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Investor Empowerment for Sustainability

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Abstract: The transition to a sustainable economy currently involves a fundamental transformation of markets and market actors. This paper makes the case for investor empowerment as the main tool towards achieving greater sustainability in capital markets. This trust in institutional investors is grounded in various recent developments both on the supply side and the demand side of financial markets, and also in the increasing tendency of institutional investors to engage in common ownership. The need to build coalitions among different types of asset managers or institutional investors, and to convince fellow investors of any given initiative, can then act as an in-built filter helping to overcome the pursuit of idiosyncratic motives and supporting only those campaigns that are seconded by a majority of investors. In particular, institutionalized investor platforms have emerged over recent years as a force for investor empowerment, serving to coordinate investor campaigns and to share the costs of engagement. ESG engagement has the potential to become a very powerful driver towards a more sustainability-oriented future. Any regulatory activity should then be limited to a facilitative and supportive role.

Keywords: sustainability, corporate governance, green finance

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1 Introduction

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

The current discussion on this matter frequently revolves around achieving this goal through modifying the legal regime governing the corporate organization. There is, however, another path towards achieving greater sustainability in capital markets, namely through the empowerment of investors. The past several years have seen an unprecedented surge in investor-led initiatives steered toward sustainability. This has been evidenced most prominently by the rise of ESG activists—hedge funds and other specialized investors who have been actively influencing the management of their investee companies to pursue more sustainable decision-making. But, perhaps more surprisingly, passive investment funds, index funds, and exchange-traded funds (ETFs) have also jumped on the bandwagon and are pushing for more responsible investment strategies, either with independent campaigns or by supporting the activist investors.

Some commentators are skeptical about such investor-led sustainability, possibly due to a general distrust in markets that has dominated the public discourse since the global financial crisis and that has continued into the ongoing Covid-19 pandemic (Brest et al. 2018; Macey 2022; Mahoney and Mahoney 2021). In contrast, this paper argues that ESG engagement can be a very powerful driver towards a more sustainability-oriented future in corporate governance. Indeed, I show that investor-led sustainability has many advantages compared to a more prescriptive, regulatory approach where legislatures are in the driver's seat. For example, a greater focus on investor initiatives would follow a more flexible and dynamic pattern rather than complying with pre-defined criteria that are slow to change. Moreover, investor-promoted assessments are not likely to impair welfare creation in the same way as ill-defined legal standards; they would also not trigger regulatory arbitrage and would avoid deadlock situations in corporate decision-making. Any regulatory responses should then be limited to a facilitative and supportive role.

This article proceeds as follows: Section 2 traces the recent trend towards increased ESG and sustainability in corporate governance and finance, and in particular documents the rise of investor-led initiatives in this field. Section 3 discusses the merits of such shareholder engagement and makes the case that ESG initiatives pursued by investors are consistent with business realities and conform

with market logic of both demand and supply, while this section also demonstrates that the market trend towards common ownership holds great promise for such engagement. Section 4 turns to the main advantage of ESG engagement, namely that it increasingly relies on coalitions and team-building between different types of institutional investors. I argue that these teaming-up strategies have a dual benefit and a double genius in that they give greater support to campaigns, but also serve as an in-built screening mechanism that would exclude the realization of idiosyncratic benefits for individual investors. Sections 5 and 6 develop some regulatory implications and conclude the analysis.

2 The Rise of ESG Investment

In many ways, the intellectual starting point for a substantial re-direction of the world economy towards greater sustainability was the adoption of the UN's Sustainable Development Goals (SDGs) in 2015, which set out an ambitious agenda to be implemented by 2030. The term “ESG” had first been coined by the United Nations Global Compact in 2004. Shortly afterwards, in collaboration with an international group of leading institutional investors, the UN launched its famous “Principles for Responsible Investment” (PRI), promoting the integration of ESG issues within the investment industry.

Reinforced by the ambitious Paris Agreement on climate change mitigation, adaptation, and finance, which came into force in 2016, there was widening recognition that action at all levels was warranted to achieve these ambitious goals. These agendas were supported by the grassroots initiative “Fridays for Future” that dominated the public agenda during 2018–2019, and by the subsequent and ongoing Covid-19 pandemic that has caused a fundamental global rethink of our values and goals. Driven by these trends, a consensus grew that traditional policy tools (such as regulation, subsidies, and taxation) would be insufficient to reach the self-set goals pursuant to a more sustainable economy. It was against this backdrop that new life was breathed into the idea of promoting sustainability goals through the governance of corporations—i.e. do not (only) target particular activities such as carbon emissions directly, but rather encourage structures and purposes of firms and market actors themselves so that markets would intrinsically be geared towards more sustainable development.

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

Policymakers worldwide have seized the idea and developed an array of activities, initiatives, and policy papers, with the European Union spearheading the movement. For example, the 2018 Action Plan entitled “Financing Sustainable Growth” mandated E.U. agencies to report and advise on potential undue short-termism in financial markets (European Commission 2018). The European Securities and Markets Authority (ESMA) reported back one year later and developed a number of proposals, including a revised disclosure framework for non-financial risk as well as reinforced monitoring of remuneration and engagement standards. Furthermore, a 2020 study on directors’ duties and sustainable corporate governance, carried out by EY for the European Commission, explored the need to redefine the legal catalogue of directors’ duties and advocated a rethink in this area (EY 2020).

These efforts have been paralleled by increased ESG-related engagement throughout the international investor community. The most salient example here has been the increased activism around ESG targets that has been initiated by the “Big Three” institutional investors, BlackRock, Vanguard, and State Street Global Advisors. These leading three asset managers have significant power to influence corporate decisions: they control about 80 percent of all global indexed money, making them a dominant force in the governance of public companies around the world (Coates 2019). Together, these three giants now control a staggering 25 percent of the shares of all S&P 500 companies, and this share is growing (Bebchuk and Hirst 2019a).

ESG-minded investors use their powers to influence investee firms in a variety of ways. Some will simply focus on, and invest in, companies with high ESG ratings (thereby divesting from firms that have low ratings), while others invest in firms that do not (yet) engage in ESG issues, with a view to actively encouraging them to step up their efforts in the future (for example, through shareholder resolutions). Both strategies have their merits: the former will improve the market position of investee companies that are complying with ESG ratings, while the latter promises to actively change corporate policy to embrace ESG. For example, a broad coalition of institutional investors (including Amundi, Legal & General, and others) recently urged large banks to stop financing carbon-intensive projects, to scale-up their green lending, and to ensure that executive pay is linked to net zero targets.

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

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

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

Growing academic research is now studying the impact of such investor engagement. For example, a number of studies illustrate how engagement actions have increased target firms’ ESG/CSR activities and scores (Barko et al. 2022; Dimson et al. 2015; Hoepner et al. 2021; Naaraayanan et al. 2020). Peer effects appear to be particularly important, where collaboration between different institutional investors becomes the key for successful engagement campaigns (Cao et al. 2019; Dimson et al. 2021; McCahery et al. 2016). We shall return to this particular point below.

At this stage, it is still uncertain how strong the impact of ESG engagement will ultimately be and, specifically, whether we will see an impact sufficient to bring public companies in line with the Paris Agreement goals. We shall come back to the exact calibration of institutional stewardship in Section 5 where we explore how such efforts may be supported.

3 The Promise of Institutional Owners

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

Before that, it is apt to begin with discussing the opposite, more skeptical viewpoint. A number of eminent scholars such as Mahoney and Mahoney (2021) or Brest et al. (2018) have taken the view that institutional investors are unlikely to ultimately steer the economy towards greater sustainability. One common argument here is that index fund managers lack incentives to take on a stronger stewardship role (Bebchuk and Hirst 2022). In its simplest form, the argument is that index funds *de facto* hold shares in a portfolio of very similar firms to that of their competitors.

For this reason, any investment in the improvement of the value of their portfolio would not provide them with a competitive advantage over their rivals. On the contrary, any engagement might upset managers of portfolio companies who might then prefer to direct their firm's savings to other funds (Kahan and Rock 2007). In a similar vein, the low fee structure charged by the asset managers of index funds means that they would share only a small portion of the gain potentially brought by any governance engagement in the investee company, which would not justify the cost of the engagement (even if the gain is sufficiently attractive for the beneficiaries of the investment fund).

Others have questioned whether investors would really prefer sustainable instruments when this involves sacrificing profit (Brest et al. 2018). Relatedly, some commentators have also questioned whether the market's price mechanism would be able to adequately deal with a challenge as momentous as climate change (Pistor 2021). With these views in mind, it would seem ill-advised to put too much faith in the hands of market investors to address sustainability concerns.

There is empirical support for this skeptical view. For example, it has been shown that index funds frequently take a rather passive stance on governance matters such as challenging executives, putting forward shareholder proposals, or the active promotion of best practice standards in corporate governance (Strine 2020; Bebchuk and Hirst 2022). Instead, skeptics have argued, fund managers will rather comfortably side with the incumbent management in any contested decision (Brav et al. 2019). In addition, as Bebchuk and Hirst (2022) have demonstrated, the Big Three and other large institutional investors have only very small-sized teams, relative to their overall manpower, that are dedicated to engagement policies. That in itself, it has been put forward, precludes any meaningful ESG impact.

Other commentators have argued that an investor-led shift towards ESG may be conceivable, but would only succeed if framed in a certain pro-shareholder guise (Lund and Pollman 2021).

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

3.1 The Supply Side: The Attractiveness of ESG Funds

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

charge higher fees. It is crucial here to understand that the entire trend towards index investing was originally driven by the exact opposite consideration: the selling point of fees being significantly lower has always been the main argument for the success of index funds over their actively-managed rivals (Elton et al. 2003; Kahan and Rock 2020). When index investing turned mainstream, it became a victim of its own success: when low fees are ubiquitous, profit margins shrink and index investing becomes intensely competitive. In the hunt for new business opportunities, specialized ESG indices provide an exit from this difficult situation in that they allow fund managers to charge higher fees that drive up revenues. Rather than charging higher fees for their traditional, passive index fund (which might deter investors), a second, alternative market segment allows fund managers to cater for both fee-sensitive customers and those who are environmentally conscious.

For example, BlackRock's "iShares Global Clean Energy ETF," one of the largest ESG funds in the world, carries an expense ratio of more than 11 times that of BlackRock's plain vanilla S&P500 ETF (Bancroft Burnham 2020). As a side effect, the broad index funds may see an emphasis on ESG and a wide choice of different products as beneficial when it comes to attracting new customers by differentiating the firm from other, typically smaller index-portfolio specialists. Large institutional investors would thereby benefit from economies of scale in the course of bearing the costs of introducing such new products. This could give them a certain comparative advantage as first movers.

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

3.2 The Demand Side: The Preferences of Millennials

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

There is considerable evidence that investors' preferences are shifting in that they become increasingly attracted to ESG investments over the recent several years (Ceccarelli et al. 2020; Hartzmark and Sussman 2019). Two key drivers stand out: to hedge against downside risk, and to pursue non-pecuniary goals for sustainable investment.

First, one of the greatest motivations for investors is to hedge social and, in particular, climate change related long-term risk, which has been widely documented as a significant risk factor, as perceived particularly by large and sophisticated institutional investors (Krueger et al. 2020). Seen from this perspective, climate change is viewed as a significant source of financial risk, reflected in a return premium on assets with high climate risk exposure. It is for this reason that investors are interested in strategies to hedge against such risk (Engle et al. 2020; Giglio et al. 2021). Crucially, such strategic considerations go beyond climate risk. Indeed, studies have demonstrated that investment in other sustainability and social-oriented products proves a useful hedge against downside risk in general (Albuquerque et al. 2019; Lins et al. 2017). For example, when a company suffers a reputational or economic shock, prior corporate investments in socially responsible goals may ensure customer and employee loyalty or signal differentiation against competitors, protecting the firm against such shocks.

A second driver behind the strong demand for ESG products is the increasing focus of mostly retail investors seeking to obtain non-pecuniary utility from pursuing their social, not necessarily profit-driven preferences. This phenomenon is best illustrated by the new set of values that dominate the investment interests of the so-called “millennial generation” (i.e. the cohort of the population born during the 1980s and 1990s, reaching young adulthood in the early 21st century) (Strauss et al. 2000). The millennial population is projected to peak in size and importance during the early 2030s. This generation is currently entering its wealth accumulation phase. In the coming years, staggering amounts of wealth will pass from “Generation X” parents to their millennial children, estimated by one account to amount to \$24 trillion. Crucially, this new powerful generation markedly differs in its values from previous generations, or is at least perceived to do so. In a Deloitte survey, 63 percent of millennials stated that they would understand the primary purpose of a business to be “improving society” rather than “generating profit.” Most of them identified climate change and environmental issues as the world’s greatest concerns, even above healthcare during the pandemic (Deloitte 2020). A recent Fidelity (2021) report found that almost 75 percent of millennials described themselves as “philanthropists”—a figure that is much higher when compared to the older generations usually referred to as “baby boomers” (35 percent) and “Generation X” (48 percent).

Recent research has demonstrated that investors who behave more socially in everyday life and donate more to charity also hold more socially responsible equity funds, which is consistent with pro-social preferences driving ESG investment (Riedl and Smeets 2017). This reflects millennials’ changed investment preferences, which are also very different compared to their preceding generations. A recent Morgan Stanley (2021) study reports that 99 percent of millennials expressed interest in sustainable investing, in comparison to 79 percent of regular investors. Generally

speaking, it has long been documented that millennials are less interested in investment returns and more interested in investments reflecting their social values (Barzuza et al. 2020). According to Fidelity (2021), 43 percent of millennials are engaged in impact investing, compared to just 12 percent of baby boomers, and 22 percent of Generation X. Meanwhile, a study by Natixis (2021) revealed that 74 percent of millennials wanted to “make a positive social impact” with their investments, a substantially higher percentage compared to other, older age cohorts.

As these business purpose preferences are undergoing profound changes, it is understandable that the financial services sector would be offering products sought by the demand side. In this light, many index funds have been strengthening their efforts to redefine corporate valuations from an ESG perspective, and offering new instruments and index products that focus on principles other than just shareholder returns. Furthermore, a wave of ESG activism has led funds to use their voting power to promote ESG values as well as widely reporting their efforts publicly to catch the attention of this new crop of wealthy investors (Barzuza et al. 2020). Likewise, there is evidence that portfolio companies have strong incentives to do “good” by serving a beneficial purpose and to attract financially sophisticated and dedicated investors (Economidou et al. 2021).

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

3.3 Index Funds and Common Ownership

The third argument that supports the case for investor-led sustainability relies on the phenomenon of *common ownership*. Over the past several years, this term has come to describe the phenomenon where a number of large diversified institutional investors dominating today’s corporate landscape, such as the Big Three, are holding

significant stakes in the vast majority of firms in many economies (Bebchuk and Hirst 2019b). While this trend has been criticized for having anti-competitive effects, it does have some *positive* implications in terms of its penchant for favoring policies and initiatives that support ESG values. This is because funds to have invested in virtually every firm in the market are less concerned with the performance of individual portfolio companies, and more interested in the state of whole economies, if not the world economy. Against this backdrop, scholars have argued that the trend towards common ownership would increase their incentives to push for greater ESG commitment in investee firms, or at least favor general policies that support such efforts (for example, Condon 2020). Seen in this light, funds that “own the market” appear to be the ideal conduits for the internalization of a large fraction of the negative externalities caused by environmental damage and social disparities. This prospect is even more promising in the ESG field than in the context of traditional corporate governance engagement, which predominantly relies on firm-specific analysis (Barzuza et al. 2020).

This argument is in line with the so-called “universal owner” hypothesis, which has long argued that shareholder engagement is becoming a powerful weapon for sustainability (Alexander 2020). The reasons are twofold. First, institutional investors, in particular the long-term ones like pension funds, recognized that sustainability (both of their portfolio companies and of society more generally) was a precondition for being able to honor their pension promises which would be due decades into the future. Therefore, institutional investors became persuadable with regard to the virtues of taking a long-term view of their holdings (Sautner and Starks 2021).

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

More recently, Gordon (2022) convincingly argued that large, diversified investors’ foremost duty should be to address “systematic” risk, as opposed to idiosyncratic, firm-level risk. Coining the term “systematic stewardship,” he noted that

most asset managers' business model drives them to pursue policies to mitigate portfolio-wide risk, which most notably would include factors such as climate change, financial stability, and social stability. In a similar vein, Coffee (2021) has shown that common owners should rationally concentrate on systematic risk and generally disregard the idiosyncratic risk of individual firms. Indeed, the best evidence that these diversified investors are following economic logic lies in a new pattern under which such investors are actively voting and lobbying public companies in common, primarily on ESG-related issues (Dimson et al. 2021).

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

To be sure, the Big Three have been accused of “greenwashing” (i.e. claiming to pursue climate-oriented policies for marketing reasons) (Brakman Reiser and Tucker 2020; Christie 2021; Gibson Brandon et al. 2020; Liang and Renneboog 2020; Yu et al. 2020). But there is now evidence emerging to suggest that large institutions have genuinely encouraged their investee firms to reduce carbon emissions, and even that their efforts have been successful in changing the behavior of portfolio companies in this direction (Azar et al. 2021; Condon 2020; Dyck et al. 2019). A recent study confirmed that, at least outside of the U.S., institutional investors who publicly commit to responsible investing principles do in fact exhibit better ESG performance (Gibson Brandon et al. 2020).

Recent surveys go even further. Bolton and Kacperczyk (2021), investigating the effects of carbon emissions in a cross-section of stock returns, found a “carbon premium” charged on U.S. and other capital markets, which conventional risk factors could not fully explain. The carbon premium has been shown to have increased in the years after the adoption of the Paris Agreement, suggesting that investor awareness of climate issues is playing an ever more significant role, and that climate risk is generally impounded into asset prices at the firm level (Choi et al. 2020;

Monasterolo and de Angelis 2020). Dasgupta et al. (2021) have shown that the presence of socially oriented investors can amplify the impact of any formal enforcement activity taken by the U.S. Environmental Protection Agency.

Certainly, free-rider effects are present in generic rulemaking activity too. But three factors make this a more effective means of intervention than attempting to improve individual companies' governance. First, while exit is a rational strategy with regard to particular investment objects, it is not rational with respect to market-wide rules. Hence, the choice is simply between intervention and free-riding (but not exit). Exerting influence over the content of ESG rules may yield positive returns, even in the presence of free-riding activity. Brocardo et al. (2020) have recently shown that, in competitive markets, voice is more effective than exit in pushing firms to act in a socially responsible manner: in other words, engagement trumps divestment. Secondly, given that common owners cannot easily exit the market, each institution recognizes that if it is not involved in influencing a change, others might do so in a way that harms its interests. Hence, a prevalent strategy is one of coordinated lobbying for rules that were expected to maximize the joint welfare of institutional investors. Finally, coordinated efforts by the investor community may fend off any more interventionist government activity that might eventually entail hardcore regulation (Campbell 2007; Vogel 2010); thus, self-regulatory standards and ESG campaigns are especially attractive for investors (Barzuza et al. 2020).

As the influence of large index funds has been growing in recent years, their role is also evolving from being mere passive investors. The largest passive investors are now responding to calls for more active engagement with management. BlackRock, Vanguard, and State Street recently expanded their corporate governance teams and made their interactions with management more transparent, while investment stewardship teams at large active and passive funds have significantly grown, with some doubling in size over the past 10 years (Sodali 2021). A 2021 survey found that 85 percent of index funds were giving ESG more attention when exercising their right to vote. In this way, the lines between what is passive and what is active engagement are blurring, and traditionally reticent investors are increasingly embracing activist tactics and engaging in activist campaigns (Grossman and Stronski 2021; Tett 2018).

4 Team-Building

The final and most prominent phenomenon in favor of investor-led sustainability relates to greater *collaboration* between different types of ESG-oriented investors, thereby supporting engagement and activism. First observed in the context of traditional shareholder activism, the collaboration model is becoming increasingly important in the context of green activism. Board-oriented practitioners may

sometimes refer to this trend as “pincer attacks.” But coalition-building, as we shall see below, has become a very valuable component of ESG activism, not least through institutionalized platforms of collaboration.

4.1 Traditional Collaboration for Shareholder Engagement

By way of background, greater collaboration between institutional investors has been observed in traditional corporate governance for several years already, and it is seen as one of the most promising trends in enhancing shareholder engagement, as it sets out to improve the accountability of management and to overcome traditional free-rider problems and concerns about the rational apathy of shareholders (Gilson and Gordon 2013; Kahan and Rock 2010; Kedia et al. 2021; Ringe 2018). The peculiar incentive structure of activist hedge funds promises to ultimately overcome these collective action problems, yet hedge funds have been accused of pursuing idiosyncratic goals and serving their own profit-making goals. As I have explained elsewhere, the fact that such hedge funds need the support of larger, traditionally passive institutional investors (such as pension funds or mutual funds) may operate as a “vetting process,” where asset managers would only lend their support if they can be sure that the proposed action would be beneficial for the body of shareholders as a whole (Ringe 2018). Traditional investors such as pension funds, foundations, and sovereign wealth funds would then act as guardians of long-term value creation (Liang and Renneboog 2020; Semenova and Hassel 2019; Wagemans et al. 2018). Indeed, many cases have shown their voting behavior to be more orientated towards the long term than was previously the case (Oikonomou et al. 2020; Starks et al. 2017). This influence has helped to protect companies from controversial practices, such as excessive executive compensation or investments (Breitinger 2017). In this way, the “teaming-up” of activist funds and larger institutional investors creates a system of checks and balances, which gives greater credibility and legitimacy to shareholder activism and serves as a filter to ensure support is only given to campaigns that are value-creating for all shareholders (Bebchuk et al. 2015; Brav et al. 2015; de Haan et al. 2019).

4.2 Collaboration for ESG

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

The most prominent story of recent times in terms of ESG activism was that of Engine No. 1, an “impact-focused fund” who launched an activist campaign at U.S. oil

giant ExxonMobil. Starting in December 2020, the tiny hedge fund initiated a proxy contest at ExxonMobil for its alleged failure to adequately respond to evolving energy needs and emissions standards. The following months saw increasingly strong pressure from Engine No. 1, which had urged Exxon to cut capital spending and to focus on accelerating rather than on deferring the transition to cleaner energy. This culminated in an epic shareholder meeting on May 26, 2021, where Engine No. 1 successfully convinced fellow shareholders to support three of its director nominees – which, in effect, was a major defeat for the incumbent management (Brower 2021).

Interestingly, the hedge fund held a stake of only \$54 m in a company with \$248bn in market capitalization (i.e. equal to just 0.02 percent). Key to its success was therefore coalition-building. Engine No. 1 partnered from the beginning of its campaign with the U.S.'s second-largest pension fund, California State Teachers' Retirement System (CalSTRS). Shortly afterwards, none other than the Church of England joined forces with both investors, lending further support to the campaign. In the run-up to the shareholder vote, the team was also successful in convincing other important funds such as the California Public Employees' Retirement System (CalPERS) and New York state's pension fund New York State Common. It was reported that Blackrock and Vanguard, two of the largest Exxon shareholders, also voted to support at least three of the four director nominees on Engine No. 1's slate. Together, this alliance proved critical in the campaign's victory and may herald a new era for shareholder activism (Phillips 2021). The coalition of investors was therefore not only successful in shaking up Exxon Mobil, but it also handed a major victory to the ESG movement as a whole.

Other pertinent examples abound. In January 2020, activist hedge fund Elliott Management sent a letter to the board of Evergy, an American utility company. Among other things, Elliott criticized the company's insufficient carbon reduction targets, stating that Evergy ought to be a leader in decarbonization system investments, which, in turn, would help transition the company's coal fleet to renewable resources. One year later, both sides announced a settlement whereby Evergy committed to maintaining a focus on its Sustainability Transformation Plan, with Elliott agreeing to support management until the 2022 annual shareholder meeting (French 2021). Again, the backing from other institutional firms was of paramount importance, especially that of Bluescape Energy Partners who supported the deal.

The formerly aggressive hedge fund TCI (The Children's Investment Fund) has also shifted its attention to ESG in recent years. In 2020, TCI launched a "say on climate" campaign, calling for a shareholder vote on climate policy (Human 2020a). They filed resolutions at seven U.S.-listed issuers, including Moody's, S&P Global, Union Pacific Railroad, Charter Communications, Alphabet, Canadian Pacific

Railway, and Canadian National. The resolutions called for these companies to disclose annually their greenhouse gas emissions, to produce a plan to manage those emissions, and to hold an annual advisory vote on the plan. In the case of Spanish airport operator Aena, TCI was successful in pushing for the introduction of the world's first "say on climate" vote (Human 2020b). Once more, the push for an advisory vote on the climate plan was supported by BlackRock, which said in a voting bulletin it would be "beneficial at Aena given the material risk to its business model and its need to accelerate its efforts."

Another somewhat different example has been the widely reported campaign of hedge fund Jana Partners targeting IT giant Apple and demanding more features on the latter's devices to better enable parents to control and limit their children's screen time. Jana enlisted the help of social activists and rock star Sting. Most importantly, the campaign was conducted in partnership, once again, with ESG-oriented pension fund CalSTRS, and this was crucial in its success (Eccles 2018). The campaign convinced Apple to respond; the company unveiled a new 'screen time' feature on its devices several months later.

An even more recent phenomenon is that ESG campaigns may not only be initiated by activist funds or halo funds, but may instead be prompted or encouraged by more passive asset managers themselves. For example, it was recently reported that the New York State Common Retirement Fund is reaching out to shareholders of the world's six largest banks, seeking to convince them to back plans that would force the banks to align their policy with the 2050 net zero goal (Hodgson 2022).

4.3 Institutionalized Platforms

Such coalitions between different investors may either be built for individual campaigns or may become more institutionalized themselves. At the one extreme end of the spectrum, the initiative Climate Change 100+ brings together more than 570 investors, responsible for over \$54 trillion in assets under management. The goal of the initiative is to engage firms on improving climate change governance, cutting emissions, and strengthening climate-related financial disclosures. Launched in December 2017, Climate Action 100+ garnered immediate worldwide attention. Apparently, it not only coordinates actions but also distributes leadership roles for individual campaigns and geographical areas of specialization, thereby sharing the cost of activism (Condon 2020; Christie 2021). In January 2020, BlackRock joined Climate Action 100+, adding itself to a long list of other prominent signatories (including CalPERS, CalSTRS, Fidelity, J.P. Morgan Asset Management, and the pension funds of the City and State of New York). The United Nations has identified

Climate Action 100+ as one of the “most consequential global initiatives to combat global warming” (Tonello 2021).

But coalitions do not always need large numbers of participants to have a meaningful impact. In April 2021, two investor groups, BlackRock and Singaporean sovereign wealth fund Temasek, agreed on an institutionalized partnership called “Decarbonization Partners,” which committed \$600 million to advancing decarbonization solutions (Shieber 2021). Furthermore, a broad range of international investor advocacy groups, like As You Sow, Follow This, Majority Action, the Shareholder Association for Research and Education, the Shareholder Commons, ShareAction, and Investor Advocates for Social Justice, represent both individual and institutional investors by filing shareholder resolutions on their behalf, tracking campaigns, and defending them against legal challenges that typically come from the corporate management of the investee company. There is also a growing trend of several institutions simultaneously “co-filing” shareholder resolutions.

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

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

A recent study by Dimson et al. (2021) documented a large number of coordinated engagements, conducted by a prominent international network of long-term shareholders who cooperate to influence target firms on ESG issues. In particular, they showed that investors tended to choose a two-tier engagement strategy, combining a lead investor (who spearheads the dialogue) with several supporting investors (typically major investment institutions). This strategy has proved highly effective in achieving the stated engagement goals and has also led to improved target performance. This particular study was based mostly on data from a collaboration platform provided by the UN’s Principles for Responsible Investment (PRI). The PRI is a leading network and the largest initiative of its kind in the world for investors committed to responsible ownership and long-term, sustainable returns.

Other researchers have confirmed the importance of established networks to further ESG campaigns. Indeed, several studies have illustrated the role of “investor-driven governance networks” (IGNs) as a key component of the infrastructure for private environmental governance: IGNs are coalitions or alliances led by investors, formed around a specific public good or issue such as climate, in which investors are the primary actors (MacLeod and Park 2011; Yang et al. 2018). Such IGNs include the Carbon Disclosure Project (CDP), the Interfaith Center for Corporate Responsibility (ICCR), the Coalition for Environmentally Responsible Economies (Ceres), Investors Against Genocide, the Network for Sustainable Financial Markets, and the Institutional Investors Group on Climate Change (IIGCC). Such purpose-driven networks are designed for advocacy following a particular mission, with varying rigor, and many tend to partner with classic institutional investors such as pension funds and mutual funds. Others have emphasized in greater detail the function that coalitions play in fostering shareholder engagement on ESG issues (Cundill et al. 2018). Pertinently, they disseminate information relating to their mission and propose strategies and tactics for action, while they also serve as rallying points for individual and institutional shareholders seeking to influence companies and facilitate cost-sharing for campaigns.

Another emerging trend is collaboration between existing shareholder coalitions (Grayson and Nelson 2020). Thus, the recently launched “Net Zero Asset Managers Initiative” is a “network of networks” bringing together platforms such as Ceres, the PRI, and the IIGCC, who share a commitment to push the companies they invest in towards reducing their net greenhouse gas emissions to zero by 2050. Among the signatories of this initiative are the Big Three and many other asset management firms from across the globe.

4.4 Ratings, Indexes and Proxy Advisors

Collaboration, however, is not only happening at a bilateral level. Intermediaries are playing an increasingly prominent role in facilitating ESG engagement and investment, by helping investors to better evaluate their portfolio companies’ ESG performance. As we saw above, firms have strong incentives to do “good” by engaging in ESG activities; however, in order to attract investors, their practices need to be visible to the market, through outside rating procedures (Economidou et al. 2021). Therefore, it is unsurprising that ESG ratings and ESG indexes have recently expanded in quantity, quality, complexity, and variety (Pagano et al. 2018). This is unsurprising given the soaring investor demand, as well as heightened regulatory pressure.

An ESG rating is a scoring framework through which a target firm’s performance on ESG factors is evaluated and measured in a systematic way to create a combined

ESG score for that company. In contrast, an ESG index describes an investable index, usually a market capitalization-weighted index value which is calculated by aggregating the individual company scores assessed for the ESG performance of each member in the group of companies that form the index. Crucially, neither of these two evaluations include any indicators of financial performance.

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

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

The key problem here is obvious: the lack of a standardized methodology. As there is no common definition of "ESG" or "sustainability," different results can be obtained depending on the methodology used by the data provider, rating agency, or index designer. Some ESG rating agencies do not even disclose what criteria they use to determine their rating in the first place. This may create significant uncertainty for investors. A recent study (Berg et al. 2020a; see also Dimson et al. 2020) found correlation of only an average of 0.54 for ESG ratings of six different providers. In stark contrast, for traditional credit ratings, the correlation is 0.99. Meanwhile, further research has documented widespread retroactive changes to the historical ESG ratings provided by Refinitiv (Berg et al. 2020b).

A related problem is that rating agencies obtain their data either from the companies' self-reporting efforts or from algorithms that evaluate ESG reports and company websites. Self-reporting is, for obvious reasons, not necessarily the most reliable source for ratings. A recent study by Hargreaves Lansdown, a British financial services company, ranked the five companies in the FTSE 100 that were deemed the most environmentally friendly and socially responsible, based on data from Refinitiv. Much to their surprise, the top five companies included firms such as British American Tobacco, a supplier of over 200 brands of cigarettes, Coca-Cola, renowned for its sugary soft drinks, and Glencore, a global mining company (Lund-Yates 2021).

Finally, proxy advisors have emerged as powerful players on the capital market, serving as intermediaries to further responsible investment. Proxy advisory firms

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

More recently, scholarly attention has turned to consider the role that proxy advisors play in promoting ESG objectives (Matsusaka and Shu 2020; Rose 2021). It has emerged that proxy advisors such as ISS, the dominant player, is even more supportive of environmental and social resolutions than most traditional asset managers (Chuah et al. 2021). For example, ISS have adopted a new voting policy relating to so-called "significant greenhouse gas emitters," a set of companies that are accounting for over 80 percent of corporate industrial greenhouse gas emissions and are thus perceived as key to driving the global net-zero emissions transition. Focusing on these companies, ISS guidelines say that it will recommend voting against the incumbent chair of the responsible board committee if it determines the company is not taking the "minimum steps" needed to understand, assess and mitigate climate risks, both for the company and larger economy (ISS 2021). What it considers as "minimum steps" will sharpen over the course of the next year as ISS seeks detailed disclosure about climate risks, including board governance, corporate strategy, risk management analyses and metrics/targets, and reduction targets for greenhouse gas emissions that cover at least a significant portion of the company's direct emissions. Further, they will generally recommend voting against proposed directors where the board has no apparent racially or ethnically diverse members or women (ISS 2021).

ISS has also been found to be more supportive on ESG matters than the second-largest proxy firm, Glass Lewis (Chuah et al. 2021). While the problem of overreliance on proxy advisory recommendations has certainly not yet been resolved, their influence on voting decisions still represents additional support for a reliable investor-driven move towards responsible investing.

5 Implications

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

The first of these lessons is negative. As investors are providing strong and sensible pressure in pursuit of the achievement of ESG goals, additional modifications of the regime governing corporate *boards* appear unwarranted. Worse still, modifying directors' duties may prove counterproductive in terms of investor-led sustainability. For example, corporate management may hide behind the guise of protecting stakeholders' interests by opposing institutional shareholders and their efforts, thereby becoming more entrenched (Bebchuk and Tallarita 2020).

Efforts by rule-makers, in particular the European Commission (2020), to reform the regulatory regime governing corporate directors should therefore not be pursued further. As noted in a recent submission in response to E.U. proposals, these efforts need to be reconsidered in light of economic evidence and in light of the "self-regulation" approach presented here (Bassen et al. 2020). The Commission's initiative as well as the underlying EY report (EY 2020) have also drawn fierce criticism from different academic quarters (e.g. Roe et al. 2021; Bianchi and Milič 2020). The same is true for other, mostly mandatory attempts at prescribing sustainability criteria (Zetzsche and Anker-Sørensen 2022).

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

5.1 Facilitation and Clarification

Rather than *mandating* sustainability goals, the present analysis has identified the role of regulation, if anything, to *facilitate* and allow ESG investments. A good example on what regulation can sensibly do is exemplified by currently proposed rules by the U.S. Department of Labor (DOL). They concern the ability of retirement

plan fiduciaries to invest in ESG funds in the retirement plans that they sponsor under the U.S. public pension ERISA framework.

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

These changes, technical as they may seem, have the potential to “change the ESG game” (Kahn 2021), as they will (re-)open up the ESG market for the vast funds of ERISA retirement plans. Crucially, however, the proposed rules are not prescriptive in mandating ESG investment; they simply clarify the position that fiduciaries *may* invest into ESG products if they wish to do so. Once these rules are adopted, ESG factors may be considered material, depending on the individual facts and circumstances, and that not only fiduciaries may properly consider them, but that in some instances and evaluation of those factors may even be warranted.

5.2 Disclosure and Standardization

Any attempt at self-regulation faces the difficulty of information asymmetry and of a lack of market standardization. At the moment, a patchwork of standards exists around the globe, accompanied by poor data quality, which makes compliance challenging and undermines the efficacy of investor engagement, both for investors that invest directly and for those relying on ratings. For companies operating in multiple jurisdictions, the widely varying rules and guidelines may impose extensive but differing disclosures, and make it harder for investors to compare and ascertain

reliable and verifiable information. At the same time, they invite regulatory arbitrage and “greenwashing” (Brakman Reiser and Tucker 2020). What is worse is that diverging standards may ultimately result in a race to the bottom (Raby 2021). On a more practical level, the opacity of products, data, and standards makes it challenging for ultimate investors to put their funds to the most appropriate use, thus undermining the force of the investor-led model for sustainability (Steuer and Tröger 2022). It is therefore no surprise that institutional investors are increasingly calling for the adoption of more standardized and comparable reporting standards (PwC 2021).

Over the past several years, a number of ESG reporting frameworks have been adopted worldwide, such as the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), the World Economic Forum’s (WEF) Metrics on Sustainable Capitalism, and a framework adopted by the Task Force on Climate-related Financial Disclosures (TCFD), which was established by the G20 Financial Stability Board. According to a recent survey, investors recommend the SASB (75 percent) and the TCFD (53 percent) as the best standards when it comes to communicating ESG information (Sodali 2021).

At present, national and regional approaches differ significantly. In the U.S., the Big Three asset managers and others currently encourage companies to follow the SASB reporting standards and the TCFD regime. The Securities and Exchange Commission (SEC) is currently considering the adoption of new rules that would require specific ESG disclosures. At the same time, private institutions are pursuing their separate agendas. For example, Nasdaq (2020) has introduced changes to its listing standards that will require its listed companies as of 2022 to enhance their disclosures regarding board diversity and require them to have, or to disclose why they do not have, a minimum of two “diverse” board members.

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

Finally, the E.U.'s Taxonomy Regulation is an important pillar of the E.U. regime in that it categorizes and classifies types of investment, and provides common definitions and standards for what constitutes 'green' investment activities. It thus has the clear objective of addressing the problem of greenwashing. Moreover, it obliges firms to disclose the ratio of their turnover that qualifies as environmentally sustainable (art. 8). The Taxonomy Regulation entered into force in July 2020 and was expected to create legal certainty for investors, to protect private investors from greenwashing, to help companies to plan their transition, to mitigate market fragmentation, and eventually to help shift investments toward where they are most needed.

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

This short overview demonstrates that the jungle of different regulatory instruments, standards, and obligations is hardly conducive to a transparent, global investment market seeking to promote investor-led sustainability. What is needed here is a truly global standard that makes investments and activities comparable. On the positive side, the ESG movement has already triggered the establishment of multiple initiatives and disclosure frameworks, albeit these are lacking coordination and consistency. A laudable initiative is the Corporate Reporting Dialogue (CRD), essentially a platform that is set up by the International Integrated Reporting Council to promote greater coherence, consistency, and comparability between international corporate reporting frameworks, standards, and related requirements. Likewise, the International Accounting Standards Board (IASB) recently announced the development of an ambitious global standard for ESG reporting. Key in this is the new International Sustainability Standards Board (ISSB), which is to establish a singular, global ESG disclosure framework for companies. Whichever standards will play the leading role globally in the future would require the backing of a strong, independent, and, most importantly, credible institution (Brest and Honigsberg 2022).

5.3 Removing Barriers to Collaboration

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

Yet there are a number of regulatory barriers in place that limit the possibility of investor collaboration. For example, U.S. proxy solicitation rules make it very costly to initiate an investor campaign. During the Trump administration, the SEC further toughened those requirements. Specifically, in 2019, the SEC adopted guidance on proxy advisors and proxy solicitation that made it more difficult and costly for investment advisers to exercise shareholder voting rights on behalf of their clients relying on independent proxy voting advice. One year later, the SEC adopted new rules and additional guidance related to proxy advisors that imposed further cost and complexity into the voting process, and mandated greater issuer involvement in proxy voting decisions. And most recently, regulatory reform of Rule 14a-8 has raised the thresholds and made it even more difficult for shareholders to adopt shareholder proposals for corporate general meetings. This trend in policy making has been severely criticized, even from within the SEC, for obstructing shareholder engagement and in particular ESG initiatives (Lee 2020).

European and other jurisdictions’ rules on “acting in concert” limit the possibility of coalition-building: under EU disclosure rules, blocks of shares held by concerted parties would have to be counted together, which would require earlier disclosure. In the U.S., investors informally acting together on an issue without disclosure may be regarded as being in violation of Regulation “Fair Disclosure.” They may also be required to make a joint 13D filing, disclosing their equity position. At present, SEC (2022) is proposing to modify this regime.

A related problem is that investors acting in concert might have to make a mandatory bid under the EU Takeover Directive if they together are in “control” of the company. These rules have long been seen as a large barrier to more effective shareholder engagement as they trigger large financial consequences (McCahery et al. 2016; PRI 2022). Finally, there is a certain tension and vast legal uncertainty concerning shareholder activism under existing insider dealing laws, which needs to be resolved (Taleska 2020).

Regulators are beginning to realize that investor engagement should be facilitated, and not restricted, particularly when pushing for sustainability. For example, former SEC Commissioner Allison Lee (2020) heavily criticized the 2020 regulatory changes and argued that the Commission should seek to facilitate greater ESG engagement rather than stifling it. Also, the European Securities and Markets Authority (ESMA) maintains a White List of activities that would not count as “acting in

concert” (ESMA 2019b). It recently proposed a review of this list and explored whether it should include an explicit reference to coordination activities among institutional investors in the area of e.g. to stimulate engagement in this field (ESMA 2019a). Such initiatives are to be welcomed.

5.4 Facilitating Investor Platforms

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

One example is the PRI Collaboration Platform established by investors in partnership with the UNEP’s Finance Initiative and the UN’s Global Compact. The PRI platform is the leading network and the largest initiative worldwide for investors with a commitment to responsible ownership and long-term, sustainable returns. It provides a significant database with records on ESG engagements worldwide. The platform allows lead investors to launch and market campaigns, with supporting investors either invited by the PRI or the leader to join an engagement, or allowed to join via the PRI’s Collaboration Platform online (Dimson et al. 2021).

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

Outside of the ESG realm, investor platforms exist in various shapes and forms. An example is the Dutch corporate governance platform Eumedion, which represents the interests of institutional investors worldwide to have invested in Dutch listed companies. The platform seeks to promote good corporate governance and sustainability policies at Dutch listed companies and to promote engaged and responsible share ownership by its members. Eumedion, inter alia, supports its members by facilitating dialogue among them, and between the members and Dutch listed companies. A similar institution is the Canadian Coalition for Good Governance (CCGG), which bundles together institutional shareholders that invest in Canadian public equities (see Doidge et al. 2019). The CCGG aims to promote good governance practices at Canadian public companies and coordinates engagement activities. It also claims to focus on topics related to the governance of environmental and social risks (CCGG 2021).

These and other networks and platforms are crucial in facilitating investor engagement, as well as overcoming free-rider incentives and collective action problems. Dimson and colleagues argued that they are paramount in helping

investors to exploit the advantages and overcome the challenges of jointly pursuing shared objectives (Dimson et al. 2021). Related research has documented that institutional investors use such platforms to improve governance outcomes through collective action (Doidge et al. 2019). To be sure, such platforms may also be set up by business associations themselves and these evolve by way of self-regulatory initiatives. However, the UN's PRI platform, considered as the most effective platform promoting ESG objectives, draws a considerable part of its strength from the financial and reputational support stemming from the United Nations. Regulators may therefore be inclined to consider establishing or sponsoring further platform solutions in the field. The German Sustainable Finance Expert Group (2021), in its final report, recommended the establishment of such a platform to facilitate collective engagement.

6 Conclusion

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

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