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Institutional Investor ESG Engagement: The European Experience

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1 Introduction

The view according to which institutional investors are key actors in corporate governance of publicly listed firms is long since established,[1] and increasingly topical. As they hold relevant stakes in an incalculable number of publicly listed firms globally, and, collectively, they are often a corporation's major shareholders,[2] leading institutional investors are very often called upon to perform an effective stewardship function and exert influence over investee companies.[3] In line with the fiduciary duties they owe to end-clients (including the duty to make informed voting decisions) and the objective to improve investment returns and prevail over competitors, asset managers' engagement is primarily aimed at preserving and enhancing the overall value of the firms they are invested in and, by doing so, at maximizing shareholder value for their clients, whose money they ultimately manage.

Over the last several years, institutions' appetite for engagement has grown. Not only do asset managers and asset owners – especially larger ones – regularly vote portfolio shares at shareholders' meetings. Institutions' active ownership playbook also largely relies on meeting the board, or management, of portfolio companies to discuss key issues, convey their concerns and views and urge the board to collaboratively respond to investor demands. Amongst other tools (see Article 3g(1)(a) SRD II[4]), private dialogue with corporate directors that takes place 'behind the scenes' is an instrument of investor engagement that has gained much traction in recent years.[5]

Indeed, available evidence shows that private board-shareholder dialogue has grown into one of the levers of engagement most popular among institutional shareholders.[6] As further studies suggest, privately meeting company directors and management (and, more generally, activism behind the scenes) can actually create value and have an impact on issuers' decisions.[7]

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[1] See, e.g., European Commission (2012), p 8.
[2] See Griffin (2020), p 411.
[3] European Fund and Asset Management Association (2018), p 3.
[4] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, pp 1-25 (so-called Shareholders' Rights Directive II – SRD II).
[5] See European Securities and Markets Authority (2019), p 55.
[6] Ibid.; McCahery et al. (2016), pp 2911-2912.
[7] See Becht et al. (2010), pp 3108-3118; Carleton et al. (1998), p 1335; Bonacchi et al. (2022).

Seeking to increase the amount and value of the assets under management to earn enhanced financial returns remains the primary and fundamental objective for any institutional investor. However, the focus of institutions' investment and engagement strategies has changed over time to include broader, non-financial objectives as well. Different factors contributed to bringing about this shift in institutions' approach to investment management in regard to portfolio companies.

First, the theory of shareholder value maximization, and shareholder primacy, according to which corporations are bound to primarily serve the interests of their shareholders,[8] has attracted increased criticism. Also due to the insufficiency of government regulation to correct market failures and advance public welfare[9], calls on corporations to pursue a broader purpose and act according to societal interests to generate long-term value for all stakeholders have multiplied.[10] In particular, companies are insistently being urged to play an active role in the global transition towards a sustainable economy and, especially, in contributing to mitigating the consequences of climate change.

Second, beyond controlling stockholders, ownership at publicly listed companies is becoming increasingly concentrated in the EU, owing to the unstoppable growth in intermediated investments and the concentration of the asset management industry itself. According to EFAMA, at the end of 2020, 'European asset managers held 25.8% of the debt securities and 26.9% of the listed shares issued by European residents', and 'the industry holding of listed shares represented 34.5% of the free-float market capitalisation in Europe'.[11] Moreover, despite the fact that evidence about European markets in regard to common ownership is rare, a study promoted by the European Commission found that, over the period from 2007 to 2017, '[t]he number of listed firms that are cross-held by block-holders has been increasing from about 15.5 thousand to about 17.5 thousand', and their proportion over the whole set of firms is rather stable on 'values around 67%' – such results being 'very close to US-based indicators'.[12] The top-ranking investors, presenting maximum values in the density-based indices, were found to be 'Bank of New York Mellon, BlackRock, Fidelity, JP Morgan Chase, Norway, State Street and Vanguard', indicating that mainly US-based large investors 'show a clear dominance over the set of listed firms active in Europe'.[13]

As assets, the asset management industry and corporate ownership tend towards concentration, institutions' stewardship generally has turned

[8] See, famously, Friedman (1970).
[9] See Lund (2022), pp 7, 25.
[10] Business Roundtable (2019). See also World Economic Forum (2019).
[11] European Fund and Asset Management Association (2021), p 26.
[12] Rosati et al. (2020), p 52.
[13] Ibid., p 57.

inescapable. Not surprisingly, regulatory action has reckoned with the increases in institutional ownership and ownership concentration by enhancing institutions' 'responsibilities' in performing the corporate governance functions associated with share ownership, including the expectation that leading investors, as corporations' main shareholders beyond controlling stockholders, take a proactive part in driving a shift towards corporate sustainability and favoring the transition to a net-zero economy.[14] As explicitly acknowledged by the European Commission, the scale of the investment required to meaningfully address climate change and environmental degradation and avoid major adverse implications for financial stability 'is well beyond the capacity of the public sector'. Hence, 'the alignment of all sources of finance – public and private, national and multilateral – is required'.[15]

As a consequence of such evolutionary patterns, the understanding of the role of institutional investors as corporate stewards has changed. Only a few years ago, stewardship focused essentially, if not exclusively, on portfolio firms' corporate governance. Today, stewardship and investment strategies adopted by many institutional investors embrace environmental and social standards as well, along governance standards (ESG), as a means to incorporate the risk assessment of long-term environmental, social and governance challenges and developments, and foster investee companies' more responsible conduct to positively impact the environment and society at large.[16] With a view to capturing and attracting ever-widening cohorts of end-clients more sensitive to environmental and social concerns and to increasing assets under management, major institutional investors now regularly uphold that ESG factors are at the core of their engagement policies and practice, and claim they are indeed willing to play a major part in pursuing sustainability and, particularly, in fighting climate change.

On the normative side, enhanced awareness of the systemic challenges posed by environmental and social issues, addressing many of which can be delayed no further, has driven regulatory action undertaken at the EU level more strongly by far than in any other jurisdiction. Institutional investors are viewed as pivotal in achieving the so-called European Green Deal, by which the European Commission intends to make Europe 'a modern, resource-efficient and competitive economy', put it 'on a new path of sustainable and inclusive growth' and ultimately make it 'the first climate-neutral continent'.[17] According to the Commission, '[t]he private sector will be key to financing the green transition. Long-term signals are

[14] Strine, Jr (2020).
[15] European Commission (2021a).
[16] See Boffo and Patalano (2020), p 14.
[17] See European Commission (2021a).

needed to direct financial and capital flows to green investment and to avoid stranded assets'.[18]

Against this backdrop, the question as to whether institutional investors really can effectively play the role of the engagement and sustainability champions EU-level legislation has tailored for them remains however controversial. This article examines whether the EU rules and standards are enough to actually encourage institutions' conduct to that effect, and whether institutions are well equipped to play such role.

This article proceeds as follows. Part 2 introduces the concepts of shareholder engagement and stewardship and their actual relevance in the practice of shareholder-issuer relationships. Part 3 turns to analyzing the relevant EU regulatory framework which underpins private dialogue as a tool to promote institutional investors' active share ownership. Part 4 focuses on sustainable investing as a potentially powerful driver of institutions' engagement, and the new disclosure obligations imposed on them by the Sustainable Finance Disclosure Regulation (SFDR)[19] and the Taxonomy Regulation.[20] Issuer disclosures under the Non-Financial Disclosure Directive (NFRD[21] and the Commission's proposals for a Corporate Sustainability Disclosure Directive (CSRD)[22] and for a Corporate Sustainability Due Diligence Directive (CSDD)[23] are accounted for in Part 5, mainly from the standpoint of institutional investors as the primary users of corporate sustainability information. Part 6 analyses the incentives structure which is typical of (different kinds of) institutional investors as a foundation based on which to evaluate, by also taking account of a number of further factors, largely independent of the asset managers themselves,

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[18] Ibid., pp 16-17.

[19] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, OJ L 317, 9.12.2019, pp 1-16.

[20] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, OJ L 198, 22.6.2020, pp 13-43.

[21] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OJ L 330, 15.11.2014, pp 1-9.

[22] European Commission (2021b). The CSRD was adopted by the European Parliament on 10 November 2022, and the Council is expected to adopt the proposal on 28 November 2022, after which it will be signed and published in the EU Official Journal. See Position of the European Parliament adopted at first reading on 10 November 2022 with a view to the adoption of Directive (EU) 2022/… of the European Parliament and of the Council amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting (P9_TC1-COD(2021)0104), https://www.europarl.europa.eu/doceo/document/TA-9-2022-0380_EN.html#title2.

[23] European Commission (2022a).

institutions' actual readiness, and ability, to effectively take on the stewardship role they are assigned by the EU. Part 7 concludes.

2 The Call for Investor Engagement, and the Role of Stewardship and Corporate Governance Codes in Underpinning Board-Shareholder Engagement

Before being first explicitly embraced by EU legislation, the concepts of shareholder engagement and, as a broader category, stewardship grew popular in the EU with the rise of best practice codes and principles for institutional investors. In effect, more active institutional share ownership was, and still is, largely underpinned by soft regulation in the form of both stewardship and corporate governance codes targeting institutional investors and publicly listed corporations.[24] Indeed, all main stewardship codes, and many corporate governance codes as well, look at director-shareholder dialogue as an important lever for engagement.

While several methods of engagement exist,[25] interaction with corporate directors and managers behind closed doors is key to investors.[26] More confrontational strategies, such as submitting resolutions at general meetings or voting against resolutions proposed by the management, are generally considered only by way of escalation, if and when portfolio companies fail to constructively respond to shareholders' demands and concerns, as is also generally recommended by stewardship principles.[27]

For example, according to the UK Stewardship Code 2020, signatories are expected to engage with issuers to maintain or enhance the value of the assets under management, and engagement methods include meeting the chair or other board members, as well as the company's management.[28] The EFAMA Code includes a similar recommendation.[29] Institutional investors should interact with investee companies on an ongoing basis to protect and secure value over the long term; discussions may entail meeting with the chief executive officer, senior independent directors, or the chair of the supervisory board, as the case may be, or with other independent directors or board members. More generally, when investors are concerned about the company's strategy and performance, the EFAMA Code recommends that they should seek to ensure that the appropriate members of an investee company's board are made aware of them.

[24] See Hopt (2011), pp 10-14.
[25] See Financial Reporting Council (2019), p 17.
[26] European Securities and Markets Authority (2019).
[27] European Fund and Asset Management Association (2018), p 7.
[28] Financial Reporting Council (2019), p 17.
[29] European Fund and Asset Management Association (2018), pp 6-8.

On the issuer side, corporate governance codes do typically include principles and recommendations concerning director-shareholder dialogue that run parallel to those by which stewardship codes target institutional investors as shareholders. The UK Corporate Governance Code recommends that

> [i]n addition to formal general meetings, the chair should seek regular engagement with major shareholders in order to understand their views on governance and performance against the strategy. Committee chairs should seek engagement with shareholders on significant matters related to their areas of responsibility. The chair should ensure that the board as a whole has a clear understanding of the views of shareholders.[30]

Provisions similar to those comprised in the UK Corporate Governance Code can be found in corporate governance codes adopted in other Member States as well. The 2020 Belgian Code on Corporate Governance recommends that the board 'ensure an effective dialogue with shareholders and potential shareholders through appropriate investor relation programmes, in order to achieve a better understanding of their objectives and concerns'[31] and 'encourage shareholders, and in particular, institutional investors, to communicate their evaluation of the company's corporate governance prior to the general shareholders' meetings and at least through participation in the general shareholders' meeting'.[32] One further example is that of the Italian Corporate Governance Code, under which '[t]he board of directors promotes dialogue with shareholders and other stakeholders which are relevant for the company, in the most appropriate way'.[33] The Code also recommends that 'a policy for managing dialogue with the generality of shareholders, taking also into account the engagement policies adopted by institutional investors and asset managers' be adopted by the board of directors and be described in the yearly corporate governance report the board is required to file for public disclosure ahead of the shareholders' meeting.[34]

3 The SRD II as the Regulatory Milestone for Shareholder Engagement. Scaling Down Potential Regulatory Hurdles to Board-Shareholder Dialogue

[30] Financial Reporting Council (2018), p 4.
[31] Corporate Governance Committee (2019), p 24.
[32] Ibid.
[33] Italian Corporate Governance Committee (2020), Principle IV.
[34] Ibid., recommendation No. 3 to Article 1.

Unlike in other jurisdictions such as the United States, the concept of shareholder engagement is explicitly encompassed in EU legislation since the 2017 SRD II. The European debate concerning engagement, including board-shareholder interaction, was actually initiated by the Commission's 2012 Action Plan on European company law and corporate governance,[35] which morphed into the proposal for a Directive reforming the Shareholders Rights Directive of 2007.[36] The first draft of the amending Directive already included provisions on director-institutional shareholder dialogue, which have been maintained in the final text of the SRD II.

In fact, Article 3g SRD II stipulates under a comply-or-explain rule that institutional investors and asset managers develop and publicly disclose an engagement policy describing how they integrate shareholder engagement into their investment strategy. Among other things, the engagement policy is to describe how institutions 'conduct dialogues with investee companies'.[37] Under the same rule, institutions are also required to publicly disclose, on an annual basis, how their engagement policy has been implemented, especially, but not limited to, as regards voting portfolio shares. Relatedly, Article 3j SRD II requires proxy advisors to yearly disclose, i.a., 'whether they have dialogues with the companies which are the object of their research, advice or voting recommendations and with the stakeholders of the company, and, if so, the extent and nature thereof'. The transparency obligations imposed on proxy advisors are intended to complement institutional investors' disclosures, based on the assumption that – institutions being proxy advisors' almost exclusive clients – service providers will engage with publicly listed firms by essentially taking the standpoint of client institutions, if not by acting on behalf of client institutions.

Hence, as regards the EU, the SRD II may be looked at as the regulatory milestone for engagement generally, and for board-shareholder dialogue particularly. As noted by the ESMA, the SRD II recognizes that engagement should be reinforced to reduce excessive managerial focus on short-term returns, and that encouraging long-term shareholder engagement is its key goal.[38]

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[35] European Commission (2012).

[36] European Commission (2014).

[37] One further reference to director-shareholder dialogue is included in Recital 49 to the SRD II, which recognizes that shareholders and investors can engage with the company on the implementation of the remuneration policy. Due to the introduction of 'say-on-pay' votes, executive compensation has become a privileged area of engagement both in the US and in Europe. See Thomas et al. (2012), p 1256.

[38] European Securities and Markets Authority (2019), p 53.

Against this backdrop, the preferences of institutional investors for board-shareholder dialogue as an effective lever for engaging with portfolio firms should not be cooled down by concerns associated with the application of further pieces of regulation which may, at first sight, seem to oppose that practice.[39]

In fact, potential legal constraints to board-shareholder dialogue associated with the Market Abuse Regulation (MAR)[40] and, in particular, with issuers' disclosure obligation of non-public price-sensitive information and the ban on trading based on inside information, do not pose any absolute ban on board-shareholder dialogue. The same applies in regard to the principle of equal treatment of shareholders laid down by Article 17 of Directive 2004/109/EC (Transparency Directive) and by Article 46 of Directive 2012/30/EU.[41]

First, regarding financial markets law, Recital 19 to the very MAR makes it clear that the mandatory disclosure and insider dealing regimes laid down by Articles 17 and 8 are 'not intended to prohibit discussions of a general nature regarding the business and market developments between shareholders and management concerning an issuer', given that '[s]uch relationships are essential for the efficient functioning of markets'. Articles 17 and 8 MAR only prohibit directors to disclose inside information within private meetings with shareholders, unless – under the selective disclosure exemption provided for by Article 10 MAR – shareholders agree to sign a confidentiality agreement and abstain from trading securities to which inside information relates. Importantly, however, during engagement-related dialogue, investors generally seek to communicate their opinions and concerns regarding corporate governance and ESG matters, strategies or individual transactions, and are indeed unwilling to receive any inside information, since this would restrain their freedom to trade the securities concerned (Article 8 MAR).[42]

Second, board-shareholder dialogue, and the selective disclosure of (non-price-sensitive) information to participating investors are not

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[39] See McCahery et al. (2016), pp 2920-2922; Fairfax (2013), pp 834-838. See also European Securities and Markets Authority (2019), p 64.

[40] Regulation 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, [2014] OJ L173/1 (MAR).

[41] Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, OJ L315/74.

[42] See, e.g., Soltes (2018), pp 148, 149.

incompatible with the principle of equal treatment of shareholders. Directors can lawfully consult with major shareholders, since the principle of equality applies to the shares, not to the shareholders as such. That view is consistent with the wording of Article 17 Transparency Directive, under which only shareholders 'who are in the same position' should be treated in an equal manner. Reasonably enough, as major shareholders cannot be considered to find themselves in the same position as retail investors holding negligible stakes, directors should be allowed to engage in dialogue with selected relevant shareholders.

More generally, private meetings between directors and selected shareholders are allowed as long as directors do not discriminate shareholders arbitrarily but resort to specific, objective justifications for the benefit of the company as a whole to support the choice of the investors participating in such meetings.[43] This reasoning is coherent with the market sounding regime set out by the MAR, stating under Article 11(2) that disclosure of inside information by a person intending to make a takeover bid for the securities of a company, or a merger with a company, to parties entitled to the securities, shall constitute a market sounding, provided that the willingness of parties entitled to the securities to offer their securities is reasonably required for the decision to make the takeover bid or merger.

But even beyond the paradigm of market soundings,[44] there are good reasons to believe that ongoing dialogue between the directors and relevant shareholders should be considered beneficial to the company as a whole, and therefore be permitted.[45] In effect, dialogue-based engagement by institutional investors is *per se* consistent with the interests of the company, since sound investor relations are crucial for publicly listed firms.[46] Therefore, any deviation from the principle of equal treatment of shareholders for these purposes is not arbitrary, but legitimate, as is also apparent from the SRD II, as well as from the stewardship and corporate governance codes mentioned above, all of which encourage effective board-shareholder dialogue. And, finally, the MAR seems to confirm that a principle of equal information is not absolute in nature also in another

[43] See Lombardo and Mucciarelli (2017), p 35.

[44] The regime for market soundings (Article 11 MAR) indirectly confirms that the MAR leaves sufficient scope for director-shareholder dialogue, insofar as either dialogue does not involve inside information – in which case (arguably, the ordinary case) information can freely be exchanged– or, were inside information to be disclosed to investors participating in dialogue, procedural safeguards modelled on those laid down for market soundings under Article 11 are (voluntarily) put in place in order for the investors participating in the dialogue to benefit from the same protective effect they are granted by Article 11 in the context of market soundings.

[45] See, for Germany, Hirt et al. (2016), p 737; Fleischer (2009), pp 523-525.

[46] Hirt et al. (2016), p 737.

respect.[47] Since both the duty to ensure equal access to information and issuers' disclosure obligation under Article 17 only apply to inside information as defined by Article 7,[48] the MAR implicitly allows institutional investors to lawfully gain an informative advantage from dialogue with directors, as long as this does not entail the disclosure of inside information.

4 Sustainable Investing as a Driver for Institutional Investor Engagement: the SFDR and the Taxonomy Regulation

One further factor that has proven to support institutional investors' active ownership is sustainable investing, which has gained momentum in more recent years. In particular, climate change has become the most powerful driver of a 'tectonic shift' towards sustainable assets, and of shareholders' demands to investee companies.[49]

As there is an increasing demand for ESG investments,[50] especially by younger generations,[51] asset managers have been widening their offer of green and sustainable products, most notably including ESG ETFs,[52] and they are increasingly focusing on sustainability issues in their engagements with portfolio companies.

Sustainable investing has grown strongly in recent years, with asset managers applying, in Europe, 'an ESG investment approach to an estimated total of EUR 11 trillion of assets by the end of Q1 2021'.[53] Strikingly,

> [b]etween the end of 2010 and the end of 2020, net assets of sustainable equity UCITS increased by 360%, reaching EUR 1.2 trillion by the end of 2020. The share of sustainable equity in total net assets of equity UCITS has also grown, from 22% at the end of 2010 to 29% at the end of 2020.[54]

The rise of sustainable investing has widened the scope of institutions' engagement activities, with stewardship focusing no longer just on the

[47] Fleischer (2009), pp 512-513.
[48] See European Court of Justice (2009), para. 48.
[49] See Fink (2021). See generally Strampelli (2021).
[50] See, e.g., Global Sustainable Investment Alliance (2021), pp 16-17. See also Standard Chartered Bank (2021), p 3.
[51] See, e.g., Barzuza et al. (2020), p 1285.
[52] See, e.g., Moisson (2021).
[53] European Fund and Asset Management Association (2021), p 19.
[54] Ibid., p 22.

application of 'governance standards that are considered good practices in the market in which companies are listed' but also on '[e]ncouraging companies to manage environmental and social issues in a sustainable and responsible manner'.[55] Environmental and social concerns are also among the reasons for the growing incidence of activist campaigns in both the United States and Europe, with 'ESG activism ... expanding beyond dedicated funds, … with several blue-chip activists incorporating ESG into 2021 campaigns'.[56] The surge of ESG investing seems in fact to be capable of broadening the reach of activist intervention and of driving an evolution in the activist landscape. If traditional activism typically leverages business financial underperformance to agitate for strategic changes at targeted companies, a new set of ESG-specialist actors has emerged that emphasize environmental and social factors as a catalyst for change, relatedly to current stock price performance and shareholder return.[57]

Indeed, the rapid and ever-increasing rise of sustainable investing 'enables activists to improve perceived ESG weaknesses in businesses but also bolster fundraising by branding themselves as forward-thinking and socially conscious',[58] and seems likely to further subsidize the interplay between activist and non-activist investors. Especially leading diversified passive asset managers may consider to support activist campaigns and to escalate their stewardship efforts, including by filing proposals to be voted on at shareholders' meetings.[59] In effect, it is increasingly the case that mainstream institutions back sustainability-related activist proposals with their votes at the shareholders' meeting of portfolio companies. One well-known example is that of Engine No 1, a small hedge fund which, despite its tiny 0.02 percent holding in Exxon shares, gained support from fellow shareholders in its efforts to overhaul the company's board of directors with a view to thus strengthening the company's prospects to abandon fossil fuels.[60]

While institutional investors' sustainability-led active ownership seems to be rapidly turning into a global trend, it is especially strong in Europe,[61] where regulatory action has been stepping up pressure on asset owners and asset managers to integrate climate considerations into both the investment strategies and decisions, and the engagement policies they are required to adopt and publicly disclose, implement and publicly report on under the comply-or-explain rule set by Article 3g of the SRD II. EU legislation is

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[55] Ibid., p 23.
[56] Lazard (2022), p 23.
[57] See Lazard (2021), p 21.
[58] Ibid.
[59] See Mooney (2021).
[60] Ibid. See also, for further examples, Ringe (2021a), pp 20-24.
[61] See Morningstar (2021), pp 3-5 and Exhibits 2-3.

clearly directed at enhancing the responsibility (not only of large companies but also) of institutional investors in contributing to address sustainability issues, and has indeed created a normative expectation that institutional investors take an active stance in supporting sustainability with respect to portfolio companies.[62]

To connect finance with sustainability, since 2018 the Commission has been developing a comprehensive policy agenda on sustainable finance, comprising the Action Plan on Financing Sustainable Growth[63] and the development of a Renewed Sustainable Finance Strategy[64] in the framework of the European Green Deal and the new Strategy for Financing the Transition to a Sustainable Economy.[65] In its 2018 Action plan the Commission has envisaged to take action aimed at clarifying institutions' duties in relation to sustainability considerations by (i) explicitly requiring institutions 'to integrate sustainability considerations in the investment decision-making process', and (ii) increasing 'transparency towards end-investors on how they integrate such sustainability factors in their investment decisions, in particular as concerns their exposure to sustainability risks'.[66]

The Commission's intentions rapidly translated into the Sustainable Finance Disclosure Regulation (SFDR), which requires asset managers to explain how they deal with sustainability risks in their investment policies and to describe what effects these risks might have on returns.[67] As summarized in Recital 12 to the SFDR, financial market participants are required to consider the impacts of investment decisions on sustainability factors in that they

> should integrate in their processes, including in their due diligence processes, and should assess on a continuous basis not only all relevant financial risks but also including all relevant sustainability risks that

[62] See Kelly (2021), pp 18-22.
[63] European Commission (2018a).
[64] European Commission (2018b).
[65] European Commission (2021a).
[66] European Commission (2018a), pp 8-9.
[67] On 6 April 2022 the European Commission adopted Delegated Regulation (EU) 2022/1288 'supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of the content and presentation of the information in relation to the principle of "do no significant harm", specifying the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts, and the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic reports'.

might have a relevant material negative impact on the financial return of an investment or advice.

Given that 'a sustainability risk means an environmental, social or governance event or condition that, if it occurs, could cause a negative material impact on the value of the investment',[68] in the eyes of the EU legislator, enhanced pre-contractual and ongoing disclosures about the integration of sustainability risks into the investment process, alongside the adoption of transparent written policies for integrating sustainability risks, could direct the assets of end-investors towards institutional investors most conscious of and active on sustainability risks, thereby ultimately channeling investments towards environment-friendly or socially committed businesses.[69]

In line with this policy goal, and based on the consideration that, indeed, '[s]ustainable products with various degrees of ambition have been developed to date',[70] sustainability-related pre-contractual disclosures required by the SFDR vary depending on whether or not the investment products marketed by a given institution do have stated sustainability or ESG ambitions.

Thus, Article 6 SFDR sets the minimum standard for pre-contractual transparency required of *any* investor by imposing on all market participants an obligation to disclose the integration of sustainability risks, whether material or not, and their likely impacts on the returns of the financial products they make available. Article 8 then requires institutions that sell products which *promote* environmental and/or social characteristics, among others, to additionally specify how they will promote such characteristics – whether or not an index has been designated as a reference benchmark – and how the companies they are invested in follow good governance practices. In turn, Article 9 requires market participants that sell products which have *as an objective* a positive environmental or societal impact, and for which an index has been designated as a reference benchmark, to provide pre-contractual information on how the designated index is aligned with that objective, and an explanation as to why and how the designated index aligned with that objective differs from a broad market index. Where no index has been designated as a reference benchmark, the information to be disclosed needs to include an explanation on how that objective is to be met. Further still, information due under Article 9 includes an indication of where the methodology used for the calculation of the indices and the benchmark adopted is to be found.

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[68] Article 2 (22) SFDR, and Recital 14 to the SFDR.
[69] See Recital 8 to the SFDR.
[70] Recital 21 to the SFDR.

In addition to pre-contractual disclosures, further information is required by Article 11 SFDR of Article 8 and Article 9 investors to be disclosed in ongoing annual reports, explaining how the sustainability characteristics, or the sustainable objective, of the financial products are met.

As a consequence of such varied disclosure requirements, the SFDR has 'de facto split the EU fund universe into three categories':[71] conventional Article 6 funds with no stated sustainability or ESG ambition, required to disclose how they integrate sustainability risks into the investment process; Article 8 funds that, among other characteristics, promote sustainability characteristics [also called 'light green' funds], and Article 9 funds that do have a sustainability objective ['dark green' funds]. While Article 9 funds are sometimes referred to as 'impact funds', the term 'sustainable funds' more closely aligns with the wording of Article 2(17) SFDR.[72]

It should be noted that the three-pronged classification of the investment products set by the SFDR was not intended to create product labels,[73] but rather was motivated by the willingness to bring some order in the high-rocketing but quite disorderly universe of investment products featuring self-branded – and not always truthful – ESG characteristics and avoid, or at least restrain, greenwashing. Interestingly, following on from the sustainability disclosures rules implemented in March 2021, after noting that Europe accounted for 88 per cent of the global market in ESG products and finding 'ambiguous language' in legal filings, Morningstar removed the sustainable investment label from more than 1,200 funds (totalizing $1.4tn in assets) previously included in its list, 'including many that listed ESG criteria to self-classify as promoting environmental and/or social characteristics under European disclosure rules', mostly under Article 8 SFDR.[74] In and for itself alone, such adjustment provides a clear picture of the scale and seriousness of the challenge facing both end-investors and

[71] European Fund and Asset Management Association (2021), p 19.
[72] According to which a 'sustainable investment' is 'an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance'.
[73] European Fund and Asset Management Association (2021), p 19.
[74] Quinio (2022).

regulators vis-à-vis institutional investors and asset managers in finding common ground on what constitutes green or sustainable investments.

As mentioned earlier, one further pillar of the Commission's Action Plan on Financing Sustainable Growth is the Taxonomy Regulation, by which the EU provides a taxonomy of the activities that can be considered sustainable as regards, in a first step,[75] the issue of climate change, with institutional investors that sell financial products marketed as environmentally sustainable required to disclose how and to what extent these financial products are actually invested in environmentally sustainable activities as per the taxonomy. By providing a unified classification system for economic activities that can be considered (environmentally) sustainable based on performance thresholds for six key environmental objectives (see Article 9 of the Taxonomy Regulation) and requiring that sustainable activities substantially contribute to at least one of these without harming any other (see Article 10 of the Taxonomy Regulation), the EU taxonomy is explicitly (and more strongly than the SFRD) intended to prevent market participants from engaging in greenwashing when disclosing their sustainability footprint, and to 'enhance investor confidence and awareness of the environmental impact of those financial products or corporate bonds'.[76]

While only applying to SFDR Article 8 and Article 9 investment products, and large companies, the EU taxonomy is however likely to indirectly impact other financial market participants and other issuers seeking to attract sustainability-focused capital as well, as it may be expected to drive broader market expectations of disclosure. Encouraging actors other than those subject to the Taxonomy Regulation to voluntarily comply with this Regulation is, in fact, an outcome explicitly considered by the EU legislators, who point out that voluntary disclosures aligned with the obligations set by the Regulation

> will not only help financial market participants and other relevant actors on the financial markets to easily identify which economic operators carry out environmentally sustainable economic activities, but will also make it easier for those economic operators to raise funding for their environmentally sustainable activities.[77]

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[75] See Recital 6 to the Taxonomy Regulation. Disclosure requirements associated with climate change mitigation and adaptation objectives apply from 1 January 2022; those set for all other environment-related objectives apply from 1 January 2023. In turn, social and governance objectives are expected to be proposed as additions to the existing framework in the coming year.

[76] Recital 11 to the Taxonomy Regulation.

[77] Recital 15 to the Taxonomy Regulation.

5 The Issuer Side of Sustainability: from the NFRD to the CSRD, Through to the CSDD

One fundamental tool for meeting the disclosure obligations imposed on institutional investors by the SFDR, in alignment with the EU Taxonomy, are – alongside engaging with the board and major external stakeholders – issuers' sustainability reports, disciplined by Directive 2014/95/EU (Non-Financial Disclosure Directive – NFRD) which requires certain large companies to provide non-financial reports alongside the yearly financial reports, as a form of disclosure of information on the way they manage social and environmental challenges. The relevance of issuers' non-financial reports for institutional investors' disclosures is explicitly acknowledged by the SFDR. As stated by Article 11(3) SFDR with respect to Article 8 and Article 9 funds, for the purposes of their ongoing reports, financial market participants may resort to corporate information included (in management reports required by the Accounting Directive and) in non-financial statements. As is quite evident,

> [w]ithout sufficient, reliable and comparable sustainability-related information from investee companies, the financial sector cannot efficiently direct capital to investments that drive solutions to the sustainability crises we face, and cannot effectively identify and manage the risks to investments that will arise from those crises.[78]

Moreover, the Taxonomy Regulation requires companies under the scope of the NFRD to disclose their alignment with activities that qualify as being environmentally sustainable according to the EU taxonomy. Hence, availability of reliable, comparable and relevant information on sustainability risks, opportunities and impacts is essential for the successful implementation of the objectives of both the SFRD and the Taxonomy regulation.[79]

The developments in the EU regulatory framework since the adoption of the NFRD, and dissatisfaction with the actual quality of non-financial information provided under the NFRD despite non-binding guidance provided by the Commission in 2017 and 2019,[80] are among the reasons why, based on the review clause in the NFRD, the EU is heading towards amending the existing non-financial reporting requirements by adopting a

[78] European Commission, Guidelines on non-financial reporting: Supplement on reporting climate-related information, 20 June 2019, 2019/C 209/01, OJ C 209/1, C 209/2.
[79] European Commission (2021b), p. 5-6.
[80] European Commission (2021c); European Commission (2021d).

new Corporate Sustainability Reporting Directive (CSRD). The CSRD not only extends the scope of application of the NFRD to all large companies and all publicly listed firms (except for listed micro enterprises) and requires audit assurance of reported information, but, most notably, introduces a requirement for issuers to report according to *mandatory* EU sustainability reporting standards to be developed around the concept of double materiality, hence considering materiality of ESG issues from both a financial and an impact (non-financial) perspective.[81] Under the CSRD, addressee firms are thus going to be required 'to report about how sustainability issues affect their business and about their own impact on people and the environment', with both dimensions (financial, according to an outside-in perspective, and impact, according to an inside-out perspective) extending beyond matters that are within the direct control of the reporting entity, since they include its down- and upstream value chain. According to the Commission, the adoption, by means of delegated regulations, of mandatory EU sustainability reporting standards – the first set of which is to be delivered by 30 June 2023 – derives from the need to ensure comparability and completeness of the information disclosed, enable the audit and digitalization of sustainability reporting, and facilitate its supervision and enforcement.[82] Moreover, '[n]o existing standard or framework satisfies the Union's needs for detailed sustainability reporting by itself', also considering the need for such standard to align, amongst others, with the disclosure requirements laid down in the Taxonomy Regulation and the underlying indicators and methodologies set out in the delegated acts adopted under the SFDR.[83] From the standpoint of the main users of sustainability reporting, i.e., of institutional investors, the proposed adoption of mandatory, double-materiality principled reporting standards is of paramount importance, since it is obviously bound to heavily impact their processes and decisions.

The broad framework drawn by the EU in regard to sustainability includes one further piece of legislation which targets corporate issuers concerning sustainable corporate governance. Following on from its 'Sustainable Corporate Governance' Initiative aiming 'to improve the EU regulatory framework on company law and corporate governance', on the one hand, by 'enabl[ing] companies to focus on long-term sustainable value creation rather than short-term benefits', and, on the other hand, 'to better align the interests of companies, their shareholders, managers, stakeholders

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[81] European Commission (2021b). The text of the Directive following approval by the European Parliament on 10 November 2022 is available at https://www.europarl.europa.eu/doceo/document/TA-9-2022-0380_EN.html#title2 (accessed 22 November 2022).
[82] Ibid., Recital 32.
[83] Ibid., Recitals 33 and 35.

and society' and 'help companies to better manage sustainability-related matters in their own operations and value chains as regards social and human rights, climate change, environment, etc.',[84] in early 2022 the European Commission adopted a Proposal for a Directive on Corporate Sustainability Due Diligence (CSDD).[85]

The CSDD Proposal eventually did not follow up on the issue of curbing short-termism, at least not in regard to investor-driven, trading-motivated short-termism allegedly resulting in undue pressure on company directors to deliver short-term financial results and resort to management strategies aimed at sustaining share prices in the short run. To be true, no single provision of the CSDD Proposal actually refers to addressee companies' shareholders, while granting their stakeholders – which, according to Article 3(n) of the Proposal, do not (explicitly) include the shareholders[86] – a series of prerogatives ranging from that of being consulted when identifying the company's actual and potential human rights and environmental adverse impacts and when developing a prevention action plan as well as a corrective action plan,[87] to the right to submit complaints in case of legitimate concerns regarding those potential or actual adverse impacts, to submit substantiated concerns to any supervisory authority when believing that a company is failing to comply with the Directive, and to provide inputs relevant to setting up the company's due diligence policies,[88] through to the right to claim compensation for damages suffered as a consequence of the company's failure to comply with its due diligence obligations.[89]

Still, the provisions of the CSDD affect institutional shareholders indirectly. Specifically, the proposed rules that require large companies and those operating in certain high-impact sectors, including non-EU companies, to identify and, where necessary, prevent, end or mitigate adverse impacts of their activities on human rights and on the environment, will provide investors with some assurance, additional to that stemming from corporate sustainability reports, that actual or potential portfolio companies do engage in managing ESG risks, thus strengthening the overall reliability of the sustainability information investors use in the investment process and the associated disclosures, as mandated under the SFDR. As

[84] European Commission (2020).
[85] European Commission (2022a).
[86] Based on Article 3(n) of the CSDD Proposal, '"stakeholders" means the company's employees, the employees of its subsidiaries, and other individuals, groups, communities or entities whose rights or interests are or could be affected by the products, services and operations of that company, its subsidiaries and its business relationships'.
[87] See Articles 6(4), 7(2)(a) and 8(3)(b) of the CSDD Proposal.
[88] See Articles 9, 19 and 26 of the CSDD Proposal.
[89] See Article 22 of the CSDD Proposal.

pointed out by the Commission, the proposed CSDD will complement the framework set out by the NFRD and the CSRD

> by adding a substantive corporate duty for some companies to perform due diligence to identify, prevent, mitigate and account for external harm resulting from adverse human rights and environmental impacts in the company's own operations, its subsidiaries and in the value chain.[90]

6 Uncertainties Surrounding Institutional Investors' Walk to Sustainable Finance

In spite of the growing practical relevance of active share ownership generally, and the increasing reliance made by the EU on institutions' stewardship to support the transition toward sustainability and, particularly, to counter climate change, whether institutional investors and asset managers are motivated to effectively play such crucial a role remains controversial. Even assuming they were motivated, and were committed to not just cosmetically contributing to mitigating the ever-increasing, and no more just looming but already materializing, systemic risks posed by global environmental and social issues, still there are limitations to the reasonable reach of investor action in face of the scale of the challenges at stake. Limitations not only derive from the deficient incentives structure and the collective action issues that are typical of asset managers. They also depend on external factors not in the asset manager's control, such as voluble end-investor preferences and priorities, and availability of better and more reliable ESG data and information to drive institutions' assessments, and the cost thereof. Skepticism concerning the capacity of institutional investors and asset managers to be active owners in regard to sustainability issues seems to be justified on account of evidence referring to institutions' actual voting behavior at portfolio companies.

6.1 Resource and Cost Constraints to Active Stewardship, and the Problem of Collective Action

The actual capacity of institutional investors to provide tangible incentives for action by investee companies that are informed by sustainability objectives and to restrict the pursuit of different short-term objectives is dependent, first and foremost, on the scale of the resources dedicated to achieving those objectives. The evidence shows that the stewardship teams

[90] European Commission (2022a), p 4.

of major institutional investors are significantly smaller than the size of the task they are entrusted with.[91] For example, in BlackRock's case it is estimated that investment in stewardship activity totals around 13.5 million dollars, which is equivalent to around 0.15% of the (estimated) asset management fees collected.[92] In addition, stewardship teams appear to be largely understaffed relative to the number of companies covered by stewardship initiatives. Given their limited size, stewardship teams are unable to carry out specific checks in regard to a large number of portfolio companies, regarding which they do not actively engage but apply pre-determined voting policies, or rely on the assistance of proxy advisors, the accuracy of whose analyses is, as is known, a matter of debate.[93]

More so, engaging on an ever-expanding array of topics indeed requires asset managers to dedicate more and more time and resources to stewardship, thus exacerbating the cost- and incentive-issue. As the scale of the challenges associated is 'likely to favor larger players',[94] and in any case imposes to set priorities based on which to select which companies to engage with, and on which topics, medium and small-sized portfolio companies, and those in which stakes are less relevant, are likely to escape investor scrutiny to a larger extent, irrespective of the relevance of any ESG concern they may pose. The very same scale considerations are also likely to further contribute to the factual concentration of corporate power in the hands of a few larger universal owners. If, due to cost considerations, size is among the determinants of stewardship, the broadening topics to be covered erect for small institutional investors and asset managers higher barriers to engagement than those imposed on large investors.[95] Both these factors are to be reckoned with when assessing the European ambitions related to sustainable finance.

Beyond the issue of size, resource and cost constraints are particularly pronounced where passive investment prevails. In fact, costs associated with stewardship impinge much more significantly on asset managers' income, as passive funds have much lower fees. Performance fees do not usually apply for passively managed vehicles, but rather only subscription fees proportional to the amounts invested in the fund; therefore, the incentive for managers to allocate funds to stewardship activities with the aim of improving the fund's return is limited.[96] Indeed, passively managed investments

[91] See, e.g., Bebchuk and Hirst (2019), pp 2077-2080.
[92] Ibid.
[93] For example, BlackRocks' stewardship teams currently comprises 46 persons: BlackRock (2020), p 5. See, e.g., Franks (2020), p 266; Sharfman (2022b), p 15.
[94] Goldman Sachs Equity Research (2019), p 5.
[95] See Ringe (2021b), p 95.
[96] See Kahan and Rock (2020), pp 1795-1797.

> exist in a super competitive industry with extremely low management fees, providing [even the largest global players dominating passive investing] with very little ability to spend resources on becoming informed about portfolio companies. In sum, the Big Three are not being paid to be informed, only to do as much as they can to serve the interests of beneficial investors when they vote and engage on their behalf.[97]

One further factor that adversely affects investment in stewardship is the fact that highly diversified investors face significant collective action problems. This is especially the case for passively managed funds because, as each fund tracking the same index holds the same stocks in the same proportion, funds managed by other index fund managers will capture exactly the same returns from the stewardship activity.[98] To be true, the scale of such disincentive is reduced, at least to some extent, in the case of ESG funds, and even more so of customized ESG funds, since sectoral passive funds and personalized index funds, unrepresentative of the broader market, are created around particular, smaller or fund-specific benchmark indices actually based on active-like investment strategies which lead to more concentrated portfolios.[99]

However, irrespective of the scale of collective action problems, there still remains that index fund managers are able to capture only a small fraction of the benefits from stewardship, given the very low fees that they charge.[100] Therefore, sensitivity to the free-rider problem is high, particularly in contexts where competition for investor capital is high, as is the case within the asset management industry, where fund managers compete to attract assets under management based on performance relative to alternative investment opportunities.[101] At the same time, according to some scholars, leading institutional investors have strong incentives to be deferential to the preferences of portfolio companies' managers as they have significant business ties with the companies in which they hold positions.[102]

However, these lines of argumentation are controversial, since other scholars contend that leading passive, highly diversified investors do have

[97] Sharfman (2022).
[98] See Bebchuk and Hirst (2022), p 41.
[99] See Robertson (2019), p 795 et seq; Mahoney and Robertson (2021), p 311 et seq.
[100] Bebchuk and Hirst (2022), p 42.
[101] Coates, IV, and Glenn Hubbard (2007), p 5.
[102] Bebchuk and Hirst (2022), p 47.

incentives to invest in stewardship and, specifically, to actively engage with portfolio companies.[103]

First, in order to reduce the comparative advantage that competing actively managed funds enjoy vis-à-vis passive funds on account of their ability to trade, passive funds need to exert their voice to improve the corporate governance and performance of investee companies and prevent asset outflow.[104] Such reasoning seems to be reinforced by the tendency of institutional investors to incorporate ESG factors into their investment and stewardship guidelines. As clearly stated by Larry Fink, leading asset managers focus on sustainability not because they are environmentalists, but because they must act in the interest of their end clients, whereas tackling portfolio-wide externalities or sustainability-related systematic risk can improve risk-adjusted portfolio returns.[105] Along the same lines, it is also theoretically plausible that the EU taxonomy, and mandatory investor disclosures drafted against the taxonomy, may spur competition for sustainability-minded end-investors based on the degree of taxonomy alignment of the funds managed by them, thus prompting institutional investors to enhance voice as the primary strategy by which to achieve higher levels of taxonomy alignment and more credibly attract end-clients.[106]

However, contrary to this view, it should be noticed that 'removing systematic risk from the portfolio, whether caused by climate change or social risk, is likely to be a costly endeavor' that does not lend itself to a low-cost stewardship approach, and, as the benefits of any market-wide intervention undertaken would be shared by competing institutions, there is 'a strong incentive not to undertake them and instead take a free ride'.[107] In effect, for portfolio primacy to be effective in regard to voting and engagement as a way to maximize end-investor returns across the portfolio, asset managers need to be informed about portfolio firms: which, precisely, is contested. Hence, it is argued, being uninformed, 'the only practical way for the Big Three to implement portfolio primacy is to implement a general policy of deferring to board authority at their portfolio companies' in spite of significant bias that may exist in some board recommendations.[108]

Second, given their interest in preventing asset outflow and attracting new clients, there is growing reputational and regulatory pressure for leading fund managers – chiefly the largest passive fund managers – to be

[103] See Condon (2020), p 1.
[104] See Fisch et al. (2019); Kahan and Rock (2020), pp 1795-1797.
[105] Fink (2022). See also, amongst others, Gordon (2022), pp 2-3; Azar et al. (2021), p 675.
[106] See Pacces (2021), p 12 et seq.
[107] Lund (2022), pp 12-13 and 26.
[108] Sharfman (2022b), pp 24-25.

active monitors.[109] It can hence be argued that, faced with mounting pressure from a variety of stakeholders, asset managers have no option but to increase their level of engagement with portfolio firms to demonstrate their commitment in encouraging positive change.[110] However, it is also credible that creating the appearance of active ownership will help fund managers to win over clients. Therefore, fund managers may see corporate engagement 'as a branding or marketing tool that provides them with another dimension on which to compete for assets'.[111]

6.2 Dependency on End-Investor Preferences and Priorities

Also due to the fact that ESG investments do not have a very long record, evidence is still mixed concerning whether or not sustainable investing holds promise on delivering financial returns that are competitive vis-à-vis non-ESG investing.[112] Asset managers' readiness to direct investment to sustainable businesses remains open to discussion, as badly performing ESG funds might very well induce beneficial investors to switch their preferences towards less sustainable but more profitable investments.[113] Simply put, markets' cyclicality does not necessarily, nor easily, match with investor preferences and hence with ESG challenges, that are structural by nature, since it is still unclear whether investors are actually willing to forego profits when investing in ESG products.[114]

After all, as acknowledged by BlackRock, the success of investment strategies incorporating sustainability considerations is due, first of all, to the belief that, by mitigating systematic risk at portfolio level, these strategies are likely to achieve higher returns at reduced risk.[115] However, studies do not unequivocally support this view.[116] A number of empirical analyses have not identified any increase either in the returns at firms that enact sustainability-informed strategies or in the returns at portfolios that include companies with better ESG ratings and performance.[117] And,

[109] See, e.g., Kahan and Rock (2020), p 1797.
[110] See Bioy (2017).
[111] Fisch et al. (2019), p 13; Kahan and Rock (2020), pp 1799-1800.
[112] See Boffo and Patalano (2020), p 3; Bhagat (2022).
[113] See Somerset Webb (2022).
[114] See Zetsche and Anker-Sørensen (2022), p 65.
[115] BlackRock Investment Institute (2020), p 3.
[116] Davies (2020), p 22 ; Zetsche and Anker-Sørensen (2022), p 64.
[117] See Lopez de Silanes et al. (2019), p 2; Bolton and Kacperczyk (2021), p 517; Demers et al. (2021); Hartzmark and Sussmann (2019); Raghunandan and Rajgopa (2022), p l. However, as a demonstration of how arguable the conclusions are in this area, it is interesting to note that indices based on ESG parameters appear to have better withstood the financial market crisis triggered by the spread of the Coronavirus in February and March 2020. See Tett et al. (2020).

importantly, it should be noted that, based on a global survey, active asset managers 'expressed commitment to ESG goals in their investing and as a priority for their portfolio companies', but, at the same time, 'most (81% of) respondents expressed reluctance to take a hit on their returns exceeding 1 percentage point in the pursuit of ESG goal'.[118] Further, composite ESG scores seem to be a strong driver for institutional investors when picking stocks to be added to portfolios, with the governance component having the highest impact on holdings. The prevalence of the G dimension of ESG scores in driving firm selection shows that 'it is through investing in forms with high governance quality, that investors are able to effectively drive increased E and S performance',[119] namely by engaging with investee companies. However, ESG scores are not a driver for the size of ownership stakes, suggesting that large investors are much less sensitive to ESG considerations. Where looking at the individual components of ESG scores, the governance component has been found to more robustly correlate with financial performance, in terms of reduced volatility and systemic risk, than the E and S components.[120]

Moreover, if more robust evidence were to be found that ESG funds do not deliver better ESG performance either, then one should conclude that 'funds investing in companies that publicly embrace ESG sacrifice financial returns without gaining much, if anything, in terms of actually furthering ESG interests'.[121] The latter conclusion is however essentially tentative, since, as cautioned by EU institutions, availability of information that may be used to assess non-financial performance of sustainable investment products is 'largely inadequate'.[122] As 'fund performance associated with ESG varies considerably, depending on the scores used and the analytical approaches employed',[123] more research is needed to assess the extent to which ESG scoring methodologies can affect the measure of performance.[124] At any rate, both these issues need to be accounted for, since they might possibly adversely affect end-investor inflow to, and asset managers' interest in, ESG pooled vehicles.

6.3 External Limitations to Institutional Investors' ESG Investing and Stewardship

[118] Chalmers et al. (2021), pp 2 and 4.
[119] Lopez de Silanes et al. (2022), p 17.
[120] Ibid., pp 23-24.
[121] Bhagat (2022).
[122] European Securities and Markets Association (2022), p 21.
[123] Boffo and Patalano (2020), p 35.
[124] Ibid, p 37.

One serious challenge investors are faced with when evaluating ESG priorities is the lack of quality and consistency of the information made available to them by both issuers' non-financial reports and third-party data providers' ESG benchmarks and ratings.[125] Also due to the absence of consistent and comparable issuer non-financial disclosures, ESG ratings and data products have grown into essential tools within the ESG ecosystem, and, following increased demand, the role and influence of private providers of ESG ratings and data products have grown significantly.[126] ESG ratings and data products are not flawless, however, and do not typically fall within the remit of regulation.[127] As a result, deficiencies in the quality of the relevant information makes it hard for investors to differentiate between companies on ESG-related performance, and try to shift capital towards firms credibly making progress on the way to, e.g., net zero.

While the CSRD is intended to tackle the issue of insufficient relevance, reliability, and comparability of corporate sustainability reporting, still impaired ESG investors' assessments caused by the adoption of differing sustainability reporting frameworks will not be overcome unless meaningful international convergence of such standards is achieved.

But, on top of issuer disclosures, differing, and opaque, ESG indexes and ratings sold by the index and ESG rating providers industry add one further layer of complexity to investors' assessments. As is well known, asset managers are heavy benchmark users, both in the case of index funds and ETFs – where benchmarks are used as a target for index tracking funds – and in the case of the evaluation of an active manager's performance – where the fund performance is measured against an index or a set of indices. Hence, the use made by asset managers of ESG information is not only direct – through access to issuer-disseminated non-financial disclosures – but also indirect, through ESG ratings commercially available or, to a lesser extent, that are built by the asset manager itself.

Rating practices, in terms of determining which data to include, and how to weigh metrics in terms of materiality, and layering subjective judgment as to absolute and relative scores within and across industries, are very wide-ranged, and third-party index providers and rating agencies develop and sell ESG ratings and indices based on intrinsically different data and methodologies.[128] Ratings, data and indices used by market participants to identify and assess companies that adopt better ESG practices – either to make active investment decisions through a selected

[125] See, e.g., PricewaterhouseCoopers (2021), pp 4-5.
[126] See International Organization of Securities Commissions (2021), p 5.
[127] Ibid., p 1.
[128] See Boffo and Patalano (2020), p 21.

approach relative to an index, to structure investment portfolios aligned with a given index, or to take stewardship action – are not only largely varied and not comparable, but also opaque, due to a fundamental lack of transparency in the underlying methodologies.[129]

Hence, the problem of non-consistent frameworks for corporate non-financial disclosures, and the underlying diverging concepts of materiality, couples with that of divergent, and opaque, ESG ratings and indices.[130] In particular, low correlation among the scores assigned by different providers to the same companies, and the lack of transparency in how such scores are developed, make it hard for investors to resort to yet essential, and reliable, information they need to properly perform sustainability assessment. Tellingly enough, the lack of transparency around external ESG rating methodologies is among the reasons why users are encouraged to build proprietary rating methodologies.[131] Commendable as it may be, this option is however factually limited to the largest asset managers, since 'producing proprietary internal ESG ratings may not be feasible or cost effective for small or medium sized asset managers'.[132]

In addition, with ESG scores largely dependent on the methodologies used by providers – either ESG raters or portfolio managers themselves – 'the extent to which end-investors can be assured that ESG investing provides enhanced returns or aligns with any particular societal values is dubious',[133] which, in turn, is likely to 'confuse end investors and undermine their trust and confidence in sustainable financial products'.[134] It plainly follows that

> [g]iven the influence of ratings providers, the differences in ratings methodologies, and their level of transparency in final rating decisions that also incorporate qualitative judgments, are critical to understanding the resilience of the ESG financial intermediation chain.[135]

Further concern associated with ESG ratings and indices is, alongside high levels of market concentration around a few global players, the potential for conflict of interests deriving from providers offering companies other types of services (as ESG ratings providers can assume different roles, such as consultant, data provider, or rating provider,

[129] Ibid.
[130] See Chiu (2022), p. 105 et seq.; Zetsche and Anker-Sørensen (2022), pp 70-71.
[131] International Organization of Securities Commissions (2021), p 27.
[132] Ibid.
[133] Ibid, p 29.
[134] European Fund and Asset Management Association (2022a), p 3.
[135] Boffo and Patalano (2020), p 22.

representing the interests of both companies and investors), notably with regard to their ESG performance. Additional concern derives from uneven covering of the products offered (with certain industries, companies or geographical areas benefitting from more coverage than other firms),[136] and the rising, and excessive, cost of ESG data services which, associated with the lack of pricing transparency, is 'particularly detrimental to smaller firms with fewer resources and bargaining power and ultimately affects end investors as potentially these costs may be passed on to them', and can possibly be in breach of 'the non-discrimination and cost-based/cost-related principles laid down in the various national regulations'.[137]

While in the EU the regulatory framework for benchmarks may be relevant for certain providers of benchmarks with an ESG or climate dimension, it is not directly relevant for the broad scope of ESG ratings and data products.[138] ESG indices fall within the scope of the Benchmarks Regulation,[139] but ESG ratings and assessments do not. Yet ESG benchmarks are not independent of ESG ratings. As highlighted by the ESMA, the very low levels of correlation that different ESG ratings display make the construction of ESG benchmarks problematic 'with the choice of ESG rating provider significantly impacting the constituents of those indices'.[140] Moreover, as 'companies in highly polluting industries can obtain high environmental scores from some ESG rating providers',[141] there is the risk, ultimately, that capital allocation aligned with sustainability objectives is impaired, undermining the sustainability-related endeavors of both sustainability-minded end-investors and the EU. Therefore, in light of the ever-growing size of the industry, and interest in ESG benchmarks, ensuring the credibility of ratings is necessary.

Having identified a number of key points for consideration, early in 2021, the ESMA urged the European Commission to take appropriate regulatory steps to ensure the quality and comparability of ESG ratings and assessment tools,[142] following which the Commission launched a consultation, the results of which may induce the Commission to actually

[136] See International Organization of Securities Commissions (2021), p 10 et seq.
[137] See European Fund and Asset Management Association (2022a), pp 3 and 6.
[138] International Organization of Securities Commissions (2021), p 14.
[139] Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation EU (No 596/2014).
[140] European Securities and Markets Authority (2021), p 2.
[141] Ibid.
[142] Ibid.

take regulatory action in the field,[143] also following up on the recommendations issued by the IOSCO.[144]

6.4 ESG Voting in Practice

Some skepticism concerning the capacity and willingness of institutional investors to be active owners in regard to sustainability issues seems to be justified on account of evidence referring to institutions' actual voting behavior at portfolio companies. Statistics concerning ESG engagement and, specifically, voting on environmental and social matters, depict a picture that would appear not to be perfectly aligned with institutions' claimed ambitions. Based on an analysis of how 65 of the world's largest asset managers voted in 2021 across 146 social and environmental resolutions globally, the actual reach of global asset managers' active ESG share ownership still remains open to discussion, especially as far as the very largest players are concerned.[145]

First, voting support to E&S resolutions appears to be dominated by European asset managers, whose 'for' votes outpace on average those of US-based institutions by 25 per cent in frequency (64 and 39 per cent respectively).[146] Arguably, the favorable regulatory environment in the EU acts as a driver for European investors' enhanced positive voting behavior compared to US peers.

Second, the six largest asset managers in the world – BlackRock, Vanguard, Fidelity Investments, State Street Global Advisors, Capital Group, and J.P. Morgan Asset Management – each supported fewer than 40 per cent of E&S resolutions they voted on. And, interestingly enough, they all showed a tendency to vote more conservatively than recommended by major proxy advisory firms, considering that ISS recommended backing 75 per cent of the proposals assessed, and Glass Lewis 44 per cent.[147] While not being a feature exclusive of the very largest asset managers (68 per cent of the institutions considered actually shared this trend of supporting fewer proposals than recommended by ISS, or 23 per cent where considering Glass Lewis' recommendations[148]), such tendency is however particularly evident for US-based institutions, whose voting records seem to be at odds with their claims of being at the forefront of ESG engagement.[149] As has been noticed, an additional 10 per cent of the resolutions examined for 2021

[143] European Commission (2022b).
[144] International Organization of Securities Commissions (2021), Chapter 5.
[145] See ShareAction (2021).
[146] Ibid., p 13.
[147] Ibid., p 21.
[148] Ibid., p 22.
[149] See Lafarre (2022), p 6.

would have achieved majority support had one or more of the Big Three voted in favour instead of against.[150] Where the size of the assets under management and the potential of influence these players can wield over corporate behavior are accounted for,[151] these findings shed some shadows on the reasonableness of the EU institutions' heavy reliance on institutional investors' contribution to the implementation of the sustainable finance agenda.

That holds true, at least trend-wise, even if proper consideration is given to the fact that the proportion of passive investments relative to the overall size of assets under management in the EU is lower, and perhaps even significantly lower, than in the United States, and that, correspondingly, common ownership in continental Europe is less significant.[152] The power, and problems, of highly diversified institutions, in particular index fund managers such as the prototypical Big Three, may at present be less enhanced in Europe than in the United States –an issue to be factored in, and further explored, by EU regulators when shaping any policy and intervention. Yet, they cannot be underestimated. First, at least at some EU firms, particularly large dispersed firms which are typically represented in many indices, diversified ownership and the stakes collectively held by index funds are notable.[153] Second, alongside large universal owners such as the Big Three, other asset managers are passive investors, or quasi-indexers. Finally, where looking at the outgrowth of index funds and ETF-investing in the EU and their speedy pace, and considering that 'the main reason behind this growth is the lower cost of passive funds and ETFs',[154] the common expectation is for such evolutionary trend to further strengthen.

It may very well be, of course, that failure to support E&S proposals is motivated by the willingness not to oppose the management where the investor believes that sufficient progress is being made by the company in regard to the relevant issue. This is particularly true where such belief is based on previous behind-the-scenes engagements with the issuer. After all,

[150] ShareAction (2021), p 25. These data are consistent with Griffin (2020), pp 411, 422, 444. See also Posner (2021).
[151] ShareAction (2021), pp 23-24.
[152] See Rosati et al. (2020), pp 52-53. Less pronounced (but still meaningful, at least among the largest issuers with no controlling shareholders: see Steuer (2022), p 29) levels of common ownership in the EU relative to the United States seem consistent with both the facts that the passive investment segment in the EU is overall less pronounced than in the United States (see European Securities and Markets Authority (2022), p 13; European Fund and Asset Management Association (2022b), p 42), and that large non-institutional blockholders, including controlling stockholders, are common at European listed firms, whereas they are not in the Unites States (see De La Cruz et al (2019), p 11).
[153] See Steuer (2022), p 27.
[154] See European Fund and Asset Management Association (2021), p 46.

voting against the management is *per se* a confrontational stewardship tool that stewardship principles recommend to resort to by way of escalation. Still, the imbalance between voting behaviour and divergent proxy advisors' recommendations, coupled with time- resource- and cost-related constraints on institutions' stewardship, as well as conflicted business models that are typical for large asset managers, remains remain striking.

The fact that most asset managers' E&S voting behaviour tends to remain the same over the years, and that the overall proportion of 'for' votes only shows slight increases,[155] coupled with further findings that some (European) players fail to exercise more than 40 per cent of their voting rights – in spite of being often a member of the Climate Action 100+ initiative and a signatory to the Principles of Responsible Investment (PRI)[156] – and that the vast majority of asset managers are reluctant to file, or co-file, E&S shareholder proposals at portfolio companies,[157] may be interpreted as a signal that investors are, at a minimum, too slow at adapting to the urgency of the challenges posed by E&S risks on the way they manage assets.

Even more so, investors' adaptation to sustainable investing and to the needs of booming sustainability-aware end-clients is slow where the so-called impact perspective of investment management is accounted for. As further inquiries suggest, while asset managers are increasingly considering the implications of ESG issues for financial performance where making investment decisions, a conceptual shift towards considering the real-world impact of their investments on the environment and society, and more comprehensively integrating systemic ESG risks into the investment process, seems far from being achieved in spite of the fact that investee firms' (negative) inside-out impact can profoundly, and adversely, affect the economy at large, and thereby pose financially material risks to the portfolio.[158] That view is evidently shared by the European Commission, whose CSRD Proposal relies, amongst other things, on the consideration that the two perspectives of the double-materiality principle for non-financial reporting are 'often not well understood or applied', making it necessary to both 'clarify that undertakings should consider each materiality perspective in its own right, and should disclose information that is material from both perspectives as well as information that is material from only one perspective',[159] and compel reporting entities to embrace EU-mandated double-materiality principled common reporting

[155] ShareAction (2021), p 27.
[156] Ibid., pp 29-30.
[157] Ibid., p 28.
[158] See ShareAction (2020), pp 5, 19-21.
[159] Recital 25 to the CSRD Proposal, as amended by Coreper.

standards to ensure that all relevant information that is material to users is disclosed.[160]

Nevertheless, the fact remains that low rates of voting support from the largest asset managers to environmental and social proposals seem to be in contrast with the likely preferences of E&S-minded end-investors.[161]

One possible way by which to align asset managers' E&S votes with the actual preferences of end-investors is to overcome the judgement of stewardship teams, and the associated biases, by resorting to pass-through voting or end-client voting instructions based on the format 'If X, do Y', i.e., mechanisms by which to ultimately transfer the power to decide how to vote the shares in the fund from the fund to their investors.[162] As the fund managers would be required to follow end-investor-generated guidelines when voting the shares, such mechanisms would force funds to split the exercise of voting rights proportionately rather than voting as an undifferentiated bloc; which would remove some of the largest asset managers' discretionary power and reduce their concentrated voting influence.[163] While, famously, pass-through voting was actually launched by BlackRock as a first-mover in January 2022 for institutional clients invested in certain pooled vehicles managed in the US and UK,[164] some (equally large) asset managers may perhaps follow the lead in the future. After all, pass-through voting might also serve as a lever for offering competitive advantage to a firm's current and potential clients.

As pass-through voting is not possible in any jurisdiction from a regulatory standpoint, regulators, too, may consider assessing whether to allow end-investors who wish so to access similar tools on a legal basis.

[160] Recital 32 to the CSRD Proposal, as amended by Coreper. See also European Commission (2021c), pp 57-58.
[161] See Griffin (2020), pp 439-440.
[162] Ibid., p 440.
[163] Ibid., p 441. See also Griffin (2020b), p 964.
[164] On 13 June 2022, BlackRock announced it would be increasing the range of funds eligible for its 'Voting Choice' program in the UK and expand the program to Canadian and Irish pooled funds. Nearly half (47%) of the $4.9 trillion index equity assets are now eligible to participate in the firm's program. Following the changes announced, voting choice is available for 100% of US pension plans, and 95% of the firm's institutional index equity funds (amounting to about half of the firm's index equity assets and virtually all of its index equity assets outside ETFs and retail mutual funds). In Europe and the UK, 80% of BlackRock's index equity assets (other than ETFs) are eligible for the program. See BlackRock (2022a). Blackrock also published a white paper outlining the firm's ambition to expand Voting Choice to all investors, including individual investors in funds: see Blackrock (2022b). According to the firm, BlackRock clients have committed $530 billion – or a quarter of eligible assets –to voting their own preferences through Voting Choice. Of these, clients representing $120 billion of assets have elected to vote their own preferences in the five months since BlackRock introduced the program: ibid., p 4.

Accurately accounting for the many challenges and unknowns such a move indeed poses would however be imperative.[165]

To begin with, pass-through voting is likely, at present, to be most impractical for the vast majority of not-so-large asset managers, let alone considering its costliness and operational complexity.[166] But, in turn, if pass-through voting were adopted by larger asset managers only, this might further entrench their competitive power over smaller players. Further, 'passing voting authority for hundreds of companies to investors would not only be overwhelming for the fund, but also for investors', unless some corrective mechanism be adopted, such as restricting the rule to specified 'non-routine' matters, amongst which E&S issues.[167]

Moreover, based on experience with early adopters of BlackRock's voting choice program, it is not unlikely that many institutional end-clients would eventually end up instructing the asset manager to vote according to some partnering proxy advisor's voting policy selected out of a given menu.[168] Even if end-client choice would probably achieve a better alignment of the votes cast with its own preferences (as mirrored in the proxy advisor policy chosen), still this kind of pass-through voting is a way of shifting voting authority from one agent (the asset manager) to another (the proxy advisor) who is not free from criticism either. Were pass-through voting to be extended to individual shareholders in the funds, proxy advisor-based voting would probably be the outcome of most voting-choice adopters. The issues of rational apathy, information cost, and financial illiteracy, which still prevent large cohorts of retail stockholders from voting their shares, would predictably prevent individual retail shareholders in the fund from choosing to instruct the asset manager based on any option requiring them to directly make a voting decision – except, perhaps, for younger, and technology-at-ease, investor generations that claim for their voice to be heard, particularly where ESG issues are at stake at portfolio companies. Finally, pass-through voting can make it very hard for portfolio firms to predict shareholders' voting behavior, adding further challenges on the board when defining corporate E&S strategy.

7 Conclusions

The strong regulatory signals on sustainable finance ignited by the implementation of the EU's Sustainable Finance Agenda, which set clear

[165] See, e.g., Lipton (2022).
[166] See Stevens (2018).
[167] Lund (2018), p 530.
[168] See BlackRock (2022b), p 10.

priorities and expectations of investors, may well be among the factors contributing to European asset managers' overall stronger performance concerning their approach to responsible investing and engaging relative to US managers and the rest of the world.[169] It may also be the case that investors' approach to sustainable investing and ESG-related stewardship will improve over time and become more effective. This however requires, at the very least, that more reliable, in terms of heightened transparency, granularity and comparability of ESG ratings and indices be made available, and be made available at a fair price. Where no such condition is granted, key determinants of asset managers' decisions 'can be over simplistic and may not return the desired results'.[170] The same is true with respect to corporate non-financial disclosures, where international convergence of disclosure standards is warranted too.

The regulatory efforts in the EU clearly highlight the fact that, in an ever globalizing market for investing, in which investments are typically cross-border, action is needed on a much larger scale than just at the level of the EU in order for sustainability objectives to be more credibly met, or even only neared.[171] Regulatory initiatives regional in scope cannot, almost by definition, address challenges that are global in nature. It is true that the scope of application of EU legislation on sustainable finance is indeed very broad. For example, disclosure obligations imposed by the Taxonomy Regulation also cover third-country financial market participants that sell financial products in the EU, and companies subject to the NFRD regardless of their location.[172] Non-EU investors offering products in Europe are subject to the SFDR as well. The extra-territorial reach of EU regulations in the field of sustainable finance may perhaps support a 'Brussels effect',[173] to some extent, since investors and companies might choose to extend the EU requirements to their global operations, if the benefits of standardization around a specified regulatory standard outweigh the costs of differently managing operations in the EU and the rest of the world.

Yet, limitations on the role to be possibly played by institutional investors in the transition towards sustainable growth are unlikely to be easily overcome. First, the expectation that institutions invest resources with the aim of promoting socially responsible conduct and achieving particular ESG objectives entails an internalization of costs by institutional

[169] See ShareAction (2020), p 27; Lafarre (2022), p 31.
[170] See Boffo and Patalano (2020), p 36.
[171] See generally Busch (2021).
[172] See European Commission and Technical Expert Group on Sustainable Finance (2020), p 10.
[173] Bradford (2020); Bradford (2012), p 3. The Brussels Effect refers to how EU rules and regulations can penetrate outside the EU through market mechanisms, resulting in the globalization of standards.

investors,[174] the effects of which will be felt not only by them (in terms of the lower net earnings) but also by end investors (in terms of the lower returns). Therefore, even assuming that largely diversified institutional investors adopt a portfolio value maximization approach according to which they can push ESG policies that can impair the value of some portfolio companies while benefiting some others,[175] the fact remains that '[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'.[176] Coupled with further disincentives, as described above, this reasoning justifies scepticism as to whether institutional investors can perform a 'public' function for the benefit of society at large and restrain the need for governmental or sharper regulatory intervention.

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[174] See generally Johnston et al. (2021), p 39.
[175] See Enriques (2020).
[176] Condon (2020), p 6.

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