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Sustainable Corporate Governance: The Role of the Law

Luxembourg Sustainable Finance Seminar

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Outline

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Motivation

1. Large listed companies responsible for big part of GHGs
   - > 70% GHGs by 100 largest companies; 1/3 publicly held
2. Who owns large companies? Institutional investors: 41% public equity worldwide
3. Institutional ownership (→ voting power) is concentrated
   - US/UK: > 50% on average
   - Europe: > 15% on average (> 30% in NL and Sweden)
4. Institutional investors *can* have an impact on corporate decision-making
   - Do they?
   - Can this impact contribute to a more sustainable corporate governance?
   - Would sustainable corporate governance be efficient?
     - Would this impact align with the sustainability preferences of ultimate investors (beneficiaries)?
     - Why not leave it to the political process → environmental regulation?

Framing the question

1. Can law support a Sustainable Corporate Governance?
2. A more more precise version:
    - Focus on *shareholders* (institutional/their beneficiaries)
    - Focus on *environmental* sustainability → GHGs (measurable)
    - Which law? *Securities law* → knowledgeable choice of institutional investors by beneficiaries
3. What are we after?
    - Correction of negative externalities → climate change mitigation
    - Hart & Zingales (2017) framework
        - Some individual shareholders (beneficiaries) have prosocial preferences
        - Mutual funds incorporating these preferences in their voting → corporate decisions more ‘sustainable’
    - Hart & Zingales overlook the *role of law*
        - Transaction cost: in the political process, but also in institutional shareholding (agency cost)
        - Securities law → ameliorating agency problem → correcting externalities

Environmental externalities: regulation vs institutional investors

- Limits of Regulation/Pigouvian taxes
  - Effective lobbying
  - Ineffective international coordination
  - Underrepresentation (especially young/future generations)

- Advantages of institutional shareholders
  - Can *persuade*, not coerce corporate management
  - Large institutional investors are *global*
  - Investment potentially incorporates the interest of *future generations*

- Challenges of sustainable corporate governance by institutional investors
  - Credible commitment to environmental sustainability
  - Commitment must be <u>recognizable</u> by beneficiaries → agency problems (e.g. greenwashing)

The agency cost challenge

- Do beneficiaries really want environmental sustainability?
  - Inflows /outflows of mutual funds respond to salient measures (e.g. Morningstar Globes, LCD)
  - Institutional investors react → portfolio rebalancing towards 'greener' companies
- Institutional investor behaviour → Effective impact on corporate decision-making?
  - Exit / Voice → Voice (engagement) more effective → beyond negative screening
  - Different business models → different incentives to engage
    - Example *index funds*: pursue low-cost strategies, market returns, but cannot exit large companies
- Key issue: alignment of institutional investors' incentives
  - Lack of *transparency* on sustainable investments
  - Lack of *transparency* on sustainable engagements
- **The role of (securities) law**
  - Improve transparency → reduce agency cost
  - **Disclosure *salient* to beneficiaries → choice of institutional investors → impact on corporate decisions**

The promise of EU securities regulation for a sustainable corporate governance

- Revised Shareholders Rights Directive 2017/828 (SRD II)
  - Transparency of voting, voting policies, engagements on ESG
  - Comply-or-explain
  - Do ultimate investors understand?
- Sustainable Finance Disclosure Regulation 2019/2088 (SFDR)
  - Mandatory disclosure
  - Specific info on sustainable investment/ promotion environmental characteristics
  - Salient to ultimate investors? Discussion on RTS
- Taxonomy Regulation 2020/852 (TR)
  - **Key innovation**: *definition* of what is environmentally sustainable, what is not
  - More salient than SFDR: **quantitative disclosure** – *proportion* of taxonomy-compliant investment
  - Negative disclosure – in the absence of taxonomy compliance (art. 7)
  - Industry-specific definitions (=*thresholds*): Technical Screening Criteria

Will a sustainable corporate governance ever work?

- How will beneficiaries react to the Taxonomy?
  - Experiencing a *salient* definition of what is sustainable, what is not
    - Question 1: how much choice do they have (e.g. pension funds)?
    - Question 2: how much do they value sustainability relative to financial return?
- How will institutional investors react to the Taxonomy?
  - Index investors
    - Not much choice: engage on ESG or disclose a lower proportion of Taxonomy compliance. Enough incentive?
  - Active investors
    - May continue (negative) screening: Exit > Voice
    - But, they still need to diversify risk → more engagement with unsustainable industries that can't be avoided
- Political economy
  - Lobbying by industries to qualify for the Taxonomy (e.g. gas) → Greenwashing again?
  - Why should large, diversified institutional investors care to lobby for particular industries?

Looking forward to your questions

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