

# The Future of Disclosure: ESG, Common Ownership, and Systematic Risk

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## Abstract

The U.S. securities markets have recently undergone (or are undergoing) three fundamental transitions: (1) institutionalization (with the result that institutional investors now dominate both trading and stock ownership); (2) extraordinary ownership concentration (with the consequence that the three largest U.S. institutional investors now hold 20% and vote 25% of the shares in S&P 500 companies); and (3) the introduction of ESG disclosures (which process has been driven in the U.S. by pressure from large institutional investors). In light of these transitions, how should disclosure policy change? Do institutions and retail investors have the same or different disclosure needs? Why are large institutions pressing for increased ESG disclosures?

This article will offer two reasons for the desire of institutions for greater ESG disclosures: (1) ESG disclosures overlap substantially with systematic risk, which is the primary concern of diversified investors; and (2) high common ownership enables institutions to take collective action to curb externalities caused by portfolio firms, so long as the gains to their portfolio from such action exceed the losses caused to the externality-creating firms. This transition to a portfolio-wide perspective (both in voting and investment decisions) has significant implications but also is likely to provoke political controversy. As institutions shift to portfolio-wide decision making, the disclosure needs of individual investors and institutional investors diverge and serious conflicts can arise.

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# THE FUTURE OF DISCLOSURE: ESG, COMMON OWNERSHIP, AND SYSTEMATIC RISK

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## ABSTRACT

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# THE FUTURE OF DISCLOSURE: ESG, COMMON OWNERSHIP, AND SYSTEMATIC RISK

By John C. Coffee, Jr.\*

## INTRODUCTION

How should disclosure policy change at the SEC in light of new market conditions and an evolving market structure? So framed, this is a fairly narrow question, which assumes that one accepts the need for a mandatory disclosure system.<sup>1</sup> Once over that first hurdle, a second question logically follows: Do all investors have the same informational needs? Or do some have special needs? This article will suggest that individual and institutional investors have different needs (largely based on their level of diversification), and sharp conflicts can arise between them, particularly as institutional investors come to make voting and investment decisions on a portfolio-wide basis (instead of on a stock by stock basis).

One cannot assess this topic without recognizing that we have moved far away from the environment in which the SEC grew up. In fact, three distinct and important transitions are in progress, but each is at a very different stage:

First and most obvious, the “institutionalization” of the market has now been fully realized. Historically, the SEC has always seen its interests as closely aligned

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<sup>1</sup>Because this topic has been debated at length elsewhere, it will be sidestepped here. For defenses of a mandatory disclosure system, see John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717 (1984) (finding such a system is a cost-effective subsidy and produces positive externalities); Merritt B. Fox, Retaining Mandatory Disclosure: Why Issuer Disclosure is Not Investor Empowerment, 85 Va. L. Rev. 1335 (1999).

with those of the retail investor.<sup>2</sup> It has proclaimed itself “the investors’ advocate,”<sup>3</sup> and public investors have in turn recognized and applauded the SEC’s efforts. This mutual alliance gave the SEC relative political immunity that assured it reasonable budgetary appropriations, despite major swings in policy and times of great stress for other agencies over recent decades.<sup>4</sup>

But that is past. The era in which retail investors “owned” companies or moved the trading markets is long gone and “deader than disco”. Today, retail investors account for only a modest minority of the ownership of large, publicly traded companies and probably less than 2% of the trading in NYSE-listed companies.<sup>5</sup> Stock ownership is now dominated by institutional investors, who are increasingly diversified and often indexed.<sup>6</sup>

The second transition involves the more recent and extraordinary concentration in stock ownership, with the result that as few as five to ten institutions

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<sup>2</sup> For this conclusion, see Joel Seligman, *THE TRANSFORMATION OF WALL STREET: A History of the Securities and Exchange Commission and Modern Corporate Finance* (3d ed. 2003).

<sup>3</sup> Professor Donald Langevoort opens an excellent article dealing with the transition from a retail to an institutional market (and its implications for the SEC) by observing correctly in his first sentence: “The Securities and Exchange Commission thinks of itself as the investors’ advocate, . . .” Donald C. Langevoort, The SEC, Retail Investors, And The Institutionalization of the Securities Markets, 95 Va. L. Rev. 1025 at 1025 (2009). This phrase also appears regularly on the SEC’s website.

<sup>4</sup> I do not mean that the SEC always got what it wanted (or needed), but in comparison to other “consumer protection” agencies, including the Commodities Futures Trading Commission and the more recent Consumer Financial Protection Bureau, it has done relatively well. I attribute this not to uniformly brilliant leadership at the SEC, but to the fact that Congressmen know the SEC is popular with individual investors (and voters) in their jurisdiction. Here, it is also noteworthy that institutional investors do not vote.

<sup>5</sup> The level of institutional ownership can be measured in various ways but for some time institutions have owned over 73% of the market value of outstanding equity securities in the U.S. Compare Sec. Industry & Fin. Mkt. Ass’n (“SIFMA”), 2007 Fact Book 65 (Charles M. Bartett, Jr. ed.) (73.4% institutional ownership) with #. For the 2% figure for trading by individuals, see Alicia Davis Evans, A Requiem for the Retail Investor, 95 Va. L. Rev. 1105 at 1105 (2009).

<sup>6</sup> “Indexing,” or “indexed investing” refers to a passive investment strategy under which the investor invests in a broad market index (such as, for example, the S&P index), seeking not to outperform the market, but only to match it. As later discussed, much empirical research strongly suggests that retail investors cannot outperform the market and lose money when they attempt to do so. Indexed investing also reduces trading costs, as it is a “buy and hold” policy, and it can minimize tax liabilities.

today may be in a position to exercise *de facto* control over even a large public corporation. The Big Three of institutional investors -- BlackRock, Inc., State Street Global Investors, and the Vanguard Group -- now hold over 20% of the shares in S&P 500 companies (and vote approximately 25%).<sup>7</sup> Potentially, this might suggest that retail investors are exposed to domination by institutional control groups, but such a thesis would be overbroad. At first glance, little conflict is apparent between diversified institutions and retail investors, but, as will be discussed later, a potential conflict is developing as institutional investors, recognizing the power of their common ownership, are beginning to make decisions on a portfolio-wide basis (rather than seeking only to maximize each individual firm's value).

Meanwhile, retail investors have moved their investments from stock-picking mutual funds to index funds.<sup>8</sup> Collectively, retail investors seem to have finally

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<sup>7</sup> This difference between 20 and 25% reflects the fact that many shares are not voted. For these percentages and for their prediction that the holdings of the Big Three will rise eventually to 40% or more, see Lucian Bebchuk and Scott Hirst, The Specter of the Giant Three, 99 B.U. L. Rev. 721 (2019). To give an example of activism in action, just six shareholders control 24% of ExxonMobil, and the same six control 26% of Chevron, and they have pressured both companies regarding emissions and climate change. See Madison Condon, Externalities and the Common Owner, 95 Wash. L. Rev. 1, 10-11 (2020). These six included the foregoing Big Three and Northern Trust, Bank of America, and Capital Research Global Investors. Id. at 10 n.38. The stock in publicly held companies (in terms of asset values) that is held by the ten largest mutual funds (not all of which are index funds) rose from 44% in 2000 to 56% in 2015, and the corresponding percentages held by the five largest such funds grew from 32% in 2000 to 45% in 2015. See The Investment Company Institute, 2016 INVESTMENT COMPANY FACTBOOK at 14 and 17 (56<sup>th</sup> ed. 2016).

Much of this literature about the growing concentration in the hands of a limited number of institutional owners has focused on the danger that such concentration will be anticompetitive, leading to shareholder pressure in some industries for firms not to compete. See Einer Elhauge, Horizontal Shareholding, 129 Harvard L. Rev. 1267 (2016); Jose Azar, Martin Schmalz and Isabel Tecu, Anticompetitive Effects of Common Ownership, 73 J. Fin. 1513 (2018). However, the flip side of this coin is that institutions can use their collective power to induce their portfolio companies to behave in a more socially responsible manner (at least when it will benefit their portfolio on a net basis). In particular, concentrated owners can balance the gains caused to some companies in their portfolio by shareholder activism that restricts or discourages externalities that injure them against the losses experienced by the externality-causing firms in the same portfolio. Although it cannot be assumed that the potential gains will necessarily exceed the potential losses, when they do, it is good business to force the internalization of the externalities by the firms causing them. See Condon, *supra*, at 10-11.

<sup>8</sup> In 2019, index funds (i.e., mutual funds that track a broad market index) for the first time exceeded traditional stock picking funds, holding \$4.27 trillion in assets as compared to \$4.25 trillion for traditional stock picking funds. See Dawn Lin, "Index Funds Are The New Kings Of Wall Street," The Wall Street Journal, Sept. 18, 2019; see also Jill



recognized that they are poor stock pickers who systematically lose money when they trade actively on their own.<sup>9</sup> As a result, they have migrated in large numbers to invest in highly diversified institutional intermediaries (led by the Big Three), thereby further increasing ownership concentration.<sup>10</sup>

Finally, the third important transition involves a new demand among investors (particularly among large institutional investors) for a new category of information, known as “ESG” disclosures (ESG is an acronym that stands for “environmental, social, and governance”).<sup>11</sup> ESG investing broadly relies on governance factors at the firm, as well as the environmental and social impact of the firm and its products on society.<sup>12</sup> Although it is clear why social activists want to encourage such socially relevant disclosures, it puzzles many why diversified institutional investors appear to be the strongest proponents of increased ESG

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Fisch, Assaf Hamdani, Steven Davidoff Solomon, The New Titans of Wall Street: A Theoretical Framework for Passive Investors, 168 U.Pa. L. Rev. 17 (2019).

<sup>9</sup> The simple truth is that only a small minority of actively managed funds have outperformed passive index funds. In his Presidential Address to the American Economics Association, Professor Kenneth R. French assembled data showing that, over the period from 1980 to 2006, a passive investor would have on average beaten an actively trading investor by over sixty-seven basis points per year. See Kenneth French, Presidential Address, The Cost of Active Investing, 63 J. Fin 1537, 1561 (2008).

<sup>10</sup> While the Big Three now hold over 20%, some estimate that they will hold 40% or more of the shares in the S&P 500 within two decades. See Bebchuk and Hirst, *supra* note 7, at 739, 741.

<sup>11</sup> Many believe that trustees and other fiduciaries “have come under increasing pressure to use environmental, social, and governance (ESG) factors in making investment decisions.” See Max M. Schanzenbach and Robert H. Sitkoff, Reconciling Fiduciary Duty and Social Conscience: The law and Economics of ESG Investing by a Trustee, 72 Stanford L. Rev. 381, at 381 (2020). Although there may be pressure (particularly in the case of public pension funds, which are politically accountable), this article will assert that sound economic reasons better explain why fiduciaries at large diversified investors favor ESG principles, and thus ESG investing is likely to increase for reasons unrelated to political pressure. Interestingly, journalists report that while European oil companies have been pressured by their governments to incorporate ESG criteria into their decision-making, the pressure on U.S. oil companies for the same outcome has come exclusively from large institutional investors (and not at all from the government). See Stanley Reed, “Europe’s Oil Titans Ramp Up Transition To Cleaner Energy,” *The New York Times*, August 17, 2020 at B-1, 3.

<sup>12</sup> For a similar description of ESG investing, see Schanzenbach and Sitkoff, *supra* n. 11, at 388.

disclosure.<sup>13</sup> This article will suggest that a fundamental economic logic explains their interest, which flows directly both from the Capital Asset Pricing Model (“CAPM”<sup>14</sup>) and from the just-noted fact of the high institutional common ownership of portfolio companies. Put simply, with high common ownership across a broad portfolio, it becomes rational and predictable that these institutional investors will make both investment and voting decisions on a portfolio-wide basis (rather than simply trying to maximize the value of individual stocks). This, in turn, permits the netting of gains and losses across the portfolio, and the implications of this transition are sweeping.

How should the SEC respond (if at all) to these transitions? Many will argue that the SEC should keep the protection of the retail investor as its first priority, but this article is premised on the belief that this transition by retail investors to indexed investing has been salutary. In fact, the SEC should encourage (and even gently push) retail investors to diversify, shifting their retirement savings to diversified (and generally indexed) institutional intermediaries (i.e. mutual funds and pension funds). Still, this preference leaves unanswered our initial question: How do the informational needs of institutional investors and retail investors differ? How should the SEC respond to their differing needs?

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<sup>13</sup> Anecdotal evidence is abundant that diversified institutional investors, including the Big Three, are placing significant pressure on many companies, particularly including energy companies to expedite their dates for “carbon-neutrality” and on all companies to achieve greater board diversity. See Condon, *supra* n.7; Reed, *supra* n.10.

<sup>14</sup> For the original statement of this model, see William F. Sharpe, Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk, 19 J. Finance 425 (1964); see also John Lintner, The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets, 47 Rev. Econ. & Stat. 13 (1965).

This question has been approached by others, but not directly answered. A dozen years ago, Professor Donald Langevoort focused on the transition from retail to institutional markets at the time of the SEC's 75<sup>th</sup> Anniversary.<sup>15</sup> His recommendations seemed to suggest that the U.S. market would likely become more like the European securities market, which, as he accurately observed, was characterized by (1) “light touch” enforcement, (2) a lesser disclosure burden emphasizing principles-based disclosure, and (3) considerably less reliance on ex post litigation to enforce disclosure norms. Others challenged him,<sup>16</sup> but the greater problem with Professor Langevoort's thesis was his unfortuitous timing. Shortly after he wrote, the 2008 financial crisis broke and, in response, even the U.K. abandoned “light touch” regulation. While differences in enforcement intensity still separate the U.S. and Europe (and will likely continue),<sup>17</sup> a greater consensus exists today over the need for stronger enforcement and a mandatory disclosure system.

This article will therefore skirt the topic of enforcement and instead focus on how the disclosure needs of retail and institutional investors may differ. Here, other transitions are also relevant. Increasingly, private offerings that are exempt from the Securities Act of 1933 (hereinafter, the “1933 Act”) have come to rival public offerings as a means for issuers to raise capital. Indeed, in recent years, the number of private offerings and the total capital raised in them has exceeded the corresponding figures

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<sup>15</sup> See Langevoort, *supra* note 3.

<sup>16</sup> See Evans, *supra* note 5.

<sup>17</sup> For a detailed examination of relative enforcement intensity between the U.S., the U.K., and Europe, see John C. Coffee, Jr., Law and the Market: The Impact of Enforcement, 156 U. Pa. L. Rev. 229 (2007).

for public offerings subject to the 1933 Act.<sup>18</sup> Because these exempt offerings require little disclosure (at least as a legal matter<sup>19</sup>), this might seem to imply that institutional investors need less information. Yet, a confounding fact interferes with this simple a conclusion: the character of the disclosure actually made in offerings done pursuant to Rule 144A (the exempt private offering favored by large public issuers<sup>20</sup>) closely resembles the character of the information in a registration statement filed pursuant to the 1933 Act. In particular, the issuer's disclosures in a Rule 144A offering typically follows the same standardized format. Although no precise metric exists that proves that the same quantum of information is present in both exempt and registered offerings, institutional investors appear to want (and implicitly demand) roughly the same information, and they prefer it presented in the same standardized format. The inference best drawn from this evidence is that diversified institutional investors want at least as much information (and probably more) as do individual investors, and they want a standardized format to enhance the comparability of disclosures across companies. Particularly as they come to make decisions on a portfolio-wide basis, diversified institutions will increasingly want to

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<sup>18</sup> The principal exemption for private placements is Regulation D (17 C.F.R. §230.500 to 508). The number of “Reg D” offerings has exceeded the number of public equity offerings by a 30 to 1 margin. See Coffee, Sale and Henderson, *SECURITIES REGULATION: Cases and Materials* (13<sup>th</sup> ed. 2015) at p.368. The aggregate amount raised in private markets has also exceeded that raised in public markets in some years. For example, in 2012, \$1.7 trillion was raised in private markets versus \$1.2 trillion in public markets in registered offerings. *Id.*

<sup>19</sup> Under Rule 502(b) of Regulation D (17 C.F.R. § 230.502(b)), the issuer need not provide information to purchasers when selling to “accredited investors.” Typically, such offerings are as a result limited to “accredited investors,” which term is defined in Rule 501 of Regulation D to require only a modest \$1 million net worth or an annual income for the two most recent years equal to or exceeding \$200,000. See Rule 501(a)(5) and (6). With inflation, this test has become much more permissive and now includes millions of investors. As a generalization, the purchasers in Reg D offerings are generally individuals and smaller institutions, and the disclosure they receive tends to be quite modest.

<sup>20</sup> See Rule 144A (17 C.F.R. §230.144A). This rule permits private sales to institutional buyers that own and invest at least \$100 million in securities of unrelated issuers (in short, the profile of a large institutional investor). The volume and quality of the disclosure in Rule 144A offerings is much higher than in Reg D offerings to smaller investors, suggesting that large institutions are demanding more information based on their market power.

know and compare the gains and losses at multiple firms in their portfolio that will result from voting decisions that they may make. In contrast, undiversified shareholders have no such need to make similar comparisons.

This article will offer a number of conclusions that are brief and blunt; to be brief, it is necessary to be blunt. Organizationally, Part I of this article will focus on the informational needs of the institutional investor (and particularly, the fully diversified institution). How do their needs and priorities differ from those of the retail individual investor? Relying on the CAPM, it will suggest that institutional investors are more concerned with “systematic risk” than are individual investors and that ESG disclosures overlap with systematic risk to a greater degree than has been previously recognized. Part II will then return to the individual retail investor, who certainly remains on the scene and is the dominant investor in smaller companies that offer less liquidity.<sup>21</sup> What new needs (and fears) might the retail investor reasonably have in the contemporary investment environment? Here, a partial answer will be that, although institutions tend to be tolerant of risk and skeptical of diversification, individual investors rationally have the reverse preferences. Finally, Part III will turn to the growth of ESG disclosures. Although such disclosures are now becoming mandatory in Europe, ESG disclosures remain optional and voluntary in the U.S., with the SEC taking no firm position on them.<sup>22</sup>

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<sup>21</sup> Institutional investors greatly value liquidity: namely, the ability to buy or sell the stock without affecting its market price. Institutional investors also want to make investments in the multi-million dollar range and are not interested in smaller investments. Thus, they tend to invest mainly in large capitalization stocks.

<sup>22</sup> The SEC has not implemented any ESG requirements, leaving them entirely voluntary. For a good summary of the SEC’s positions (and the reasons for it), see Thomas L. Hazen, [Social Issues In The Spotlight: The Increasing Need To Improve Publicly-Held Companies’ CSR And ESG Disclosure](https://papers.ssrn.com/abstract_id=3615327), [https://papers.ssrn.com/abstract\\_id= 3615327](https://papers.ssrn.com/abstract_id=3615327) (June 29, 2020).

What explains the pronounced interest of diversified institutions in ESG? Equally important, what obstacles exist under current law to the fiduciaries who make investment and voting decisions at institutional investors and who wish to rely on this information? How should the SEC assist, encourage, or otherwise regulate ESG disclosures?

More descriptive than prescriptive, this brief article intends to make some logical (and possibly provocative) connections that do not seem to have been clearly made to date, but it will not attempt to draft SEC rules or micromanage the Commission. It does, however, suggest a general direction for disclosure reform and submits that this new direction is consistent with economic logic.

I. THE INFORMATIONAL NEEDS OF THE INSTITUTIONAL INVESTOR:  
HOW ARE THEY DIFFERENT?

It is traditional to begin any discussion that relies on “law and economics” with the mandatory observation that “one size does not fit all.” Not all institutional investors are alike. Some mutual funds and many hedge funds are “stock pickers;” they engage in active trading, and believe they can outperform the efficient market. Generally, they are wrong, but not invariably (which could be explained by the fact that some may have access to private information). Still, a larger percentage of institutional investors are diversified (or even indexed) than are individual investors, and typically these highly diversified investors do not attempt to outperform the market (but rather to mirror it cheaply).

Given their dominance, it is prudent to ask what kinds of information does the fully diversified investor want? Here, one needs to turn to the CAPM, and its most relevant teaching for our purposes is that diversification reduces “unsystematic” risk, but not “systematic” risk.<sup>23</sup> Unsystematic risk is that risk that is unique to a company or industry; for example, a company’s (or an industry’s) technology may be outdated or outperformed by a new emerging technology (e.g., natural gas or solar power may become cheaper than oil or coal-based power). But some risks affect all companies: inflation may increase; a banking crisis may disrupt finance and cut off credit across the board; or, more recently, a pandemic may require all companies to suspend operations. Diversification does not offer meaningful protection from these risks.

The CAPM assumes that the capital markets ignore unsystematic risk in pricing the value of a financial asset (including corporate stock) because diversified investors do not bear unsystematic risk. Because diversification involves little cost or effort for investors with regard to the common stocks of large public companies, the price of a stock, according to this model, is set by diversified investors, who need only consider the company’s systematic risk. In effect, if two companies have the same expected return, the fact that one has higher unsystematic risk will not affect their relative valuation to the extent the market price is set by diversified investors who do not bear this risk. Put differently, investors cannot demand a higher return for bearing unsystematic risk that they could have easily diversified away.

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<sup>23</sup> For a concise discussion of this difference in the standard finance textbook, see Richard Brealey, Stewart C. Myers, & Franklin Allen, *PRINCIPLES OF CORPORATE FINANCE*, 168-170 (10<sup>th</sup> ed. 2011).

The key implication here is that the price of a financial asset will be determined by the asset's systematic risk compared to the risk of the market as a whole. To be sure, the CAPM has been much criticized and may overstate.<sup>24</sup> But, even its critics believe that it points in the right direction and is roughly accurate.<sup>25</sup> The CAPM's immediate implication for our topic of disclosure policy is that, as the market becomes increasingly dominated by diversified investors, these investors will focus primarily on systematic risk. But systematic risk has never been a key focus of the SEC's retail investor-oriented disclosure policy.

Let us assume that the CAPM makes assumptions that many will regard as overstated.<sup>26</sup> But, even if we need to take it with a substantial grain of salt, the CAPM still legitimately implies that the SEC needs to modernize its disclosure policy and focus more seriously on systematic risk. This does not mean that the SEC need ignore unsystematic risk (because many investors will remain less than fully diversified), but it does suggest that diversified investors who constitute a majority of the market have an unmet disclosure need.

Skeptics may respond to this claim that if there were any such demand for more disclosure about systematic risk, we would have heard investors clamoring for such information? But arguably they are clamoring. Increasingly, the largest and most diversified institutional investors (led by BlackRock, State Street and

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<sup>24</sup> For such a critique, see Eugene F. Fama & Kenneth R. French, Common Risk Factors in the Returns on Stocks and Bonds, 33 J. Fin. Econ. 3, 4-5 (1993) (finding the CAPM to be empirically inadequate).

<sup>25</sup> In a series of articles, they proposed supplementing the original CAPM with a few additional factors. See Eugene F. Fama & Kenneth R. French, A Five-Factor Pricing Model, 116 J. Fin. Econ. 1 (2015). Thus, although they believe the CAPM needs to be supplemented, they do not reject it as a starting point.

<sup>26</sup> See text and notes supra at nn. 24 and 25.



Vanguard) are not only pressing public companies to provide greater ESG disclosures, but they are acting on these disclosures through both voting and litigation.<sup>27</sup> Although “ESG” can mean different things to different persons, its core meaning involves disclosures relating to corporate sustainability and climate change. Today, these words fall near dead-center in terms of what may determine a company’s exposure to systematic risk.

Indeed, climate change may present the clearest example of systematic risk. Although it will not affect all companies the same (i.e., the risk is heterogeneous), investors cannot escape it through diversification. That is, there is no obvious class of companies whose stock will go up as the result of global warming so as to compensate diversified investors for those stocks that go down. Given that they are exposed to this risk, diversified investors rationally need to estimate its impact on their portfolios. Further, they may want to take action (either by voting, litigation, or persuasion) to induce change that reduces such risk (even if it causes losses to some companies in their portfolio, so long as the action taken implies greater gains than losses to the portfolio).

Much like Molière’s gentleman who was surprised to learn that he was speaking prose without knowing it, the SEC may already be focusing more on systematic risk than it realizes. Recently, the SEC has concentrated on Covid-19 disclosures, asking all public companies to explain how the pandemic is affecting

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<sup>27</sup> For an article that shows how a group of six institutional shareholders (including, the above three) were able to press both ExxonMobil and Chevron to support climate change reforms that these firms had previously opposed, see Condon, *supra* note 7. Not only are broadly diversified firms seeking such disclosures, they are also acting upon them as well, often by suing portfolio companies. See Alexander Platt, Index Fund Enforcement, 53 U.C. Davis L. Rev. 1453 (2020).

them.<sup>28</sup> Of course, pandemics represent a form of systematic risk as diversification cannot protect investors' portfolios. Perhaps (unlike Molière's gentleman), the SEC does not care that it is already speaking prose (by requiring some disclosure relating to systematic risk), but it needs to be encouraged to go further and develop its fluency in this new language.

Skeptics will again respond that not all ESG disclosure relates to systematic risk. For example, ESG disclosures often focus on racial diversity and inclusiveness. How, they will assert, can that be called systematic risk disclosure? They may argue further that such disclosure is aimed at, and demanded by, activists and stakeholders, not mainstream shareholders. In the short-run, this may be an understandable question, but over the long-run, these disclosures arguably do relate to the viability of our corporate system. If the corporate system cannot offer inclusiveness and promote diversity, it may become subject to a political risk that capitalism (or, at least, contemporary corporate governance) will be politically challenged and could conceivably yield to a more state-run system of corporate governance. To some degree, such a transition seems to be already occurring in Europe and the U.K.<sup>29</sup> Again, diversification could not protect investors against this

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<sup>28</sup> There has been a continuing stream of SEC statements since March, 2020. See, Division of Corporation Finance, Securities and Exchange Commission, "CF Disclosure Guidelines: Topic No. 9A, "Coronavirus (Covid-19) - Disclosure Considerations Regarding Operations, Liquidity, and Capital Requirements" (June 23, 2020). For a brief overview, see "Updating Public Traded Company Disclosures for Covid-19," LAW360 (March 20, 2020).

<sup>29</sup> Nations can be located on a corporate governance continuum ranging from "shareholder-centric" systems (of which the U.S. is the leading example) to "stakeholder-centric" systems (into which category most European nations fall). In Europe and the U.K., there has been recent movement towards increasing the rights of, and duties owed to, stakeholders. One step in this direction has been the recent popularity of "stewardship codes" for investors. See Jennifer G. Hill, Good Activist, Bad Activist: The Rise of International Stewardship Codes, 41 Seattle U. L. Rev. 497 (2018); Jennifer G. Hill, Shifting Contours of Directors' Fiduciary Duties and Norms in Comparative Corporate Governance, 5 J. of Int'l & Comp L. Rev. 163 (2020); Katherine Jackson, Toward a Stakeholder-Shareholder Theory of Corporate Governance: Comparative Analysis, 7 Hastings Bus L. J. 309 (2018).

risk of political upheaval, which could directly threaten the traditional investor's goal of shareholder wealth maximization.

One last point about “systematic risk” needs to be underscored: its relationship to securities law’s bedrock concept of materiality is both close and clear for diversified investors. Because systematic risks cannot be diversified away by investors, information about such risks arguably becomes more material to diversified investors than information about “unsystematic risks,” both because institutional investors are in theory only exposed to “systematic risk” and because they (and only they) may be able to take corrective action to minimize externalities.<sup>30</sup> In truth, this is the same distinction as between a risk that is insurable and one that is uninsurable; obviously, a risk that is uninsurable more seriously threatens investors. For example, a fire will not destroy a major bank holding corporation, but a 2008 style financial catastrophe could. Similarly, a pandemic or rapidly accelerating climate change are unhedgeable risks that can produce far greater damage to investors’ portfolios than can any firm-specific disaster (even an Enron) -- but they are also susceptible to direct action by coordinated shareholders (through litigation, proxy fights, or the threat of divestment).

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<sup>30</sup> For discussions of the magnitude of climate change as a leading systematic risk and investors’ concerns about it, see Inst. For Sustainable Leadership, Univ. of Cambridge, “Unhedgable Risk: How Climate Change Sentiment Impacts Investment,” Stefano Battison, *A Climate Stress-Test of the Financial System*, 7 *Nature Climate Change* 283, 288 (2017); Steven Schwarcz, *Systemic Risk*, 131 *J. Fin. Econ.* 693 (2018). For our purposes, “materiality” is defined for the federal securities laws in remarkably broad language, which was set forth in *Basic, Inc. v. Levinson*, 485 U.S. 224, at 231 (1988) (stating that “an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”). In short, if reasonable investors want the information, it becomes presumptively material. My premise here is only that mega-sized institutional investors (such as the Big Three) are objectively reasonable.

## II. THE RETAIL INVESTOR: THE RELEVANCE OF OPTION PRICING THEORY

Institutional and individual investors disagree over an important issue of business policy. Institutional investors do not want the corporate issuer to diversify or to hold a conglomerate-like portfolio of unrelated companies in different industries. Because the institutional investor can easily diversify its own holdings, and because it is redundant to diversify on both the investor and corporate levels, diversified investors want to streamline the corporation's portfolio and sell or spin off unrelated assets. From an economic perspective, only synergies between divisions can justify a corporation in holding investments in multiple unrelated companies. Still, many individual investors do not diversify and therefore do not share this policy preference. Why do they not diversify? This presents something of a mystery, but they may lack adequate resources or their failure may be the product of simple ignorance. Regardless, such undiversified individual investors logically benefit from corporate diversification, as it reduces the risk of the investments they hold.

Today, activist hedge funds regularly “engage” target corporations, buying a 5% or slightly greater stake and then seeking to pressure the target into reducing its degree of diversification (and simultaneously increasing leverage, often through stock buybacks).<sup>31</sup> Generally, these campaigns produce an immediate positive stock market reaction when the activist hedge fund crosses the 5% ownership threshold and files the mandatory Schedule 13D (which typically announces both its ownership position

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<sup>31</sup> For a detailed discussion of this pattern, see John C. Coffee, Jr. & Darius Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, 41 J. Corp. L. 545 (2016).

and its proposed plans to reduce diversification and increase leverage).<sup>32</sup> Although this stock price reaction suggests shareholders as a group are made better off by these campaigns, undiversified investors may arguably be made worse off. As “buy and hold” investors,<sup>33</sup> the retail individual investor is unlikely to sell and probably will continue to hold a stock that is now subject to higher risk at the corporate level (because of reduced diversification). Does the increase in expected return justify this increased risk? No simple conclusion is justified here.<sup>34</sup>

Because the CAPM assumes that the market price of a widely traded stock is determined by the interaction of large, fully diversified institutional investors, the small retail investor will not have much impact on the stock price (even if some such investors do sell). Because the stock price is thus unlikely to decline (as institutional investors are happy with this new trade-off of risk and return), these individual investors need disclosure that makes clear to them that they may now be subject to greater risk. Arguably, if the SEC continues its traditional policy of protecting retail investors, the SEC should mandate disclosures that warn these investors of this increased risk. Effectively, they should use this opportunity to prod investors toward

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<sup>32</sup> Although an intense debate continues over the long-term impact of hedge fund activism, a consensus exists that the filing with the SEC (usually on Schedule 13D) of a disclosure announcing that the activist has taken a 5% (or greater) position in the stock of a publicly held company is associated with a positive abnormal stock return. See Alon Brav et al., Hedge Fund Activism, Corporate Governance and Firm Performance, 63 J. Fin. 1729, 1736-37 (2008). Beyond that point, empirical conclusions are contested.

<sup>33</sup> Retail investors tend to be “buy and hold” investors (who do not trade actively) probably because they face higher trading costs than institutional investors who, because they trade in volume, receive quantity discounts.

<sup>34</sup> The taste for risk is subjective and individuals differ. Thus, although a hypothetical 5% stock market gain might induce some (or even most) investors to accept the increased risk associated with increased leverage or reduced diversification, it may not please all shareholders. Also, the increased risk may not be evident to many retail shareholders (who see only the increased stock price). This conclusion will be regarded as heresy by neo-classical economists who assume that all shareholders favor policies that increase the share price. See Frank H. Easterbrook & Daniel Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW, 69-71 (1991). This, however, ignores that rational investors will focus on the risk-return ratio and vary in their reactions.

greater diversification. Nothing in existing disclosure rules provides for anything resembling such disclosure or such advice.

This point about the increase risk associated with hedge fund activism needs to be generalized. The famous (and Nobel Prize-winning) work of Fischer Black and Myron Scholes on option pricing theory begins from their insight that, once a public company takes on significant debt, its common stock can be modeled (and is best understood) as an option on the corporation's assets.<sup>35</sup> That is, the common stockholders collectively hold an option, which, on the maturity of the debt, allows them either to let the corporation default on its debt (which is the equivalent of letting their option expire) or to pay the debt off (which is the equivalent of exercising their option). In this view, the "real" owners of the corporation are its debt holders, who have no choice (because the shareholders have limited liability and cannot be held personally liable if the firm defaults on its debt). Unlike the debtholders, the stockholders do have the choice of either allowing the company to default (and thus turning the company over to the creditors) or of paying off the debt (and in effect exercising the option). Presumably, they will make the choice that maximizes their own interests (possibly at the expense of creditors and other stakeholders).

The immediate relevance of this point involves the incentive effects on the option holder (i.e., the common shareholders). As option holders, they can be expected to act rationally so as to maximize the value of their option. What does that imply?

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<sup>35</sup> Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. Pol. Econ. 637 (1973). For an accessible explanation of option pricing, see Ronald J. Gilson & Bernard Black, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT (1993) at 252-257.

Under the Black/Scholes model, the most important factor in determining the value of an option is the variance in the value of the underlying asset (here, the corporation's assets). In short, the greater the variance in expected corporate returns, the greater the value of the option. This may seem counter-intuitive, because greater variance in expected returns is unattractive to debtholders and reduces the value of the corporation's assets in their hands. Still, a critical insight of the option pricing model is that the common stockholders, as the holder of an option, can increase the value of their option by increasing the variance associated with the corporation's assets and investments. More bluntly, this means that by increasing the riskiness of the corporation's investments, they benefit themselves (as the option holder) at the expense of the corporation's creditors and other stakeholders.

Thus, we now have a scenario for opportunism by the shareholders: if they take on riskier investments, or leverage up the company, they gain and the creditors lose. Of course, creditors can resist by insisting on protective covenants in loan agreements and bond indentures, but these are in declining use.<sup>36</sup> Even if creditors could negotiate contractual protections against increased leverage, it is much harder to prevent their corporate borrower from taking on riskier investments and making higher-risk bets. Such restrictions would be hard to draft and would be resisted intensely by corporate managers because it would tie their hands, denying them needed flexibility over an extended period.

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<sup>36</sup> Debt covenants became disfavored in the 1980s, and empirical surveys found that large public corporations had successfully avoided them. See Morey McDaniel, *Bondholders and Corporate Governance*, 41 Bus. Law. 413 (1986); see also William Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 Duke L. J. 92.

In this light, the behavior of activist hedge funds in seeking to reduce corporate diversification and/or to increase leverage (or otherwise withdraw funds from the firm) makes perfect sense from the standpoint of the Black/Scholes model. The hedge funds are essentially seeking to increase risk to benefit the majority of shareholders at the expense of creditors (and other stakeholders). Although the hedge funds are not themselves diversified, they know that they will be rewarded by a share price increase if they propose an action (such as increasing leverage or reducing diversification) that will benefit the diversified shareholders that they are serving.

Although there has been a voluminous and heated debate over the practices and ethics of activist hedge funds,<sup>37</sup> this debate has usually been framed in terms of whether hedge funds have a “short-term” perspective that contrasts with the allegedly “long-term” perspective of the target corporation’s managers. Without denying that there could be such differences between activist shareholders and managers,<sup>38</sup> it is simpler (and theoretically more elegant) to focus instead on the enhanced value to the option held by the shareholders as the result of accepting increased risk.

Possibly, some will respond: if this is so obvious, why didn’t the target management do this themselves and accept increased risk and lesser diversification?

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<sup>37</sup> For representative positions, see Lucian A. Bebchuk, Alon Brav & Wei Jiang, The Long-Term Effects of Hedge Fund Activism, 115 Colum. L. Rev. 1085 (2015); Coffee and Palia, *supra* note 29; and Leo E. Strine, Jr., Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge fund Activism and Our Strange Corporate Governance System, 126 Yale L.J. 1870 (2017).

<sup>38</sup> Standard compensation formulas in the hedge fund industry (which typically annually award hedge fund managers 20% or more of the fund’s gains) do give hedge fund managers considerable reason to focus on the short-run. Moreover, hedge fund managers are aware that their investor clients can easily move funds to another hedge fund if they do not deliver immediate gains. In contrast, corporate managers are conventionally assumed to have a longer term (and more risk-averse) perspective because of their locked-in human capital.



Why have only activist hedge funds proposed this? Here, there is a simple answer: corporate managers have firm-specific human capital invested in the firm, which they cannot easily hedge. Put simply, shareholders hold multiple stocks, but managers have only one job. Managers will resist the risk of increased leverage or diminished diversification, because it exposes them to potential bankruptcy and the loss of their human capital. Thus, shareholders make superior risk bearers.

Today, activist hedge funds have learned that if they propose a specific scenario for increasing risk (such as by following a riskier investment policy, selling off corporate assets that mainly provide unneeded diversification, or increasing leverage, buybacks and dividends), they will find it easy to sell this policy to diversified institutional shareholders. This motivation to increase risk and reduce diversification did not begin with activist hedge funds. “Bust-up” takeover bidders did the same thing in the late 1980’s. But these bidders were chilled by the poison pill, state takeover laws, and judicial developments.<sup>39</sup> The evidence is clear that activist hedge funds can today compel target managements to negotiate their demands and place the hedge fund’s agents on the target’s board.<sup>40</sup> More importantly, the activist fund spends far less, fares far better, and achieves results far more quickly than the traditional hostile bidder. As a result, the activist hedge fund has

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<sup>39</sup> During the 1980s, the Delaware Supreme Court upheld the validity of the poison pill in Moran v. Household International, Inc., 500 A. 2d 1346 (Del. 1985), and after Paramount Communications, Inc. v. Time Incorporated, 571 A. 2d 1140 (Del. 1990) it seemed (at least for a time) that to uphold a “just say no defense” would be valid in Delaware. Possibly as a consequence, hostile takeovers declined, following 1990 and, other techniques (including hedge fund engagements) grew.

<sup>40</sup> For a fuller discussion of the tactics and success of hedge fund campaigns, see John C. Coffee, Jr., Robert J. Jackson, Jr., Joshua R. Mitts & Robert Bishop, Activist Directors and Agency Costs: What Happens When An Activist Director Goes on the Board?, 104 Cornell L. Rev. 381, 395-408 (2019).

largely replaced the hostile bidder, but the implications for the undiversified retail investor remain the same: increased risk is generally contrary to their preferences.

Although the clear winners here are diversified shareholders and activist funds, the clear losers are not only creditors, managers and stakeholders. In addition, the undiversified retail investor is a bystander whose fate is less easily summed up. This shareholder may sometimes win and sometimes lose, depending upon how much risk the shareholder is willing to accept. The bottom line then is that not only creditors are placed at risk by such practices, but undiversified retail shareholders are forced to bear more risk than they may want or can recognize.

How (if at all) should the SEC protect these investors? The long term answer may be that retail investors should be prodded (or at least encouraged) by the SEC to diversify. But the SEC's ability at investor education is open to doubt.<sup>41</sup> The public does not respond well to the Government's paternalistic advice. To the extent that investor education falls short (as I expect it will), the second best policy may be to require greater disclosure alerting the individual investor to the risk and dangers associated with hedge fund campaigns, reduced diversification, and increased leverage. This policy, of course, can only be pursued on a case-by-case basis, but the end goal should be to encourage greater diversification by retail investors.

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<sup>41</sup> Unquestionably, retail investors need investor education, but it is highly questionable that the SEC can teach this course successfully. Part of the problem is that for every dollar spent by the SEC toward this end, far more will be spent by mutual funds, investment advisers, and the advocates of crowdfunding, all predicting that they can find you the next Microsoft or Apple. A more likely candidate to teach the value of diversification are the private proponents of diversification, such as most notably Vanguard.

### III. THE SPECIAL CASE OF ESG DISCLOSURES: CAN FIDUCIARIES USE THIS INFORMATION?

Although the term “ESG” is of fairly recent vintage, the concept has been around for forty years or longer.<sup>42</sup> Still, a paradox remains: even if investors want such information, can fiduciaries, acting on their behalf, use it lawfully in either investing or voting decisions? The problem is that fiduciaries are legally barred from relying on ethical considerations, except under special circumstances. Conservatives have long argued that fiduciaries (and particularly trustees subject to ERISA or common law standards) are not permitted to rely on ethical or moral judgments (or socially desirable goals), unless they can conclude, based on clear evidence, that pursuit of such goals will work to the financial advantage of their beneficiaries.<sup>43</sup> From this perspective, ESG data can be considered by fiduciaries only if they can reasonably find that it satisfies a risk-return test that enables them to improve their portfolio’s overall risk-adjusted return.<sup>44</sup> But this is a more complex exercise than it initially appears. This section will argue that the SEC can play a useful role in resolving this dilemma.

A. A BRIEF HISTORY OF ESG. The idea that investors should consider the social behavior and impact of the companies they invest in has a long history, and some trace it back as far as the sermons of John Wesley, the founder of the Methodist

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<sup>42</sup> For a good history of the rise of ESG investing, see Schanzenbach & Sitkoff, *supra* note 11, at 395-399.

<sup>43</sup> This debate can be easily traced back to the 1980s, when the key issue involved divestment campaigns aimed at South Africa’s apartheid policies. For the conservative view that social investing was illegitimate, see John H. Langbein & Richard A. Posner, Social Investing and the Law of Trusts, 79 Mich. L. Rev. 72 (1980). Professors Schanzenbach & Robert H. Sitkoff appear to be following in this tradition (with some modifications)

<sup>44</sup> This is essentially the position of Professors Schanzenbach and Sitkoff. See Schanzenbach & Sitkoff, *supra* note 11, at 453.

Church, who advised his followers that they could not ethically invest in companies that profited from the slave trade.<sup>45</sup> Similarly, some mutual funds have long employed a social screen to winnow out those companies that made anti-social products. The first such U.S. fund, Pioneer Investments, dates to 1928 and remains in business today, continually stressing its commitment to Christian values.<sup>46</sup> The broader concept of socially responsible investing (or “SRI”) flowered in the 1980s, when the issue of South African apartheid provoked a crisis and caused ethical investors to seek to disinvest companies that were active in South Africa.<sup>47</sup> Such ethical investing was always in tension with trust fiduciary law, which requires a trustee to consider only the interests of the beneficiary.<sup>48</sup> This “sole interest rule” is intended to protect beneficiaries from fiduciaries who might subordinate the beneficiaries’ financial interests to those of political or social groups with whom the fiduciary sympathized. Legally, the “sole interest rule” implied that the trustee had to prefer investments with superior risk-adjusted returns, regardless of the social impact of the corporate issuer. Nervous that they might run afoul of the law, many risk-averse fiduciaries shied away from SRI investing.<sup>49</sup>

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<sup>45</sup> *Id.* at 392.

<sup>46</sup> *Id.* at 392-393.

<sup>47</sup> *Id.* at 393-395.

<sup>48</sup> Under what is known as the “sole interest rule,” a trustee must “administer the trust solely in the interest of the beneficiaries.” 3 Restatement (Third) of Trusts §78(1). Under a comment to this section, the Restatement adds that “the trustee has a duty to the beneficiaries not to be influenced by the interests of any third person or by motives other than the accomplishment of the purposes of the trust,” 3 Restatement of Trusts §78(1) cmt.f. See also Unif. Trust Code §802(a) (Unif. Law Comm’n 2000). If the trustee acts based on mixed motives, “an irrefutable presumption of wrongdoing” arises. See Daniel Fischel & John Langbein, *ERISA’s Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. Chi. L. Rev. 1105, 1114-15 (1988). As noted later, however, a plaintiff will still have to prove damages, which can be a considerable hurdle.

<sup>49</sup> One recent study surveying 310 fiduciaries found that 47% believed that the use of ESG criteria either conflicted or might conflict with their fiduciary duty. See Fi360, *ESG Survey for Fi360 Designees 2* (2009). For other recent studies, see Schanzenbach & Sitkoff, *supra* note 11, at 385 n. 7.

To bring SRI investing into the mainstream, something had to be done, and predictably clever lawyers devised an answer. Conceptually, they “rebranded” SRI investing and converted it into ESG investing by asserting that consideration of the “governance factors” associated with public corporations would enable the fiduciary to identify superior investments and enhance risk-adjusted return.<sup>50</sup> By adding governance to the mix, they argued, one not only did good (ethically), but one also did better (financially).<sup>51</sup> This in turn enabled law firms to opine to their clients that ESG investing was fully compatible with the trustee’s fiduciary obligations.<sup>52</sup> A few went even further and suggested that consideration of ESG factors might be mandatory.<sup>53</sup>

Necessity is often the mother of invention, and the modest claim here advanced is merely that the need to calm the fears of risk-averse trustees best explains the addition of “governance” factors to environmental and social ones in order to convert SRI into ESG. Whatever the motive, this rebranding seems to have worked and in a brief period brought ESG into the investment mainstream. As of late 2019, some 1,900 asset managers (including some of the world’s largest) have signed the PRI’s

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<sup>50</sup> I borrow the term “rebranding” from Schanzenbach & Sitkoff, *supra* n. 11 at 388. A key moment in this semantic transition from SRI to ESG came in 2005 with the release of a report sponsored by a UN working group and prepared by the international law firm of Freshfield Bruckhaus Deringer, which asserted that ESG investing was not only consistent with the trustee’s fiduciary duties, but was “arguably required in all jurisdictions.” See UNEP FIN. INITIATIVE, *A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT* at 13 (2005). See Schanzenbach & Sitkoff, *supra* note 11, at 389.

<sup>51</sup> An influential study in 2003 by Paul Gompers, Joy Ishii, and Andrew Merrick gave considerable credibility to the claim that governance factors did relate to firm performance. See Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. Econ. 107, 114-29 (2003). See also, Lucian Bebchuk et al., *What Matters in Corporate Governance*, 22 Rev. Fin. Stud. 783 (2009).

<sup>52</sup> The Freshfields opinion noted earlier, *supra* n. 50, is one example.

<sup>53</sup> See UNEP FIN. INITIATIVE, *supra* note 50, at 13; Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. Colo. L. Rev. 731, 734-36 (2019).

statement of principles endorsing ESG investing;<sup>54</sup> hundreds of ESG indices have been published that provide ESG ratings on individual companies;<sup>55</sup> and Delaware and Oregon have amended their trust law to specifically address and facilitate ESG investing.<sup>56</sup> Even the major index funds, including BlackRock and Vanguard, which ordinarily ignore firm-specific factors as “indexed investors,” are now proclaiming that they will consider some ESG issues, such as climate change.<sup>57</sup>

B. THE REMAINING LEGAL UNCERTAINTY. Still, problems persist. Although the law in Europe has been sufficiently revised and clarified to make ESG investing appear safe for even the most risk-averse trustee,<sup>58</sup> U.S. fiduciary law still imposes in most states a “sole interest rule” that instructs the fiduciary to consider only the interests of the beneficiary (and thus not to give weight to the interest of others, including, the billions who may be affected by adverse climate change).<sup>59</sup> Of course, the reformulation of ESG was designed to show that ESG, as revised, could improve risk-adjusted returns, thus satisfying a hard-nosed economic test, even without giving weight to collateral benefits to others. Some scholars buy this argument and consider

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<sup>54</sup> Schanzenbach & Sitkoff, *supra* n. 11, at 387 (citing Principles for Responsible Investment, Signatory Directory, updated 11 2019 (2019)). Of these 1,900, the majority were European asset managers, showing the greater acceptance of ESG investing in Europe.

<sup>55</sup> *Id.* at 387.

<sup>56</sup> In 2018, Delaware amended its trust law to authorize ESG investing if it is authorized in the trust instrument. See Del. Code Ann., at 12, §3303(a)(4). See also Or. Rev. Stat. §§130.020, .755. These are referenced only as straws in the wind, and not to suggest that they resolve all issues.

<sup>57</sup> See Schanzenbach & Sitkoff, *supra* note 11, at 386-387.

<sup>58</sup> European regulators have generally accepted and encouraged ESG investing. See Press Release, Eur. Ins. & Occupational Pensions Auth., “EIOPA Issues Opinions on Governance and Risk Management of Pension Funds (July 10, 2019, 3:00PM) <https://perma.cc/M3YG-TFT3> (urging national regulatory authorities within the EU to “encourage pension funds to consider the impact of their long-term investment decisions and activities on ESG factors”). See also Schanzenbach & Sitkoff, *supra* n. 11, at 387.

<sup>59</sup> See text and notes *supra* at notes 48-49.

ESG to no longer be controversial,<sup>60</sup> but others continue to have doubts. Most notably, Professors Max M. Schanzenbach and Robert H. Sitkoff have drawn a sharp distinction between (1) ESG investing based on moral or ethical reasons or to achieve various collateral benefits (such as, I suppose, saving the Earth), and (2) ESG investing intended to improve risk-adjusted returns.<sup>61</sup>

This distinction between (in their words) “collateral benefit” ESG investing and “risk-return” ESG investing seemingly makes everything depend on the fiduciary’s motive. Realists will, of course, recognize that, once risk-averse fiduciaries are properly advised as to the law, they will express the legally proper motive and deny the legally improper motive. (Hey guys, isn’t that what lawyers are for?). Thus, under this approach, the practical risk of fiduciary liability seems relatively small.

Still, the test proposed by Schanzenbach and Sitkoff would actually require considerably more than just a proper motive. They would require the prudent trustee to conclude, before investing based on any special ESG factor, that the “capital markets consistently misprice the factor in a predictable manner that can be exploited net of any trading and diversification costs.”<sup>62</sup> Although this test purports to permit ESG investing, it may well be a wolf in sheep’s clothing. Its very demanding standard about mispricing may be nearly impossible for most trustees to satisfy. In effect, the trustee must determine, first, that ESG factors relate to firm performance

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<sup>60</sup> See Gary, *supra* n. 53. Professor Gary served as the Reporter for the Uniform Prudent Management of Institutional Funds Act, which alone makes her a significant voice in this field. The Principles for Responsible Investment (or “PRI”) represents probably the leading statement of the necessity for fiduciaries to adopt ESG factors into their investment analysis. It has obtained over 1,900 asset manager endorsements of its statement of principles. Schanzenbach & Sitkoff, *supra* n. 11, at 387.

<sup>61</sup> See Schanzenbach & Sitkoff, *supra* n. 11.

<sup>62</sup> *Id.* at 451.

in the case of a specific company, and, second, that this factor has been sufficiently mispriced that the fiduciary can exploit this mispricing (net of trading and diversification costs).<sup>63</sup>

Although I agree with them that ESG investing is not mandatory and that prudent trustees can reasonably conclude that they cannot outperform the market (as the Supreme Court has also observed in a relevant recent decision<sup>64</sup>), the possibility still seems remote that any court, either state or federal, would second guess and hold liable trustees who do decide to engage in ESG investing in the belief that it will enable them to achieve a superior portfolio. Courts are not suspicious of professional trustees, and, absent a personal self-interest on the part of the fiduciary, they have little reason to apply any enhanced scrutiny standard. Nor is there any clear history of courts intervening in this private world to impose liability.

Nonetheless, the fact that I view the legal risk associated with ESG investing as modest does not necessarily mean that risk-averse trustees will agree, particularly when recognized experts, such as Schanzenbach and Sitkoff, are warning them. Thus, even though the risk may be small, some risk-averse trustees could simply decide to avoid the problem and stick to passive investing.<sup>65</sup>

C. THE IMPACT OF A PORTFOLIO-WIDE PERSPECTIVE. What is the best way out of this quandary? Here, we need to recognize that the new high level of common ownership enables diversified institutional investors to take concerted action on a

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<sup>63</sup> *Id.* at 390, 450-453.

<sup>64</sup> See *Fifth Third Bancorp v. Dudenhofe*, 134 S. Ct. 2459, 2468 (2019).

<sup>65</sup> Some trustees appear to take exactly this position. See Schanzenbach & Sitkoff, *supra* n. 11, at 385 and n. 7.



portfolio-wide basis. Professors Schanzenbach and Sitkoff seem to ignore this possibility, but it may allow fiduciaries to engage in ESG investing in full compliance with the “sole interest rule.” Suppose that Big Three-level index funds were to push the major energy companies to adopt tighter standards on emissions and to advance the date on which they would become carbon neutral. Their justification might be that, although this would reduce the financial returns for some portfolio companies (i.e., coal companies), it would benefit other companies (for example, those who produced solar power, wind power or nuclear power). Such pressure has in fact been successfully applied to Royal Dutch Shell and others in 2018.<sup>66</sup> Economically, such interventions would make sense -- if the losses to the traditional energy companies were outweighed by gains to the other firms in the portfolio. As Madison Condon has framed it:

“A rational owner would use his power to internalize externalities so long as its share of the cost to the externality-causing firms are lower than the benefits that accrue to the entire portfolio from the elimination of the externality.”<sup>67</sup>

In the past, even a large institutional investor could not hope to cause a shift in corporate policy at a portfolio firm. But in the new age, where the Big Three usually votes 25% of the shares voted just by themselves (and can reach out to their fellow institutions for more support), they seem able to enforce their will effectively.

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<sup>66</sup> In late 2018, Royal Dutch Shell was pressured by a coalition of institutional investors to set emission reduction targets to reduce its carbon footprint by 20% by 2035 and 50% by 2050. It had previously opposed these targets and described them as “onerous and cumbersome,” but once approached by this institutional coalition, it yielded quickly. See Condon, *supra* note 7, at 2. Thereafter, this same coalition next approached ExxonMobil, Chevron and BP. *Id.*

<sup>67</sup> Condon, *supra* note 7, at 6.

Moreover, the firm managers that they will seek to pressure will typically be risk-averse and probably unwilling to jeopardize their careers by engaging in a contested proxy fight with these powerful institutions.

Of course, as fiduciaries, the trustees or similar personnel at these institutional investors would have to make an informed judgment and compare the costs and benefits from such action to their portfolio. But this is exactly where consultants will predictably be hired to perform such an analysis.<sup>68</sup> Perhaps my cynicism is showing, but these consultants will usually be able to justify the requisite findings that their clients want. Indeed, this could become a burgeoning growth business for accounting firms, proxy advisor firms, and other consultants.

This is also the juncture where the SEC could play a useful role. The SEC could require corporate managers to disclose data that they possessed about the costs of change (for example, the costs of reaching carbon neutrality by a given date). Such data (which increasingly exists at many large public companies) could be required to be disclosed in the firm's Management Discussion & Analysis ("MD&A").<sup>69</sup> This would

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<sup>68</sup> For example, an environmental consulting firm, an accounting firm, or a proxy advisor might compare the loss to a major oil company (such as Royal Dutch Shell in our earlier example) from reducing its emissions or carbon footprint by a specified percentage to the benefits to other companies in its portfolio from achieving reduced pollution and postponing adverse climate change. Some asset managers appear to be making these estimates already. Schroders, a major asset manager, has calculated that a 4 degree increase (Centigrade) would produce "global economic losses" of \$23 trillion over an 80 year period. See Condon, *supra* note 7, at 6. Because this is a short article, it will simply assert (and not demonstrate) that such calculations are difficult and tend to be error-prone.

<sup>69</sup> "Reporting companies," which term includes most exchange-listed companies, must comply with SEC Regulation S-K (17 C.F.R. §229) by filing certain mandatory periodic disclosures with the SEC. Item 303 of Regulation S-K ("Management's Discussion and Analysis of Financial Condition and Results of Operations") requires such a reporting company to "identify any known trend or known demands, commitments, events or uncertainties... that are reasonably likely" to produce material changes in the issuer's liquidity, capital resources, or results of operations. If there were even "uncertainties" about the costs of reaching environmental targets and costs could have a material impact on liquidity, capital resources, or results of operations, then disclosure would be required. The point here is that the SEC could clarify that such disclosure was required as to major ESG topics, such as climate change, and this would inform and motivate fiduciaries at the major institutional investors.

not be an aggressive step for the SEC, as it would only be requiring the disclosure of data in management's possession and not mandating any position on ESG investing.

Conceivably, one could go even a step further: arguably, fiduciaries could also calculate the benefits to their beneficiaries, as individuals, from reducing pollution or slowing climate change.<sup>70</sup> Although under ERISA fiduciaries may be legally required to focus on the financial benefits to their beneficiaries, they should be able to measure those financial benefits on a portfolio-wide basis. Considering the personal financial benefits to investors (i.e., benefits unrelated to the stock price) would be more controversial, but arguably complies with both the "sole interest rule" and ERISA's language. Again, consultants could give fiduciaries detailed estimates based on legitimate studies.

The bottom line here is that trustees who reach a careful, informed position, based on legitimate studies, are unlikely to face any serious risk of liability. What such prudent trustees most need is more information -- in particular, information that enables them to make comparisons between companies. To illustrate, suppose the SEC encouraged companies to express information in terms of estimated benchmarks. For example, by what date did the company believe it would become

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<sup>70</sup> This idea that fiduciaries could serve the best interests of their beneficiaries by considering more than simply the impact of their actions on the individual stocks before them will trouble some, as it could quickly lead down a slippery slope to very subjective judgments. For example, one could look even beyond the financial interest of the beneficiaries and add into the calculation their beneficiaries' personal interests as well (reducing pollution may enable the beneficiaries to live longer or better lives). Heretical as this may sound, two distinguished economists have endorsed such a test, arguing that fiduciaries should maximize not stock value, but shareholder welfare. See Oliver Hart and Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L., Fin., & Acct. 247 (2017). Here, ERISA's "sole interest rule" appears to require fiduciaries to focus solely on "financial benefits" (not personal benefits) to the beneficiaries. See *Fifth Third Bancorp v. Dudenhof*, 134 S. Ct. 2459, 2468 (2014) (quoting 29 USC §1104(a)(1)(A)(i)-(ii)). Still, outside of ERISA, a broader calculation of the benefit that combines financial and personal benefits might be possible.

“carbon neutral”? At what cost? Many companies have already released projected dates (2040, 2050, etc.) Other companies have remained silent, but if the company had an estimated date (which it had never publicly disclosed), the SEC could indicate that such information in its view was material (as could be any estimate of the costs involved in reaching this target date). If such disclosure of internally generated estimates were required in the MD&A,<sup>71</sup> this information would also carry very little risk of liability under the federal securities laws.<sup>72</sup>

Already, many securities analysts prepare rankings of public companies in terms of ESG criteria. The problem with such rankings is a familiar one: “Garbage In, Garbage Out” -- the “GIGO Effect.” Today, ESG disclosure is incomplete and unstandardized, with rankings that are dubious and inconsistent.<sup>73</sup> Public disclosure of ESG data would at a minimum improve the quality of such rankings and ratings and give trustees greater confidence in relying on such data. The bottom line here is that more ESG data will likely produce more decisions based on ESG criteria -- and also greater attention being given to systematic risk.

D. INVESTMENT VS. VOTING DECISIONS. Besides their failure to consider the portfolio-wide perspective, one other objection needs to be directed at Schanzenbach’s & Sitkoff’s very scholarly study: investment decisions and voting decisions are quite

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<sup>71</sup> Again, this is Item 303 of Regulation S-K, which is usually referred to as the “MD&A.”

<sup>72</sup> The Securities Exchange Act of 1934 (15 U.S.C. §78a et seq.) provides in its section 21E (“Application of Safe Harbor for Forward-Looking statements) that reporting companies (with some modest exclusions) do not have liability for forward-looking statements that prove false if the statement is “accompanied by a meaningful cautionary statements” that explain some of the factors “that could cause actual results to differ materially from those in the forward-looking statement.” See 15 U.S.C. §78u5(c).

<sup>73</sup> ESG ratings often disagree, and mutual funds that emphasize their focus on ESG often score below non-ESG funds when subjected to objective review based on their own criteria. See Schanzenbach & Sitkoff, *supra* note 11, at 431.

different and viewed very differently by both ERISA and the SEC. Although the “sole interest rule” may apply to both (as they argue), a critical difference is that both the Department of Labor and the SEC require fiduciaries to vote the shares held by their fund, on the theory that voting rights are an asset belonging to the fund and cannot be wasted.<sup>74</sup> Both agencies also recognize that voting has low costs (in contrast to investment decisions)<sup>75</sup> and that fiduciaries must constantly make these decisions across their portfolios. As a result, both have favored a rule of reason with regard to voting and shareholder activism.<sup>76</sup>

Suppose hypothetically then that an indexed mutual or pension fund owns 100 stocks, one of which would be hurt by a shareholder resolution calling for tighter and

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<sup>74</sup> The position of the Department of Labor (which administers ERISA) dates back to the famous “Avon Letter” in 1988. See Letter from the Department of Labor to Helmut Fandl, Chairman of the Retirement Board of Avon Products, reprinted in 15 Pens. & Bens. Rep. (BNA), 391 (Feb. 29, 1988) (the “Avon Letter”). This letter expressed the Labor Department’s view that fiduciaries had to exercise their voting powers and vote shares; it was later codified in an Interpretive Bulletin issued by the Department of Labor. See 29 C.F.R. §2509-94-2(3) (July 1, 2007). This bulletin expressed the view that:

“Active monitoring and communication with corporate management is consistent with a fiduciary’s obligations under ERISA when the responsible fiduciary concludes that there is a reasonable chance that such activities... are likely to enhance the value of the plan’s involvement, after taking into account the costs involved.” (emphasis added).

See generally Paul Rissman and Diana Kearney, Rise of the Shadow ESG Regulators: Investment Advisors, Sustainability Accounting, and Their Effects on Corporate Social Responsibility, 49 Environmental Law Reporter 10155, at 10168-69 (2019). This “reasonable chance” standard was later marginally massaged into a “reasonable expectation” standard, as later discussed.

The SEC followed several years later and similarly endorsed the duty of a fiduciary or investment advisor to vote the shares held by a mutual fund or other investment company. See SEC Release No. 33-8188, 34-4703 (July 21, 2003). To sum up, both agencies agree that fiduciaries must vote their shares and must do so with the objective of increasing the value of the fund to their beneficiaries.

<sup>75</sup> See Department of Labor, Employee Benefit Security Administration, Interpretive Bulletin 2016-1 (“Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statement of Investment Policy, Including Proxy Voting Policies or Guidelines”) (12/29/2016). This revised bulletin adopted a “reasonable expectation” standard for when fiduciaries should engage in shareholder activism, with the expectation being that the plan’s assets would be enhanced.

<sup>76</sup> In its most recent statement, the Department of Labor under President Trump has continued to use a “reasonable expectation” standard and to recognize that voting has lower cost than investment decisions, but it has cautioned that the objective of shareholder activism must be the enhancement of the plan’s value (meaning that the fiduciary may not be pursuing political or social preferences). See Field Assistance Bulletin No. 2018-01 (April 23, 2018).

earlier controls on carbon emissions, but five of which will benefit from that same resolution. Assume next that the fiduciaries take no action to sell any stock (after all, index funds rarely sell), but they decide to vote for this same resolution at all the affected companies, believing that the gains to the five will outweigh the losses to the one. Such a decision is intended to maximize the financial benefits to their beneficiaries and should not offend the “sole interest rule.” Equally important, this decision is entirely different from the traditional problem in the 1980s of whether fiduciaries could divest stocks of companies that continued to do business in South Africa. Divestment does imply a loss of diversification benefits to their beneficiaries. In the case of our hypothetical shareholder resolution, however, no threat is made by the fiduciaries to divest, but only to propose a slate of “friendlier” directors -- a voting decision. Although the Trump Administration has marginally cut back on the Department of Labor’s prior endorsement of shareholder activism under ERISA, it still has left in place a test that requires the fiduciary to have only a “reasonable expectation” that shareholder activism will produce benefits.<sup>77</sup>

E. THE COMING CONTROVERSY OVER PORTFOLIO-WIDE DECISION MAKING. The vision that portfolio-wide voting by institutional investors could reduce externalities has excited scholars.<sup>78</sup> But it will likely arouse controversy as well. Consider this

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<sup>77</sup> Compare Interpretive Bulletin No. 2016-1, *supra* note 75, (which was adopted by the Obama Administration in 2016), with Field Assistance Bulletin No. 2018-01, *supra* note 76 (which was adopted under President Trump). See also Rissman and Kearney, *supra* note 74.

<sup>78</sup> This idea that common ownership will lead rational investors in a common portfolio to seek to minimize externalities probably originates with Robert Hansen and John M. Lott, Jr.. See Robert Hansen and John M. Lott, Jr., Externalities and Corporate Governance in a World With Diversified Shareholder/Consumers, 31 *J. Fin. & Quantitative Analysis* 43, 47-49 (1996); see also Robert H. Gordon, Do Publicly-Traded Corporations Act in the Public Interest?, National Bureau of Economic Research, Working Paper No. 3303 (1990). But these authors wrote before the actual appearance of large scale common ownership. Recent interest in this topic may have been provoked by Madison Condon; see Condon, *supra* note 7.

hypothetical: five diversified index funds threaten a proxy contest to replace at least some of the directors of Smoky Coal Corp., unless it agrees to comply with certain environmental restrictions. Fearing a proxy contest, Smoky Coal management induces its board to agree to the restrictions and to appoint a partial slate of directors nominated by the index funds. On the announcement of this decision, Smoky Coal's stock price falls 10%, and Smoky Coal's management closes its principal mine in Kentucky, with resulting large lay-offs of miners. Employees are outraged, as is a Senator from Kentucky who announces a senatorial committee hearing on the "arrogance" of the index funds.

Meanwhile, the state legislature in Kentucky begins to draft legislation that would cancel the environmental changes just adopted, and corporate law firms develop a new form of poison pill that would bar the acquisition of more than 10% of a Kentucky company's stock by any group of mutual funds that is seeking (or later seeks) to pass or support specified shareholder resolutions.

The point here is not that this counter-reaction will succeed, but that counter-pressure is predictable. Although I suspect that the threat of such political retaliation will incline many institutional investors toward no more than reticent participation in attempts to curb externalities through collective action, it is still premature at present to predict more than that controversy will surround collective action by institutional investors.

## CONCLUSION

Briefly and bluntly, this article has offered four basic conclusions:

(1) Institutional investors logically have a greater interest in “systematic risk” than do undiversified investors (in part because only diversified investors with high common ownership can take effective action), and much of what ESG disclosures would provide relates to “systematic risk”;

(2) Individual investors (at least if undiversified) have a greater interest in firm-specific “unsystematic risk” than do institutional investors, and they are not today adequately advised about the conflicts that arise between their interests and those of diversified institutional investors;

(3) Because of the high level of common ownership among diversified institutional investors, they can potentially profit on a portfolio-wide basis by imposing constraints that seek to reduce externalities -- at least so long as such actions benefit the “winners” in their portfolio more than they impose costs on the “losers.” As common ownership grows, these practices may become more open and explicit, but they are already discernable. Once again, this aggravates the conflict between diversified and retail investors.

(4) ESG disclosures and high common ownership enable diversified institutions to make decisions on a portfolio-wide basis. The advent of portfolio-wide decision-making (both as to investments and voting) may represent the most important contemporary change in institutional investor behavior; it appears to be logically consistent with the “sole interest rule”, but it will provoke controversy.



This article has not asserted that fiduciaries must favor ESG investing. Decisions either to engage or not to engage in ESG investing should be protected, and, particularly to the extent that ESG information is normally forward-looking, the issuer should face little risk of liability either under the “sole interest rule” or the federal securities laws. The real issue for the future is whether institutional investors are truly ready to exercise this new opportunity (as it may provoke significant political pushback<sup>79</sup>).

Not since Berle and Means announced the separation of ownership and control have shareholders as a group perceived themselves to possess the power to behave as “true owners.” But, unlike the “true owners” of the 19<sup>th</sup> Century (for example, the railroad, oil and bank barons), the focus of institutional investors as owners will logically shift to maximizing portfolio value, not the value of individual stocks. The implication of this transition is that it may solve a problem that has frustrated legal scholars for decades. Over that period, many scholars have sought to find a strategy to make public corporations behave more virtuously.<sup>80</sup> Their gallant efforts have not fully persuaded most of us, and more conservative scholars have responded that reducing the externalities associated with corporate behavior was not the job of

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<sup>79</sup> In 2020, possibly in response to their activism in assisting institutional investors, proxy advisors were subjected to new and burdensome SEC rules that will slow the process by which they can advise and assist their clients. See Michael Cappucci, The Proxy War on Proxy Advisors, 16 NYU J. L. & Bus. 579 (2020). My point here is only that this example may concern and caution institutional investors, who must realize that activism can produce political retaliation in their cases as well. Nonetheless, the major institutional investors have much greater financial resources and seem less likely to attract political attacks.

<sup>80</sup> For a partial list, see Cynthia Williams, The Securities and Exchange Commission and Corporate Social Transparency, 112 Harv. L. Rev. 1197 (1999); Kent Greenfield, THE FUTURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES (2006); Lynn Stout, THE SHAREHOLDER VALUE MYTH (2012); Einer Elhauge, Sacrificing Corporate Profit to Public Interest, 80 N.Y.U. L. Rev. 733 (2005); William W. Bratton and Michael L. Wachtler, The Case Against Shareholder Empowerment, 158, U. Pa. L. Rev. 653 (2010). This list is far from exhaustive but includes articles that I considered highly original.

corporate law.<sup>81</sup> Now, without any change in corporate law, a real possibility has arisen that corporate reform (at least in the reduction of externalities) is coming.

Corporate law scholars now (at last) live in interesting times!

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<sup>81</sup> See Henry Hansmann and Reinier Kraakman, The End of History for Corporate Law, 89 Geo. L. J. 439 (2001) (shareholder wealth maximization is the goal of corporate law); Michael C. Jensen, Value Maximization, Stakeholder Theory, and the Corporate Objective Function, 14 J. App. Corp. Fin. 8, 16 (2000) (arguing that the regulation of externalities falls within the government's function and is not a task that boards should pursue).

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