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Systematic Stewardship

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Introduction

The goal of this paper is to provide a foundation for a form of engagement by large institutional investors and asset managers with their portfolio companies and with the broader corporate governance environment that fits both their theory of investing and their low cost business model. I call this "systematic stewardship," an approach that is suited to an investment strategy that creates diversified portfolios while also minimizing costs. The canonical candidate is the broad-based index fund, which is constructed to replicate the performance of the stock market as a whole while charging tiny fees, even zero fees, to its beneficiaries. "Systematic stewardship" also can serve as a guide to any institutional investor that pursuing a strategy consisting principally of wide-scale diversification and cost-minimization.

The core of the idea is this: The insight of "Modern Portfolio Theory," which has served as the foundational investment strategy for the asset management industry, is that investors' utility takes account of both risk as well as expected returns, so that investors' objective is to maximize *risk-adjusted* expected returns. Accordingly investors compete to create diversified portfolios to eliminate risk and thus are generally compensated for bearing only that risk that cannot be diversified away. Risk that pertains to a particular company, so-called "idiosyncratic" risk can be diversified away; risk that will affect returns throughout the portfolio, "systematic risk," remains. Engagements that may improve firm-specific performance are generally idiosyncratic; they will not improve the performance of the portfolio as a whole. The possible exception requires the somewhat heroic assumption that such engagements are part of a pattern designed to produce "governance externalities" that lift the performance of all firms on average, that produce positive economy-wide effects.

The straightforward implication is that advisors of extensively diversified portfolios, especially broad-based index funds, should focus on addressing the systematic risk elements in their portfolios rather than new forays into firm-specific performance-focused engagement. This could take many forms. For example, it could mean voting in support of management of a systemically important financial firm in a face-off with activist investors who want the firm to take greater risks to enhance shareholder returns. As the financial crisis of 2007-09 vividly illustrated, the failure of a SIFI can indeed result in losses across an entire portfolio. In deciding whether to support the risk-loving activist, the index-fund advisor ought to consider not only the return proposition at a single firm but the systematic risk effects. Portfolio theory teaches that investors in the index fund are seeking to maximize risk-adjusted returns, and so assessment of systematic risk effects becomes even more important in this case than the impact on single firm returns, an idiosyncratic effect.

A salient form of systematic risk is climate change risk. The disruptions associated with various realizations of climate change risk will ramify across the entire economy and thus across a diversified stock portfolio; climate change risk is systematic. Failure to mitigate climate change risks will thus reduce risk-adjusted returns for an index fund investor. Here is the importance in bringing a portfolio theory perspective: Many arguments for a climate-sensitive engagement entail a trade-off between expected returns and the social value of avoiding the potential for severe climate change harms, "socially responsible investing." Systematic stewardship grounds engagement to reduce climate change risk in the economics of investor welfare. The goal of such engagement is lower systematic risk and thus to improve risk-adjusted returns for portfolio investors. There is no trade-off investor welfare for social welfare.

Although systematic stewardship seems most obviously to fit the broad-based index mutual fund or ETF, it also can underpin engagement behavior by other institutional investors, such as defined benefit pension plans. As recent Department of Labor guidance has reminded us, private sector pension plans are subject to ERISA's "sole benefit" rule. There can be no trade off of the economic benefits for plan beneficiaries against other social values. But engagements aimed at reducing systematic risk do not run afoul of the "sole benefit" criterion; rather they are in service to it. Indeed, pension fund managers who are *not* thinking about the systematic dimension in their engagements are falling short of the objective of maximizing risk-adjusted returns.

The insights associated with systematic stewardship also have implications for investment strategies that propose to "de-carbonize" otherwise fully diversified funds. The "business case" is that such strategies produce equivalent returns while avoiding association with objectionable investments, and are perhaps even advantaged given the option value of gains if fossil fuel producers suffer severe losses from climate-focused regulation. But once systematic risk is taken into account, this approach, along with other divestment strategies, can be defended only if "exit" is more likely to promote climate change risk-mitigation than "voice." Why? In the event of severe

climate distress, the impact will be felt across the entire portfolio, the losses swamping any gains that may have been obtained through avoiding fossil fuel investments.

In one sense there is nothing new in the claim that diversified institutional investors should, and do in fact, take a portfolio approach towards their engagement activities. For example, such investors generally have developed a normative model of "good" corporate governance expressed in "guidelines" that then generates voting positions across the entire portfolio. To take a concrete example, institutions in general firmly reject classified boards, insist on annual say-on-pay votes, and argue for single class common stock, not dual class common. Supported (sometimes) by empirical evidence and other times by a certain logic about the value of managerial accountability to shareholders, such investors believe that the adoption of these positions will increase the value of the firm, on average. These views are then uniformly applied across the portfolio, even though firm-specific analysis would surely produce governance heterogeneity. Surely some firms would benefit from the relative stability or other properties associated with a classified board, for example. The institutional investor response is: yes, bespoke governance might be better for some firms, but given the cost including follow up monitoring required by such tailoring, uniformity will increase expected returns across the portfolio as a whole.

Systematic stewardship also takes a portfolio approach. The distinctive twist is the focus not on how to increase expected returns across the portfolio, but how to reduce systematic risks, and thus how to enhance risk-adjusted returns for the portfolio. This approach is not simply additive. It does not counsel, in addition to devising governance approaches that will increase expected returns, now also take into account systematic risk factors. Rather, reducing systematic risk may entail a trade-off with expected returns. For example, a diversified investor sensitive to systematic risk may have a different approach to risk-taking by large financial institutions and may favor rather than disfavor government regulation that targets such risk. It may regard its risk-adjusted returns as enhanced rather than reduced by measures that reduce expected returns on a portion of its portfolio.

In short, systematic stewardship provides a finance-based framework for the assimilation and assessment of concerns that fly under the flag of "ESG," environmental, social, and corporate governance matters. Some such concerns, climate change, for example, get quick uptake by systematic stewardship. Some elements may reflect shareholder preferences that do not have a strong systematic effect and thus may require a different justification. For example, pressure for certain environmental measures may reflect a belief that the firm ethically should not impose externalities, or should comply with applicable law and even engage in "forward compliance" in anticipation of likely legal change. Similarly, various social issues may register differently on the systematic scale. One implication is that stewards of diversified funds should devote their engagement principally to thinking about portfolio-wide effects and in particular systematic implications in their use of corporate governance tools. Systematic stewardship is both their

obligation from a beneficiary point of view and their comparative advantage, because it is compatible with the economic core of their investment management strategy. Insofar as investors are drawn to funds that advance ESG concerns while not sacrificing risk-adjusted returns, index funds may find that public support and pursuit of systematic stewardship is a persuasive point of competitive advantage. Asset managers can market their systematic stewardship stance as a way of differentiating from other index funds and thereby increasing AUM.

This paper proceeds as follows. Part I addresses the engagement conundrum for the asset manager of diversified investment products, which range the spectrum from actively-managed funds to fully-diversified index funds and ETFs. What exactly is the case for firm-specific engagement, which seems at the heart of the demand for "stewardship" by institutional investors? For an active fund, trading seems a stronger strategy than engagement, not only because that is best for the fund but also because of information content of "exit" may itself exert a disciplinary force; moreover, serious shortfalls in management's strategy or operational acumen may become the target of an activist, an engagement specialist. The index fund case is more complicated, in part because "exit" is not an option and in part because its business model leaves little space for an investment in engagement. This is reflected in a vigorous debate on whether and how index funds should vote their shares. A portfolio perspective reveals this: it does not matter. Performance improvement to the holder of a fully diversified portfolio is "idiosyncratic." It is the kind of risk that the portfolio by construction is designed to diversify away. Instead, the asset managers should attend to systematic risk.

But there is a further implication: Even though strongest fit for systematic stewardship is with a broad-based index fund that minimizes idiosyncratic risk, it has high relevance for almost all funds structured with a significant level of diversification. This is because systematic risk will figure strongly in portfolio returns. This means that most active managers should include systematic risk concerns alongside their firm-specific performance engagements.

Part II explores the nature of "systematic risk," distinguishing it from firm-specific factors in asset pricing models and indicating its connection both to ideas of "systemic risk" developed in models associated with the financial crisis and to current ideas of "ESG." In particular, the paper identifies three possible candidates for systematic risk mitigation, climate change risk, financial distress risk, and, more tentatively, social stability risk.

Part III outlines the approaches that a fund manager of broad index funds might take to implement "systematic stewardship." There is both a portfolio approach and a firm specific approach. Index fund managers should favor, as a portfolio matter, disclosure of firms' exposure to systematic threats, with sufficient granularity to enhance efficient market pricing of the risk. Such disclosure is likely to put pressure on firms to take measures that would reduce the systematic risk (and thereby improve risk-adjusted returns for the portfolio) and also help the fund manager

in its systematic risk assessment. Support for such disclosure could come through adoption of guidelines for proxy voting and for support of SEC initiatives for mandatory disclosure. Index fund managers should also consider support for the creation of derivatives and a derivatives index based on the returns of firms especially exposed to certain systematic risk, like climate change. This would aid in pricing the particular systematic risk and bring additional market pressures to bear for its mitigation. Support for these regulatory measures might most effectively be presented through an asset manager trade association, perhaps a new trade association formed to focus on systematic stewardship issues, rather than by any particular asset manager.

When it comes to firm-specific engagement, such a manager would be justified in taking a stance of "rational reticence," to engage in reactive rather than active mode. For prudential reasons an asset manager might well decide to act on its systematic concerns chiefly in response to initiatives promoted by other shareholders, voting its shares on issues as framed for shareholder decision. Indeed, the business model of such funds, emphasizing low fees, is most consistent with this approach. To take some examples: A fund with a systematic perspective could readily vote in favor of a shareholder initiative calling for disclosure of a company's plan to address climate change risks and other elements relating to "sustainability." Disclosure leads both to better capital market pricing of the risks in question, which is both informative and disciplinary, and deepens the fund's ability to evaluate systematic risk associated with a particular company's activities. As noted above, the manager's approach could be based on a general portfolio guideline of support for such disclosure.

A fund could cast its votes in an activist-driven proxy battle based on its assessment of the implications for systematic concerns. It could support an activist slate that would be push for the company to reduce its carbon emissions, even if the strategy would lower the company's current earnings and the stock price, if the fund determined that this approach would reduce systematic risk. The company's implementation of the strategy might well be challenged by other shareholders claiming it transgresses the broad latitudes of the business judgment rule, but the fund need not make such a determination in voting its shares. A fund could also support *management* that followed a carbon-reducing policy against an activist slate pushing the contrary for purported higher profits. A final example: the fund could support management that resisted layoffs despite reduced profitability based on the fund's determination about the connection between a layoff policy and the systematic risk of social instability.

Part IV addresses certain objections. Can a fund shareholder exercise governance rights in way that would trade off increased expected returns at the own firm for the sake of portfolio benefits through reduction of systematic risk? In a sense we've already crossed that bridge, in permitting shareholders to promote corporate governance models that might sacrifice value at a particular firm to obtain benefits across the portfolio as a whole. But a fuller answer addresses the distinction in corporate law between the voting preferences of a non-controlling shareholder,

which are unbounded, versus the obligation of the directors, which are bounded under current law by the business judgment rule.

Can a fund pursue a systematic approach in its voting decisions even no single firm's actions would have a systematic impact? In the case of a SIFI, a single firm's failure could have a systematic consequence, as Lehman's failure illustrates. But for climate change, no single firm's conduct could itself trigger a systematic shock. The nexus between the systematic approach and the single-firm case is less tight than in the case of a SIFI. Nevertheless the fund could take account of systematic concerns at a single firm as part of a systematic risk reduction policy that it would apply across the sector and could also look to the "governance externalities" across the sector resulting from a single firm outcome. Indeed, this is the way that activism generally works: managers see the outcome of contests at similar firms, infer general shareholder preferences and judgments, and modify their behavior accordingly. Activism generally has value because of its portfolio effects; that is certainly true where the objective is systematic risk reduction.

Would announcement of and acting on sympathy to systematic concerns by large asset managers produce some of the negative effects associated with "common ownership"? First, each asset manager will be making individual judgments as how to cash out systematic concerns in any particular shareholder matter. But second, the welfare effects of expected systematic risk mitigation will be different from the purported anticompetitive effects associated with the common ownership literature. The reduced risk of an economy-wide negative event will improve consumer welfare across the board.

Part V concludes.

Part I: Stewardship for Fully Diversified Passive Funds Should Have a Strong Systematic Focus

This Part argues that the optimal stewardship strategy for a fully diversified passive fund is to focus on systematic risk factors rather than engagement with specific portfolio companies. Such funds may establish governance "best practice" guidelines that they believe increase returns, on average, for the firms in the portfolio. Such funds may also support various forms of shareholder activism targeted at single firm performance issues especially if they think that such activism generates "governance externalities" across the portfolio. But in general single firm engagement by the fund will not improve portfolio outcomes. This is because single firm performance improvement is idiosyncratic; such idiosyncratic factors are precisely what full diversification is designed to eliminate. Fully diversified passive funds may choose, as a prudential matter, to engage in firm specific engagement, but true "stewardship" by these unique capital market creations calls for a systematic perspective; that truly is the only way such funds can improve risk-adjusted returns for their beneficiaries.

A. Shareholder voice: Active Managers

Ever since the reconcentration of share ownership began in the US in the 1980s, institutional investors have been looked to as the solution to the problem first identified by Berle and Means in the 1930s, the way that diffusion of stock ownership among the general public left management in control of large corporations.[1] In particular, the hope was that institutions exercising "voice" could constrain various sorts of mis-management better than control market devices like hostile tender offers, which were feasible economically only where strategic or operational shortfalls had become very serious and which were, in any event, highly disruptive. The relatively large stakes held by institutional owners coupled with access to sophisticated securities analysis would reduce collective action barriers and would thus open the way to superior "voice" strategies. That was the hope. The reality has deviated considerably from an Athenian ideal of shareholder engagement.

The business model of many institutional investors as it interacted with developing theories and empirics of investment management has muted their corporate governance role. At the beginning of the period a substantial fraction of institutional money was actively managed. This became the heart of the case for the proponents of institutional investor activism. The research that was associated with active management would inform the investors' judgments about governance or performance shortfalls and fuel their capacity to exercise "voice" to address them. This vision faltered because it turned out that sustained monitoring was inconsistent with the asset managers' business model, both in the economic incentives and the legal exposure.[2]

In general an active asset manager's success is measured in terms of relative performance. If the asset manager is advisor to a mutual fund, superior relative performance will lead to greater "assets under management." Investors and investment advisors pay keen attention to relative performance measures and allocate funds accordingly. Asset manager compensation is ordinarily set as percentage of AUM. Accordingly, since research and other portfolio management costs are relatively fixed, manager profits increase (decrease) sharply as AUM increases (decreases), even where the fee percentage varies negatively with AUM. If the asset manager is advisor to a pension fund or endowment, relative performance is similarly used in retention and compensation decisions. Relative performance measures directly affect "voice." Assume the manager's research reveals serious governance problems or performance shortfall. There are two ways that the manager can capitalize on this information: sell in anticipation of the market's eventual realization of these problems that leads to downward share price adjustment, or undertake active measures to remedy them, through the exercise of voice. Meaningful "voice" in this context is costly because success against a recalcitrant company management team will require organizational efforts with other shareholders. Moreover, the gains will necessarily be shared with other shareholders, who can free

[1] See Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. Rev. 811 (1992); Roanld Gilson & Reiner Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863 (1991); Jeffrey G. Gordon, Institutions as Relational Investors: A New Look at Cumulative Voting, 94 Colum. L. Rev. 124 (1994).

[2] This argument is spelled out in greater detail in Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. 863 (2013).

ride on the voice-exerciser's effort. So: in cases where "voice" has been successfully employed, the active manager has occurred a positive cost not borne by other shareholders (and unlikely to be reimbursed by the company) for a gain that is shared by all. This is not a winning proposition from a relative performance perspective.

For the asset manager to a mutual fund, a "voice" strategy also runs into the demands of daily liquidity. Unanticipated redemption requests may require the manager to sell out positions to raise cash. The optimal dispositions from a liquidity perspective may be in tension with a sustained "voice" engagement with a particular company. Moreover, since the manager is always in the hunt for superior relative performance, it may decide that redeployed investment of its limited funds in another company will outperform the voice target, even if the target were to improve.

Finally, an asset manager is likely to advise a host of funds as part of a fund "family," which may raise thorny legal complications. Aggressive voice strategies by portfolio manager at one fund could well be attributed to the asset manager parent, which is deemed to be the beneficial owner of all the securities that it manages because of its control over the disposition and voting of those interests. This will raise on-going legal questions under sections 13(d) (disclosure) and 16(b) (short swing profits) of the 1934 Securities Exchange Act alongside concerns that active voice may trigger a target's poison pill.[3]

These forces will produce a style of voice that Gilson & Gordon (2013) described as "rational reticence."[4] Funds (via their managers) ordinarily will not generate firm-specific proposals but will evaluate and respond to others' proposals. This explains the success of hedge funds in the current governance ecology in the United States. Hedge funds have a different business model, based on absolute returns: They seek out companies where they perceive strategic or operational shortfalls and invest heavily in research and organizational efforts to persuade institutional shareholders (and their advisors) of the value of a different approach. Active managers are called upon to adjudicate such disputes on the shareholder value "merits." In making such decisions, active managers can evaluate not only the current activist proposal but also the track record of the particular activist in creating sustainable gains, its "reputation."[5] In this way hedge fund activists act as kind of governance intermediary, performing a complementary role in light of the current ownership pattern. Thus active managers can realize the value of research that reveals problems at a particular portfolio company by holding in anticipation of an activist intervention (perhaps even nudging an activist) as well as by selling. From a corporate governance perspective this is an improvement, since the active manager can employ both this intermediated voice as well as exit.

This interaction between active managers and activist shareholders in specific contests produces portfolio effects as well, through "governance externalities." Managers and their advisors observe the pattern of activist success (which channels shareholder views) and integrate the lessons into their strategic and operational decision-making. Thus the main impact of hedge fund activism is not through the particular

[3] John D. Morley, Too Big to Be Activist, 92 USC L. Rev. 1407 (2019).
[4] Gilson & Gordon (2103), supra.
[5] For empirical confirmation of the value of reputation, see Travis L. Johnson & Nathan Swem, Reputation and Investor Activism: A Structural Approach (Journal of Financial Economics forthcoming 2020).

encounters that attract attention, but through the own-firm action of managers who are eager to avoid becoming an activist target. [6]

The form of shareholder "voice" that has arisen from the interaction between hedge funds/other shareholder activists and the active asset managers has not received universal acclaim, to put the point mildly.[7] The two core objections are that this style of corporate governance is (i) short-termist, sacrificing long term shareholder interests for immediate payoffs and/or (ii) excessively focused on shareholder interests, to the detriment of other stakeholders. The objectors frequently hold onto the forlorn hope that the conflicts *among* stakeholders and the time-varying conflicts *between* shareholders and (some of) the stakeholders can be resolved if only planning looked to the long term.

"Stewardship" has been offered up as an alternative to the kind of voice that would emerge solely from the rational self-interested behavior of asset managers and institutional investors. "Stewardship" in its simplest form calls on asset managers and other institutional investors to exercise their rights as shareholders, their voice, on a firm-by-firm basis, even when the strictly rational approach might be to minimize, even avoid altogether, the administrative costs of shareholder voting. At least on the Anglo-American model stewardship can also be understood as an effort to use "soft law" to take into account a broad set of governance and social concerns, to fulfill in some way the better governance-through-engagement aspiration associated with institutional ownership.[8]

B. Shareholder voice: The rise of broadly-diversified passively managed funds

The previous section argued that the business model of most active asset managers pointed towards a muted form of shareholder voice, most strongly expressed through interaction with hedge fund activists. "Stewardship" is an effort to channel the firm-specific knowledge that implicitly goes into portfolio composition by active managers into a more robust form of voice. If you know enough to own the shares,

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[6] See, e.g., Shane Goodwin, Management Practice in an Age of Engaged Investors, Col. Busn School R.P. No. 17-97 (Sept. 2017, available at https://ssrn.com/abstract=3045411 (developing a proprietary Vulnerability Score for use by managers seeking to avoid becoming an activist target).

[7] See, e.g., Leo Strine, Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and our Strange Corporate Governance System, 126 Yale L. J. 1870 (2017); John C. Coffee, Jr. & Darius Palia, The Wolf at The Door: The Impact of Hedge Fund Activism on Corporate Governance, 1 Annals of Crop. Governance 1 (2016).

[8] This is illustrated by the evolution of the UK Stewardship Code from its initial promulgation in 2010, calling for institutional "engagement" with individual companies, to the 2020 version, including a particular activities within the stewardship responsibilities of institutional investors, most notably directing attention to "material environmental, social, and governance issues and climate change" and other market wide factors. See Paul Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, in GLOBAL SHAREHOLDER STEWARDSHIP: COMPLEXITIES, CHALLENGES AND POSSIBILITIES 4-22 (Dionysia Katelouzou & Dan W. Puchniak eds., Cambridge Univ. Press, forthcoming), working paper version available at https://ssrn.com/abstract=3553493

For a typology of stewardship that identifies four distinct "stewardship supportive regulatory measures" across 14 countries, see Mark Fenwick and Erik P.M. Vermeulen, How to Create a 'Stewardship Culture'", TILEC Discussion Paper February 2018, available on SSRN at https://ssrn.com/abstract=3098235. Also see Dionysia Katelouzou & Konstantinos Sergakis, Shareholder Stewardship Enforcement, ECGI W.P. (May 2020), available at http://ssrn.com/abstract_id=3564266.

you should know enough to engage with management in a constructive way and vote the shares, seems the theory. But this call for active asset manager "voice" has run into a serious issue: an increasing disbelief in the capacity of most active managers to outperform the market, which in turn led to a massive outflow from actively managed funds to passive funds structured to mimic market returns with lowest possible fees.

The rise of institutional investors in the 1980s and 1990s coincided with increasingly strong evidence that few active managers of public securities portfolios could consistently deliver net-of-fees superior returns. The "efficient market hypothesis" gained the status of received wisdom, at least in the variant that asserted that public stock markets are so quick and thorough at digesting new information that traders earn at best only a normal rate of return. An active investor with a record of success was quickly deluged with funds that washed out any niche investing acumen. So-called quants could seemingly deliver "alpha" through arcane strategies that plumbed pricing patterns for fleeting arbitrage opportunities, scooping pennies in front the bulldozer, but there was no investment thesis in their activities.

The belief in stocks but not stock-pickers led to the rise of passive investment vehicles, in particular broad-based index funds. These follow two prescriptions drawn from modern portfolio theory. The investor has only two sure-fire ways to achieve optimal investment performance in a securities portfolio, meaning, the best risk-adjusted returns: minimize fees (to increase expected returns); diversify maximally (because the investor is compensated only for bearing risk that cannot be eliminated through diversification). Broad-based index mutual funds and ETFs have been a roaring success. Assets under management in such funds sponsored by BlackRock, Vanguard, State Street, and Fidelity now account for approximately 20% of the market capitalization of US public companies.[9]

The structure of broad-based index funds has generated certain anomalies in the governance debate. On the one hand, index funds, passive not active by design, are the ultimate "buy and hold" investor, so, one might think, if "exit" is not an option, such funds are leading candidates for "voice." Yet their core business model is simply to offer the market return at lowest cost. Investment in firm-specific engagement will not benefit the fund or generally its beneficial owners. As to the fund, remembering the relative performance model: Serious engagement is costly, yet any benefits will be necessarily be shared with all other funds following the same index. A passive fund, unlike an active fund, cannot benefit through overweighting or underweighting portfolio positions in light of firm-specific interventions. Moreover, the portfolios of index funds are formed without *any* firm-specific securities research, meaning: without a substantive basis for the exercise of voice. Engagement is not only inconsistent with an index fund's business model; it is purely a bolt on.[10]

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[9] *See* Matthew Backus, Christopher Conlon, Michael Sinkinson, *Common Ownership in America: 1980-2017*, NBER Working Paper 25454 (2019), *available at* https://www.nber.org/papers/w25454.pdf, at 17. AEJ: Micro, forthcoming.
"Index funds" can be created to mimic returns on market segments, not just the broad-based market measures such as the S&P 500 or CRSP U.S. Total Market. The AUM of the funds indexed to broad-based market measures dominate the targeted indexers. See Adriana Z. Robertson, Passive in Name Only: Delegated Management and "Index" Investing, 26 Yale J. Reg. 795 (2019) (Table 2). This article particularly addresses the broad-based funds.

[10] This functional indifference has led some scholars to propose that passive funds should lose their votes or would gladly buy shares without votes, compare Dorothy S. Lund, The Case Against Passive Shareholder Voting, 43 J. Corp. L 101 (2018) with Dorothy S. Lund, Non-Voting Shares and Efficient Corporate

As to the beneficial owners: by construction, a broad-based index fund will diminish, perhaps eliminate, idiosyncratic risk. A performance change in a company is the kind of idiosyncratic element that broad-based diversification is designed to suppress. Performance improvements by Company A in a business sector is likely to come at the expense of another company in broadly-diversified index, not result in an absolute increase in the value of the portfolio.

In thinking about firm-specific performance engagement, it's valuable to think about comparative advantage. As observed previously, hedge funds and other shareholder activists have made a business of identifying underperforming companies, generating an alternative strategy, and undertaking the organizational work to mobilize other shareholders. The activists make concentrated investments in particular companies and receive concentrated returns in proportion to gains. This obviously gives the activist stronger incentives to get it right than a passive index fund manager who may make a diversified set of engagement decisions. If the activists will pursue under-performers, why isn't the optimal index fund manager strategy to free ride? Or, at most, to engage in the "rational reticence" strategy of active investors, that is, evaluate specific engagement cases teed up buy the activists.[11] What is the evidence for an undersupply of shareholder activists that ought to motivate additional initiatives by notionally passive investors?[12] Moreover, the "undersupply" hypothesis needs to take account of the governance externalities associated with the current level of activism. To avoid becoming an activism target, managers often engage

Governance, 71 Stan. L. Rev. 687 (2019. Others claim that since passive funds generally are sponsored by asset managers that include active funds in the family, the actives can guide informed choices by the passives whose votes will add clout. Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, The New Titans of Wall Street: A Theoretical Framework for Passive Investors, 168 U. Pa. L. Rev 17, 42-43 (220). This doesn't deal with might be called the "Vanguard" problem – a fund family consisting almost exclusively of passive index funds; or the BlackRock counter-example: in response to investor demand, shifting resources away from active funds (laying off portfolio managers, ideally situated to exercise voice) in favor of quantitative funds.

This functional indifference has also led some to insist that index funds should face carrots and sticks to take a more assertive governance role, carrots in the regulatory permission to charge a certain level of firm-specific engagement expenses directly to the fund; sticks, in a requirement to do so. See Lucian Bebchuk & Scott Hirst, Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy, 119 Colum. L. Rev. 2029 (2019).

[11] Indeed, the presence of passive shareholders seem to incline activists to pursue a director-replacement strategy that is consist with the passives' interest in improving director quality generally as a way of improving portfolio performance. See Ian R. Appel, Todd A. Gormley & Donald B. Keim, Standing on the Shoulders of Giants:The Effects of Passive Investors on Activism, 32 Rev. Fin. Stud. 2720 (2019)

[12] Lund draws the analogy to the way that stock markets can remain informationally efficient even if only some investors engage in securities research and trading and that positive returns will be sufficiently likely to motivate an adequate level of such activity. Dorothy S. Lund, Passive Investing and Corporate Governance: A Law and Economics Analysis, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3623381 (referencing Sanford J. Grossman . & Joseph E. Stiglitz, , On the Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 3939 (1980)).

in self-scrutiny and follow-on action. Yet some object that this already leads too many companies to focus on too narrowly on shareholder value.[13]

Some have argued that the very size of index fund positions give fund managers incentives to make substantial firm-specific engagement investments.[14] Apple, for example, carries a market capitalization of $2 trillion dollars. An intervention that produces a 5% increase in value for a fund holding 5% of Apple's stock results in a gain for the fund of $5 billion; assume the fund earns a management fee of 10 basis points, 0.1% (on the high side these days), so the manager earns additional fees of $5 million, annually, assuming that the gains are sustained; if capitalized at current stock price multiples, maybe $100 million! Surely that potential gain is sufficient to evoke some useful performance-based engagement. To state the hypothetical is to show how unrealistic, since we don't observe behavior that this example suggests would be rational by economically motivated parties.[15]

There are two key points. The first is that the nature of diversification means that firm specific gains do not translate into portfolio gains. Perhaps some of Apple's gains will come from market share or profits captured from private market companies that are not reflected in a public market index; or perhaps from small companies in the Russell 3000 not in the S&P 500. Nevertheless the overwhelming fraction of any such gains will be at the expense of other large public players, Google/Android and Microsoft/Surface, just because of the magnitudes; in short, idiosyncratic. From a portfolio perspective, at best such engagements would add to the general performance pressure already associated with the current level of shareholder activism, the governance externalities already abundantly supplied. Nor does the size of the index fund investment in specific large capitalization stocks give such funds a unique opportunity to pursue performance improvements in such firms, a narrow version of the undersupply hypothesis. Activist engagements have taken on the biggest firms; size is no protection.[16]

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[13] Some may claim that hedge fund activism leaves a significant margin of managerial agency costs unaddressed. This seems to be the premise of Bebchuk & Hirst, supra note --. On average hedge fund activism is associated with a 7 percent increase in the target's stock price, and the hedge fund's profit typically comes from appreciation on equity positions obtained before announcement of the activist intervention. Thus hedge fund activism places a cap on "managerial slack" (seen from a shareholder perspective) of this 7 percent. Thus there is a margin of managerial agency costs that theoretically could be addressed through firm specific engagements. Let us put aside both the objections of incentive incompatibility for passive diversified investors and the fact that such firm-specific interventions are likely to be idiosyncratic only. Fact is, our "science" of corporate governance is hardly refined enough to what interventions will create own-firm value, without deep engagement with firm specific features. Thus, as argued in the introduction, firm-specific engagement should focus on issues that resonate on the systematic dimension, because of the portfolio-return implications and because of the unique interests of the fully-diversified fund.

[14] Edward Rock & Marcel Kahan, Index Funds and Corporate Governance: Let Shareholders be Shareholders, 2018 (ssrn.com/abstract=3295098).

[15] Some argue that the fund managers are conflicted out because they more in AUM by increasing the take-up of their fund products and retirement planning services by the companies that might be eventual targets. If so we might see a differential pattern of targeting divided between customer companies and non-customer companies that I don't think the literature has found. The funds also support activists in control contests on a regular basis, including behind the scenes, even if a majority of public votes favor management.

[16] Eg, Icahn, Apple; Jana Partners, Apple; Trian, du Pont. See Wachtell, Lipton, Risen & Katz, "Dealing with Activist Hedge Funds andOther Activist Investors" (Jan. 17, 2020) ("No company is too large, too

The second key point is that the legal risk taken on by managers of the broad-based fund through such firm-specific performance activism will be prohibitive. By construction, the fund holds shares in every large public company in the tech sector (to continue with the Apple example). In addition to the "fund family" legal risks associated with activism under the federal securities law, by opening a channel of direct influence over companies' operations the fund manager would have created an existential business risk for the fund in light of antitrust concerns stemming from common ownership. Put otherwise, firm specific performance engagement gives away the funds' best defense against the antitrust claim: we have no channel. It cannot serve the interests of the beneficiaries of the funds for the managers to take on existential risk to this desirable investment vehicle for sustained firm-specific engagement activity that will have such unlikely connection to beneficiary welfare.

C. Shareholder voice: Towards Systematic Stewardship

As a matter of current policy most index funds focus their corporate governance activities on portfolio-wide guidelines that comport with a normative idea of "best practice" corporate governance. Presumably the asset managers believe that such governance measures will increase, on average, expected returns across the portfolio.[17] There may be prudential considerations. The SEC requires mutual funds to disclose their shareholder votes.[18] Precisely to avoid vote-stripping and other regulatory interventions, index funds want to look like usual shareholders in exercising their governance rights but also want to conserve on such costs. This strongly inclines them to voting guidelines formulated in interaction with proxy advisors.[19] In general such guideline positions are chosen to enhance the latent power of shareholders, including resistance to classified boards, annual advisory say-on-pay votes, preference for single class common stock, and endorsement of a majority vote for director election.[20] Firm specific engagements tend to focus on the quality of directors, as part of portfolio-wide strategy to sustain and improve the quality of boards.[21] In a majority of activist challenges, index funds favor managements against activist challenges, though votes in favor of an activist director are not uncommon.[22] Indeed, the presence of passive shareholders seem to incline activists to a campaign for board seats rather than an immediate

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popular, too new or too successful" to "consider itself immune from hedge fund activism"), available at https://corpgov.law.harvard.edu/2020/01/20/dealing-with-activist-hedge-funds-and-other-activist-investors-3/.

[17] For positive evidence on this proposition, see Fatima-Zahra Filali Adib, Passive Aggressive: How Index Funds Vote on Corporate Governance Proposals, available at: https://ssrn.com/abstract=3480484.

[18] See SEC, Proxy Voting by Investment Advisers, Release No. IA-2106 (Jan. 31, 2003); 17 CFR 275.206(4)-6. Mutual fund votes are filed on Form N-PX.

[19] See Giovanni Strampelli, Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing, 55 San Diego L. Rev. 803, 816-826 (2018).

[20] See Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. Fin. Econ. 111, 114 (2016) (increased ownership by passives is associated with more independent directors, elimination of takeover defenses, more single class common).

[21] BlackRock.

[22] See See Giovanni Strampelli, Are Passive Funds Active Owners? Corporate Gvoernance Conequences of Passive Investing, 55 San Diego L. Rev. 803, 827-830 (2019).

strategy change.[23] This is consistent with the view in Gilson & Gordon (2019, 2020) that institutional investors understand the limitations of the present board model, are inclined to support management if they are sufficiently confident in the current directors, and believe (and hope) that willingness to reject weak directors will have portfolio-wide effects on director quality, yet another governance externality.[24]

"Systematic stewardship" is another portfolio approach but importantly difference: focusing not on increasing expected returns across the portfolio but reducing systematic risk and in this way improving risk-adjusted portfolio returns. Actually the current stewardship movement began with an intuition about the need for institutional investors to assert their governance rights to reduce systematic risks. Adoption of the UK Stewardship Code came in the wake of the 2007-09 Global Financial Crisis. In a post-crisis assessment the Walker Committee concluded that one of the crisis causes had been a corporate governance defect, namely, the failure of institutional investors to rein-in excessive risk-taking by the largest banks and other large financial firms,[25] and the subsequently promulgated Stewardship Code called for such institutional investor engagement.[26] However, the Stewardship Code and the subsequent discussion did not sufficiently attend to the distinctive reason that institutional investors should focus on such firm-specific behavior: it was because failure of a systemically important financial firm was not just a firm-specific problem but rather would produce losses across the entire portfolio (across the entire economy). The risk of failure of such a firm was not idiosyncratic. It was not diversifiable. The risk of a systemic shock was "systematic." To produce the optimal risk-adjusted returns to investors, a widely diversified institutional investor should have attended to this risk and tried to mitigate it.[27] The foremost stewardship mission of a diversified institutional investor or an asset manager was to mitigate and avert such risk realizations.

This distinctive case for "systematic stewardship" has been lost in the ensuing discussion, although a glimmer of it has emerged in the 2020 UK Stewardship Code, which begins to frame "ESG" analysis by institutions in this way, albeit through a glass darkly.[28] It is not just a systematic stewardship *duty* that

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[23] See Ian R. Appel, Todd A. Gormley & Donald B. Keim, Standing on the Shoulders of Giants:The Effects of Passive Investors on Activism, 32 Rev. Fin. Stud. 2720 (2019).

[24] Some argue that the current willingness of index funds to vote in favor of ESG issues is a marketing strategy based on the social tastes of millennial investors. See Michal Barzuza, Quinn Curtis & David F. Webber, Shareholder Values(s): Index Fund ESG Activism and the New Millennial Corporate Governance (forthcoming 2020-21 USC L. Rev). To the contrary I think index investors are acting from motives that I would associate with systematic stewardship. First, on the promotion of gender diversity on corporate boards, advanced particularly by State Street Global Investors (SSGI), is consistent with a portfolio-wide increased expected return strategy: appelenlisting a new source of talent to serve on boards should produce better performance

[25] David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities. Final Recommendations* 24 (Nov. 26, 2009), https://ecgi.global/sites/default/files/codes/documents/walker_eview_261109.pdf.

[26] UK STEWARDSHIP CODE, FIN. REPORTING COUNCIL (2010), https://www.frc.org.uk/getattachment/e223e152-5515-4cdc-a951-da33e093eb28/UK-Stewardship-Code-July-2010.pdf.

[27] See John Armour & Jeffrey Gordon, Systemic Harms and Shareholder Value, 6 Journal of Legal Analysis 35 (2014).

[28] UK STEWARDSHIP CODE, FIN. REPORTING COUNCIL (2020), https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf .

should evoke such behavior (soft law) but rather: a focus on systematic risk mitigation is rational for asset managers. A systemic shock, a realization of systematic risk, will abruptly reduce AUM and thus reduce the fee-based revenues and managers' profits, even if on a relative performance basis the particular manager is no worse than others. That's a crucial distinction from firm-specific engagement generally. Precisely because any performance improvement is idiosyncratic, the portfolio value will not increase. The invocation of "stewardship" in that context is at best a soft law cudgel to coerce a largely unwilling actor to perform. "Systematic stewardship" calls on the manager to take steps that could lower the undiversifiable portfolio risks and thus improve beneficiary welfare, and, if successful, will reduce the likelihood of events that could abruptly shrink portfolio values and thus reduce manager profits.

Put otherwise, managers of a broad-based index fund should specialize in understanding the systematic risks that threaten the value of their portfolio, both in the persistent risk that cannot be diversified away and those risks whose realization could bring an immediate decline in portfolio values. This will be expressed both in "guideline" style strategies that operate across the portfolio as whole and in firm-specific engagements. Systematic stewardship both fits the economic interests of the fund's beneficiaries and looks to the comparative advantage of managers of such fully-diversified funds in developing a portfolio approach. Put otherwise, the low fee/broad-based index fund model constrains the capacity that such funds (their managers) will have for engagement. The work of addressing firm-specific performance issues can be addressed by other actors, including most notably the hedge fund activists in their interaction with institutional investors. Broad-based index fund managers have special reasons to think about the performance of the portfolio as a whole, in particular, the systematic risk dimension, and should devote their constrained resources accordingly.

Part II: Systematic Risk: Theory and Candidates

This part sketches out the parameters of "systematic risk" that ought to be within the province of systematic stewardship. Many "systematic" elements that figure in the cross-section of returns in contemporary asset pricing models -- systematic in the sense of explaining the co-movement of stocks – would not be suitable targets. But elements that ramify throughout the market portfolio, because they affect the overall economy, would be potentially suitable. In particular, *systemic* risk factors are particularly important because their potential for sudden adverse realizations produces the risk of abrupt price declines throughout the portfolio and in consequence will generate a negative overhang on portfolio values generally. Avoidance or mitigation of these risks, systemic risks-as-systematic, would surely improve risk-adjusted returns. This analysis provides a basis for analyzing "ESG" proposals within a framework that is consistent with an asset manager's primary duty to investor welfare rather than a difficult to manage and defend trade-off of investor welfare for socially desirable ends.[29] To be sure, there may be quantification issues in assessing the welfare effects of a potential trade off of lower expected

[29] To be clear, an investment vehicle that discloses that it will be guided in its investment and/or corporate governance activities by ESG principles is not subject to the same investor welfare objectives as a general purpose fund such as a plain vanilla index fund.

returns for reduced systematic risk, but specifying and calibrating the necessary models is within the competence of asset managers.

Many elements of social policy can be said to have economy-wide effects and will be likely to improve expected returns across the portfolio. For example, investments in education and infrastructure historically have been associated with substantial economic gains. But these investment typically reflect choices made by government actors, not portfolio companies, nor do they reflect systematic *risk* factors of the kind that an asset manager of a conventional financial product is readily in a position to evaluate. On the other hand, regulatory interventions that directly bear on systemic risk-taking by portfolio companies could well be within the asset manager's domain because of the foreseeable impact on portfolio values.

1. The Nature of Systematic Risk

The central argument on behalf of "systematic stewardship" is that managers of a broadly-diversified investment vehicle would improve the portfolio's risk-adjusted returns (and thus improve the welfare of their beneficiaries) through mitigating systematic risk. This effort can be operationalized within the existing framework of asset pricing, which has paid increasing attention to systematic risk. The initial operationalization of portfolio theory focused only single factor associated with stock price co-movement, returns on the market index. Contemporary asset pricing models decompose that "systematic risk" into various other factors that explain systematic return variation. Nevertheless these models generally retain an irreducible level of "market risk" that becomes a target for systematic stewardship.

"Systematic risk" falls out naturally from the simplest account of portfolio theory: it's the risk that cannot be diversified away from a fully-diversified portfolio of securities. It's also axiomatic that in a competitive securities market environment investors are compensated only for bearing such risk. Decades of work in financial economics have attempted to drill down on the nature of systematic risk and, in particular, how to analyze whether a particular security is accurately priced in light of its susceptibility to systematic risk. The effort to more particularly describe systematic risk might be said to vary between "structural" approaches (meaning: based on a model about how the firm should perform conditional on changes in the real economy) and "statistical" approaches (meaning: what factors have significant explanatory power in a data mining exercise); sometimes the statistically relevant factors have an economically meaningful interpretation.

The initial translation of portfolio theory into an asset pricing model, the Capital Asset Pricing Model, assessed overall market variance, presumably stemming from shocks or other phenomena that broadly affected the real economy, as a singular factor. The famous "beta" variable measured a stock's performance vis-a-via changes to the market index. Subsequent asset

pricing models based on arbitrage pricing theory[30] have decomposed systematic risk into a series of factors that account for the co-movement of stocks of particular characteristics. The Fama-French model in its various versions includes factors that take account of firm size and firm value (proxied by book-to-market) but always includes excess return on the market, meaning the return on the market index minus the risk free rate.[31] For a particular firm, these factors can be time-varying. Various empirical analyses have produced a proliferation of purported systematic elements, notorious as "the factor zoo."[32] The empirical technology employed to identify these factors and weight them properly especially in high frequency trading era has become advanced.[33]

Another approach to explaining at least some systematic influences on returns is to look at the influence of "rare disasters."[34] Any particular "disaster" is a black swan, but as seen as a class, "rare" disasters are foreseeable. Indeed, parallel to the development of asset pricing models has been a growing appreciation that the risk of "rare disasters" exerts a pervasive influence over market pricing, perhaps explaining all or part of the "equity premium puzzle," the unexplained excess returns of a diversified stock portfolio over the risk free asset, US Treasury bills[35]; at minimum, these "tail risks" have a strong effect on asset prices.[36] This "rare disasters" analysis fits the experience of the breakout of "systemic risk" commonly associated with financial sector

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[30] Stephen A. Ross, The Arbitrage Theory of Capital Asset Pricing, 13 J. Econ. Theory 341 (1976); Richard Roll & Stephen A. Ross, An Empirical Investigation of the Arbitrage Pricing Theory, 35 J. Fin. 1073 (1980).

[31] See Eugene Fama & Kenneth French, Common Factors in the Returns on Stocks and Bonds, 33 J. Fin. Econ. 3 (1993) The Carhart variant adds a firm's stock price "momentum" to the Fama-French factors. Mark Carhart, On Persistence in Mutual Fund Performance, 52 J. Fin. 57 (1997). Fama and French have recently derived a revised set of five factors that they regard as having more explanatory power, ie, fit the data better. Eugene Fama & Kenneth French, A Five-Factor Asset-Pricing Model, 116 J. Fin. Econ. 1 (2015).

[32] Guanhao Feng, Stefano Giglio, Dacheng Xiu, Taming the Factor Zoo: A Test of New Factors, 75 J. Fin 1327 (2020)

[33] See, e.g., Markus Pelger, Understanding Systematic Risk: A High Frequency Approach, 75 J. Fin.2179 (2020).

[34] Robert J. Barro, Rare Disasters and Asset Markets in the Twentieth Century, 121(3) Q.J. Econ. 823 (2006); Robert J. Barro & Gordon Liao, Tractable Rare Disaster Probability and Options-Pricing, WP (2019; Thomas A. Rietz, The Equity Risk Premium: A Soiution, 22 J. Monetary Econ. 117 (1988).

[35] Rajnish Mehra & Edward C. Prescott, The Equity Premium: A Puzzle, 15 J. Monetary Econ. 145 (1985). The extent to which "rare disasters" resolve the equity premium puzzle is of course disputed and the "puzzle" is still open. Nevertheless it seems certainly the case that the prospect of extreme shocks – which repetitively recur albeit in different ways – is indeed a systematic risk factor. Given the state of asset pricing models, it's part of the black box of influences that bear on the "excess returns" associated with the market index.

[36] The effort to quantify the return effects of extreme downside risk has been the subject of several recent papers. See, e.g., Brian Kelly & Hao Jiang, Tail Risk and Asset Prices, 27 Rev. Fin Studies 2841 (2014). Brian Weller, Measuring Tail Risks at High Frequency, 32 Rev. Fin Stud. 3571 (2019); Sofiane Aboura & Y. Eser Arisoy, Can Tail Risk Explain Size, Book-to-Market, Momentum, and Idiosyncratic Volatility Anomalies? 46 J. Business Fin. & Acctg 1263 (2019); Turan G. Bali & Hao Zhou, Risk, Uncertainty, and Expected Returns, 61 J. Fin. & Quant. Analysis 707 (2016); Marteen van Oordt & Chen Zhou, Systematic Tail Risk, 51 J. Fin. & Quant. Analysis 685 (2016)

distress: the kind of risk that can lead to a sudden collapse in stock prices because of a pervasive negative impact on the real economy that threatens the profitability, even viability, of many firms. This systemic risk-as-systematic risk overhangs stock market prices generally and of course a realization of this risk would produce a dramatic decline in stock prices. Systematic stewardship consists in the effort of managers to reduce these risks.

This Part II now turns to candidate risks for targeting by institutional investors and asset managers within the framework of systematic stewardship. Part III surveys the kinds of actions that such actors might pursue as systematic stewards.

2. Candidate Systematic Risks for Systematic Stewardship

i. *Climate change risk*. A particularly strong candidate for systematic stewardship is the risk associated with climate change associated with increasing levels of atmospheric CO_2. Diverse analysts describe first order economic effects associated with the resulting temperature rises.[37] A 2017 report in *Science*, for example, estimates a loss of 1.2% of GDP for each degree centigrade rise; without intervention, analysts predict up to a 4 degree increase; the GDP impact would exceed the recession associated with the Great Financial Crisis.[38] Other analysts predict even starker outcomes, with an impact that would rival the massive impact of the SARS-CoV-2 pandemic.[39] The World Economic Forum's 2020 Global Risk Report put climate change at the top of the risk list.[40]

There are multiple channels through which massive economic harms could result from unmitigated climate change risk. There is of course the physical damage from extreme weather events; damage from rising sea levels; agricultural losses from lost arability, and all the disruptions that would result from these physical manifestations. Postponement of firm-specific adaptations necessary to eliminate CO_2 emissions and reverse atmospheric CO_2 would only increase the

[37] These are canvassed in Madison Condon, Externalities and the Common Owner, 95 Washington L. Rev. 1, 43-48 (2020)

[38] Solomon Hsiang et al., Estimating Economic Damage From Climate Change in the United States, 356 Science 1362 (2017). Also see Peter H. Howard & Thomas Sterner, Few and Not So Far Between: A Meta-Analysis of Climate Damage Estimates, 68 Envtl & Resource Econ 197 (2017) (Approximately 10% GDP loss from predictable temperature rises). Schroders Climate Dashboard Points to Four Degree Rise - Despite Increase in Carbon Prices, Schroders (Oct. 19, 2018), https://www.schroders.com/en/au/institutions/insights/investmentinsights/schroders-climate-dashboard-points-to-four-degree-rise—despite-increase-in-carbon-prices/ [https://perma.cc/NE73-78JJ] (permanent damage 3 to 4 times that of the GFC; NCA (National Climate Assessment). 2018. Fourth National Climate Assessment. Volume II: Impacts, Risks, and Adaptation in the United States. NCA. https://nca2018.globalchange.gov/ (10% GDP loss).

[39] Tom Kompas, Pham Van Ha & Tuong Nhu Che, The Effects of Climate Change on GDP by Country and the Global Economic Gains From Complying With the Paris Climate Accord, 6 Earth's Future 1153 (2018);

[40] World Economic Forum, The Global Risk Report 2020, available at http://www3.weforum.org/docs/WEF_Global_Risk_Report_2020.pdf.

eventual transition costs; the "stranded assets" would pile up. Another channel is the threat to financial stability that has led many central bankers to focus on climate change.[41] Profs. Conti-Brown and Wishnick describes the systemic threat as first, the risk that a particular climate shock would produce a "rising tide of debtor defaults" that would bring down significant banks, and second, more generally, the risk of "a global, correlated set of threats to our current forms of economic production."[42]

Climate change risk is thus a worthy target for systematic stewardship not just because its impacts may produce sharp declines in GDP and thus losses across a diversified securities portfolio but also because its manifestations will be unpredictable, like the weather. Many of the climate-change affected systems are non-linear, the ocean currents, the movement of Greenland's glaciers and the Antarctic ice shelf, for example, all candidates for a "rare disaster." Climate change risk systematically overhangs a fully diversified portfolio, reducing risk-adjusted returns.

ii.. Financial stability risk. The Great Financial Crisis demonstrated the systematic impact of the distress of systemically important financial institution. Looked at solely from the prospective of stock market participants, the consequence was a dramatic loss to holders of the market portfolio. The S&P 500 experienced a peak-to-trough loss of 57% over the October 2007 to March 2009 period,[43] overall stock market losses of nearly $8 trillion. This was associated with a comparable loss in GDP of 4.3% over the period and resulted in the longest post-War II recession. A break down in financial stability rapidly rolls into the real economy because of the disruption in credit provision; the uncertain solvency of many financial firms means that many parties will "run" on such firms generally. These runs will produce a further contraction in credit availability, both because solvent firms will refrain from additional lending to hoard cash and because insolvent firms will simply collapse.

The Great Financial Crisis of course had many causes but a critical feature was the balance sheet fragility of many large publicly traded financial firms and the risk-taking that was incentivized by option-heavy executive compensation. Senior managers felt pressure to pursue aggressive strategies to enhance return-on-equity and other quantitative measures of shareholder advancement irrespective of the consequent build-up of systemic risk. Financial firm managers

[41] See Open Letter on Climate-related Financial Risks (Mark Carney, Governor, Bank of England et al) (April 17, 2019) (describing work of Network for Greening the Financial System, 66 central banks and supervisors), https://www.bankofengland.co.uk/news/2019/april/open-letter-on-climate-related-financial-risks. See NGFS Climate Scenarios for Central Banks and Supervisors (June 2020), available at https://www.ngfs.net/sites/default/files/medias/documents/820184_ngfs_scenarios_final_version_v6.pdf

[42] Peter Conti-Brown & David Wishnick, Technocratic Pragmatism, Bureaucratic Expertisae, and the Federal Reserve (forthcoming 2020 Yale Law Journal). Also see Seraina Grunewald, Climate Change as Systemic Risk – Are Macroprudential Authorities Up to the Task?, Eur. Banking Inst WP 2020-62 (April 2020).

[43] The high was October 9, 2007, 1565; the low was 677. The Dow Jones and Nasdaq indices experienced comparable declines.

seemed to be unheeding of the risks to financial stability. "When the music plays, you dance." Precisely because of the widespread portfolio losses associated with a financial crisis, financial stability is an appropriate target for systematic stewardship.[44] Financial distress produces losses across the full economy and thus a diversified portfolio; the risk of an outbreak of financial distress is a systematic overhang for portfolio values generally. Systematic stewardship brings a distinct perspective to the behavior of systemically important financial firms, realizing that the traditional corporate governance pressure for own-firm maximization does not give due weight to the systematic costs.[45]

iii. Social stability risk

The US corporate governance system is set up for firms to be highly responsive to changes in the economic environment but in a way that results in the imposition of the adjustment costs of economic change on various stakeholders, in particular the employees. The structure of share ownership – the reconcentration into diversified investment vehicles -- has produced pressures and incentives that have diminished the capacity of firms to provide stakeholder insurance against such adjustment costs. In turn the outward shift of adjustment costs have made it easier for firms to respond to and anticipate changes in the economic environment, producing a change in the rate of change. The consequence is a heightening sense of social instability, not just though the dislocation in careers and life circumstances but in a growing sense that the set-up produces an unacceptable distribution of gains. For a diversified portfolio investor, the potential backlash is a systematic risk, because the consequence could be changes that would impose losses across the entire portfolio. Measures that reduce this systematic risk would improve risk-adjusted returns. Breakdowns in financial stability that produce sharp declines in employment and other elements of social well-being also produce heighten risks of social instability, an additional reason why a systematic steward should particularly care about financial stability from a portfolio investor point of view.

The moving parts of this argument need some elaboration. The intuition behind diversification is an ancient one: it's generally best for an investor not to put all his/her eggs in one basket. The insight of modern portfolio theory as applied to investment management is that investors can achieve optimal diversification at the portfolio level rather than at the firm level, meaning that the investor can most efficiently eliminate uncompensated idiosyncratic risk by holding a portfolio of firms with a narrow focus rather than holding shares in firms that themselves pursue diverse business segments in the name of diversification. That has several implications. First, investors are risk neutral with respect to the failure of any particular firm in the portfolio

[45] For further development of the differences in optimal corporate governance for financial firms vs. non-financial firms, see John Armour & Jeffrey Gordon, Systemic Harms and Shareholder Value, 6 Journal of Legal Analysis 35 (2014); Jeffrey Gordon, Corporate Governance and Executive Compensation in Financial Firms: the Case for Convertible Equity-Based Pay, 2012 Colum. Bus. L. Rev. 834.

(except for the limited group whose failure would have systemic implications). This means investors would support firms/management teams that took the highest net present value business risks, even if failure was a possible outcome, because this the way to increase expected returns of the portfolio without increasing the systematic risk. Managers (and creditors) are compensated for this additional risk-taking through stock-based compensation, but employees rarely are.

Moreover, investors who are diversified at the portfolio level want managers to keep a tight control of diversification at the firm level. "Related diversification" that produces synergies and complementarities within the firm is acceptable; "unrelated diversification" as in a conglomerate firm is disfavored because managerial capacity is commonly over-stretched. As the firm cuts back on diversification, it faces greater exposure to business risk. A diversified firm can shift profits from one prospering segment to another facing severe losses, socializing losses at the firm level. A focused firm loses this cushion and thus is more likely to fail. As noted above, managers are compensated for this extra risk through stock-based pay, a share of the upside, but employees, who have lost the protection of this within-the-firm safety net, commonly are not. Moreover, facing declining profits, managers in this tightly-focused world are likely preemptively to engage in cost-reduction, further increasing the risk to employees. Even though manager have been compensated ex ante for the extra risk, in the moment of firm-level distress, managers would prefer to save the firm and thus will look to layoffs to achieve cost-reduction.

The final point is to appreciate the role of the reconcentration of share ownership in the hands of institutional investors. As Ron Gilson and I argued some years ago, such investors are "rationally reticent" but not passive. For these purposes it means that they are at least persuadable by activist shareholders as to the existence of target management's strategic or operational shortfalls, which would include diversification that is inefficient by this analysis but also the failure to adapt to changing economic circumstances. Under these arrangements, changes in the economic environment will rapidly be transmitted through capital market signals and the behavior of the relevant market actors to the firm and all of its stakeholders. The firm simply cannot credibly supply life time employment insurance. In a dynamic economic environment the business cycle will be shorter than the career cycle, producing the adjustment costs for employees.

What's important to note is the way that diversified funds, including index funds, are very much part of this economic structure. These funds provide the low cost means for diversification at the portfolio level and play an essential role in the governance structure that results in this risk shift that may disfavor employees. This is not a story that relies on short-termism, but follows simply from the economic logic of portfolio theory, the investment vehicles produced by capital markets, and the kind of governance "voice" potentiated by the resulting ownership structure as energized by the activists. I have elsewhere suggested that the best way to acknowledge and address the consequences are robust forms of social insurance, as a complement to the kind of

capitalism that our ownership structure facilitates.[46] But the point is this: that the heightened adjustment costs are tied to the ownership patterns; the costs, if unaddressed, may well generate a backlash that could have portfolio-wide, or systematic, implications. Social stability risk may well rise to systematic concern for an asset manager determined to provide the best risk-adjusted returns.

Part III – Implementation of Systematic Stewardship

Stewardship calls upon institutional investors and the associated asset managers to "engage" rather than remaining "passive." But in fashioning "engagement," an institutional investor or asset manager faces multiple binary choices that interact to form a multi-dimensional array. These choices seem particularly important: firm-specific vs. portfolio (or subpart of portfolio); corporate governance feature vs. strategic/operational; initiatory vs. responsive; regulation vs. private ordering; own-action vs. trade association. To be more concrete: Engagement by institutional investors these days has depended heavily on guidelines focused on various corporate governance features that are meant to apply across the portfolio. Institutions are prepared to support the guidelines with respect to specific companies through "just vote no" or withhold-vote strategies on matters that issuers must put to shareholders, like director elections or "say on pay." So: with respect to these matters, the institutions' engagement would be described as *initiatory* in adopting *portfolio* guidelines, but *responsive* in enforcement at the *specific firm.*

Hedge fund activism, by contrast, has focused on firm-specific strategic and operational matters rather than governance features, and the mechanism has commonly been through contested director elections. Here the institutions' posture has been *responsive*; they may consider an activist's argument but will not *initiate* a proxy contest. Some have been critical of the institutions' current approach, invoking "stewardship" to call for initiatory firm-specific engagement by institutional investors, even on matters that relate to strategy or operations.[47]

Funds (and the assets managers) have generally been mindful of their status as *portfolio* investors. The guidelines, which describe and prescribe a particular conception of good corporate

[46] Addressing Economic Insecurity: Why Social Insurance Is Better than Corporate Governance Reform (Aug. 20, 2019), available at http://clsbluesky.law.columbia.edu/2019/08/21/addressing-economic-insecurity-why-social-insurance-is-better-than-corporate-governance-reform/; Is Corporate Governance a First Order Cause of the Current Malaise?, 6 J. British Academy (Supp, Iss. 1) ("Reforming Business for the 21st Century") (Dec. 2018).

[47] Eg, Lucian A. Bebchuk & Scott Hirst, Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy, 119 Colum. L. Rev. 2029 (2019); Sean Griffith & Dorothy Lund, A Mission Statement for Mutual Funds in Shareholder Litigation, Univ. of Chicago L. Rev. forthcoming 2020). (Initiating derivative or class action litigation against the firm, officers, and directors).

governance, "normative corporate governance," aim to improve expected returns across the portfolio, even if not ideally fitted to the circumstances of every firm in the portfolio. The guidelines generally call for exposure to shareholder pressure and thus capital market signals, presumably because of the expected returns implications. Guidelines that call for attention to diversity and inclusion at the board level and in the C-suite also make sense on portfolio expected return grounds. High end talent is valuable and scarce; elimination of barriers to its discovery and utilization will create value across a portfolio.[48]

In devising any engagement strategy, the fund and its managers need to take account of first, the cost constraints of its particular business model, which may limit its capacity to do "deep dive" analysis for many firms in the portfolio, and second, prudential limits on its freedom of action in an environment in which corporate managers are likely to push back hard against initiatory actions by large funds on "excessive power" grounds.[49] This has produced a stance of "rational reticence" when it comes to firm-specific engagement on matters that can be expected to affect the performance of the portfolio. An actively-managed fund that is overweight in target stock will surely support a measure that will increase the target's stock price. A fund that is underweight in the target may be ambivalent. It will do less well on an immediate relative performance measure but it may judge the governance externalities of activism to increase performance across the portfolio and see benefits that way. An index fund arguably is indifferent, in that most stock price effects will be idiosyncratic but it too may regard activism as a desirable part of the normative corporate governance model that achieves the best performance across the portfolio.[50]

Systematic stewardship presents a different menu of potential interventions. Of particular value would be uniform disclosure strategies that would enlist the market in the pricing of systematic risk. This would provide market measures of the extent to which specific firms are contributing to systematic risk and therefore pressure at the firm level to reduce that risk, since a priced risk is a drag on the stock price. For example, in the effort to mitigate climate change risk, funds could favor, across the portfolio (or a relevant subsector), robust firm-level disclosure regarding activities that may contribute to climate change risk or regarding the firm's vulnerability

[48] This is a different basis than what some might regard as a problematic belief about inherent gender or racial differences in handling business problems or the challenge of adding new elements in devising the right degree of "diversity" for optimal decision-making.

[49] Of there may well be agency cost as well: many asset managers also provide retirement plan services to large companies and may be loath to challenge managers who have say-so over these arrangements.

[50] Some may argue that index funds particularly benefit from being part of a fund family that includes active funds, because the research capabilities of the active funds guide the index fund's decision-making. Actually the subsidy may go in the other direction. The votes in the index fund add clout to the active fund's judgment about a contested matter. This may be particularly important in a contested m&a scenario, in which the active fund's unbalanced position means it cares about the distribution of gains whereas the index may care only about the maximization of surplus from the transaction.

to regulatory change that could abruptly occur as climate change risks materialize. The information can be put into models that assess the evolution of climate change risk and reveal a specific firm's contribution and exposure.

Think of it this way: A multi-factor asset pricing model like Fama-French still bundles many sources of systematic risk in the residual "market risk" term. Sufficiently robust disclosure about a particular type of firm-specific systematic risk would facilitate the estimation of an additional pricing term that would both reveal the firm's risk exposure and also provide market pressure for firm-level efforts to reduce that particular systematic risk to improve the stock price. Similarly, in pursuit of systematic stewardship, parties should also consider support for the creation of derivatives and a derivatives index based on the returns of firms especially exposed to certain systematic risk, like climate change or financial stability. This would aid in pricing the particular systematic risk and bring additional market pressures to bear for its mitigation.

Systematic stewardship considerations could also play out at the specific firm level, as activists offer shareholder proposals calling for greater own-firm disclosure or a modification in the conduct of business. Or perhaps a climate change activist might offer a short-slate challenge to the incumbent board on behalf directors who might bring a different attitude. Obviously no action by a single firm can make an appreciable dent in climate change risk, but the governance externalities of a successful campaign may lead to a behavioral shift in the sector. To take a different example: In the case of financial stability, the failure of a single firm can ramify broadly, so targeting a single firm in light of its risk-taking would be consistent with a systematic stewardship stance.

One particularly important question is the extent to which institutional investors and asset managers should take an *initiatory* vs. a *responsive* posture with respect to *firm-specific* measures that might mitigate systematic risk. The answer, I think, depends upon first, the existence or not of activist intermediaries who can tee-up a question for resolution by majoritarian institutional owners, and second, the importance of single firm behavior with respect to the systematic risk in question. Gilson & Gordon (2013) argue that with regard to firm-specific performance questions, activist shareholders act as governance intermediaries in a way that permits funds to be *responsive* rather than *initiatory*. The intermediaries have strong economic incentives to identify value-creating propositions for the target firm as seen from the institutional investor perspective. With respect to financial stability this approach will not work. An activist taking a long equity position in a particular financial firm is likely to favor more aggressive risk taking that would produce higher expected returns at the particular firm (and thus a higher stock price), uncaring about a possible increase in systematic risk that, as an undiversified investor, it would not internalize. This is a glaring example of where the "unanimity rule," which holds that at least from a financial perspective all stockholders want the same thing -- to increase the stock price – breaks down. The economic motives of the activist intermediary and the portfolio investor will diverge. This

divergence suggests that institutional investors and asset managers ought to devote more firm-specific (and sector-specific) attention to financial firms precisely because (i) they cannot rely on some of the standard intermediaries and (ii) a single-firm failure can present a systemic threat.[51]

In the case of climate change, the calculus works out in a way that favors *responsive* rather than *initiatory* firm specific actions by large diversified funds and asset managers. First, a host of climate change intermediaries are now emerging to tee-up firm specific initiatives for resolution through shareholder voting. These intermediaries include NGOs and other activist organizations focused on climate change risk, sovereign wealth funds that understand that they must internalize climate change risk, and ESG funds that raise money from investors who themselves care about climate change risk. Although these entities do not have the same economic incentives as activist hedge funds, nevertheless their business models encourage climate change activism. Moreover, they are much less likely to be susceptible to industry threats either because their small size protects them from the charge that they have too much power or because they stand outside the US political threat framework. They are in a much better position than a broadly diversified fund to frame a firm specific climate change proposal, whether pertaining to disclosure or a change in business strategy. Moreover, since climate change risk transcends the actions of any single company, these activist intermediaries are better positioned to organize a campaign across many companies. Thus the funds and the asset managers can play a sufficient role by *responding* to these proposals in light of an assessment of their impact on reducing climate change risk rather than *initiating* their own proposals. In other words the large broadly-diversified funds can take the same stance as with the hedge fund activists: they can count on others to tee-up the proposals that would bear on climate change risk, and then figure out which proposals would in fact create value, that is, would reduce the risk.[52]

Another set of choices relates private ordering vs. regulation. There are now several private and quasi-governmental organizations that are trying to create uniform disclosure standards on climate change risk and various "sustainability" and other ESG metrics that could be said to engage with matters of systematic concern. Under the aegis of the Financial Stability Board, a Task Force on Climate-Related Financial Disclosures has produced a set of "voluntary, consistent climate-related financial risk disclosures" for use by companies "in providing information to investors,

[51] The Great Financial Crisis showed that portfolio investors cannot rely on the regulators to protect financial stability. Sources of systemic risk may arise from financial firms outside of the official banking sector where the regulators are most focused and clientelist pressures at the various (and competing) national and state regulatory bodies may lead regulators to underplay the build-up of systemic threats.

[52] The fund/the asset manager may well bring a different presumption to the climate change risk mitigation proposal of the climate change activist than the performance-enhancing proposal of the shareholder activist. The latter entails a judgment that the activist has the better of an argument with management, which also is focused on firm-specific performance. By contrast, management probably is not focusing on reducing systematic risk.

lenders, insurers, and other stakeholders."[53] The Climate Disclosure Standards Board, an international consortium of business and environmental NGOs formed in 2007, offers companies "a framework for reporting environmental information with the same rigor as financial information."[54] The Sustainability Accounting Standards Board, a private organization created in 2011 that models itself after the Financial Accounting Standards Board and the Internal Accounting Standards Board, recently issued 77 industry-specific reporting standards pertaining to material sustainability.[55] There are also several other reporting frameworks: for example, the Global Reporting Initiative, the Carbon Disclosure Project, and the International Integrated Reporting Council. Recently these groups have joined forces in a "Statement of Intent to Work Together Towards Comprehensive Corporate Reporting."[56]

Reliable information presented with sufficient uniformity for comparison and analysis is critical for effective systematic stewardship. Should institutional investors and asset managers be "information takers" with respect to these largely private efforts or should they engage to strengthen this private ordering approach to disclosure? Because this disclosure would have implications across the portfolio, efforts to improve it would be cost effective. It should lead to better pricing of systematic risk, which may discipline specific companies and also provide information useful to a systematic steward; it should enhance the effectiveness of activist climate change intermediaries in framing firm-specific initiatives. These reporting standards are voluntary and relatively few firms are compliant; reporting firms often attach "Sustainability Reports" outside the four corners of their financial statements. Should institutional investors and asset managers undertake either initiatory or responsive firm-specific measures to establish standards of wider and deeper voluntary disclosure? Instead of a private ordering approach, should institutional investors support mandatory disclosure, a regulatory approach that would standardize and compel disclosure?[57]

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[53] See TCFD Overview at https://www.fsb-tcfd.org/about/#. These "recommended disclosures" relate to a company's governance of climate change risk, its strategy, its risk management of climate change risk, and its metrics and targets. TCFD, Recommendations of the Task Force on Climate-Related Financial Disclosures (June 2017), available at https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-2017-TCFD-Report-11052018.pdf

[54] See CDSB Framework for Reporting Environmental and Climate Change Information (Dec. 2019), available at https://www.cdsb.net/sites/default/files/cdsb_framework_2019_v2.2.pdf

[55] "SASB connects businesses and investors on the financial impacts of sustainability. SASB standards enable businesses around the world to identify, manage, and communicate financially material sustainability information to investors. SASB standards are industry-specific and are designed to be decision-useful for investors and cost-effective for companies. They are developed using a process that is evidence based and market informed." http://www.globenewswire.com/news-release/2020/10/15/2109232/0/en/Seventeen-Data-and-Analytics-Providers-Now-Have-a-Licensing-Relationship-With-SASB-Improving-Access-to-Financially-Material-ESG-Information.html

[56] https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf

[57] For expression of investor frustration with current ESG reporting and consideration of private ordering vs. regulatory alternatives, see GAO, Public Companies: Disclosure of Environmental, Social and

Mandatory disclosure of course of course comes only after official regulatory action, which would involve, if not enmesh, the institutional investors and the asset managers in the political process. Just this August 2020 the SEC updated provisions of its major disclosure guide, Regulation S-K. Although the SEC broadened the "human capital" reporting requirement, many were disappointed for its recourse to a "principles based" approach only. [58] Moreover two Commissioners voted against the proposal because of its failure to move toward "standardized, consistent, reliable and comparable ESG disclosures that [investors] need to protect their investments and allocate capital toward a sustainable economy."[59]

This leads to another binary choice: should large diversified fund and asset managers act through trade associations in pursuing systematic risk mitigation rather than acting on an own-fund basis. Particularly if systematic risk reduction entails controversial political steps or may best be advanced through a legislative or regulatory change rather than through the corporate governance channel only, a representative intermediary may be wise. Wall Street firms have benefited enormously through their capacity to act through the Securities Industry/Financial Market Association (SIFMA)[60] and the large banks have similarly made good use of The Clearing House (TCH), both energetic participants in the legislative and regulatory process. "Asset Managers Concerned About Systematic Risk" (AMCASR), a just-invented trade association, could act for asset managers and institutional investors collectively in the regulatory and legislative domain. But isn't this just the aggregation of power on which alarums about the Big Three[61] and the Problem of Twelve[62] rest? Actually no. Industry participants acting collectively to petition the government for action or relief is core first amendment activity; it is immune from antitrust challenge. But the real problem is otherwise: Whatever their power with managers, there is no reason to believe it carries over with regulators, much less legislators. The institutional investors and asset managers can replace corporate managers, not regulators or legislators. Moreover, they are not the source of major campaign contributions and their clout is likely to suffer accordingly.

Governance Factors and Options to Enhance Them, GAO-02-530 (July 2020), available at https://www.gao.gov/assets/710/707949.pdf

[58] Modernization of Regulation S-K Items 101, 103, and 105, Sec. Rel. No. 33-10825, 85 Fed. Reg. 73726, 63737-63740 (Oct. 8, 2020) (amending Item 101(c)(2)(ii)).

[59] Thomas Riesenberg, SASB, A View on the SEC Rules Regarding Human Capital Disclosures, Harv. Corp. Gov. Blog, Sept. 12, 2020, available at https://corpgov.law.harvard.edu/2020/09/12/a-view-on-the-sec-rule-regarding-human-capital-disclosures/

[60] SIFMA describes itself as "the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets, " https://www.sifma.org/about/

[61] Lucian Bebchuk & Scott Hirst, The Specter of the Giant Three, 99 BU L. Rev 721 (2019).

[62] John C. Coates, The Future of Corporate Governance Part I: The Problem of Twelve (September 20, 2018). Harvard Public Law Working Paper No. 19-07, available at SSRN: https://ssrn.com/abstract=3247337.

The concern about action by "common owners" cuts the other way: precisely because systematic risk reduction does not immediately result in increased AUM – at best it preserves the value of AUM – asset managers may have insufficient incentives to pursue this. Here is where "systematic *stewardship*" becomes relevant. "Stewardship" is an effort to use soft law incentives to induce pro-social behavior where the incentives point to passivity. The pursuit of systematic stewardship ought to be framed as a distinctive positive contribution that these parties are in a unique position to appreciate and push forward. It can become an offset to concern about their power in the corporate realm, consideration for their on-going social license.[63]

The next section addresses some of the concerns about the exercise of systematic stewardship.

Part IV Addressing Certain Objections

[to come]

[63] An alternative argument is that an index fund's willingness to engage in systematic stewardship becomes a marketing tool and in that way increases AUM. More generally, in light of an increasing cohort of investors who would like to advance ESG objectives alongside their desire to maximize risk-adjusted returns, index funds may compete in their support of ESG measures that they can explain as increasing risk-adjusted returns.