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Investor-Led Sustainability in Corporate Governance

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ABSTRACT

The transition to a sustainable economy currently involves a fundamental transformation of our capital markets. Lawmakers, in an attempt to overcome this challenge, frequently seek to prescribe and regulate how firms may address environmental, social, and governance (ESG) concerns by formulating conduct standards. Deviating from this conceptual starting point, the present study makes the case for another path towards achieving greater sustainability in capital markets, namely through the empowerment of investors.

This trust in the market itself 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 a 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

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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. 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 focus on investor-led priorities would follow a more flexible and dynamic pattern rather than complying with inflexible predefined criteria. Moreover, investor-promoted assessments are not likely to impair welfare creation in the same way as ill-defined legal standards; they will also not trigger regulatory arbitrage and would avoid deadlock situations in corporate decision-making. Any regulatory activity should then be limited to a facilitative and supportive role.

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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 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. For example, policy makers and courts toy with the idea of expanding the list of directors' duties by making corporate directors legally accountable for the promotion of ESG goals.[1] Another idea here might be to tie executive remuneration to certain

[1] In the U.S., litigation against corporate boards is increasingly relying on the *Caremark* duty for failing to exercise proper risk oversight. The European Commission even consulted on a proposed legal change in this direction: Public consultation on Sustainable Corporate Governance (Oct. 26, 2020–Feb. 8, 2021), https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/public-consultation_en.

sustainability criteria.[2] Furthermore, a third proposal, which has been gaining supporters worldwide, is the promotion of stewardship codes encouraging institutional investors inter alia to pursue ESG criteria in their investment decisions and disclose their engagement policies.[3]

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.[4] However, this study 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

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[2]For example, in Germany, listed companies are required to adopt a remuneration structure which is to be geared "towards a sustainable and long-term development" of the company (see Aktiengesetz § 87a [AktG; Stock Corporation Act]). Thereby, social and ecological aspects should also be taken into account when adopting remuneration incentives. See generally on the link between ESG and executive pay Jean McGuire *et al.*, *Do Contracts Make Them Care? The Impact of CEO Compensation Design on Corporate Social Performance*, 157 J. Bus. Ethics 375 (2019).

[3]The paradigm example is the U.K. Code, which in its latest 2020 version also includes ESG criteria. See Financial Reporting Council, The UK Stewardship Code 2020, available at https://www.frc.org.uk/investors/uk-stewardship-code.

[4]For skeptical views, see Paul G. Mahoney & Julia D. Mahoney, *The New Separation of Ownership and Control: Institutional Investors and ESG*, Col. Bus. L. Rev. 840 (2021); Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *How Investors Can (and Can't) Create Social Value*, 44 J. Corp. L. 205 (2018); Jonathan R. Macey, *ESG Investing: Why Here? Why Now?*, 19 Berkeley Bus. L. J. 256 (2022).

driver's seat.[5] 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 study 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.

[5] I do not, however, argue against any additional regulatory initiative that seeks to curb externalities such as a carbon tax.

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