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

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Abstract

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

This article will focus on the desire of institutions for greater ESG disclosures and suggest that two reasons underlie this demand for more information: (1) ESG disclosures overlap substantially with systematic risk, which is the primary concern of diversified investors; and (2) high common ownership enables institutions to take collective action to curb externalities caused by portfolio firms, so long as the gains to their portfolio from such action exceed the losses caused to the externality-creating firms. This transition to a portfolio-wide perspective (both in voting and investment decisions) has significant implications but also is likely to provoke political controversy. In its final hours, the Trump Administration adopted new rules that discourage voting based on ESG criteria and thus by extension chill ESG investing. This controversy will continue.

As more institutions shift to portfolio-wide decision making, there is an optimistic upside: externalities may be curbed by collective shareholder action. But, there are also downsides, including that the disclosure needs of individual investors and institutional investors will increasingly diverge, and serious conflicts can arise. Of course, not all institutional investors are indexed or even diversified, but those that remain undiversified (for example, hedge funds) logically have the perspective of an option-holder and favor greater risk-taking. Once again, retail investors have different perspectives and preferences than institutional investors. The SEC should seek to serve the needs of these different classes, rather than subordinate them to an assumed common standard.

Keywords: Black/Scholes Option Pricing Model, Capital Asset Pricing Model (CAPM), Common Ownership, Disclosure, ERISA, Externalities, Index Fund, Institutional Investor, SEC Sole Interest Rule.

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

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

By John C. Coffee, Jr.*

INTRODUCTION

How should the norms of corporate governance and disclosure policy change (at the SEC and elsewhere) in light of new market conditions and a changing population of shareholders? So framed, this may seem a fairly narrow question, which assumes that one accepts the need for a mandatory disclosure system.[1] Yet, once over that first hurdle, a second question logically follows that is broader and more nuanced: Do all investors have the same informational needs and goals? Or do some have distinctive needs and preferences? This article will suggest that individual and institutional investors have different needs (largely based on their level of diversification) and that conflicts can arise between them, particularly as institutional investors come to make voting and investment decisions on a portfolio-wide basis (instead of on a stock by stock basis). Indeed, viewed in light of the growth in index investing and the high level of common ownership among such indexed investors, we may be moving from a system of corporate governance that is premised

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

on a "shareholder primacy model" to a system that is premised on a "portfolio primacy model."[2] That is, in the future, our largest institutions may knowingly accept and even cause losses at some firms in their portfolio if they expect that those losses will be outweighed by correlative gains at other portfolio firms.

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

First and most obvious, the "institutionalization" of the market has now been fully realized. Historically, the SEC has always seen its interests as closely aligned with those of the retail investor.[3] It has proclaimed itself "the investors' advocate,"[4] and public investors have in turn recognized and applauded the SEC's efforts. This mutual alliance gave the SEC relative political immunity that assured it reasonable budgetary appropriations, despite major swings in policy and times of great stress for other agencies over recent decades.[5]

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[2] This idea of a "portfolio primacy model" should not be confused with a "stakeholder primacy model," which has been supported by many commentators who want boards and managers to balance the interest of other stakeholders in the corporation with those of shareholders. A focus on maximizing the value of the portfolio is quite different from a focus on sustainability or wealth transfers to stakeholders (even though the two perspectives may overlap).

[3] For this conclusion, see Joel Seligman, THE TRANSFORMATION OF WALL STREET: A History of the Securities and Exchange Commission and Modern Corporate Finance (3d ed. 2003).

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

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

But that is past. The era in which retail investors "owned" companies or moved the trading markets is long gone and "deader than disco". Today, retail investors account for only a modest minority of the ownership of large, publicly traded companies and probably only around 4% of the trading in NYSE-listed companies.[6] Stock ownership is now dominated by institutional investors, who are increasingly diversified and often indexed.[7]

The second transition involves the more recent and extraordinary concentration in stock ownership, with the result that as few as five to ten institutions today may be in a position to exercise *de facto* control over even a large public corporation. The Big Three of institutional investors -- BlackRock, Inc., State Street Global Investors, and the Vanguard Group -- now hold over 20% of the shares in S&P 500 companies (and vote approximately 25%) and are projected to vote over 40% by 2038.[8] Potentially, this might suggest that retail investors are exposed to domination

[6] The level of institutional ownership increases with the size of the company's market capitalization (as institutions desire liquidity and thus concentrate on large cap stocks). Thus, if we look at the market value of all outstanding, publicly traded equity securities in the United States, institutions have owned over 62% for a number of years. See Katie Kolehin & Justyna Podziemiska, Sec. Indus. & Fin. Mkt. Ass'n. ("SIFMA"), CAPITAL MARKETS FACT BOOK, 2019 at 60 to 61, (percentages range between 64.7% and 62.4% between 2008 and 2018). If, however, we look at the U.S. companies that are among the 10,000 largest companies in the world, this percentage rises to 72% according to a recent OECD report. See A. De La Cruz et al., ORG. For ECON. COOP. & DEV., OWNERS OF THE WORLD'S LISTED COMPANIES 11, tbl. 3 (2019).

For the level of trading in publicly listed equities by retail investors, a recent estimate is 3.68% (based on data from 2010 to 2015). See Ekkehart Boehmer et al., Tracking Retail Investor Activity 8 (August 31, 2020) (https://papers.ssrn.com/sol3/papers.cfm/abstract_id=2882105). For an earlier estimate of 2% for trading by individuals investors, see Alicia Davis Evans, A Requiem for the Retail Investor, 95 Va. L. Rev. 1105, at 1105 (2009). In 2020, the percentage of trading by retail investors has seen some increase as the result of market strategies adopted by Robinhood Markets, Inc. and other online brokers, but it remains to be seen whether this is more than a short-term phenomenon.

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

[8] This difference between 20 and 25% reflects the fact that many shares are not voted. For these percentages and for their prediction that the votes cast by the Big Three will rise eventually to 40% or more, see Lucian Bebchuk and Scott

by institutional control groups,[9] but such a thesis still seems premature. At first glance, little conflict is apparent between diversified institutions and retail investors (as indexed institutions are not seeking control), but a potential conflict may be developing: as diversified institutional investors, utilizing their power of common ownership, begin to make decisions on a portfolio-wide basis (deliberately pursuing strategies that boost the stocks of some firms in their portfolios while depressing the stocks of others, to achieve a net gain), they will be taking actions contrary to the interests of undiversified investors in those firms that experience losses. Eventually, this conflict will trigger controversy and may necessitate new and enhanced disclosures.

Meanwhile, retail investors have moved their investments from "actively managed" (or "stock-picking") mutual funds to more passive index funds.[10]

Hirst, The Specter of the Giant Three, 99 B.U. L. Rev. 721, 724 (2019). To give an example of activism in action, just six shareholders control 24% of ExxonMobil, and the same six control 26% of Chevron, and they have pressured both companies regarding emissions and climate change. See Madison Condon, Externalities and the Common Owner, 95 Wash. L. Rev. 1, 10-11, 24 and note 116 (2020). These six included the foregoing Big Three and Northern Trust, Bank of America, and Capital Research Global Investors. Id. at 10 note 38. The stock in publicly held companies (in terms of asset values) that is held by the ten largest mutual funds (not all of which are index funds) rose from 46% in 2005 to 61% in 2019, and the corresponding percentages held by the five largest such funds grew from 35% in 2005 to 51% in 2019. See The Investment Company Institute, INVESTMENT COMPANY FACTBOOK at 46, fig. 2.14 (60th ed. 2020).

[9] Much of the literature that is concerned about the growing concentration of shares in the hands of a limited number of institutional owners has focused on the danger that such concentration will be anticompetitive, leading to shareholder pressure in some industries for firms not to compete. See Einer Elhauge, Horizontal Shareholding, 129 Harvard L. Rev. 1267 (2016); Jose Azar, Martin Schmalz and Isabel Tecu, Anticompetitive Effects of Common Ownership, 73 J. Fin. 1513 (2018). However, the flip side of this coin is that institutions can use their collective power to induce their portfolio companies to behave in a more socially responsible manner (at least when it will benefit their portfolio on a net basis). In particular, concentrated owners can balance the gains caused to some companies in their portfolio by shareholder activism that restricts or discourages externalities that injure them against the losses experienced by the externality-causing firms in the same portfolio. Although it cannot be assumed that the potential gains will necessarily exceed the potential losses, when they do, it is good business policy to force the internalization of the externalities by the firms causing them. See Condon, supra note 8, at 10-11.

[10] In 2019, index funds (i.e., mutual funds that track a broad market index) for the first time exceeded traditional stock picking funds, holding $4.27 trillion in assets as compared to $4.25 trillion for traditional stock picking funds. See Dawn Lin, "Index Funds Are The New Kings Of Wall Street," The Wall Street Journal, Sept. 18, 2019; see also Jill Fisch, Assaf Hamdani, Steven Davidoff Solomon, The New Titans of Wall Street: A Theoretical Framework for

Collectively, retail investors seem to have finally recognized that they are poor stock pickers who systematically lose money when they trade actively on their own.[11] As a result, they have migrated in large numbers to invest in highly diversified institutional intermediaries (led by the Big Three), thereby further increasing ownership concentration.[12]

Finally, the third important transition involves a new demand among investors (particularly among diversified institutional investors) for a new category of information, known as "ESG" disclosures (ESG is an acronym that stands for "environmental, social, and governance").[13] Investors who pursue "ESG investing" tend to focus heavily on the environmental and social impact of the firm and on its human capital (including the level of racial and gender diversity at the firm).[14] Although it may be clear why social activists want to encourage such socially relevant disclosures, it puzzles many why diversified institutional investors have been the

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Passive Investors, 168 U.Pa. L. Rev. 17 (2019).

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

[12] While the Big Three now hold over 20%, some estimate that they will hold 40% or more of the shares in the S&P 500 within two decades. See Bebchuk and Hirst, supra note 8, at 739, 741.

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

[14] For a similar description of ESG investing, see Schanzenbach and Sitkoff, supra note 13, at 388.

strongest proponents of increased ESG disclosure.[15] This article argues that this development is neither strange nor the product of the political sympathies of individual fund managers, but is the consequence of a fundamental economic logic. Put simply, their interest in ESG disclosures flows directly both from the Capital Asset Pricing Model ("CAPM"[16]) and from the just-noted fact of their high common ownership in portfolio companies. Both these factors imply that diversified investors should rationally concentrate on systematic risk and generally disregard idiosyncratic risk. Indeed, the best evidence that these diversified investors are conforming to economic logic lies in a new pattern under which they are actively voting and lobbying public companies in common, primarily on ESG-related issues.[17]

Given high common ownership across a broad portfolio, it becomes rational and predictable that diversified institutional investors will increasingly make both investment and voting decisions on a portfolio-wide basis (rather than simply trying to maximize the value of individual stocks). Proposals made by a diversified institutional investor to the firms in its portfolio will likely produce some winners and some losers, particularly for proposals relating to climate change and other ESG issues. If netting these gains and losses produces a positive result, the indexed investor profits in a way that the undiversified investor cannot duplicate. These

[15] Anecdotal evidence is abundant that diversified institutional investors, including the Big Three, are placing significant pressure on many companies, particularly including energy companies to expedite their dates for "carbon-neutrality" and on all companies to achieve greater board diversity. See Condon, supra note 8; Reed, supra note 13.
[16] For the original statement of this model, see William F. Sharpe, Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk, 19 J. Finance 425 (1964); see also John Lintner, The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets, 47 Rev. Econ. & Stat. 13 (1965).
[17] See Elroy Dinsom, Oguzhan Karakas, and Xi Li, Coordinated Engagements (ECGI Working Paper January 21, 2021), see https://ssrn.com/abstract=3209072(Nov. 11, 2020) (finding an "international network of long-term shareholders cooperating to influence firms on environmental and social issues").

opportunities are most likely to arise with respect to ESG issues. The implications of this strategy are sweeping, controversial and probably as adverse to the interests of retail investors as they are advantageous to the interests of large diversified investors.[18]

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

This question has been approached by others, but not directly answered. A dozen years ago, Professor Donald Langevoort focused on the transition from retail to institutional markets at the time of the SEC's 75th Anniversary.[19] His recommendations seemed to suggest that the U.S. market would likely become more like the European securities market, which, as he accurately observed, was characterized by (1) "light touch" enforcement, (2) a lesser disclosure burden emphasizing principles-based disclosure, and (3) considerably less reliance on ex post

[18] What is new here is that large institutional investors can profit by deliberately causing losses to some firms in their portfolios if doing so results in greater gains to other firms in their portfolio. Although non-controlling shareholders have never owed a duty of loyalty to the corporations in which they invest, it is hard to think of any comparable instance in which causing losses to some could benefit them.
[19] See Langevoort, supra note 4.

litigation to enforce disclosure norms. Others challenged him,[20] but the greater problem with Professor Langevoort's thesis was his unfortuitous timing. Shortly after he wrote, the 2008 financial crisis broke and, in response, even the U.K. abandoned "light touch" regulation. While differences in enforcement intensity still separate the U.S. and Europe (and will likely continue),[21] a greater consensus exists today over the need for stronger enforcement and a mandatory disclosure system.

This article will therefore skirt the topic of enforcement and instead focus on where the disclosure needs of retail and institutional investors may differ and where they are not being addressed. Here, other transitions in securities law practices are also relevant. Increasingly, private offerings, which are exempt from the Securities Act of 1933 (the "1933 Act"), have come to rival public offerings as a means for issuers to raise capital. Indeed, in recent years, the number of private offerings and the total capital raised in them has exceeded the corresponding figures for public offerings subject to the 1933 Act.[22] Because these exempt offerings require little disclosure (at least as a legal matter[23]), this might seem to imply that institutional investors need less information. Yet, a confounding fact interferes with this simple conclusion: the

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[20] See Evans, supra note 6.

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

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

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

character of the disclosure actually provided in offerings done pursuant to Rule 144A (the exemption from registration preferred by large public issuers[24]) closely resembles the character of the information in a registration statement filed pursuant to the 1933 Act. In particular, the issuer's disclosures in a Rule 144A offering typically follows the same standardized format. Although no precise metric exists that proves that the same quantum of information is present in both exempt and registered offerings, institutional investors as a group appear to want (and implicitly demand) at least the same information as other investors, and they prefer it presented in the same standardized format. Particularly as they come to make decisions on a portfolio-wide basis, diversified institutions will increasingly want to know and compare the likely impact of ESG-related policy changes on all firms in their portfolio. In contrast, undiversified shareholders, lacking common ownership, are not in a position to implement similar portfolio-wide policies.

This article will offer a number of conclusions that are brief and blunt; to be brief, it is necessary to be blunt. Organizationally, Part I of this article will focus on the informational needs of institutional investors (and particularly, the fully diversified institution). How do their needs and priorities differ from those of the retail individual investor? Relying on the CAPM, it will suggest, first, that institutional investors are more concerned with "systematic risk" than are individual investors[25] and, second, that ESG disclosures address systematic risk to a much

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

[25] The claim here is not that individual investors disregard or ignore systematic risk, but that they are unable to do

greater degree than the SEC has recognized. Part II will then return to the individual retail investor, who certainly remains on the scene and is the dominant investor in smaller companies that offer less liquidity. What new needs (and fears) might the retail investor reasonably have in the contemporary investment environment? Here, a partial answer will be that, although diversified institutions tend to be tolerant of risk, individual investors rationally have the reverse preference. Finally, Part III will turn to the growth of ESG disclosures. Although such disclosures are now becoming mandatory in Europe, ESG disclosures remain optional and voluntary in the U.S., with the SEC having stubbornly avoided taking any firm (or even coherent) position on ESG disclosures.[26] This article seeks both to explain the strong interest of diversified institutions in ESG disclosures and the obstacles that exist under current law to the use of such information by certain fiduciaries. This leads to a final question: how should the SEC assist, encourage, or otherwise influence this process?

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

It is traditional to begin any discussion that relies on "law and economics" with the mandatory observation that "one size does not fit all." Not all institutional

much about it. Lacking high common ownership, they cannot take meaningful collective action. Although portfolio firms may face different degrees of systematic risk, the retail investor also has choices with regard to a vast range of companies with differing idiosyncratic risks and thus have less reason to focus disproportionately on systematic risk.

[26] The SEC has not implemented any mandatory ESG disclosure requirements, leaving them entirely voluntary. For a critical evaluation of the SEC's positions, see Thomas L. Hazen, Social Issues In The Spotlight: The Increasing Need To Improve Publicly-Held Companies' CSR And ESG Disclosure, https://papers.ssrn.com/abstract_id= 3615327 (June 29, 2020).

investors are alike. Some mutual funds and many hedge funds are "stock pickers;" they engage in active trading and believe they can outperform the efficient market. Generally, they are wrong, but not invariably (which could be explained by the fact that some may have access to private information). Today, highly diversified institutional investors owe more assets under their management than do institutions engaged in "actively managed" stock picking. Typically these highly diversified investors do not attempt to outperform the market (but rather to mirror it cheaply).

Given their dominance, it is prudent to ask what kinds of information does the fully diversified investor want? Here, one needs to turn to the CAPM, and its most relevant teaching for our purposes is that diversification reduces "idiosyncratic" risk, but not "systematic" risk.[27] Idiosyncratic risk (or non-systematic risk) is that risk that is unique to a company or industry; for example, a company's (or an industry's) technology may be outdated or outperformed by a new emerging technology (e.g., natural gas or solar power may become cheaper than oil or coal-based power). But some risks affect all companies: inflation may increase; a banking crisis may disrupt finance and cut off credit across the economy; or, more recently, a pandemic may require all companies to curtail or suspend operations. Diversification does not offer satisfactory protection from these risks.

The CAPM assumes that the capital markets ignore unsystematic risk in pricing the value of a financial asset (including corporate stock) because diversified investors do not bear non-systematic risk. Because diversification is easily achieved

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

with little cost or effort for investors, the price of a stock, according to this model, is set by diversified investors, who need only consider the company's systematic risk. In effect, if two companies have the same expected return, the fact that one has higher non-systematic risk will not affect their relative valuation to the extent the market price is set by diversified investors who do not bear this risk. Put differently, investors cannot demand a higher return for bearing non-systematic risk that they could have easily diversified away.

The key implication here is that the price of a financial asset will be determined by the asset's systematic risk compared to the risk of the market as a whole. To be sure, the CAPM has been much criticized and may overstate.[28] But, even its critics believe that it points in the right direction and is roughly accurate.[29] The CAPM's immediate implication for our topic of disclosure policy is that, as the market becomes increasingly populated by diversified investors, these investors will focus primarily on systematic risk. Individual investors may have some concern about systematic risk, but it does not dominate their intention because there is little they can do about it and they have a range of other choices. Unsurprisingly, the SEC, as an agency that has always served the retail investor, has never addressed systematic risk in anything approaching a comprehensive manner.

[28] For such a critique, see Eugene F. Fama & Kenneth R. French, Common Risk Factors in the Returns on Stocks and Bonds, 33 J. Fin. Econ. 3, 4-5 (1993) (finding the CAPM to be empirically inadequate).
[29] In a series of articles, Fama and French proposed supplementing the original CAPM with a few additional factors. See Eugene F. Fama & Kenneth R. French, A Five-Factor Pricing Mode, 116 J. Fin. Econ. 1 (2015). Thus, although they believe the CAPM needs to be supplemented, they do not reject it as a starting point.

Let us assume that the CAPM makes assumptions that many will regard as overstated.[30] But, even if we need to take it with a substantial grain of salt, the CAPM still legitimately implies that the SEC needs to modernize its disclosure policy and focus more seriously on systematic risk. This does not mean that the SEC should ignore non-systematic risk (because many investors will remain less than fully diversified), but it does suggest that diversified investors who constitute a majority of the market have an unmet disclosure need.

What has the SEC done to this point with regard to ESG disclosures? The short answer is very little. In 2018, institutional investors representing over $5 trillion in assets under management submitted a rule-making petition to the SEC requesting it to mandate ESG disclosure standards for public companies.[31] More than 60 governments and international organizations, including the United Nations and the International Organization of Securities Commissions, have promulgated ESG standards,[32] but the SEC has resisted these pressures (probably motivated by countervailing pressures from corporate issuers). The SEC's principal expressed concern has been the danger of information overload that would inundate investors with low-quality information and often inconsistent metrics and rankings.[33] To date, the SEC's only real action has been to update its standards under Regulation S-K (which specifies the disclosures mandated in SEC filings), but here it has limited

[30] See text and notes supra at notes 28 and 29.
[31] For a fuller description, see Virginia H. Ho & Stephen Kim Park, ESG Disclosure In Comparative Perspective: Optimizing Private Ordering In Public Reporting, 41 U. Pa. J. Int'l L. 249, 250 (2019).
[32] Id.
[33] For an evaluation of this danger and an answer to it, see Virginia H. Ho, Disclosure Overload?: Lessons For Risk Disclosure and ESG Reporting in the Regulation S-K Concept Release, 65 Vill. L. Rev. 67 (2020).

itself to extremely general "principles-based disclosures."[34] Meanwhile, the largest U.S. institutional investors (including the Big Three) have gone well beyond adopting general policies and have directly engaged major companies on climate change issues or have even sued them.[35]

This activism of diversified institutional investors on ESG issues contrasts sharply with their general passivity on firm-specific business issues, and this disparity can only be explained in one way: diversified institutional investors are deeply concerned about systematic risk but generally indifferent to idiosyncratic risk. Not only can they ignore non-systematic risk, but they may waste resources in seeking to respond to it.[36]

Climate change probably presents the clearest example of systematic risk. Although it will not affect all companies the same (i.e., the risk is heterogeneous),

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[34] In 2020, the SEC "modernized" its requirements with respect to Items 101, 103 and 105 of Regulation S-K, but required only very general "principles-based" disclosures. For example, with respect to Item 101 (which requires a description of the issuer's business), it did address the "social" component of ESG, but only in a minimal way by instructing issuers to provide:

> "A description of the registrant's human capital resources, including the number of persons employed by the registrant, and any human capital measures or objectives that the registrant focuses on in managing the business (such as, depending on the registrant's business and workforce, measures or objectives that address the development, attraction and retention of personnel)."

See Securities Act Release Nos. 33-10825, 34-89670 (April 26, 2020). This brief statement was the SEC's only reference in this Release to the goals of diversity and affirmative action. Thus, although Item 101 now at last addresses the social component of ESG, it does so in an extraordinarily minimal way. Not surprisingly, some observers have found that public corporations are not responding to this invitation to discuss their policies on human capital. [add citation]

[35] For a description of a forceful intervention by a group of six large institutional shareholders (including the Big Three) that succeeded in causing both ExxonMobil and Chevron to support climate change reforms that these firms had previously opposed, see Condon supra note 8. Not only are broadly diversified institutions seeking more ESG disclosures, they are also acting upon them as well, sometimes by suing portfolio companies. See Alexander Platt, Index Fund Enforcement, 53 U.C. Davis L. Rev. 1453 (2020).

[36] For example, if a diversified institutional investor expended money and effort to cause a given firm to improve its performance on some specific business issue, it might profit with respect to that stock, but lose money on the stock of a rival company that loss market share to the company that improved its performance. Being fully diversified implies that efforts directed at improving a single firm in the portfolio could be counterproductive. Also, index funds chiefly compete with other index funds that are also matching the same indexes; thus, if one index investor intervenes to improve the earnings of a portfolio firm, it benefits its rivals as much as itself (while bearing all the cost). That is not a successful competitive strategy.

investors cannot escape it through diversification. That is, there is no obvious class of companies whose stock will go up as the result of global warming so as to compensate diversified investors for those other stocks that go down.

Given that they are unavoidably exposed to this risk, diversified investors rationally want disclosures that enable them to estimate its impact on their portfolios. Further, they may want to take actions (either by voting, litigation, or persuasion) to induce changes that reduce such risk (even if it causes losses to some companies in their portfolio, so long as the action taken implies greater gains than losses to the portfolio). A clear indication of this new activism came in January, 2021 when BlackRock's CEO, Larry Fink, wrote to the CEOs of major public corporations, asking them to commit to a "goal of net zero greenhouse gas emissions" by 2050.[37] This is a costly change that will adversely impact earnings at many companies (but it is designed to benefit other firms in BlackRock's portfolio even more and thus to result in a net benefit for BlackRock).

Another example of a systematic risk that has concerned both institutional investors and the SEC involves the Covid-19 pandemic. Here, the SEC has been actively seeking increased disclosure, asking all public companies to explain how the pandemic is affecting them.[38] Obviously, pandemics represent a form of systematic risk because diversification again cannot protect an institution's portfolio.

[37] See Larry Fink, "Letter to CEOs," Harvard Law School Forum on Corporate Governance, January 30, 2021. This letter went on to describe several metrics that BlackRock would use in evaluating whether their portfolio companies were in compliance and a "heightened scrutiny model" that its actively managed funds would use in dealing with non-complying portfolio companies. Id. at 3-4.

[38] There has been a continuing stream of SEC statements since March, 2020. See, Division of Corporation Finance, Securities and Exchange Commission, "CF Disclosure Guidelines: Topic No. 9A, "Coronavirus (Covid-19) - Disclosure Considerations Regarding Operations, Liquidity, and Capital Requirements" (June 23, 2020). For a brief

Although the examples of climate change and a pandemic are clear, skeptics may respond that not all ESG disclosure relates to systematic risk. For example, ESG disclosures often focus on racial diversity and inclusiveness. Skeptics may doubt that such disclosures relate to systematic risk disclosure. Yet, over the long-run, these disclosures arguably relate to the potential viability of our corporate system. If our corporate system cannot offer inclusiveness and promote diversity, it may subject itself to a political risk that capitalism (or, at least, contemporary corporate governance) will be politically challenged and could conceivably yield to a more state-run system of corporate governance. To some degree, such a transition seems to be already occurring in Europe and the U.K.[39] Again, diversification could not protect investors against this risk of political upheaval, which could directly threaten the traditional investor's goal of shareholder wealth maximization.

One last point about "systematic risk" needs to be underscored: for diversified investors, systematic risk overlaps heavily with securities law's bedrock concept of materiality. Because systematic risks cannot be diversified away by investors, information about such risks is more material to diversified investors than information about "idiosyncratic" risks, both because institutional investors are in theory exposed only to "systematic risk" and because they (and, as a practical matter,

overview, see "Updating Public Traded Company Disclosures for Covid-19," LAW360 (March 20, 2020).

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

only they) may be able to take corrective action to minimize such risk.[40] Indeed, as later discussed, the major diversified institutions have begun to take direct action on a coordinated basis (through litigation, proxy fights, or the threat of exit).

Ultimately, the informational needs of the diversified institutional investor depend on the role that it is willing to assume. For some time, commentators have presented the diversified investor as being "rationally reticent" and willing to act only on issues framed and presented by non-diversified activist investors.[41] Understandable as this view was, it no longer conforms with the current reality in which the Big Three (and others) are taking a leadership role in pressing portfolio companies for systematic risk-related changes. BlackRock, for example, showed little "reticence" in insisting that its portfolio companies adopt a "net-zero" emissions policy by 2050. Thus, it is necessary to recognize that, within the boundaries set by systematic risk, indexed investors can indeed be activists--even (because of their greater scale) more effective activists than the hedge funds.

II. THE RETAIL INVESTOR: THE RELEVANCE OF OPTION PRICING THEORY AND COMMON OWNERSHIP

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

[41] See Ronald J. Gilson & Jeffrey N. Gordon, The Agency Cost of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights, 113 Colum. L. Rev. 863 (2013) (arguing that "activists"--such as hedge funds--will research and frame issues, which index firms will support without having to expend funds or effort).

Two different conflicts are arising between institutional and retail shareholders, which have not been recognized or addressed by existing SEC policy:

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

Today, activist hedge funds regularly "engage" target corporations, buying a 5% or slightly greater stake and then seeking to pressure the target into reducing its degree of diversification (and simultaneously increasing leverage, often through stock buybacks).[42] Generally, these campaigns produce an immediate positive stock market reaction when the activist hedge fund crosses the 5% ownership threshold and files the mandatory Schedule 13D (which typically announces both its ownership position and its proposed plans to reduce diversification and increase leverage).[43] Although this stock price reaction suggests shareholders as a group are made better off by these campaigns, undiversified investors may still be made worse off. As "buy and hold" investors,[44] retail individual investors are unlikely to sell and probably will continue to hold stocks that are now subject to higher risk at the corporate level (because of reduced diversification). Does the increase in expected return justify this increased risk? No simple conclusion is justified here.[45]

Because the CAPM assumes that the market price of a widely traded stock is determined by the interaction of large, fully diversified institutional investors, the small retail investor will not have much impact on the stock price (even if some such investors do sell). Because the stock price is thus unlikely to decline (as institutional investors are happy with this new trade-off of risk and return), these individual

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

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

[44] Retail investors tend to be "buy and hold" investors (who do not trade actively) probably because they face higher trading costs than institutional investors who, because they trade in volume, receive quantity discounts.

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

investors need disclosure that makes clear to them that they may now be subject to greater risk. Arguably, if the SEC continues its traditional policy of protecting retail investors, the SEC should mandate disclosures that warn these investors of this increased risk. Effectively, the SEC should use this opportunity to prod investors toward greater diversification. Nothing in existing disclosure rules provides for anything resembling such disclosure or such advice.

This point about the increase risk associated with hedge fund activism needs to be generalized. The famous (and Nobel Prize-winning) work of Fischer Black and Myron Scholes on option pricing theory begins from their insight that, once a public company takes on significant debt, its common stock can be modeled (and is best understood) as an option on the corporation's assets.[46] That is, the common stockholders collectively hold an option, which, on the maturity of the debt, allows them either to let the corporation default on its debt (which is the equivalent of letting their option expire) or to pay the debt off (which is the equivalent of exercising their option). In this view, the "real" owners of the corporation are its debt holders, who have no choice (because the shareholders have limited liability and cannot be held personally liable if the firm defaults on its debt). Unlike the debtholders, the stockholders do have the choice of (a) allowing the company to default (and thus turning the company over to the creditors) or (b) paying off the debt (and in effect

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

exercising the option). Presumably, they will make the choice that maximizes their own interests (possibly at the expense of creditors and other stakeholders).

The immediate relevance of this point involves the incentive effects on the option holder (i.e., the common shareholders). As option holders, they can be expected to act rationally so as to maximize the value of their option. What does that imply? Under the Black/Scholes model, the most important factor in determining the value of an option is the variance in the value of the underlying asset (here, the corporation's assets). In short, the greater the variance in expected corporate returns, the greater the value of the option. This may seem counter-intuitive, because greater variance in expected returns is unattractive to debtholders and reduces the value of the corporation's assets in their hands. Still, a critical insight of the option pricing model is that the common stockholders, as the holder of an option, can increase the value of their option by increasing the variance associated with the corporation's assets and investments. More bluntly, this means that by increasing the riskiness of the corporation's investments, they benefit themselves (as the option holder) at the expense of the corporation's creditors and other stakeholders.

Thus, we now have a scenario for opportunism by the shareholders: if they take on riskier investments, or leverage up the company, they gain and the creditors lose. Of course, creditors can resist by insisting on protective covenants in loan agreements and bond indentures, but these are in declining use.[47] Even if creditors could

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

negotiate contractual protections against increased leverage, it is much harder to prevent their corporate borrower from otherwise taking on riskier investments or making higher-risk bets. Such restrictions would be hard to draft and would be resisted intensely by corporate managers because these restrictions would tie their hands, denying them needed flexibility over an extended period.

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

Although there has been a voluminous and heated debate over the practices and ethics of activist hedge funds,[48] this debate has usually been framed in terms of whether hedge funds have a "short-term" perspective that contrasts with the allegedly "long-term" perspective of the target corporation's managers. This misses the larger point. Without denying that there could be differences in the time frames favored by activist shareholders and managers,[49] it is simpler (and theoretically more

[48] For representative positions, see Lucian A. Bebchuk, Alon Brav & Wei Jiang, The Long-Term Effects of Hedge Fund Activism, 115 Colum. L. Rev. 1085 (2015); Coffee and Palia, supra note 39; and Leo E. Strine, Jr., Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge fund Activism and Our Strange Corporate Governance System, 126 Yale L.J. 1870 (2017).

[49] Standard compensation formulas in the hedge fund industry (which typically annually award hedge fund managers 20% or more of the fund's gains) do give hedge fund managers considerable reason to focus on the short-run. Moreover, hedge fund managers are aware that their investor clients can easily move funds to another hedge fund if

elegant) to focus instead on the enhanced value to the option held by the shareholders as the result of accepting increased risk.

Possibly, some will respond: if this desire to increase the risk level is so obvious, why didn't the target management do this themselves and profit from accepting increased risk and lesser diversification? Why have only activist hedge funds proposed this? Here, there is a simple answer: corporate managers have firm-specific human capital invested in the firm, which they cannot easily hedge. Put more simply, shareholders hold multiple stocks, but managers have only one job. Managers will rationally resist the risk of increased leverage or diminished diversification, because it exposes them to potential bankruptcy and the loss of their human capital. Thus, shareholders make superior risk bearers.

Today, activist hedge funds have learned that if they propose a specific scenario for increasing risk (such as by following a riskier investment policy, selling off corporate assets that mainly provide unneeded diversification, or increasing leverage, buybacks and dividends), they will find it easy to sell this policy to institutional shareholders. This motivation to increase risk and reduce diversification did not begin with activist hedge funds. "Bust-up" takeover bidders did the same thing in the late 1980's. But these bidders were chilled by the poison pill, state takeover laws, and judicial developments.[50] The evidence is clear that activist hedge

they do not deliver immediate gains. In contrast, corporate managers are conventionally assumed to have a longer term (and more risk-averse) perspective because of their locked-in human capital.

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

funds can today compel target managements to negotiate their demands and place the hedge fund's agents on the target's board.[51] More importantly, the activist fund spends far less, fares far better, and achieves results far more quickly than the traditional hostile bidder. As a result, the activist hedge fund has largely replaced the hostile bidder, but the implications for the undiversified retail investor remain the same: increased risk is generally contrary to their preferences.

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

How (if at all) should the SEC protect these investors? The long term answer may be that retail investors should be prodded (or at least encouraged) by the SEC to diversify. But the SEC's ability at investor education is open to doubt.[52] The public does not respond well to the Government's paternalistic advice. To the extent that investor education falls short (as I expect it will), the second best policy may be to

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

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

require greater disclosure that alerts the individual investor to the risk and dangers associated with hedge fund campaigns, reduced diversification, and increased leverage. This policy, of course, can only be pursued on a case-by-case basis, but the end goal should be to encourage greater diversification by retail investors.

B. <u>Common Ownership and the Undiversified Retail Investor</u>. As noted earlier, BlackRock has announced that it will push all its portfolio companies to comply with a "net-zero" emissions goal by 2050.[53] For companies engaged with fossil fuels (oil, gas or coal), this will be a considerable challenge that could imply a period of continuing losses (or at least greatly reduced earnings). Nor will BlackRock's challenge be the only one that many companies receive with respect to climate change. Other asset managers may assert challenges on social or governance issues (including diversity). Because indexed investors must remain invested in the indexes with respect to which they promised their shareholders they would conform, there is little possibility that these investors will "exit" and disinvest if disappointed with the portfolio company's response. By definition, index investors are there to stay, although increasingly they may have a hostile relationship with management.

Ideally, these policies will prove profitable for the asset managers who are asserting them, but there is every reason to believe that undiversified retail investors will be caught between the rock and hard place. To such investors, BlackRock's challenge is essentially a threat. Although political and even legal challenges to BlackRock's strategy are possible, the immediate need is for disclosure that explains

[53] See text and note supra at note 37.

the impact of its policy to retail investors. How much will it cost shareholders to reduce the company's emissions level to zero? What actions might a BlackRock or other asset manager take to enforce its position or discipline deviant firms?[54]

The SEC does not yet seem to have thought through the kinds of disclosures that are necessary or desirable from both sides once such an adversarial relationship develops.

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

Although the term "ESG" is of fairly recent vintage, the concept has been around for forty years or longer.[55] Still, a paradox remains: even if investors want such information, can their fiduciaries, acting for them, make decisions based on such criteria with regard to either investing or voting? The problem is that some fiduciaries are legally barred from relying on ethical considerations, except under special circumstances. Conservatives have long argued that fiduciaries (and particularly trustees subject to ERISA or common law standards) are not permitted to rely on ethical or moral judgments (or socially desirable goals), unless they can conclude, based on clear evidence, that pursuit of such goals will work to the financial advantage of their beneficiaries.[56] From this perspective, ESG data can be considered by fiduciaries only if they can reasonably find that it satisfies a risk-return test that

[54] Here it should be recognized that even passive asset managers, such as BlackRock, also run actively managed firms that could exit from a non-complying portfolio firm, thereby driving down its stock price even further.

[55] For a good history of the rise of ESG investing, see Schanzenbach & Sitkoff, supra note 13, at 395-399.

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

enables them to improve their portfolio's overall risk-adjusted return.[57] But this is a more complex exercise than it initially appears. This section will argue that the SEC can play a useful role in resolving this dilemma.

A. A Brief History of ESG. The idea that investors should consider the social behavior and impact of the companies they invest in has a long history, and some trace it back as far as the sermons of John Wesley, the founder of the Methodist Church, who advised his followers that they could not ethically invest in companies that profited from the slave trade.[58] Similarly, some mutual funds have long employed a social screen to winnow out those companies that made anti-social products. The first such U.S. fund, Pioneer Investments, dates to 1928 and remains in business today, continually stressing its commitment to Christian values.[59] The broader concept of socially responsible investing (or "SRI") flowered in the 1980s, when the issue of South African apartheid provoked a crisis and caused ethical investors to seek to disinvest from companies that were active in South Africa.[60] Such ethical investing was always in tension with trust fiduciary law, which requires a trustee to consider only the interests of the beneficiary.[61] This "sole interest" rule is

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[57] This is essentially the position of Professors Schanzenbach and Sitkoff. See Schanzenbach & Sitkoff, supra note 13, at 453.
[58] Id. at 392.
[59] Id. at 392-393.
[60] Id. at 393-395.
[61] Under what is known as the "sole interest" rule, a trustee must "administer the trust solely in the interest of the beneficiaries." 3 Restatement (Third) of Trusts §78(1). Under a comment to this section, the Restatement adds that "the trustee has a duty to the beneficiaries not to be influenced by the interests of any third person or by motives other than the accomplishment of the purposes of the trust," 3 Restatement of Trusts §78(1) cmt.f. See also Unif. Trust Code §802(a) (Unif. Law Comm'n 2000). If the trustee acts based on mixed motives, "an irrefutable presumption of wrongdoing" arises. See Daniel Fischel & John Langbein, ERISA's Fundamental Contradiction: The Exclusive Benefit Rule, 55 U. Chi. L. Rev. 1105, 1114-15 (1988). However, a plaintiff will still have to prove damages, which can be a considerable hurdle.

intended to protect beneficiaries from fiduciaries who might subordinate the beneficiaries' financial interests to those of political or social groups with whom the fiduciary sympathized. Legally, the "sole interest" rule implied that the trustee had to prefer investments with superior risk-adjusted returns, regardless of the social impact of the corporate issuer. Nervous that they might run afoul of the law, many risk-averse fiduciaries shied away from SRI investing.[62]

To bring SRI investing into the mainstream, something had to be done, and predictably clever lawyers devised an answer. Conceptually, they "rebranded" SRI investing and converted it into ESG investing by asserting that consideration of the "governance factors" associated with public corporations would enable the fiduciary to identify superior investments and enhance risk-adjusted return.[63] By adding governance to the mix, they argued, one not only did good (ethically), but one also did better (financially).[64] This in turn enabled law firms to opine to their clients that ESG investing was fully compatible with the trustee's fiduciary obligations.[65] A few went even further and suggested that consideration of ESG factors might be mandatory.[66]

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[62] One recent study surveying 310 fiduciaries found that 47% believed that the use of ESG criteria either conflicted or might conflict with their fiduciary duty. See Fi360, ESG Survey for Fi360 Designees 2 (2009). For other recent studies, see Schanzenbach & Sitkoff, supra note 13, at 385 note 7.
[63] I borrow the term "rebranding" from Schanzenbach & Sitkoff, supra note 13, at 388. A key moment in this semantic transition from SRI to ESG came in 2005 with the release of a report sponsored by a UN working group and prepared by the international law firm of Freshfield Bruckhaus Deringer, which asserted that ESG investing was not only consistent with the trustee's fiduciary duties, but was "arguably required in all jurisdictions." See UNEP FIN. INITIATIVE, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUITONAL INVESTMENT at 13 (2005). See Schanzenbach & Sitkoff, supra note 13, at 389.
[64] An influential study in 2003 by Paul Gompers, Joy Ishii, and Andrew Merrick gave considerable credibility to the claim that governance factors did influence firm performance. See Gompers et al., Corporate Governance and Equity Prices, 118 Q.J. Econ. 107, 114-29 (2003). See also, Lucian Bebchuk et al., What Matters in Corporate Governance, 22 Rev. Fin. Stud. 783 (2009).
[65] The Freshfields opinion noted earlier, supra note 63, is one example.
[66] See UNEP FIN. INITIATIVE, supra note 63, at 13; Susan N. Gary, Best Interests in the Long Term: Fiduciary Duties and ESG Integration, 90 U. Colo. L. Rev. 731, 734-36 (2019).

Necessity is often the mother of invention, and the modest claim here advanced is merely that the need to calm the fears of risk-averse trustees best explains the addition of "governance" factors to environmental and social ones in order to convert SRI into ESG. Whatever the motive, this rebranding seems to have worked and in a brief period brought ESG into the investment mainstream. As of late 2019, some 1,900 asset managers (including some of the world's largest) have signed the PRI's statement of principles endorsing ESG investing;[67] hundreds of ESG indices have been published that provide ESG ratings on individual companies;[68] and Delaware and Oregon have amended their trust law to specifically address and facilitate ESG investing.[69] Even the major index funds, including BlackRock and Vanguard, which ordinarily ignore firm-specific factors as "indexed investors," are now actively focused on some ESG issues, such as climate change, and seeking to impose changes on firms in their portfolio.[70]

B. The Remaining Legal Uncertainty. Still, problems persist. Although the law in Europe has been sufficiently revised and clarified to make ESG investing appear safe for even the most risk-averse trustee,[71] U.S. fiduciary law still imposes in most states

[67] Schanzenbach & Sitkoff, supra note 13, at 387 (citing Principles for Responsible Investment, Signatory Directory, updated 11 2019 (2019)). Of these 1,900, the majority were European asset managers, showing the greater acceptance of ESG investing in Europe.

[68] Id. at 387.

[69] In 2018, Delaware amended its trust law to authorize ESG investing if it is authorized in the trust instrument. See Del. Code Ann., at 12, §3303(a)(4). See also Or. Rev. Stat. §§130.020, .755.

[70] See Schanzenbach & Sitkoff, supra note 13, at 386-387. For example, BlackRock's Larry Fink's letter to corporate CEOs asking for "net-zero" emissions by 2050 is an example of a strong intervention by a diversified investor. See supra note 37.

[71] European regulators have generally accepted and encouraged ESG investing. See Press Release, Eur. Ins. & Occupational Pensions Auth., "EIOPA Issues Opinions on Governance and Risk Management of Pension Funds (July 10, 2019, 3:00PM) https://perma.cc/M3YG-TFT3 (urging national regulatory authorities within the EU to "encourage pension funds to consider the impact of their long-term investment decisions and activities on ESG factors"). See also Schanzenbach & Sitkoff, supra note 13, at 387.

a “sole interest” rule that instructs the fiduciary to consider only the interests of the beneficiary (and thus not to give weight to the interest of others, including, the billions who may be affected by adverse climate change).[72] Of course, the “rebranding” of ESG some fifteen years ago was designed to show that ESG, as revised, could improve risk-adjusted returns, thus satisfying a hard-nosed economic test, even without giving weight to collateral benefits to others. Some scholars buy this argument and consider ESG to no longer be controversial,[73] but others continue to have doubts. Most notably, Professors Max M. Schanzenbach and Robert H. Sitkoff have drawn a sharp distinction between (1) ESG investing based on moral or ethical reasons or to achieve various collateral benefits (such as, I suppose, saving the Earth), and (2) ESG investing intended to improve risk-adjusted returns.[74]

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

[72] The “sole interest” rule applies to fiduciaries under private trusts, at ERISA plans, and at charitable foundations, but does not normally apply to the directors or officers of mutual funds or hedge funds (unless they are serving as advisors to an ERISA plan).
[73] See Gary, supra note 65. Professor Gary served as the Reporter for the Uniform Prudent Management of Institutional Funds Act, which alone makes her a significant voice in this field. The Principles for Responsible Investment (or “PRI”) represents probably the leading statement of the necessity for fiduciaries to adopt ESG factors into their investment analysis. It has obtained over 1,900 asset manager endorsements of its statement of principles. Schanzenbach & Sitkoff, supra note 13, at 387.
[74] See Schanzenbach & Sitkoff, supra note 13.

Still, the test proposed by Schanzenbach and Sitkoff would actually require considerably more than just a proper motive. They would require the prudent trustee to conclude, before investing based on any special ESG factor, that the "capital markets consistently misprice the factor in a predictable manner that can be exploited net of any trading and diversification costs."[75] Although this test purports to permit ESG investing, it may well be a wolf in sheep's clothing. Its very demanding standard about mispricing may be much harder for ERISA fiduciaries to satisfy. In effect, the fiduciary must determine, first, that ESG factors relate to firm performance in the case of a specific company, and, second, that this factor has been sufficiently mispriced that the fiduciary can exploit this mispricing (net of trading and diversification costs).[76]

Although I agree with them that ESG investing is not mandatory and that prudent trustees can reasonably conclude that they cannot outperform the market (as the Supreme Court has also observed in a relevant recent decision[77]), the possibility still seems remote that any court, either state or federal, would second guess and hold liable trustees who do decide to engage in ESG investing in the belief that it will enable them to achieve a superior portfolio. Courts are not suspicious of professional trustees, and, absent a personal self-interest on the part of the fiduciary, they have little reason to apply any enhanced scrutiny standard. Nor is there any clear history of courts intervening in this private world to impose liability.

[75] Id. at 451.
[76] Id. at 390, 450-453.
[77] See Fifth Third Bancorp v. Dudenhofer, 134 S. Ct. 2459, 2468 (2019).

In fairness, the "sole interest" rule regulates only some institutional investors (principally ERISA plans, common law trusts, and charitable foundations) and does not apply to mutual funds or hedge funds, which are subject to SEC regulation. Still, pension funds account for nearly half of the assets held by the institutional investors and the "sole interest" rule (and a Department of Labor rule extending it) may greatly reduce the size of the coalitions that can form to take collective action on ESG issues.

C. The Impact of a Portfolio-Wide Perspective. What is the best way out of this quandary? Here, we need to recognize that the key development is the new high level of common ownership that enables diversified institutional investors to take collective action on a portfolio-wide basis. Professors Schanzenbach and Sitkoff do not discuss this possibility, but fiduciaries should be able to engage in ESG investing on a portfolio-wide basis in full compliance with the "sole interest" rule so long as they make a finding that their collective strategy should raise returns or lower risks. For example, suppose that ERISA plans were to join both mutual funds and hedge funds in a joint effort to push the major energy companies to adopt tighter standards on emissions and to advance the date on which they would become carbon neutral. Their justification might be that, although this would reduce the financial returns for some portfolio companies (i.e., coal companies), it would benefit other companies (for example, those who produced solar power, wind power or nuclear power). Such pressure has in fact been successfully applied to Royal Dutch Shell and others in 2018.[78] Economically, such interventions would make sense -- if the losses to the

[78] In late 2018, Royal Dutch Shell was pressured by a coalition of institutional investors to set emission reduction targets to reduce its carbon footprint by 20% by 2035 and 50% by 2050. It had previously opposed these targets and

traditional energy companies were outweighed by gains to the other firms in the portfolio. As Madison Condon has framed it:

> "A rational owner would use his power to internalize externalities so long as its share of the cost to the externality-causing firms are lower than the benefits that accrue to the entire portfolio from the elimination of the externality."[79]

In the past, even a large institutional investor could not hope to cause a shift in corporate policy at a portfolio firm. But in the new age, where the Big Three usually votes 25% of the shares voted just by themselves (and can reach out to their fellow institutions for more support), they seem able to enforce their will effectively. Moreover, the firm managers that they will seek to pressure will typically be risk-averse and probably unwilling to jeopardize their careers by engaging in a contested proxy fight with these powerful institutions.

Of course, fiduciaries at an ERISA plan would have to make an informed judgment and compare the costs and benefits from such action to their portfolio. But this is exactly where consultants will predictably be hired to perform such an analysis.[80] Possibly, my cynicism is showing, but these consultants will usually be able to justify the requisite findings that their clients want. Indeed, this could become

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described them as "onerous and cumbersome," but once approached by this institutional coalition, it yielded quickly. See Condon, supra note 8, at 2. Thereafter, this same coalition next approached ExxonMobil, Chevron and BP. Id.

[79] Condon, supra note 8, at 6.

[80] For example, an environmental consulting firm, an accounting firm, or a proxy advisor might compare the loss to a major oil company (such as Royal Dutch Shell in our earlier example) from reducing its emissions or carbon footprint by a specified percentage to the benefits to other companies in its portfolio from achieving reduced pollution and postponing adverse climate change. Some asset managers appear to be making these estimates already. Schroders, a major asset manager, has calculated that a 4 degree increase (Centigrade) would produce "global economic losses" of $23 trillion over an 80 year period. See Condon, supra note 8, at 6. Because this is a short article, it will simply assert (and not demonstrate) that such calculations are difficult and tend to be error-prone.

a burgeoning growth business for accounting firms, proxy advisor firms, and other consultants.

This is also the juncture where the SEC could play a useful role. The SEC could require corporate managers to disclose data that they possessed about the costs of change (for example, the costs of reaching carbon neutrality by a given date). Such data (which increasingly exists at many large public companies) could be required to be disclosed in the firm's Management Discussion & Analysis ("MD&A").[81] This would not be an aggressive step for the SEC, as it would only be requiring the disclosure of data in management's possession and not mandating any position on ESG investing.

Conceivably, one could go even a step further: fiduciaries might also calculate the benefits to their beneficiaries, as individuals, from reducing pollution or slowing climate change.[82] Although under ERISA fiduciaries may be legally required to focus on the financial benefits to their beneficiaries, it may be possible to quantify those financial benefits on a portfolio-wide basis. Considering the personal financial

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

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

benefits to investors (i.e., benefits unrelated to the stock price) would be much more controversial, but the Department of Labor's rule could be modified to permit fiduciaries more discretion and still comply with ERISA's statutory language. Again, consultants could give fiduciaries detailed estimates based on legitimate studies.

The bottom line here is that trustees who reach a careful, informed position, based on legitimate data, are unlikely to face any serious risk of liability. What such prudent trustees most need is more information -- in particular, information that enables them to make comparisons between companies. To illustrate, suppose the SEC encouraged companies to express information in terms of estimated benchmarks. For example, by what date did the company believe it would become "carbon neutral"? At what cost? Many companies have already released projected dates (2040, 2050, etc.) Other companies have remained silent, but, to give an example, if the company had an estimated date (which it had never publicly disclosed), the SEC should indicate that this information was in its view material (as could be any estimate of the costs involved in reaching this target date). If such disclosure of internally generated estimates were required in the MD&A,[83] this information would also carry very little risk of liability under the federal securities laws.[84]

[83] Again, this is Item 303 of Regulation S-K, which is usually referred to as the "MD&A."

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

Already, many securities analysts prepare rankings of public companies in terms of ESG criteria. The problem with such rankings is a familiar one: "Garbage In, Garbage Out" -- the "GIGO Effect." Today, ESG disclosure is incomplete and unstandardized, with rankings that are dubious and inconsistent.[85] Public disclosure of ESG data would at a minimum improve the quality of such rankings and ratings and give trustees greater confidence in relying on such data. The bottom line here is that more ESG data will likely produce more decisions based on ESG criteria -- and also greater attention being given to systematic risk.

D. INVESTMENT VS. VOTING DECISIONS. Proponents of the "sole interest" rule tend to overlook the differences between voting and investment decisions. Historically, they have been viewed differently by both ERISA and the SEC. Although the "sole interest" rule may apply to both, a critical difference is that both the Department of Labor and the SEC long required fiduciaries to vote the shares held by their funds, on the theory that voting rights are an asset belonging to the fund and should not be wasted.[86] Both agencies also recognized that voting has low costs (in contrast to

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[85] ESG ratings often disagree, and mutual funds that emphasize their focus on ESG often score below non-ESG funds when subjected to objective review based on their own criteria. See Schanzenbach & Sitkoff, supra note 13, at 431.

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

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

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

investment decisions)[87] and that fiduciaries must constantly make voting decisions across their portfolios. As a result, for many years, both favored a rule of reason with regard to voting and shareholder activism.[88]

Then, in December, 2020 in the concluding days of the Trump Administration, the Department of Labor dropped a bombshell, reversing its prior approach to shareholder activism. No longer endorsing mandatory voting of shares and dropping the prior "reasonable expectation" test, it adopted a rule under which a fiduciary subject to ERISA "must not vote any proxy unless the fiduciary prudently determines that the matter being voted upon would have an economic impact on the plan."[89] A prerequisite to voting by an ERISA fiduciary is thus a prior determination by the fiduciary that the vote will have an economic impact on the plan; a "no impact"

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

[87] See Department of Labor, Employee Benefit Security Administration, Interpretive Bulletin 2016-1 ("Interpretive Bulleting Relating to the Exercise of Shareholder Rights and Written Statement of Investment Policy, Including Proxy Voting Policies or Guidelines") (12/29/2016). This revised bulletin adopted a "reasonable expectation" standard for when fiduciaries should engage in shareholder activism, with the expectation being that the plan's assets would be enhanced. However, in December, 2020, the Department of Labor withdrew Interpretive Bulletin 2016-1 and adopted a new final rule that significantly changed the standard for voting decisions to require that an ERISA fiduciary believe that voting shares in a particular case would enhance firm value. See text and notes infra at notes 88 to 89.

[88] Even under President Trump, the Department of Labor continued to use a "reasonable expectation" standard until the final days of the Trump Administration. Although it cautioned that the objective of shareholder activism must be the enhancement of the plan's value (meaning that the fiduciary may not be pursuing political or social preferences), it did not alter significantly prior Department of Labor positions. See Field Assistance Bulletin No. 2018-01 (April 23, 2018). However, this position changed dramatically in December, 2020, as explained in the text and the next footnote.

[89] See U.S. Dep't of Labor, "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," 85 Fed. Reg. at pages 81658-81695 (to be codified at 29 C.F.R. 2550.404a-1) (December 10, 2020). This rule became effective on January 15, 2021, just days before the end of President Trump's term. Before adopting this proposal on shareholder voting under ERISA, the Department of Labor a month earlier adopted a similarly restrictive rule on investments by an ERISA plan under ERISA's "exclusive benefit" rule. See U.S. Dep't of Labor, "Financial Factors In Selecting Plan Investments," 85 Fed. Reg. 72846 (November 13, 2020) (instructing fiduciaries that they "may not subordinate return or increase risks to promote non-pecuniary objectives…"). Id. at 72848. This provision was somewhat less surprising than the later rule on shareholder voting, because investments do involve greater costs and risks. Both may be re-examined by the Biden Administration.

determination implies then that the shares may not be voted. This is a proposed rule of enforced passivity, which goes well beyond simply precluding votes based on moral or ethical considerations.

Consider what this does to ERISA plans that tend to vote affirmatively on ESG measures. Hypothetically, suppose that an ERISA plan would like to vote on a shareholder proposal favoring greater diversity on the board. Is it now barred from voting on this precatory (and entirely aspirational) measure? Must it conduct a potentially expensive study first (whose outcome is not automatically obvious)? Must it show that the market has "mispriced" this special factor?[90] The Department of Labor's new rule does seem to intend that such steps be prerequisites to voting, and it is quickly attracting a firestorm of criticism.[91]

Three basic arguments call into question the legitimacy of this rule: First, voting is different from an investment or sales decision in that (i) loss of diversification benefits is less threatened by voting (whereas such benefits were threatened when investors sold off stocks of South African-based companies in the 1980's), (ii) the transaction costs of a voting decision are trivial (no brokerage fee is involved and no sale proceeds have to be re-invested), and (iii) the failure to vote can also result in loss to shareholders. That is, shareholders may suffer losses as much from the inability to vote as from "bad" voting decisions. Second, an ERISA fiduciary can make a voting decision on a portfolio-wide basis, and the rule should apply

[90] This is the position taken by Professors Schanzenbach and Sitkoff. See text and notes supra at note 75.
[91] For example, see Kurt Schacht, "The Labor Department Is Tearing Down a Landmark of Investor Protection," Barron's (Online), September 12, 2020; Brian Croce, "Proxy Proposal Angers Institutions: Shareholders Believe DOL Awarding 'Big Fat' Giveaway To Business," Pensions & Investments, Vol. 48. Issue 18 (Sept. 7, 2020); Peter Rasmussen, "ERISA Voting Proposal Would Limit ESG Factor Use," Bloomberg Law Analysis, Sept. 10, 2020.

differently in these cases to reflect the prospect of gain. Sometimes (as in the case of climate change votes), the fiduciary may be able to net out the gains and losses across its portfolio and find that a positive financial result from the vote is likely. Other times (such as in cases involving race or gender issues), the fiduciary may believe that a market wide shift toward board diversity would yield positive gains, but it would be too costly to conduct the requisite studies.[92] Third, some states have amended their "sole interest" rule to recognize and permit ESG investing,[93] but the Department of Labor's rule may now preempt such inconsistent state rules. Traditionally, federal agencies (particularly in Republican administrations) have been cautious about preempting state law in the belief that, in a federal system, states should be entitled to experiment and respond to local conditions and circumstances. Nonetheless, without explanation or justification, the new Department of Labor rule would seem to preempt inconsistent state rules. Obviously, the Biden Administration should review and reconsider this rule carefully.

E. THE COMING CONTROVERSY OVER PORTFOLIO-WIDE DECISION MAKING. The vision that portfolio-wide voting by institutional investors could reduce externalities has excited scholars.[94] Viewed in economic terms, this is a relatively conservative

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[92] An elaborate literature exists concluding that investments in Corporate Social Responsibility" (or "CSR") do increase firm value modestly and do reduce systematic risk. See Rui Albuquerque, Yrjo Koskinen, and Chendi Zhang, Corporate Social Responsibility and Firm Risk: Theory and Empirical Evidence, Management Science 65(10): 4457-4469 (https://doi.org/10.1287/mnsc.2018.3043).

[93] See text and note supra at note 68 (discussing statutes in Delaware and Oregon).

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

idea, because it does not involve fiduciaries subordinating economic returns to social welfare (as the proponents of "stakeholder capitalism" sometimes demand). Rather, fiduciaries are simply seeking to improve returns and reduce risk by responding to systematic risks that could depress the entire economy.

Nonetheless, it will likely arouse more controversy than modest concessions to stakeholders. Consider this hypothetical: five diversified index funds threaten a proxy contest to replace at least some of the directors of Smoky Coal Corp., unless it agrees to comply promptly with certain environmental restrictions. Fearing a proxy contest and their ouster, Smoky Coal's management induces its board to agree to the restrictions and to appoint a partial slate of directors nominated by the index funds. On the announcement of this decision, Smoky Coal's stock price falls 10%, and Smoky Coal's management closes its principal mine in Kentucky, with a resulting large lay-off of miners. Employees are outraged, and a prominent Senator from Kentucky announces a senatorial committee hearing on the "arrogance" of the index funds.

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

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

CONCLUSION

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

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

(2) Individual investors (at least if undiversified) have reason to fear that portfolio-wide voting by diversified institutions will adversely affect them. Today, they are not adequately advised about the conflicts that arise between their interests and those of both diversified institutional investors and activist hedge funds;

(3) Because of the high level of common ownership among diversified institutional investors, these investors can potentially profit on a portfolio-wide basis by imposing constraints that seek to reduce externalities. But again, this aggravates the conflict between diversified and retail investors.

(4) Because ESG disclosures and high common ownership enable diversified institutions to make decisions on a portfolio-wide basis and potentially to reduce systematic risk, the advent of portfolio-wide decision-making (both as to investments and voting) may represent the most

important contemporary change in institutional investor behavior. Although it appears to be logically consistent with the "sole interest" rule, it will provoke continuing controversy.

(5) There is little need for a federal "sole interest" rule. No claim has been made that the states have failed to enforce their rules. Absent a showing that state law has failed or cannot be enforced, a federal rule is undesirable, as it may preempt sensible variations at the state level.

This article has not asserted that fiduciaries must favor ESG investing. Decisions either to engage or not to engage in ESG investing should both be protected. The real issues for the future are: (i) whether the Trump Administration's efforts to chill ESG voting decisions (and thus by extension ESG investing) should be reversed; and (ii) whether institutional investors are prepared to face significant political controversy and pushback if they pursue portfolio-wide voting policies.[95]

For the SEC, this transition may force it to redefine itself. Since its creation, it has been an agency committed to serving "stock picking" individual investors. Such investors are, however, fading from the scene. This does not mean they should be ignored, but that greater attention must be given to the majority of individual shareholders who are today diversified (and often indexed).

[95] It is not just institutional investors who are under attack; nor simply the Department of Labor that is leading this campaign. In 2020, possibly in response to their activism in assisting institutional investors, proxy advisors were subjected to new and burdensome SEC rules that will slow the process by which they can advise and assist their clients. See Michael Cappucci, The Proxy War on Proxy Advisors, 16 NYU J. L. & Bus. 579 (2020). My point here is only that this example may concern and caution institutional investors, who must realize that activism can produce political retaliation in their cases as well. To be sure, the major institutional investors have much greater financial resources than the proxy advisors.

Common ownership has both an upside and a downside, and to date little scholarly attention has focused on the upside. Shareholders have not been regarded as the "true owners" of the corporation, since Berle and Means announced the separation of ownership and control many decades ago. Yet today, shareholders have regained the powers of "true owners." Unlike their 19th Century antecedents (for example, the railroad, oil and bank barons), however, the focus of institutional investors, as owners, will logically shift to maximizing portfolio value, not the value of individual stocks. One implication of this transition is that it may solve a problem that has frustrated legal scholars for decades. Over that period, many scholars have sought to find a strategy to make public corporations behave more virtuously.[96] Despite their gallant efforts, they have not fully persuaded most of us, and more conservative scholars have responded that reducing the externalities associated with corporate behavior was not the job of corporate law.[97] Now, without any change in corporate law, a real possibility has arisen that institutional activism may curb externalities and lead to a better (and not just more profitable) society.

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

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

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