Business Law and the Transition to a Net Zero Economy

Engert / Enriques / Ringe / Varottil / Wetzer

2022
ISBN 978-3-406-78274-9
C.H.BECK

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preferences is unlikely to alter the fundamental result that voice is more aligned to social incentives than exit.

One question raised by our paper is why social engagement is relatively rare in spite of all its desirable properties. In some cases, engagement is infeasible because somebody owns a majority of the votes, such as Mark Zuckerberg with Facebook, or the company is privately held, such as Koch Industries. We think that an important additional factor resides in the current US proxy system, which tends to limit shareholders' ability to influence corporate policy. The restrictions reflect a fear that individual shareholders are activists in the sense that they put a lot of weight on a single issue. If instead individuals are socially responsible (in the way we define), this fear is unfounded. Individual shareholders have the incentive to vote on issues in a socially optimal way and their engagement can lead to more efficient outcomes.

Chapter 7. Do Responsible Investors Invest Responsibly?

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There is growing interest globally in 'responsible investing', whereby institutional investors incorporate environmental, social and governance (ESG) issues into their investment processes. One of the leading investor initiatives, the UN-sponsored Principles for Responsible Investment (PRI),[1] whose signatory members publicly commit to incorporating ESG principles, counted over 3,000 signatories representing collective assets under management (AUM) of close to US$ 100 trillion at the end of 2020. These PRI signatories are generally large institutions in terms of their assets under management and predominantly located outside of the US.

However, little is known about how these institutional investors commit to and implement responsible investment strategies and whether they 'walk the ESG talk' and actually translate their 'words into actions.'

In our recent paper,[2] we use novel survey data from the PRI reporting framework, ESG stock level ratings and institutional investors equity holdings in an attempt to shed light on these issues. For that purpose, we first compute ESG scores for each investor's equity portfolio based on the Refinitiv, MSCI and Sustainalytics ESG ratings of its constituent stocks and call this the institutional investor's portfolio-level ESG score. Second, we use the PRI Reporting Framework to compute the intensity of each PRI signatory's commitment to ESG strategies, by sorting on whether they apply a dedicated ESG equity investment style to all (100 %) or part (between 1 % and 99 %) or none (or do not report) of their equities under management. We call these three categories respectively PRI signatories with full, partial and no ESG incorporation. Our main results can be summarised as follows:

1. On average, across the world, PRI signatories seem to walk the ESG talk and have better portfolio-level ESG scores – significantly better ones, for their governance and social pillars – than their non-signing institutional investor peers. However, there are some important geographical differences: in particular US PRI signatories do not display better ESG portfolio scores than their non-signing peers.
2. US PRI signatories that do not incorporate any equity-based responsible investment strategy display even 'worse' portfolio level ESG scores than their non-signing peers, whereas, in the rest of the world, a higher

[1] PRI, www.unpri.org/ accessed 8 July 2021.

[2] Rajna Gibson et al, 'Do Responsible Investors Invest Responsibly?' European Corporate Governance Institute – Finance Working Paper 712/2020 papers.ssrn.com/sol3/papers.cfm?abstract_id=3525530 accessed 8 July 2021.

incorporation of responsible investment generally translates into a better portfolio-level ESG score.

3. A stronger level of ESG investment incorporation is positively related to stronger environmental and social norms prevailing in the countries of the PRI signatory's home location, to the institutional investor being domiciled outside of the US and a lower level of ESG investment style incorporation tends to be associated with having experienced a lower risk-adjusted portfolio performance in the past.
4. So why do some US-domiciled institutional investors sign the PRI but do not implement responsible investment? Our results shed light on this question by showing that these investors are actually able to attract significantly higher flows and thus that their primary motive is commercially-driven, pointing to some form of 'greenwashing' in the US. In other words, some US PRI signatories pretend to be more responsible than they really are to profit from the increased market interest in ESG investing.
5. So what are the main attributes of these US domiciled greenwashers? They are institutional investors who experienced poor risk-adjusted performance in the past, who cater primarily to retail clients (and are thus subject to less monitoring), who have experienced higher levels of ESG incidents in their own firms and who were late PRI joiners.

To summarize, our empirical results point to a disconnect between the commitment of some US domiciled PRI signatories and their effective ESG equity portfolio incorporation, whereas, in the rest of the world, PRI signatories actually seem to 'walk the ESG talk.' Our empirical findings thus raise some open questions. First, how important are the economic and social costs associated with greenwashing? Second, how can greenwashing and its externalities for stakeholders be mitigated? Is it through better sustainable finance literacy, through enhanced ESG reporting disclosure standards (such as the EU taxonomy for sustainable activities), through better ESG data quality and KPIs or a combination of all these measures? Finally, if such measures need to be enforced, is market self-discipline – and its related reputational costs – going to be sufficient to mitigate opportunism among institutional investors or do ESG regulatory frameworks need to be enforced?

Chapter 8. Corporate Governance, the Depth of Altruism and the Polyphony of Voice

Jeffrey N Gordon

This chapter responds to the paper *Exit v. Voice* by Eleonora Broccardo, Oliver Hart, and Luigi Zingales (BHZ),[1] which forms the basis for the authors' chapter in this volume.[2]

The paper discusses two possible mechanisms by which an 'altruistic' investor (ie, an investor who derives some utility from conferring a social benefit) can induce firms to change their behaviour in a socially responsible way, 'exit' (divestment) and 'voice' (shareholder voting). The paper follows prior work by Hart and Zingales that argues that investors can reasonably believe that firms can provide public goods at a lower cost than the government and can push firms to act accordingly.[3] The investors modelled by BHZ are consequentialists, that is, their decisions are taken from the perspective of a benevolent social planner: the cost of externality abatement by the firm should be weighed against the social benefits conferred. These investors are also sensitive to their individual utility functions, considering the trade-off in returns, risks, and the depth of their altruism.

In the classic set-up,[4] 'exit' and 'voice' are substitutes (and perhaps complements). Not here. When it comes to exit, investors on their own will engage either in excessive divestment, producing a signal that would lead firms to undertake excessive externality abatement (the BZH example is pollution) from a social point of view, or insufficient divestment. On likely measures of investors' altruism, divestment is likely to produce insufficient abatement. BZH quote Bill Gates: 'Divestment, to date, probably has produced about zero tons of emissions'. They see much more promise in 'voice', in which the votes cast by altruistic individual shareholders, if in the majority, will lead to a result that is consistent with the benevolent social planner, the right level of externality abatement.

From the perspective of an academic lawyer, one particularly interesting feature of BZH is its rejection of the classic 'exit' – 'voice' relationship. In the typical corporate governance account, investors' exit (or the threat of exit)

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[1] Eleonora Broccardo et al, 'Exit vs. Voice' ECGI – Finance Working paper No 694/2020 ssrn.com/abstract=3671918 accessed 5 July 2021.

[2] See Chapter 6 of this volume. I have benefited from comments from Oliver Hart and Luigi Zingales on a prior draft of this Chapter 8, which is not to say that they are responsible for what is now presented.

[3] Oliver Hart and Luigi Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value' 2 Journal of Law, Finance, and Accounting 247 (2017).

[4] Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to decline in firms, organizations, and states* (Harvard University Press 1970).

changes management's behaviour for two reasons: First, reduced demand for the stock will lower the stock price, which managers dislike because of their stock-related compensation; second, exit conveys negative information to other investors, which can lead to lower estimates of expected earnings and additional stock sales, further lowering the stock price, and perhaps thus leading to the appearance of an avenging angel wielding voice, the shareholder activist threatening a proxy contest. In this telling, exit is powerful and exit and voice work together. That relationship does not pertain for BHZ. They agree that divestment will lower the stock price and thus provide an incentive for the 'dirty' firm (in their pollution example) to become 'clean'. For BHZ, it is not the *direction* of action that matters, but getting the right amount of pollution abatement, on the social planner's criterion. Although the intricacies of the model are complex, BHZ assess that the all-or-none-attributes of voice, in which a majority vote is decisive, will align the firm's abatement behaviour with the social planner's objective.

In a sense it is easy to see that divestment is an imperfect tool to change the firm's behaviour. Because the decision makers are the managers trying to maximise the stock price, they are simply observing the flow of demand for stock from investors who have no collective way to express preferences. The privately maximising choice of the manager will not necessarily correspond to socially maximising course in this uncertain environment. Voice, expressed through shareholder voting, does not have this infirmity. A shareholder with an altruistic utility function will always act in accord with the socially desirable outcome, even if the private costs of pollution abatement are high (perhaps greater than the avoided private reputation costs). In BHZ this is fundamentally because the shareholder is diversified and thus the private welfare losses from the stock price decline resulting from privately inefficient abatement will be relatively minor. Or put otherwise, the non-pecuniary gains from achieving socially valuable externality abatement will satisfy the utility function of a diversified altruistic shareholder. It is not clear to me, however, why a vote of shareholders so-motivated will match the outcome of a social planner, if only because of the shareholders' imperfect information. The shareholders may vote for too much externality abatement from a social planner's perspective.

Another interesting feature of BHZ is its focus on the comparative decisiveness of the investors' action. In the divestment case, the ultimate decision whether to abate the externality is left to management, which will be making a private cost-benefit calculation. In the voice case, assuming a sufficiently large shareholder coalition, the shareholder vote will be decisive. The decision is taken out of management's hands. Because of the altruism in the shareholders' utility function, this means the decision whether to abate the externality will be subject to a social cost-benefit calculation. Thus choosing 'voice' rather 'divestment' shareholders with altruism in their utility function can improve social welfare. Because of the shareholders' diversification, the private cost to the shareholders will be less than the utility gain in their successful act of altruism. In this way the shareholders, because fully diversified, are different from managers or under-diversified blockholders.

What are the implications of this model for current investor-corporate social responsibility-sustainability practice? If the model goes through, then its implications are radical: the present agitation in favour of divestment should reverse itself. Divestment works through managerial incentives, which looks only private welfare calculation. Voice works through shareholder command-and-control, which is activated by social welfare calculation. Yes, 'ethical' investing is fine except perhaps in the most important cases, the ones in which abatement costs are greater than the share-value impact of divestment. Ethical investors should appreciate that consequentialism should supplement deontological thinking where there is chance to reduce socially harmful activity. The strong policy implications of the BHZ story call out for serious assessment.

In this assessment let's bracket the corporate governance questions about the role of shareholder initiative in fashioning a firm's business strategy. There are many good reasons why shareholders do not have direct say over, for example, whether and how much a firm should spend on pollution abatement or the abatement of other externalities.[5] And the shareholder proposal rules of the US Federal Securities Laws limit the extent to which shareholders can directly raise questions about a company's operational practices.[6] Nevertheless shareholders do have other vehicles. They can use the shareholder proposal process to call for 'reports' or offer other 'precatory' proposals that will call attention to a company's externality-creating practices in a way that through reputational effects with the company's customers or its recruitment and retention of the best employees can in fact change the managers' private welfare calculations. More in the spirit of the BHZ model, shareholders can participate in proxy contests that may replace all or some of the management-nominated directors with directors who may look to the public welfare in the corporate actions they pursue.[7] Let us similarly bracket the corporate law question whether such directors could unabashedly pursue externality-reducing policies that trade off public welfare for private shareholder value.[8]

Putting those important issues to one side, these are the problems I see in transforming a perfectly fine model into a guide for policy. First, the critical assumption is that the private cost to the altruistically motivated shareholder

[5] Jeffrey N Gordon, ' Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law' (1991) 60 U Cin L Rev 347 (A particular concern about direct shareholder decision-making is the risk that shifting shareholder majorities on issues of business strategy and operations will produce destructive cycling).

[6] Securities Exchange Act (1934) Rule 14a-8 (the Shareholder Proposal Rule). Section (7)(i)(7) permits the company to exclude a proposal from the company's proxy statement if it 'deals with a matter relating to the company's ordinary business operations'. This provision has led to a robust course of time-varying administrative process and guidance.

[7] The recent success of climate change activist fund Engine No. 1 in placing three directors on the Exxon-Mobil after a heated proxy contest shows the potential. See Matt Phillips, 'Exxon's Board Defeat Signals the Rise of Social-Good Activists' *The New York Times* (9 June 2021) www.nytimes.com/2021/06/09/business/exxon-mobil-engine-no1-activist.html accessed 5 July 2021.

[8] See, eg, *eBay Holdings, Inc. v Newmark* 16 A.3d 1 (Del Ch 2010) 9 ('Directors of a for-profit Delaware corporation cannot deploy a [policy] to defend a business strategy that openly eschews stockholder wealth maximisation – at least not consistently with the directors' fiduciary duties under Delaware law').

is minimal because of diversification. But this will rarely be the case. The 'voice' model seems to contemplate an outlier firm in an industry segment that generally follows good practices, so that costs incurred to reform such outlier behaviour (and the resulting hit to the firm's stock price) will be idiosyncratic. This easy case is surely rare. The issues that generally excite altruistically-minded shareholders reflect externality-creating practices across significant industry segments, for example, a pollutant that results from a widespread fabrication process, or exploitation of child labour in a supply chain, or firms whose very products (tobacco; plastics) create externalities. Put otherwise, on a firm-by-firm basis, diversification will lower shareholders' pecuniary losses; but as applied across large portfolio segments, the pecuniary losses from such a 'voice' strategy will surely be substantial. The response might be: for each case of pecuniary loss there will also be non-pecuniary benefits. Yet the aggregation of pecuniary losses and non-pecuniary benefits is unlikely to be a simple process of firm by firm addition for a representative shareholder. And of course, for the current case of greatest interest, the massive reduction in carbon production and usage to mitigate climate change risk, diversification is not the answer to concerns about the impact on the wealth of altruistic shareholders.

The important cases then require a trade-off of substantial pecuniary value for the non-pecuniary returns of altruism. Shareholders will certainly vary in the extent of their taste for altruism. More generally, for problems that require adjustment across the portfolio (such as climate change) the purported benefits of diversification disappear. We are left with simply a claim about investors' valuation of socially responsible investing, how much expected return will they trade away to achieve an important social objective.

This leads to an empirical question about the extensiveness of what might be described as 'deep' altruism among shareholders. The evidence here is that such tastes are relatively rare. Yes, there is an increasing flow of flows into ESG-styled mutual funds and other vehicles, but compared to investments in funds and ETFs without such a mandate, ESG funds are a minority fraction. Moreover, it seems that 'ESG' funds are in fact geared to divestment strategies rather than voice. For example, some funds screen investments on explicit ESG exclusion criteria: no fossil fuels, no 'vice' products (alcohol, tobacco, gambling), no weapons, no violators of UN labour or anti-corruption principles. Other funds make portfolio selection on the basis of ESG scores. These funds (and thus their shareholders) cannot exercise voice in an altruistic way because, by design, they are unlikely to own shares in the relevant companies. It is also a common strategy for asset managers to claim that a portfolio screened in this way will either out-perform or will not exact an economic penalty, thus not putting altruism to the test.[9] Until very recently ESG funds have been largely divestment-based, not focused on using 'voice' to change the behaviour of externality-creating companies. It is probably the case that most 'voice' driven ESG activism comes from public

[9] See, eg, Mats Andersson et al, 'Hedging Climate Risk' (2016) 72(3) Financial Analysts Journal 13.

pension funds[10] or sovereign wealth funds,[11] which are likely to take political considerations into account. These are not test cases for the BHZ altruistic shareholder activism story.

Indeed, the fact that most ESG funds are divestment funds might warrant reconsideration of the BHZ argument against the effectiveness of divestment as a pro-social tool. Should the criterion for success of divestment be the social planner's cost-benefit calculus? Perhaps we are so far away from the externality abatement 'frontier' that the concern about excess abatement that figures in BHZ is a second order concern. If divestment (or its threat) promotes a managerial response in the pro-social direction, should the altruistic shareholder forgo it? Does the very fact that divestment now occurs through collective vehicles overcome some of the BHZ objection?

The second general problem is that 'ESG' is not a unitary bundle, nicely packaged for the altruistic shareholder. Some shareholders may be highly motivated about climate change issues but not so much about supply chain issues. More problematically, much like the tension in the stakeholder debate, different elements of what might count as ESG are in tension with one another. Suppose retrofitting the plant to abate pollution will result in a technological change that will eliminate many jobs? Or, perhaps the problem is an obsolete plant that simply ought to be closed, resulting in a consolidation of facilities that results in layoffs and negative local community impact. Employee considerations are certainly a growing theme of ESG concerns. Closing down exploration and production for oil and gas resources surely will put many out of work, a significant externality. There is hardly a unanimity theorem to resolve the trade-offs among these ESG concerns for an altruistically minded shareholder. Instead of a unitary voice we have a polyphony.

Let us return to what I see as the major limitation in the BHZ approach: that for the most serious problems, such as addressing climate change risk, the necessary portfolio-wide adjustments undercut the benefits of diversification, and we are left with the socially responsible investing trade-off. It's not just the flaring practices of a gas producer or the exploration activities of multinational oil company that must change, but the engineering and production strategies of so-called "scope three" parties. GM's decisions about migration away from the internal combustion engine matter more than Exxon-Mobil's exploration decisions. Aggressive and risky growth by battery makers matters more than Exxon-Mobil's decisions.

I have elsewhere offered an approach, 'Systematic Stewardship,'[12] that turns a weakness in the BHZ approach namely, the loss of idiosyncratic risk

[10] See, eg, Leslie Kaufman and Saijel Kishan, 'Calstrs's Crucial Phone Call Eased Path for Activists' Exxon Win' *Bloomberg* (18 June 2021) www.bloomberg.com/news/articles/2021-06-18/calstrs-s-crucial-phone-call-eased-path-for-activist-s-exxon-win accessed 5 July 2021.

[11] Rebecca Henderson et al, 'Should a Pension Fund Try to Change the World? Inside GPIF's Embrace of ESG' Harvard Business School Case Collection (2020) www.hbs.edu/faculty/Pages/item.aspx?num=55547 accessed 5 July 2021 (Japanese Government Pension Fund).

[12] Jeffrey N Gordon, 'Systematic Stewardship' (2021) Columbia Law and Economics Working Paper No 640 ssrn.com/abstract=3782814 accessed 5 July 2021; forthcoming, Journal of Corporation Law (2021).