows, institutional investors have incentive to acquire the ESG label, but not necessarily to pursue environmental sustainability. On this perspective, the fact that, during the first quarter 2021, inflows into ESG funds surpassed those into conventional funds in Europe – and follow a similar, albeit somewhat lagged, trend in the U.S. – is potentially worrisome.[24] This rapid transformation of the mutual fund industry may conceal a big agency problem. In the context of environmental sustainability, this problem is called greenwashing. Even though the beneficiaries of institutional investors

20. Fiduciary duties are not necessarily defined in financial terms, as Hart & Zingales (2017), *supra* note 13, seem to assume. *See* Williams, C.A. (2018). "Corporate Social Responsibility and Corporate governance". In *The Oxford Handbook of Corporate Law and Governance*, Oxford University Press, 634–678. To be sure, aggregating financial and non-financial preferences is not trivial. In the next Sections, I will hint at the role of institutional investors to solve this problem.

21. 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.

22. Ceccarelli, M., Ramelli, S., & Wagner, A.F. (2020). "Low-Carbon Mutual Funds". European Corporate Governance Institute (ECGI) – Finance Working Paper No. 659/2020, https://dx.doi.org/10.2139/ssrn.3353239.

23. Gantchev, N., Giannetti, M., & Li, R. (2021). "Sustainability or Performance? Ratings and Fund Managers' Incentives". European Corporate Governance Institute (ECGI) – Finance Working Paper No. 747/2021, http://dx.doi.org/10.2139/ssrn.3731006.

24. Bioy, H., Stuart, E., Jmili, S., & Pettit, A. (2021). "European Sustainable Funds Flows: Q1 2021 in Review". Morningstar Manager Research. Retrieved from: https://www.morningstar.com/en-uk/lp/european-sustainable-fund-flows; and Bioy, H. Stuart, E., Hale, J., Tam, I., Kennaway, G., Sato, H., Jung, A.S., & Chow, W. (2021). "Global Sustainable Funds Flow: Q4 2020 in Review". Morningstar Manager Research. Retrieved from: https://www.morningstar.com/lp/global-esg-flows.

increasingly demand ESG funds, they do not know whether companies included in ESG funds effectively contribute to reducing environmental externalities.

Greenwashing is borne out by the empirical evidence. In the U.S., mutual funds profiling themselves as ESG-oriented underperform non-ESG mutual funds on several sustainability measures, notably including the GHGs.[25] Moreover, these funds are more expensive and financially less attractive than the non-ESG funds in the same family. To be sure, there seems to be more going on in the mutual fund industry than greenwashing. For one, institutional ownership is associated with higher environmental sustainability of portfolio companies when the institutional shareholder is based in Europe, but not when it is based in the U.S.[26] In addition, a recent empirical study reveals that self-identified ESG funds in the U.S. are more active and selective on the sustainability of portfolio companies than non-ESG funds.[27] In conclusion, ESG labels are unreliable: they reveal a different investment strategy than conventional funds, but this difference is not always reflected by lower CO2 emissions or other measures of negative externalities.

The greenwashing problem is twofold. First, there isn't a single ESG standard, but many, which diverge considerably. This incentivizes companies and institutional investor to arbitrage between ratings to get a good score at the lowest cost. Second, ESG combines different prosocial goals, most of which are hard to measure and even harder to weight against each other. Rating providers publish more granular information about the E, S, and G components, but this does not solve the problem. Unreliable ESG ratings undermine investor's ability to reduce negative externalities by picking certain institutional investors and, more broadly, the whole viability of a sustainable corporate governance. If institutional investors can pretend, at a low cost, to pursue environmental sustainability, that suffices to attract inflows from beneficiaries who care about climate change, but it won't contribute to averting it. Eventually, the inability of agents to signal a credible commitment to sustainability could lead to the unravelling of the private-label ESG market.[28]

Institutional investors can sometimes overcome greenwashing. A recent study found that the Big Three play an important role in reducing GHGs, despite managing mainly conventional index funds. These institutional investors do engage with the portfolio companies in which they have a significant stake, which are also among the world-largest contributors to GHGs. The engagements appear to be successful as large ownership by the Big Three is associated with a significant, subsequent reduction of CO2 emissions by the portfolio companies. If the Big Three can be collectively credible about reducing negative externalities in certain circumstances, why can individual

25. Gibson, R., Glossner, S., Krueger, P., Matos, P., & Steffen, T. (2021). "Do Responsible Investors Invest Responsibly". European Corporate Governance Institute (ECGI) – Finance Working Paper No. 712/2020, https://dx.doi.org/10.2139/ssrn.3525530.

26. 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.

27. Curtis, Q., Fisch, J.E., & Robertson, A.Z. (2021). "Do ESG Mutual Funds Deliver on their Promises?". European Corporate Governance Institute (ECGI) – Law Working Paper No. 586/2021. Available at SSRN: https://ssrn.com/abstract=3839785.

28. This is an adverse selection problem. *See* Akerlof, G.A. (1970). "The market for 'lemons': Quality uncertainty and the market mechanism". *Quarterly Journal of Economics*, 84(3), 488–500.

institutional investors not establish credibility about whether they pursue environmental sustainability and under which circumstances?

To cope with the greenwashing problem, the law has a role to play. This is to say, the law can reduce the agency costs of institutional ownership and enable a sustainable corporate governance. To this purpose, law should support a commitment by institutional investors, recognizable by beneficiaries, to pursue the environmental sustainability of the portfolio companies. A straightforward way to support investors' commitment is to mandate disclosure of the environmental sustainability of the portfolios based on objective quantitative criteria, such as CO2 emissions. Regulation should also include rules of conduct to make sure that such disclosure results in knowledgeable choices by retail investors, depending on their sustainability preferences. To date, no legal system supports such a commitment although the European Union is rapidly moving in this direction.

3 The Law

In this Section, I discuss how securities regulation – in particular, EU securities regulation – can reduce the agency cost in the relationship between institutional investors and their beneficiaries. Based on the previous analysis, I assume that a few beneficiaries want to invest in environmentally sustainable financial products, leading directly or indirectly to lower GHGs, even though this results in lower returns. Institutional investors have incentives to cater to such preferences, but there is the greenwashing problem. It's just too tempting to pretend being environmentally sustainable and attract fund flows. Regulation is supposed to align these incentives with the interest of beneficiaries.

A prominent goal of securities regulation is investor protection.[29] This includes supporting retail investors' knowledgeable choice of investment products. Securities regulation traditionally pursues this goal by way of mandatory disclosure rules. This approach has long revealed its limitations, as retail investors neither read nor understand complex disclosures. Retail investors focus on salient information, which, however, can be manipulated by financial intermediaries and lead to mis-selling. The reaction of securities regulation has been to simplify disclosure, on the one hand, and complement it with conduct of business rules, on the other, increasingly putting on the financial intermediaries the responsibility to match their products with the retail investors' preferences.

Sustainability adds a degree of complexity to the matter. It is already difficult to interpret the financial preferences of unsophisticated investors. Guiding them to solve the trade-off between financial return and negative externalities is a daunting task. And yet, the European legislator has embarked on this task with the Sustainable Finance Action Plan.[30] This has resulted in a significant overhaul of European Securities Regulation, introducing features unique worldwide, such as a regulatory taxonomy of sustainable economic activities.

It would be impossible to discuss the Action Plan in detail in this article. In what follows, I focus on three characteristics that may align institutional investor incentives with the sustainability preferences of their beneficiaries, thereby reducing the transaction

29. The following discussion is based on 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, 205–244.

30. *See supra* note 7.

cost of sustainable corporate governance. First, the *Sustainable Finance Disclosure Regulation* (SFDR) has created a system whereby *every* institutional investor offering financial products in the EU must publish qualitative and quantitative information about the impact of their investments on sustainability.[31] Second, the *Taxonomy Regulation* (TR) has established a system whereby every investment, offered in the EU, that claims an impact on sustainability must substantiate this claim *quantitatively*, in terms of a regulatory taxonomy of sustainable economic activities.[32] Third, the overhaul of sectoral EU financial regulation, in particular the MiFID,[33] will mandate the inclusion of sustainability preferences – framed in terms of the above-mentioned regulations – in the suitability and product governance obligations of financial intermediaries. I illustrate these three aspects in turn.

The SFDR is pivotal in the EU regulation of sustainable finance. It applies to virtually every institutional investor and asset manager that offer financial products in the EU, and it covers financial advisers too. These entities must disclose in their reports and websites how they tackle sustainability risk and the *Principal Adverse Impacts* (PAIs) of their investments on sustainability factors, detailed by secondary regulation. Institutional investors may choose not to disclose, but in this case, they must explain their choice. Extensive disclosures are mandated at the product level as well.

There are three types of financial products that can be offered in the EU according to the SFDR. First are art. 9, or so-called 'dark green' products, which have sustainable investment as their objective and must disclose how this objective is pursued concretely. Sustainable investments are those which contribute to an environmental or social goal, without harming any of these and featuring good governance practices – all notions specified by secondary regulation. Second are art. 8, or 'light green' products, which promote, among others, environmental or social characteristics and must disclose how these characteristics are met concretely. Third are all conventional financial products, which do not pursue sustainability, but must nevertheless disclose how they integrate sustainability risks into investment decision-making (art. 6) and their PAIs on sustainability factors (art 7), unless they explain why either sustainability risks or PAIs are irrelevant for their investments.

The SFDR is in force since March 2021. The disclosure templates and the quantitative and qualitative indicators of PAIs are specified by Regulatory Technical Standards (RTS) that will apply from 2022.[34] The quantitative dimension is particularly important because, in principle, it enables retail investors to compare how institutional investors and their financial products score in terms of negative externalities. The indicators notably

31. Regulation (EU) 2019/2088 of the European Parliament and of the Council on sustainability-related disclosures in the financial services sector (2019). Official Journal, L317, 1–16.

32. Regulation (EU) 2020/852 of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088 (2020). Official Journal, L198, 13–43.

33. Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (2014). Official Journal, L173, 349–496.

34. Joint Committee of the European Supervisory Authorities (ESAs) Final Report JC/2021/03 on Regulatory Technical Standards on the content, methodologies, and presentation of disclosures under SFDR (2021).

include the GHG emissions of investee companies, specifically scope 1 (direct emissions) and scope 2 (emissions from energy purchased), whereas the publication of scope 3 emissions (GHGs along the supply and value chain) is postponed until 2023 considering the current gaps in the data worldwide. However, sustainability is not only about limiting the harm to the environment or the society, but also about investing in technologies that generate fewer negative externalities. On this perspective, the SFDR mainly prescribes explanations by way of narratives, but crucially, it is complemented by the EU Taxonomy. The Taxonomy defines environmentally sustainable economic activities and investments depending on whether they make a substantial, measurable contribution to improving environmental objectives.[35]

The Taxonomy Regulation is the first step of a very ambitious project of the European Union, aiming to establish a full classification of sustainable economic activities based on standards endorsed by regulation. The project has started from environmental sustainability, focusing on two environmental objectives: climate change mitigation and adaptation. The pertinent standards will apply from 2022. For every activity considered, the standards set a quantitative threshold, typically but not exclusively in terms of GHGs, establishing whether the specific activity substantially contributes to the environmental objective. Looking at climate change mitigation, for example, activities may contribute directly (low to zero carbon transport), as transition activity (efficient electricity production), or as enabling activity (efficient building renovation). Listed activities are taxonomy-aligned if they perform above the threshold, otherwise they are not to be considered sustainable according to the Taxonomy.[36] Many activities are not included in the Taxonomy at all, although they may be included at a later stage by the Platform on Sustainable Finance – a permanent expert group of the European Commission.[37] An investment is taxonomy-aligned to the extent that it finances taxonomy-aligned activities. An investment's degree of taxonomy alignment is a percentage that must be disclosed and is immediately recognizable by retail investors.

The Taxonomy Regulation mandates disclosure of taxonomy alignment for several entities and financial products, adding a straightforward quantitative dimension to the broad coverage of SFDR. Entities subjects to the Taxonomy Regulation – which include the financial and nonfinancial firms subject to the Non-Financial Reporting Directive (NFRD)[38] – must disclose the proportion of their *turnover* and of their operating and *capital expenditures* that are taxonomy-aligned. In this way, all issuers and financial firms in scope – with the latter being expanded to all listed companies and financial intermediaries[39] – will have to publish precise information about how

35. *See* art 3 TR and the six environmental objectives in art 9 TR.

36. Draft Commission Delegated Regulation supplementing Regulation (EU) 2020/852, 4.6.2021, C(2021) 2800 final, Annex I (climate change mitigation) and Annex II (climate change adaptation).

37. *See* Platform on Sustainable Finance established under art. 20 Regulation (EU) 2020/852. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance/platform-sustainable-finance_en.

38. Directive 2014/95/EU of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosures of non-financial and diversity information by certain large undertakings and groups (2014). Official Journal, L330, 1–9.

39. Commission Proposal COM(2021)189 for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/34/EU, Directive 2004/109/EC and Regulation (EU) 537/2014 as regards corporate sustainability reporting.

sustainable they currently are (turnover) and aim to become (capital expenditures). This is important information, which feeds into the definition of environmental sustainability of individual financial products.

The Taxonomy also applies to the three categories of financial products defined by the SFDR. Dark green products will have to disclose the proportion of sustainable investment that is taxonomy-aligned with respect to a specific objective, as a percentage of all investments. Similarly, light green products will have to include such a disclosure to the extent that they promote environmental characteristics by including sustainable investments, specifying that the remaining portion of the underlying investments "does not take into accounts the EU criteria for environmentally sustainable activities". Such a negative disclosure also applies to the conventional products that make no sustainability claim. These will have to include a warning that the financial product "does not take into account the EU criteria for environmentally sustainable activities" (art 7 TR).

In this context, all EU-based asset managers will have to disclose how much of their total investments are taxonomy-aligned. Fulfilling this obligation will be challenging, particularly in the first years of application of the Taxonomy. Institutional investors must rely on issuers for this kind of information, but issuers will only be obliged to publish the proportion of taxonomy-eligible activities for the year 2022 (in 2023) and their taxonomy alignment for the year 2023 (in 2024). Thus, in the initial phase, a lot will depend on voluntary disclosures. The expectation is that institutional investors will have a strong incentive to calculate – and ask their investee companies to calculate – their degree of taxonomy alignment to avoid losing clients to competitors. At the same time, because the regulator has intentionally set the bar of environmental sustainability high (in line with the language 'substantial contribution' to climate change mitigation and adaptation), the first data on taxonomy-alignment are expected to be modest and only improve with time. Therefore, institutional investors managing mainly conventional index funds, such as the Big Three, might well disclose the taxonomy alignment of their products, if only to avoid the stigma of negative disclosure.

Most important, the degree of taxonomy alignment of a portfolio is a signal. It is easily recognizable by beneficiaries who care about environmental sustainability. Moreover, it is credible because it is based on measures established and enforced by regulation. Although these measures reflect a political compromise and thus may be flawed, they are ultimately based on CO2 emissions, which make the signal costlier to imitate and reduce greenwashing. As such, these measures can ameliorate the adverse selection problem stemming from the ambiguity of private-label ESG indicators, discussed in the previous Section. In principle, the taxonomy alignment should also lead beneficiaries to a knowledgeable choice of institutional investors matching their sustainability preferences, thereby reducing agency cost. To this purpose, however, the taxonomy should be salient to retail investors, a point to which I now turn.

Even though they are concerned about climate change and negative externalities, retail investors are not necessarily alert to indicators such as PAIs or the degree of taxonomy alignment when they choose how to invest. And even if they are alert, it is doubtful whether retail investors appreciate the consequences of these indicators on their investment choice. Most retail investors buy financial products through financial intermediaries, such as investment firms or, in Europe, banks providing investment services. A third, most important aspect of the Sustainable Finance Action Plan is, therefore, the inclusion of investor sustainability preferences into the investment firm's assessment of suitability and product governance obligations.

Normally, investment firms providing advisory or asset management services would have to provide their clients with suitable recommendations based on the client knowledge and preferences with regard to risk/return trade-off. With a recent amendment to the MiFID Delegated Regulation, the EU legislator has included the consideration for the client "sustainability preference" in the suitability test.[40] Importantly, the sustainability preference will have to be expressed in terms of SFDR or the Taxonomy Regulation, indicating, in particular: i) a minimum proportion of taxonomy-aligned activities; or, ii) a minimum proportion of sustainable investment; or, iii) qualitative or quantitative elements of acceptable PAIs. In the provision of advised investment services, investment firms will thus have to ask their clients whether they request a minimum sustainability threshold, and only then advise on the suitable risk/return combinations.

Suitability is a very important rule for investor protection and the overall efficiency of securities markets, because it enables unsophisticated investors to make investment choices consistent with their preferences.[41] Unfortunately, the applicability of this rule in the EU is limited to situations in which investors receive personalized recommendations. However, the vast majority of retail investors do not ask for official advice when they decide how to invest.[42] Investment advice is very often hidden in marketing communications by banks or other multi-service investment firms (so-called 'financial supermarkets') where the typical European investor goes to. These communications are excluded from the suitability rule and are prone to conflicts of interest. Securities regulation has responded to this problem with product governance. Product governance is a form of principle-based regulation that puts on the investment firm the responsibility to pursue the client's best interest. Financial intermediaries must embed product governance in their internal procedures, notably including those governing the design and the marketing of financial products.

The reform of MiFID framework requires the inclusion of investor sustainability preferences in product governance too.[43] All providers of investment services will have to include sustainability factors, as defined by the SFDR and the Taxonomy Regulation, in the definition of their target markets, and distribute financial instruments accordingly. Moreover, the sustainability factors of financial instruments should be presented in a transparent fashion to allow distributors to determine whether they are consistent with the client's sustainability objectives. Although these previsions are still to be implemented by national law, this approach completes the sustainable finance circle. Investment products will soon have to disclose objective and comparable measures of environmental sustainability. In offering these products to retail investors, whether through formally advised or non-advised channels, banks and investment firms will have to make sure

40. Commission Delegated Regulation (EU) C(2021)2616 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.

41. 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.

42. Amour et al. (2016) *supra* note 29, 216–218 for an explanation.

43. Commission Delegated Directive (EU) C(2021)2612 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations.

that these measures are aligned with the client's sustainability preferences. Conversely, beneficiaries of institutional investors will be prompted to indicate a minimum degree of sustainability that they consider acceptable, and then compare what is on offer in terms of risk/return trade-off.

The reform of EU securities regulation has the potential to harness the role of beneficiaries' prosocial preferences, particularly their concern for environment sustainability, in financial markets. The impact of this reform will depend, however, on how the companies being financed react. Because I have focused on corporate governance, I will now turn to institutional investors to provide a tentative answer to this question.

4 What Can We Expect from Institutional Investors?

In this Section, I try to answer a simple question: How will institutional investors react to the increased saliency, supported by regulation, of environmental sustainability for their beneficiaries? More specifically, I ask whether institutional investors will choose to exit the portfolio companies that drag down their sustainability scores, or rather use their voice to make these companies more sustainable.

These questions cannot be answered in a final way. A first problem is that most of the regulations described in the previous Section are not yet in force. Although the regulatory design is final or near-to-final, institutional investors and their portfolio companies are still figuring out how to comply. It is too early for both categories of firms to decide how to adjust. This leads to a second problem. As illustrated in Section 2, both theory and existing evidence suggests that some beneficiaries of institutional investors care for reducing negative externalities. However, how many beneficiaries actually care and how much they are willing to sacrifice in terms of financial return is ultimately an empirical question whose answer, so far, has been undermined by greenwashing. Assuming, as I have done, that the reform of EU securities regulation will act as a curb on greenwashing, one would still have to wait for the first data on taxonomy-alignment. In what follows, I will therefore present a few theoretical considerations about how institutional investors can be expected to react to the introduction of the Taxonomy and similar quantitative indicators.

Institutional investors are not all alike. They differ on a number of counts, which would be impossible to examine in detail here. A difference on which I will focus is whether they have an active or a passive management strategy. This is a longstanding distinction.[44] To simplify, in the context of equity investment, active funds are stock pickers. They can dump companies which they consider insufficiently sustainable, if they so wish. However, they must be able to offer their beneficiaries an attractive risk/return combination net of their fees. Passively managed funds, which include index funds and so-called closet indexers (or quasi-indexers), simply track an index more or less strictly. They bid extremely low management fees as they compete on keeping cost low, which

44. *See* Bushee, B.J. (1998). "The Influence of Institutional Investors on Myopic R&D Investment Behavior". *Accounting Review*, 73(3), 305–333 (dividing investors into dedicated, transient, and quasi-indexers).

is intuitive as their portfolios are essentially automated. However, passively managed funds cannot dump companies they do not like. They can engage with the companies they think are not sufficiently sustainable, but still belong to the index they track, or else change index, for instance by creating new funds or repurposing existing ones. Whatever active and passive investors choose to do, their income is a percentage of Assets Under Management (AUM). Therefore, they anyway have an incentive to increase the inflows of beneficiaries.

Let me start with active funds. They compete on relative performance net of management fees, meaning that in theory beneficiaries will pick them when they generate higher net returns than other funds. The bulk of an active fund manager's investment is information on the expected performance of stock they do and may invest in. This made the finance literature conclude that the leading strategy of actively managed funds is exit.[45] These funds are generally better off underweighting the losers and overweighting the winners than by engaging with the underperforming companies. This strategy results in both higher performance and higher attractiveness to beneficiaries. Adding the impact of environmental sustainability complicates things, however. In a recent study, Morningstar has analysed the preliminary classification of European funds as art. 8 and art. 9 SFDR funds.[46] It is expected that these green funds will account for 25% of the European investment fund universe. This is in line with the finding, discussed previously, that green funds currently attract more than half of European fund flows. Asset managers that want to cater to the beneficiaries' demand for green funds can do so by avoiding unsustainable companies and picking the more sustainable ones. However, this strategy has intrinsic limitations and more importantly, does not help to pursue environmental sustainability in the aggregate.

Funds that choose to get the green label by way of negative screening, or focusing on best-in-class transition companies, face two limitations. Firstly, there are significantly fewer companies they can invest in. What if the excluded companies are great companies, delivering great returns? These will be picked by conventional funds who will eventually outperform green funds. The performance gap acceptable for sustainability-minded beneficiaries is an open question that cannot be resolved here, but it is a matter of concern. Secondly, funds who cater to investors' demand for sustainable portfolios miss out in terms of risk diversification. This means that green funds may eventually underperform conventional funds on two counts, return *and* risk. This isn't a problem only for the individual funds that decide to compete on sustainability, rather than on risk/return, but for the society, too, bearing more risk than efficient.[47] Thirdly, negative screening of the unsustainable companies is not a solution for the negative externality. If these companies offer interesting returns, some other funds will purchase the stock divested by the green funds. While not necessarily nil, the effect of negative screening on unsustainable companies may be a small increase in the cost of capital, which pales compared to the potential impact of voice by engaged institutional owners on the redeployment of capital.

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

46. *See* Bioy et al. (2021). "European Sustainable Fund Flows: Q1 2021 in Review" *supra* note 24.

47. See Ceccarelli et al. (2020), *supra* note 22, finding that competition between institutional investors on sustainability-related labels leads to suboptimal risk diversification.

Index funds are more promising. In a way, this is intuitive. Index funds cannot do much else than engage with portfolio companies, being, as they are, committed not to exit. However, the question is whether they have incentive to do anything at all. Index funds hold stock in thousands of companies; they cannot meaningfully engage with all of them. Moreover, their business case relies on low management cost, to the point that some of them even advertise zero fees. Even the Big Three asset managers have very limited staff to decide and execute engagements with portfolio companies,[48] whereas smaller index fund managers simply follow the proxy advisors.[49] Finally, and most importantly, index funds cannot profit from improving the performance of any portfolio company as they cannot overweight it while other investors can free ride. On these grounds, some commentators argued that voting by index fund managers exacerbates the agency problem between companies and their ultimate investors.[50] Other commentators see a governance role for index fund managers in some contexts, but not in others.[51] Others again regard them as universal owners which want to minimize climate change and other cross-cutting risks because these are undiversifiable within their portfolios – but to economize on cost, would rather let activists take the initiative.[52] Despite the scepticism of the theory, large ownership by index funds seems to matter a lot empirically. Companies with a large institutional ownership have a different corporate governance and score significantly better on environmental sustainability.[53]

The starting point of the analysis is the large index fund managers, particularly the Big Three, have a lot of power. Because index funds are cheap and attractive, they pool together enormous amounts of stock making a few asset managers control voting power in most of the corporate world.[54] It is hard to imagine large institutional investors sitting on such a power and not using it. Institutional investors are aware of this power but also of its fragility, because governments have a million and one ways to curb it if they want to. Therefore, the Big Three and other large institutional investors are not open about influencing corporate management. They hardly vote against managers or support shareholder proposals that managers oppose. This suggests that indexed institutional investors are passive in corporate governance. Yet, controversial issues are rarely put to a vote because normally it suffices for large institutional investors to engage privately.[55] The sheer presence of large institutional owners affects outcomes because managers know

48. 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.

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

50. Bebchuk, L.A. & Hirst, S. (2019) *supra* note 48.

51. Rock, E.B. & Kahan, M. (2020). "Index Funds and Corporate Governance: Let Shareholders Be Shareholders". *Boston University Law Review,* 100(5), 1771–1815.

52. Gordon, J. (2021). "Systematic Stewardship". Columbia Law and Economics – Working Paper No. 640, European Corporate Governance Institute (ECGI) – Law Working Paper No. 566/2021, https://dx.doi.org/10.2139/ssrn.3782814.

53. Appel, I., Gormley, T.A., & Keim, D.B. (2016). "Passive Investors, Not Passive Owners". *Journal of Financial Economics*, 121(1), 111–141. *See* also Azar et al (2020), *supra* note 15.

54. Coates, J.C. (2018). "The Future of Corporate Governance Part 1: The Problem of Twelve". Harvard Public Law Working Paper No. 19-07, https://dx.doi.org/10.2139/ssrn.3247337.

55. 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.

that they would lose their job without their support. To be sure, the arguments by sceptics imply that index fund managers should have no incentive to engage even privately. This view neglects that index funds also must compete for beneficiaries.

The powers of index fund, as their profitability, depends on their popularity with beneficiaries. Although index fund cannot benefit from improving the performance of individual companies, engagement can still be profitable to the extent that it attracts potential beneficiaries thereby increasing AUM. As noted by some commentators – interestingly, in the legal literature – not only do index funds have incentive to minimize cost, but they also compete with non-index funds and virtually any other investment option for inflows.[56] Better performing active funds take business away from index funds. And vice versa, index funds are attractive for patient investors seeking long-term performance at a low cost. Enter the sustainability dimension in this game. Active funds can attract beneficiaries who pursue sustainable investment by offering green funds with a high degree of taxonomy alignment. Short of repurposing some of their funds towards ESG indexes, index fund managers which track conventional indexes cannot exit companies that bring down their degree of taxonomy alignment. The only way for such index funds to improve the taxonomy alignment of their portfolio, and compete for sustainability-minded beneficiaries, is to engage with some of the portfolio companies.

Engagement by index funds must be put in perspective. Sceptics are right that index fund managers do not have incentive to engage with portfolio companies on firm-specific matters. Learning about these is expensive and any other investor could free ride on this knowledge. However, large index fund managers have incentive to engage with portfolio companies on cross-cutting issues, such as environmental sustainability and a few others, because the financial and nonfinancial benefits accrue to the portfolio as a whole, while the cost can be limited by standardization. While developing general engagement policies is cheap, applying the engagement policy to specific portfolio companies is expensive. Large asset managers, which have engagement teams, can focus on key companies to maximize impact. In the context of climate change, for example, engagement can focus on the industries where GHGs are more material and on the companies in which voting by the asset manager is more likely to be pivotal. Moreover, large asset managers run fund families, which include both index and active funds. This creates synergies that reduce the cost of engagement and increase its benefits. At BlackRock, for instance, engagement and investment teams share information on a platform.[57] The engagement teams learn firm-specific information from the investment teams, whereas investment teams learn from engagement teams where industries will be going in terms of cross-cutting issues. As noted by the literature, this might result in conflicts of interest,[58] but it also provides an opportunity for both passive and active asset managers.

Large index fund managers have the historic opportunity to lead the transition towards environmental sustainability. They appear to have the power and an increasing incentive to do so. The power depends on large ownership of key companies responsible for GHGs. The incentive depends on attracting inflows from beneficiaries who care about

56. Fisch, J.E., 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.

57. This platform is called Aladdin® Research. See Azar et al (2020), *supra* note 15.

58. But see, Fisch et al (2019), *supra* note 56, 64–71, noting that most of the concerns are overstated.

environmental sustainability. After the reform of EU securities regulation, beneficiaries will be able to select institutional investors not only based on financial performance (net of cost), but also depending on how they score in terms of the EU taxonomy and similar indicators, both currently (turnover alignment) and prospectively (capital expenditure alignment). As discussed, active funds have an easy way out that is not available to index fund: dumping stock that is insufficiently taxonomy-aligned. However, in the competition between index and active funds, the commitment to pursue taxonomy-alignment via voice instead of exit is an advantage.

Negative screening is not really sustainable, both for individual funds and collectively, because it undermines risk diversification. Therefore, within a fund family, active funds are likely to follow the lead of index funds and pursue impact on unsustainable companies, instead of dumping them. For independent actively managed funds, the choice between exit and voice will rather be a question of timing. Funds committed to exclusively pursuing green investment (i.e., dark green funds) also compete with conventional and light green funds in providing efficient risk/return combinations. Depending on how fast the transition to environmental sustainability will be, dark green funds may be comparatively less attractive in terms of risk/return than other funds which are greening at a slower pace. This is potentially a competitive disadvantage of active funds. Facing the leadership of conventional index funds, active funds might have to adapt their choices on how green to be, how quickly, and whether to 'act green' by exit or by voice.

This leads me to a final point, with which I would like to conclude these preliminary considerations on what can be expected from institutional investors. Institutional investors are financiers, not entrepreneurs. They can and probably will, at least in Europe, be a driving force of sustainable corporate governance, prompting listed companies to reduce negative externalities to appease their sustainability-minded beneficiaries. However, institutional investors will not tell their portfolio companies how to become more sustainable and how quickly. The transition to environmental sustainability is a fundamentally uncertain process, which, as such, belongs to the entrepreneur's domain. As I argued in previous work,[59] institutional investors have nothing to do with entrepreneurial choice, which is made by managers or by controlling shareholders depending on the ownership structure.

The decision on how to become more sustainable is the kind of firm-specific choices that institutional investors are ill-equipped to make, although they have a lot to say about who – managers, controlling shareholders, or activist hedge funds – should make these choices. To put it bluntly, institutional investors may replace management that is sloppier and slower than competitors in the transition, but have no views on their own on how to carry out the transition in specific industries and how quickly. This apparently stands in sharp contrast with a regulatory taxonomy setting industry thresholds for environmental sustainability. The contradiction is only apparent, however, because regulation does not mandate a specific degree of taxonomy alignment, but only requires it to be recognizable by beneficiaries of institutional investors.

59. Pacces (2012), *supra* note 2, 71–74.

In the end, the market – through the choice of institutional investors by beneficiaries – will set the pace of transition to environmental sustainability. Those in control of publicly held corporations will figure out how to do this.

5 Conclusion

In this article, I have looked at the potential of the new EU rules mandating sustainability disclosure to establish a sustainable corporate governance. I have argued that EU securities regulation has such a potential because it is centred on quantitative indicators notably including a unique regulatory taxonomy of sustainable activities and investments. When this taxonomy will become operational, it will frame institutional investors' disclosure towards their beneficiaries in more credible and salient terms, curbing greenwashing.

In the absence of data on how the new mandatory disclosure rules will play out, I have analysed their expected impact theoretically. Institutional investors are expected to increasingly cater to the preferences of sustainability-minded investors by way of voice, instead of exit. On the one hand, large index investors cannot but engage on cross-cutting issues broadly affecting their portfolio, such as environmental sustainability, particularly if they will compete with active funds on the degree of taxonomy alignment. Active funds, on the other hand, cannot simply pursue taxonomy alignment by way of negative screening because this undermines risk diversification. Both categories of institutional investors will therefore push corporate manages to be more environmentally sustainable, although it is impossible to predict at which pace. The pace of the transition will be set, in different industries, by entrepreneurs who are ultimately accountable to the institutional investors that fund them, and to their beneficiaries.