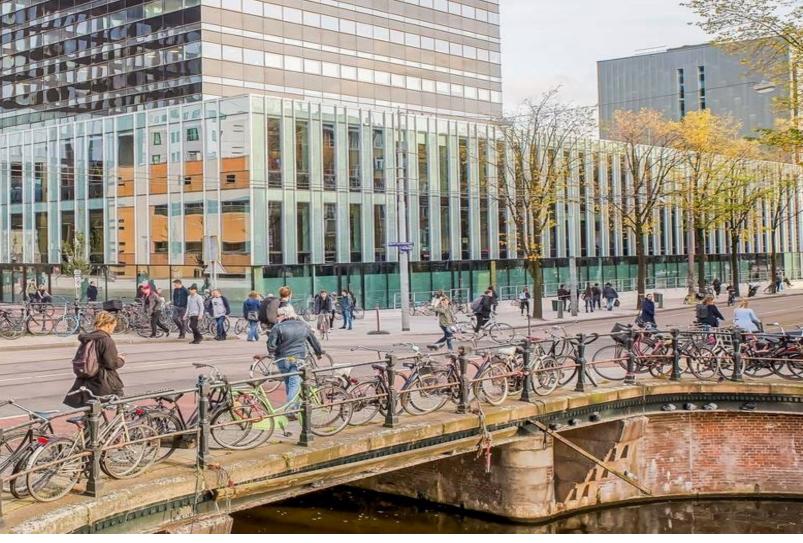




Sustainable Corporate Governance: The Role of the Law

Luxembourg Sustainable Finance Seminar

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Outline

- 1. Motivation
- 2. Framing the question
- 3. Environmental externalities: regulation vs institutional investors
- 4. The agency cost challenge
- 5. The promise of EU securities regulation for a sustainable corporate governance
- 6. Potential criticism





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 (\rightarrow voting power) is concentrated
 - \circ 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 \rightarrow 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 \rightarrow GHGs (measurable)
 - Which law? *Securities law* \rightarrow knowledgeable choice of institutional investors by beneficiaries
- 3. What are we after?
 - Correction of negative externalities \rightarrow climate change mitigation
 - Hart & Zingales (2017) framework
 - Some individual shareholders (beneficiaries) have prosocial preferences
 - Mutual funds incorporating these preferences in their voting \rightarrow 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 \rightarrow ameliorating agency problem \rightarrow 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

0 Can persuade, not coerce corporate management

• Large institutional investors are *global*

0 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?
 o Inflows /outflows of mutual funds respond to <u>salient</u> measures (e.g. Morningstar Globes, LCD)
 o 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 \rightarrow reduce agency cost

• Disclosure *salient* to beneficiaries \rightarrow choice of institutional investors \rightarrow impact on corporate decisions





The promise of EU securities regulation for a sustainable corporate governance

- Revised <u>Shareholders Rights Directive</u> 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)
 - o Mandatory disclosure

0 Specific info on sustainable investment/ promotion environmental characteristics

0 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
 - 0 Negative disclosure in the absence of taxonomy compliance (art. 7)
 - 0 Industry-specific definitions (=thresholds): Technical Screening Criteria





Will a sustainable corporate governance ever work?

- How will beneficiaries react to the Taxonomy?
 - 0 Experiencing a *salient* definition of what is sustainable, what is <u>not</u>
 - Question 1: how much <u>choice</u> 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?

 \circ Index investors

- Not much choice: engage on ESG or disclose a lower proportion of Taxonomy compliance. Enough incentive?
- o Active investors
 - May continue (negative) screening: Exit > Voice
 - But, they still need to diversify risk \rightarrow 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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