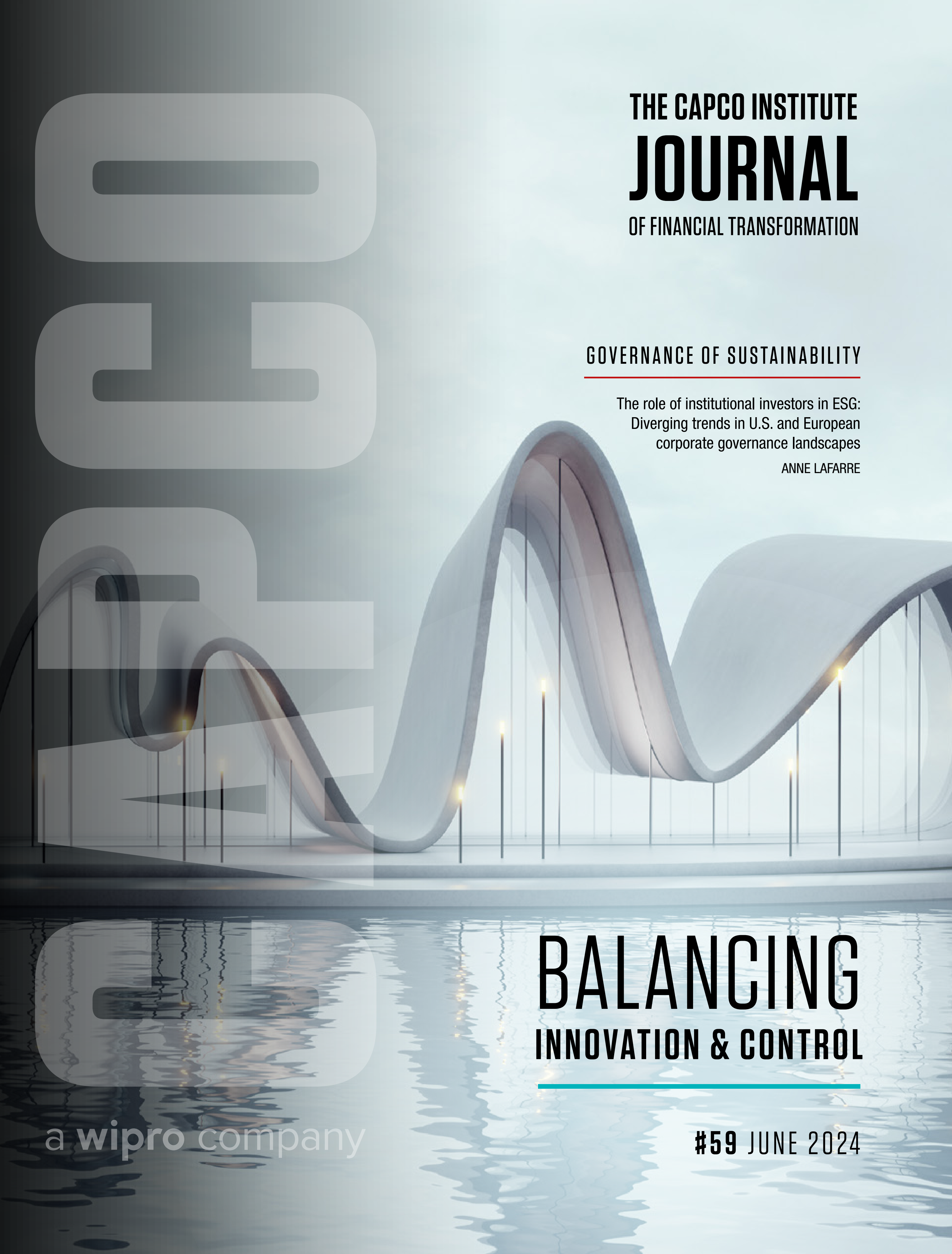

THE CAPCO INSTITUTE

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GOVERNANCE OF SUSTAINABILITY

The role of institutional investors in ESG: Diverging trends in U.S. and European corporate governance landscapes

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BALANCING
INNOVATION & CONTROL

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My thanks and appreciation to our contributors and our readers.

Anne-Marie Rowland

Annie Rowland, **Capco CEO**

THE ROLE OF INSTITUTIONAL INVESTORS IN ESG: DIVERGING TRENDS IN U.S. AND EUROPEAN CORPORATE GOVERNANCE LANDSCAPES

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ABSTRACT

This article explores the divergent regulatory, political, and societal trends in Europe and the U.S. regarding the environmental, social, and governance (ESG) rights and duties of institutional investors. While the SEC in the U.S. has demonstrated a greater focus on stricter ESG disclosure rules, political debates persist, reducing ESG discussions to mere ideology. In contrast, Europe exhibits a significant surge in sustainable finance and corporate governance, emphasizing transparency obligations outlined in regulatory initiatives like the SFDR. Examining the tools available to institutional investors, this article delves into the disparities in duties imposed on them in the U.S. and Europe and scrutinizes the voice tools they employ for promoting ESG goals as active owners, with a particular focus on shareholder sustainability proposals. In conclusion, this article highlights the need for a more harmonized and effective approach to sustainable investment. It advocates aligning European aspirations for sustainable capital allocation in the member states with increased emphasis on sustainability voice, potentially through a forthcoming new Shareholder Rights Directive (SRD III).

1. INTRODUCTION

In a period marked by major global concerns over sustainability challenges, greater attention has been paid to responsible business and financial practices. Institutional investors are facing pressure to actively use their influence regarding environmental, social, and governance (ESG) issues within the companies they choose to invest in.[1] In theory, these investors can have a central role in steering environmentally friendly corporate behaviors, including encompassing endeavors to diminish carbon emissions.[2] They possess the ability to direct funds towards sustainable investments and hold significant shareholder rights and engagement tools. These range from informal shareholder interactions like meetings, calls, and letters to actively voting against managerial proposals.[3] But in practice, there are some important doubts about their actual role in the transition towards more sustainable business activities.

Several institutional investors have openly expressed their commitment to corporate sustainability through different channels, including the yearly Letter to CEOs from BlackRock CEO Larry Fink. However, the actual impact and depth of their engagement remains debatable, with research emphasizing concerns about greenwashing practices. Some authors question the sustainability preferences of investors, especially "The Big Three" (BlackRock, Vanguard, and State Street Global Advisors), raising doubts about genuine commitment

[1] For instance, Strine, L., 2019, "Toward fair and sustainable capitalism: a comprehensive proposal to help American workers, restore fair gainsharing between employees and shareholders, and increase American competitiveness by reorienting our corporate governance system toward sustainable long-term growth and encouraging investments in America's future," University of Pennsylvania, Institute for Law & Economics research paper no. 19-39.

[2] Ringe, W-G., 2021, "Investor-led sustainability in corporate governance," ECGI Law Working Paper 615/2021

[3] McCahery, J. A., Z. Sautner and L. T. Starks, 2016, "Behind the scenes: the corporate governance preferences of institutional investors," Journal of Finance 71:6, 2905-2932

amid financial motivations.[4] Yet, being universal owners, other researchers claim that these large asset managers can potentially play a pivotal role in reducing climate and other sustainability risks that affect market performance.[5]

The current ESG landscape presents complex dynamics, with research underscoring contrasting trends in the U.S. and Europe.[6] The controversy surrounding the term "ESG" is significant.[7] Shifting political sentiments in the U.S. appear to downplay the inclination of The Big Three and institutional investors to exert influence for societal benefit.[8] Supporters of the "anti-woke" movement perceive ESG as a subjective preference,[9] contending that pension funds and institutional investors should exclude ESG criteria from their investments.[10] In August 2022, BlackRock CEO, Larry Fink, received a letter from Republican attorney generals, accusing the asset manager of prioritizing its climate agenda over pension beneficiaries' interests.[11] Florida withdrew its assets from BlackRock in protest to Fink's sustainability statements,[12] and many U.S. states have introduced anti-ESG legislative proposals.[13] In December 2023, Tennessee sued BlackRock, alleging violations of consumer protection laws through the misuse of ESG factors in its investment strategy.[14] Skepticism about ESG is evident even among financial industry leaders. In 2022, Stuart Kirk, HSBC's global head of responsible investing, dismissed concerns about climate risk, stating that such risks are too distant for banks to consider and carry minimal financial risk.[15] Kirk's perspective, shared by many, is that political and financial leaders may overstate the threats posed by climate change and other sustainability risks, viewing ESG primarily as an expression of ideology.[16]

> *"The current ESG landscape presents complex dynamics, with research underscoring contrasting trends in the U.S. and Europe."*

In Europe, in contrast, a prevailing belief underscores the indispensability of ESG investing and active ESG ownership for fostering a sustainable economy.[17] The core idea is that the financial services sector must channel capital into sustainable investments to ensure enduring economic growth.[18] The pivotal question is not whether ESG should be pursued, but how regulations can be leveraged to amplify sustainable investment activities and engagement by institutional investors, thereby contributing to a more sustainable economic landscape. This distinct European perspective appears to result in a greater commitment to ESG goals among European institutional investors, as evidenced by recent studies and in contract to their U.S. counterparts.[19]

In this article, we delve into the divergent regulatory, political, and societal trends in Europe and the U.S. regarding the rights and duties of institutional investors concerning ESG. Two primary avenues for investors influencing decision making within a company are commonly identified: voice, and exit and selection.[20] Shareholders can either directly encourage

4 Including, for instance, Bebchuk, L. A. and S. Hirst, 2019, "Index funds and the future of corporate governance: theory, evidence, and policy," Columbia Law Review 119, 2029-2146; Bebchuk, L.A. and S. Hirst, 2022, "Big Three power, and why it matters," Boston University Law Review 102, 1547-1600; Goshen, Z. and A. Hamdani, 2023, "Will systematic stewardship save the planet?" European Corporate Governance Institute – law working paper no. 739/2023.

5 Including, for instance, Azar, J., M. Duro, I. Kadach and G. Ormazabal, 2021, "The Big Three and corporate carbon emissions around the world," Journal of Financial Economics 142, 674-696.

6 ShareAction, 2023, Voting Matters 2023

7 For a discussion of the history and use of the term 'ESG', see Pollman, E., 2022, "The making and meaning of ESG," European Corporate Governance Institute – law working paper no. 659/2022.

8 Bebchuk, L. A. and S. Hirst, 2022, "Big Three power, and why it matters," Boston University Law Review, Volume 102, 1547-1600

9 Pollman, E., 2022, "The making and meaning of ESG," European Corporate Governance Institute – law working paper no. 659/2022

10 See, for example Lipton, M., 2022, "ESG, stakeholder governance, and the duty of the corporation," Harvard Law School Forum on Corporate Governance blog dated September 18.

11 See http://tinyurl.com/mtvymm49.

12 Master, B., 2023, "BlackRock steps up spending on U.S. lobbying in face of anti-ESG attacks," Financial Times Jan. 29

13 Worland, J., 2023, "Lone star 'wake up call': Texas Republicans want to ban ESG in insurance," Time, March 1. The article refers to an analysis of anti-ESG laws by Capital Monitor, http://tinyurl.com/zdkjv245.

14 Schmitt, W., 2023, "BlackRock sued by Tennessee over ESG strategies," Financial Times, December, 18

15 See http://tinyurl.com/42cu6mj8 (around minute 5:05).

16 Edgecliffe-Johnson, A., 2022, "The war on 'woke capitalism'," Financial Times, May 27, Pollman, E., 2022, "The making and meaning of ESG," European Corporate Governance Institute – law working paper no. 659/2022

17 European Commission, 2021, "Strategy for financing the transition to a sustainable economy," July 6

18 Idem.

19 Including, for instance, ShareAction, 2023, "Voting Matters 2023,"; Lafarre, A. J. F., 2024, "Do institutional investors vote responsibly? Global evidence," TILEC discussion paper no. DP2022-001.

20 Hirschman, A. O., 1970, Exit, voice and loyalty, Harvard University Press

corporate management to instigate change or abstain from including the company in their investment portfolio altogether, or opt to exit the company, thereby indirectly impacting corporate management conduct.

2. INVESTMENT STRATEGY AND ESG DUTIES

In response to growing concerns regarding deceptive investor practices, adoption of disclosure rules related to investment strategies has gained attention among regulators. The absence of standardized information in sustainable investing creates a breeding ground for misleading practices,[21] making uniform disclosure obligations a potential solution.[22] These obligations may compel institutional investors to enhance transparency, enabling clients and beneficiaries to compare investment opportunities and make well-informed decisions while encouraging investors to align with sustainability preferences. Consequently, institutional investors may find themselves competing not only on conventional financial factors but also on the sustainability spectrum.[23] This shift allows corporate sustainability leaders to distinguish themselves, garnering reputational benefits and attracting funds from sustainability-focused clients. Many researchers, however, question the effectiveness of such disclosure obligations as they do not directly require institutional investors to change their behavior; hence, their disclosures might reflect nothing more than the status quo.[24] Others highlight the complexity of sustainable finance information.[25] Notably, The Economist magazine highlights the challenges that ESG rating agencies face, indicating measurement problems that lead to contradictory scores, often forming the foundation of sustainable investment strategies.[26] Notwithstanding these limitations, there remains a regulatory focus on ESG disclosure obligations on both sides of the Atlantic.

2.1 ESG (disclosure) duties in the U.S.

In the U.S., there is a general movement towards more reliable sustainability information. On May 25, 2022, the U.S. Securities and Exchange Commission (SEC) proposed new disclosure requirements for ESG funds. First, there would be three categories of registered ESG funds: (1) "integrated" (funds that consider ESG factors, but those factors are not the primary consideration), (2) "focused" (ESG factors are the primary consideration) and (3) "impact" (funds that pursue ESG impact).[27] The proposal also requires ESG-focused funds that claim to consider environmental issues to include GHG (greenhouse gas) emissions data related to their portfolio company investments unless the fund discloses that it does not consider GHG emissions as part of its investment strategy.[28] Previously, the SEC had proposed requiring large companies to report on climate-related risks and GHG emissions.[29] In another proposal, approved on September 2023, the SEC proposed to modify the scope of the "Names Rule", which states that if a fund's name suggests a particular focus, at least 80% of the value of its assets must be invested accordingly – to include funds using ESG-related names.[30]

Although these SEC proposals seem to indicate that the U.S. is heading towards more ESG duties for institutional investors, this trajectory is not without political debate. Under the Trump administration, the U.S. Department of Labor (DOL) had proposed a change in the law to allow pension funds governed by the Employee Retirement Income Security Act of 1974 (ERISA) to include only "pecuniary factors" in their investment decisions as part of their fiduciary duty.[31] The final version of this law states that an investment decision must be based solely on monetary factors and to not subordinate the interests of participants and beneficiaries to non-monetary objectives.

[21] Berg, F., K. Fabisik, and Z. Sautner, 2021, "Is history repeating itself? The (un)predictable past of ESG ratings," European Corporate Governance Institute – finance working paper no. 708/2020
[22] Pacces, A., 2021, "Will the EU Taxonomy Regulation foster sustainable corporate governance?" Sustainability 13:21, 12316
[23] Idem.
[24] Including, for instance, Bruner, C., 2022, "Corporate governance reform and the sustainability imperative," Yale Law Journal 131:4.
[25] Ahlström, H. and B. Sjåfjell, 2022, "Complexity and uncertainty in sustainable finance: an analysis of the EU taxonomy," in Cadman, T. and T. Sarker (eds.), De Gruyter handbook of sustainable development and finance, De Gruyter
[26] The Economist, 2022, "ESG investing. A broken idea," July 21, http://tinyurl.com/yrvzrk4x. Following Cools, S., 2023, "Climate proposals: ESG shareholder activism sidestepping board authority," in Kuntz, T., (ed.), forthcoming, Research handbook on environment, social, and corporate governance, Edward Elgar Publishing.
[27] Funds that do not take ESG factors into account are not rated.
[28] See http://tinyurl.com/26d7ny4y
[29] See http://tinyurl.com/4y6dws6w
[30] See http://tinyurl.com/bdfbmc86. For a discussion of the Names Rule, see: Fisch, J. E. and A. Z. Robertson, 2023, "What's in a name? ESG mutual funds and the SEC's Names Rule," European Corporate Governance Institute – law working paper no. 697/2023.
[31] DOL, 72846 Federal Register 85(220), November 13, 2020, available at http://tinyurl.com/4f4w5at5. For the 2020 law, see http://tinyurl.com/3uydt4rh.

DOL does recognize that ESG factors may be compatible with a purely financial analysis of an investment decision. Non-monetary objectives can serve as a "tie-breaker" if investment options are financially indistinguishable, but this requires documentation of why the monetary factors were insufficient to make the decision, including a comparison of investment options and how the non-monetary objectives are consistent with the financial interests of participants and beneficiaries.

In November 2022, however, DOL passed new legislation under the Biden administration ("DOL's ESG Rule").[32] This ESG Rule removed the term "pecuniary factors" and emphasizes that investment decisions focus on the relevant "risk-return factors", and that ESG factors may be included here. DOL states that the new law seeks to eliminate "the chilling effect created by the prior administration on considering environmental, social and governance factors in investments."[33] In essence, DOL's ESG Rule from 2022 does not differ that much from the 2020 one, and does not really encourage the consideration of ESG factors.[34] However, it does remove the ambiguity as to whether the inclusion of ESG factors is permissible and the administrative costs that accompanied it under the Trump administration's legislation. Particularly, DOL's ESG Rule confirms that when selecting investments, pension funds must focus on relevant risk-return factors and not subordinate the interests of participants and beneficiaries to objectives unrelated to benefits within a pension plan. Republicans (and two Democrats) stopped this law in early March 2023 on the grounds that it would be part of woke capitalism, after which President Biden used his veto power – for the first time – on March 20, 2023 against this Congressional resolution.[35] Adding to the ambiguity surrounding the status of the DOL's ESG Rule is the filing of several lawsuits against DOL aiming to prevent its enforcement.[36]

2.2 ESG (disclosure) duties in Europe

In recent years, there has been a significant surge in emphasis on sustainable finance and corporate governance within the European Union. Europe is actively pursuing this goal through its 2018 Sustainable Finance Action Plan and its renewed strategy for financing the transition to a sustainable economy,[37] primarily relying on transparency obligations outlined in regulatory initiatives such as the Sustainable Finance Disclosure Regulation (SFDR),[38] Corporate Sustainability Reporting Directive (CSRD),[39] and the Taxonomy Regulation,[40] among others.[41] The SFDR plays a pivotal role in clarifying institutional investors' responsibilities regarding sustainability. It mandates financial market participants to furnish detailed information about sustainability risks, the sustainable attributes of financial products, and their adverse impacts on sustainability factors. One notable feature is the SFDR's classification of ESG funds, ranging from Article 6 (no sustainability objective) to Article 8 (fostering sustainability characteristics, light-green), and Article 9 (with a sustainability objective, dark-green). Complementing the SFDR are technical standards (RTS) presented as delegated regulations, offering additional insights into the content and methodology of disclosure requirements.[42]

Notably, the latest updates to the RTS, focusing on sustainable investments in the fossil gas and nuclear sectors, came into effect on February 21, 2023.[43] Moreover, as part of Europe's sustainable financial strategy, revisions to the MiFID II Delegated Regulation[44] necessitate investment firms to incorporate their clients' sustainability preferences into the advisory process. These adjustments mandate investment firms to ensure that transactions align with their clients' investment objectives, encompassing both risk tolerance and sustainability preferences.

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[32] For this 2022 law, see http://tinyurl.com/yc8yy8p3.
[33] See Dyer, E., M. Albano, C. Gottlieb, 2022, "New DOL guidance on ESG and proxy voting," Harvard Law School Forum on Corporate Governance blog, December 22.
[34] See Malone, L., E. Rozow, and G. M. Gerstein, 2023, "Biden's first veto: understanding the implications of the DOL's ESG rule," Harvard Law School Forum on Corporate Governance blog, April 6.
[35] Gardner, A., 2023, "Biden vetoes bill for first time to block anti-ESG measure," Bloomberg, March 20. See also, Fedor, L. and J. Politi, 2023, "Joe Biden expected to issue first presidential veto in anti-ESG vote," Financial Times, March 1.
[36] See Malone, L., E. Rozow, and G. M. Gerstein, 2023, "Biden's first veto: understanding the implications of the DOL's ESG rule," Harvard Law School Forum on Corporate Governance blog, April 6.
[37] European Commission, 2021, "Strategy for financing the transition to a sustainable economy," July 6
[38] Regulation (EU) 2019/2088
[39] Directive 2022/2464/EU
[40] Regulation (EU) 2020/852
[41] There is also a proposed regulation for a standard for European green bonds dated July 6, 2021 (also called "European green bonds" or "EuGBs") that was adopted by the Council in October 2023.
[42] Delegated Regulation (EU) 2022/1288
[43] Delegated Regulation EU 2023/363
[44] Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organizational requirements and operating conditions for investment firms.

The overview presented above highlights Europe's commitment to transparency obligations, including the advisory process, and the uniformity of sustainability disclosures within capital markets. Despite the complexity and ongoing changes in the European framework,[45] these obligations are designed to contribute significantly towards the actual sustainability of ESG investments. Clients and beneficiaries of institutional investors are empowered to compare investment options, facilitating well-informed investment decisions. Ideally, this shift will prompt institutional investors to compete not only on traditional financial returns but also on the sustainability of their investments.[46]

Can the direction set by the European legislature yield the intended results? Some scholars have expressed skepticism. Bruner (2022), for instance, contends that while transparency is often viewed as a crucial precursor to meaningful reform, it is frequently treated as a substitute for it.[47] Additionally, the question remains whether less sustainable companies will genuinely face a higher cost of capital.[48] In these cases, active ownership remains the preferred option. However, research shows that these ESG disclosure duties have some positive effects. For instance, Dai et al. (2023) study the effects of the SFDR and find that it has triggered a significant decarbonization of the investment portfolios within E.U. funds professing a commitment to sustainability criteria.[49] According to the authors, these reduced emissions levels can be attributed to both alterations in funds' investment strategies and shifts in firm-level emissions. It seems that with disclosure duties like the SFDR institutional investors have the ability to truly signal that they are investing sustainably. Ideally, greenwashing practices become more challenging, fostering a genuine emphasis on sustainability.

The unfolding European initiatives present contrasting trajectories compared to trends in the U.S., especially concerning the ongoing discourse on the compatibility of ESG investing and fiduciary duties under ERISA in the latter. However, even in Europe, there is an ongoing debate regarding ESG obligations of financial services organizations. Notably, the provisional agreement on the Corporate Sustainability Due Diligence Directive (CSDDD),[50] dated December 14, 2023,[51] underscores that while the financial services sector is encompassed in the legislative initiative, its application will be limited. Specifically, financial entities will only be required to implement the CSDDD for a limited part of their supply chains.

3. ACTIVE OWNERSHIP

Within the exit-voice dichotomy, voice is widely acknowledged to be the more powerful tool.[52] Shareholder engagement, often viewed as a form of shareholder activism, involves shareholders proactively initiating meaningful dialogues, frequently conducted discreetly behind the scenes.[53] Additionally, investors can exercise their formal voice rights, such as voting and shareholder proposal rights.[54] In this section on active ownership, the analysis focuses on shareholder sustainability voting, as voting serves as a crucial escalation strategy for institutional investors to exert influence on corporate management.[55]

3.1 Active ownership in the U.S.

While shareholder activism in the U.S. has historically been associated with small individual shareholders, known as "corporate gadflies", and more aggressive hedge funds, who dominate the agendas of large corporations with their

[45] For instance, Partiti, E., 2023, "Addressing the flaws of the Sustainable Finance Disclosure Regulation: moving from disclosures to labelling and sustainability due diligence," forthcoming in European Business Organisation Law Review.
[46] Pacces, A., 2021, "Will the EU Taxonomy Regulation foster sustainable corporate governance?" Sustainability 13:21, 12316
[47] Bruner, C., 2022, "Corporate governance reform and the sustainability imperative," Yale Law Journal 131:4
[48] Anabtawi, I. and L. Stout, 2008, "Fiduciary duties for activist shareholders," Stanford Law Review 60:5, 1255-1308
[49] Dai, J., G. Ormazabal, F. Penalva, and R. A. Raney, 2023, "Imposing sustainability disclosure on investors: does it lead to portfolio decarbonization?" European Corporate Governance Institute – finance working paper 945/2023
[50] Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, February 23, 2022
[51] See http://tinyurl.com/227jn3f9
[52] Broccardo, E., O. Hart, and L. Zingales, 2020, "Exit vs. voice," ECGI-Finance working paper no. 694/2020
[53] McCahery, J. A., Z. Sautner, and L. T. Starks, 2016, "Behind the scenes: The corporate governance preferences of institutional investors," Journal of Finance 71:6, 2905-2932
[54] Grewal, J., G. Serafeim, and A. Yoon, 2016, "Shareholder activism on sustainability issues," Harvard Business School Working Paper, No. 17-003; Lee, M-D. and M. Lounsbury, 2011, "Domesticating radical rant and rage: an exploration of the consequences of environmental shareholder resolutions on corporate environmental performance," Business & Society 50:1, 155-188
[55] Lafarre, A. J. F., 2024, "Do institutional investors vote responsibly? Global evidence," TILEC discussion paper no. DP2022-001

shareholder proposals, there has been a noticeable shift in recent years. Institutional investors, who nowadays own the majority of shares in companies worldwide, are no longer remaining silent and have instead started to support smaller activists and combine their powers in collaborative engagements using shareholder proposals.

A prime example of this shift is the unprecedented success of a newcomer activist group called Engine No. 1 in its proxy fight with ExxonMobil. Launched in December 2020 as an "impact hedge fund",[56] Engine No. 1 nominated four independent director candidates to the board of directors of ExxonMobil at the 2021 AGM. Despite owning only 0.02% of Exxon Mobil's stock, the fund was able to oust and replace three directors with the help of institutional investors. Engine No. 1's example also highlights another shift, namely the shift from proposals being mostly focused on governance issues – such as plurality voting rules, staggered boards, protection mechanisms, and access to the company's proxy – to shareholder proposals on sustainability topics, particularly climate change. In recent years, we have witnessed an increase in number of shareholder proposals submitted, with the highest level of submissions since 2016 in 2023.[57]

Regulations set forth by the SEC empower boards to exclude certain proposals from a company's proxy materials. These exclusions typically pertain to matters deemed inappropriate under state law or those concerning the company's routine business operations, as outlined in section 14a-8 of the Securities Exchange Act. The focal point of these no-action reliefs commonly revolves around the ordinary business operations ex Rule 14a-8(i)(7). The SEC employs a two-fold approach to evaluate the exclusion eligibility of a proposal under this exception. Firstly, a matter can be excludable for relating to ordinary business if it is fundamental to management's ability to run a company on a day-to-day basis that the matter could not, as a practical matter, be subject to direct shareholder oversight. In the Staff Legal Bulletin from October 2019,[58] the SEC, however, indicated that a company will not be permitted to exclude a proposal based on this ground that transcends the day-to-day business operations because it raises "a policy issue so significant" that it would be appropriate for a shareholder vote.

Climate-related resolutions are often categorized as significant enough to warrant the latter exception of a significant policy issue. This trend has been accentuated, particularly for climate proposals, since the end of 2021: the SEC announced its decision to no longer necessitate shareholders to demonstrate the issue's significance to the "specific" company.

Secondly, the SEC considers shareholder proposals that "excessively micro-manage the company" as related to ordinary business operations. In the same Bulletin, the SEC explained that a shareholder proposal may be considered micromanaging if it is too prescriptive, limiting the discretionary powers of the board of directors. As a result, the SEC excludes proposals that prescribe emission reduction targets in an overly detailed manner, such as stipulating specific methods for establishing or achieving these targets. The SEC illustrates the dichotomy in its approach by citing two sample shareholder proposals related to environmental, social, and governance (ESG) matters:

- **Proposal 1:** a proposal on annual reporting about "short-, medium- and long-term greenhouse gas targets aligned with the greenhouse gas reduction goals established by the Paris Climate Agreement to keep the increase in global average temperature to well below 2 degrees Celsius and to pursue efforts to limit the increase to 1.5 degrees Celsius."[59]
- **Proposal 2:** a proposal requesting a report "describing if, and how, [a company] plans to reduce its total contribution to climate change and align its operations and investments with the Paris [Climate] Agreement's goal of maintaining global temperatures well below 2 degrees Celsius."[60]

The first proposal, characterized by its excessive level of prescription, can be excluded. Conversely, the second proposal, characterized by its more general nature, would not be subject to exclusion.

While the SEC's more lenient stance on climate-related proposals may have led to an increase in ESG proposals, there is a concurrent tightening of thresholds. Under Rule 14a-8, shareholders were previously eligible to request the inclusion of their proposals in proxy materials if they held a minimum of

[56] Christie, A., 2021, "The agency costs of sustainable capitalism," UC Davis Law Review 55, 875-954
[57] See, Mueller, R. O., E. A. Ising, and T. J. Kim, 2023, "Shareholder proposal developments during the 2023 proxy season," Harvard Law School Forum on Corporate Governance blog, August 3.
[58] Staff Legal Bulletin No. 14K (CF) (SLB No. 14K)
[59] Devon Energy Corp. (March 4, 2019)
[60] Anadarko Petroleum Corp. (March 4, 2019)

U.S.$2,000 market value or 1% of the company's voting shares for at least one year preceding the submission. However, as of January 1, 2022, the threshold underwent a significant shift, becoming more contingent on the duration of shareholding. Shareholders now need U.S.$2,000 worth of the company's shares if held for a minimum of three years, U.S.$15,000 worth for a holding of at least two years, or U.S.$25,000 worth for a holding duration of at least one year. This adjustment reflects a more stringent criterion for shareholders seeking to include their proposals in the company's proxy materials.

In addition, the amendments that – transitionally – entered into force for shareholders on January 1, 2023 impose a one-proposal limit on "each person" for shareholder meetings, meaning a proponent can submit only one proposal, regardless of their capacity as a shareholder or a representative. Regarding resubmissions of shareholder proposals, the amendments raise the thresholds for excluding proposals addressing the same subject within the past five years to 5%, 15%, and 25% for votes received on matters previously voted on once, twice, or three or more times, respectively. These amendments imposed stricter rules for shareholders to submit shareholder proposals. But stricter rules will likely also apply on companies seeking to exclude shareholder proposals: on July 13, 2022, the SEC proposed further amendments to the Shareholder Proposal Rule 14a-8, but this time stricter requirements are put on companies seeking no-action relief.[61] Particularly, the suggested amendments aim to heighten the criteria for three key grounds of exclusion, making reliance on substantial implementation, duplication, and resubmission grounds for exclusion more challenging.

3.2 Active ownership in Europe

The European Commission (E.C.) addressed corporate governance shortcomings exposed by the global financial crisis, particularly the inadequate engagement of institutional investors. The 2012 Action Plan[62] led to the E.C.'s announcement of a package to enhance shareholder engagement and corporate governance reporting, culminating in the adoption of the revised shareholder rights directive (SRD II) in 2017.[63]

The Preamble of SRD II emphasizes shareholder engagement as a fundamental aspect of corporate governance, asserting that increased shareholder involvement can enhance both the financial and non-financial performance of companies, including factors related to environmental, social, and governance (ESG). The Directive operates under the corporate governance principle that shareholders play a crucial role in holding management accountable for their actions.[64] Articles 3g-3i of SRD II outline institutional investors' duties, including the disclosure of an engagement policy, monitoring of investments on crucial matters, dialogue with investee companies, exercising voting rights, cooperating with shareholders and stakeholders, and addressing conflicts of interest. The comply-or-explain principle applies to these obligations, such as disclosing the implementation of the policy and characteristics of arrangements with asset managers. Article 3h focuses on the alignment of investment strategy with long-term liabilities, and Article 3i requires asset managers to disclose how their strategy aligns with institutional investors' interests, promoting informed selection and alignment of long-term interests. Hence, following SRD II, but also the many stewardship codes that are adopted by European member states and other countries,[65] institutional investors are increasingly expected to showcase their proactive use of shareholder rights for sustainability purposes.

However, despite these initiatives, a significant gap remains between the SRD II framework and the national corporate laws of the European member states. The limitations imposed by member states' laws, grounded in the autonomy of boards, hinder the framework's ability to fully meet Europe's expectations. In traditional corporate governance discussions, two legal approaches are commonly discussed: regulatory strategies that limit the actions of company agents and governance strategies that empower shareholders (the principals).[66] While it is often believed that European member states typically adopt a governance strategy more often than the U.S., when it comes to sustainability engagement, it appears that shareholder rights in Europe are lagging behind.

[61] See: http://tinyurl.com/mswerp2k

[62] Communication From the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies (December 12, 2012)

[63] Directive (EU) 2017/828

[64] European Commission, 2011, "The EU Corporate Governance Framework," European Commission Green Paper COM(2011) 164 final, October 27

[65] Katalouzou, D. and D. W. Puchniak, 2022, Global shareholder stewardship, Cambridge University Press

[66] Kraakman, R., J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda, M. Pargendler, W-G. Ringe, and E. Rock, 2017, The anatomy of corporate law: a comparative and functional approach, third edition, Oxford University Press

The involvement of investors in sustainability matters is hindered by the distribution of substantive powers outlined in national corporate law statutes in Europe.[67] In many instances, corporate law systems in Europe categorize topics falling under the ESG umbrella as strategic matters within the purview of the board of directors, not the shareholder meeting. The scarcity of shareholder proposals in Europe is linked to regulatory differences in shareholder engagement and ownership disclosure, as well as distinctive stock ownership structures. Additionally, there is a perceived lower demand for activism on issues that have traditionally been more prominent in the U.S.[68] In the Netherlands, for instance, shareholder proposals face restrictions due to "oligarchic clauses" commonly found in the articles of association of Dutch listed companies.[69] Such clauses, for instance, necessitate shareholder resolutions to obtain approval from the managing or supervisory board, limiting the autonomy of shareholders. In addition, Dutch case law has solidified a doctrine emphasizing strong board autonomy,[70] making it practically impossible for shareholders to introduce binding and non-binding proposals related to the board's competence at shareholder meetings without the board's permission.

An important example of ESG proposal restrictions in France can be found at the 2022 AGM of the oil major TotalEnergies. In 2022, a consortium of institutional investors proposed a climate shareholder resolution to be included in the agenda of TotalEnergies' shareholder meeting. Following article L 225-105(2) of the "French Commercial Code" (FCC), one or more shareholders that represent at least 5% of the capital have the right to add a shareholder resolution to the shareholder meeting's agenda.[71] TotalEnergies' corporate board, however, refused to put it to a vote, arguing that the shareholder meeting is not the competent corporate body to decide on such a strategy matter.[72] Some members of the consortium voted against the re-election of TotalEnergies' board members in response.[73] The institutional investors formed again a consortium in 2023 to file another climate resolution at TotalEnergies' shareholder meeting. To ensure that the climate resolution will not be refused from TotalEnergies' 2023 AGM's agenda, the investors decided to make the resolution a consultative (non-binding) one.[74]

The inclusion of climate or broader sustainability-related shareholder proposals on the agenda emerges as a crucial element in steering the financial transition towards more sustainable business practices. While establishing direct causality remains challenging, research indicates that such proposals can exert a positive influence on corporate sustainability performance. Notably, Flammer et al. (2021) revealed that climate proposals contribute to companies' increased voluntary disclosures of climate risks.[75] Grewal et al. (2016) established a connection between shareholder proposals and ESG performance.[76] Additional insights from Bauer et al. (2022) sheds light on the dynamics of successful shareholder proposals. Their research underscores that success is not solely measured by actual votes but also by the withdrawal of proposals following fruitful discussions with the board.[77]

[67] Cools, S., 2023, "Climate proposals: ESG shareholder activism sidestepping board authority," in Kuntz, T., (ed.), forthcoming, Research handbook on environment, social, and corporate governance, Edward Elgar Publishing

[68] Idem.

[69] Kemp, B., 2020, "Limiting shareholder power in Dutch listed companies," Oxford Business Law blog of May 21

[70] Including HR 4 April 2014, NJ 2014, 286 (Cancun); OK May 29, 2017, JOR 2017/261 (AkzoNobel), HR 20 April 2018, ECLI:NL:HR:2018:652 (Boskalis / Fugro).

[71] If the capital is €750,000 or lower. Note that the threshold progressively declines with the size of the company's capital ex article R225-71. For instance, the threshold is 1 percent for the portion of capital between €7,500,000 and €15,000,000, and 0.50 percent for a larger share capital.

[72] In 2022, the Haut Comité Juridique de la Place Financière de Paris – a committee created to address legal uncertainties surrounding climate resolutions – confirmed that the climate strategy falls within the board's statutory competence to "set out the orientation" of the company. Haut Comité Juridique, Rapport sur les résolutions climatiques 'Say on climate' 13 (December 15, 2022), available at http://tinyurl.com/2tj4mwx3. As a result, it seems that resolutions that mandate the board to achieve certain emissions targets or hold a shareholders' vote on climate issues may infringe on the board's powers and thus may be excluded from the agenda of a shareholders' meeting. Following Cools (2023).

[73] For instance, MN stated that: "[w]e cannot approve the re-election of the board members, since we hold the board members responsible for denying a shareholder proposal being added to the ballot." And Kempen Capital Management announced that: "[w]e would like make use of this opportunity, to express our dissatisfaction with TotalEnergies' management reluctance to place a resolution that we have co-filed with a group of other share- / stakeholders asking the company to set short, medium and long-term targets to limit climate change in line with the Paris Climate Agreement." Voting rationales retrieved from the Insightia database on 1 February 2024.

[74] See for more information about this resolution: http://tinyurl.com/593fk2zm.

[75] Flammer, C., M. W. Toffel, and K. Viswanathan, 2021, "Shareholder activism and firms' voluntary disclosure of climate change risks," Strategic Management Journal 42:10, 1850-1879

[76] Grewal, J., G. Serafeim, and A. Yoon, 2016, "Shareholder activism on sustainability issues," Harvard Business School Working Paper, No. 17-003. See also, Lee, M-D. and M. Lounsbury, 2011, "Domesticating radical rant and rage: an exploration of the consequences of environmental shareholder resolutions on corporate environmental performance," Business & Society 50:1, 155-188; Bauer, R., J. Derwall, and C. Tissen, 2022, "Corporate directors learn from environmental shareholder engagements," SSRN

[77] Bauer, R., J. Derwall, and C. Tissen, 2022, "Corporate directors learn from environmental shareholder engagements," SSRN; Bauer, R., F. Moers, and M. Viehs, 2015, "Who withdraws shareholder proposals and does it matter? An analysis of sponsor identity and pay practices," Corporate Governance: An International Review 23:6), 472-488

Crucially, the absence of the right for shareholders to submit competing climate proposals to shareholder meetings could potentially skew management's understanding of shareholder preferences, particularly in the context of "Say on climate" initiatives. An example is the Shell 2021 AGM, where approximately 89% of shareholders endorsed the management's climate proposal, despite it not aligning with the Paris Agreement. This seemingly high level of support might mislead observers into thinking that the majority of shareholders endorse Shell's climate strategy. However, over 30% also supported the competing Follow This climate proposal, advocating for a stricter and Paris-aligned climate strategy.[78] This disparity highlights that a significant portion of shareholders had reservations about Shell's climate plans, contrary to what the management proposal suggested. The right for shareholders to present alternative proposals can be pivotal in ensuring a comprehensive and accurate representation of shareholder sentiments on critical issues such as climate strategy.

Moreover, in addition to the constraining doctrines imposed by European member states, the rules governing collaborative actions in Europe further complicate concerted sustainability engagement efforts for institutional investors. This complexity becomes evident, for example, when investors seek to coordinate their votes in support of a climate resolution, potentially triggering the obligation to launch a public offer for all remaining shares. This uncertainty poses challenges for collaborating investors, raising questions about the extent of their cooperative actions.[79] Addressing these concerns, in 2013, the European Securities and Markets Authority (ESMA) introduced a "white list" delineating activities in which shareholders could collaborate without being automatically presumed to have acted in concert.[80] Recognizing the evolving landscape of sustainability considerations, ESMA initiated an evaluation of this framework in 2019. The objective is to determine whether the existing guidance might be overly restrictive for institutional investors collaborating, particularly in the context of addressing ESG matters.

[78] The Follow This resolution can be found here: http://tinyurl.com/3v47seda.
[79] Article 2.1(d) of the Takeover Bids Directive defines "persons acting in concert".
[80] ESMA, 2013, "Public statement containing information on shareholder cooperation and acting in concert under the Takeover Bids Directive," ESMA/2013/1642, http://tinyurl.com/3k7kp2kw

4. CONCLUSION

In conclusion, this research underscores the significant divergence in regulatory, political, and societal trends between Europe and the U.S. concerning the ESG rights and duties of institutional investors. Although the SEC demonstrates an inclination towards heightened ESG duties, this trajectory is not devoid of political debate. Notably, despite the SEC's commitment to ESG transparency, the U.S. grapples with the fundamental question of whether sustainability should be pursued, often reducing ESG discussions to mere ideology. In contrast, Europe has witnessed a significant surge in emphasizing sustainable finance and corporate governance. The European focus centers on transparency obligations outlined in various regulatory initiatives, including the SFDR. This European approach starkly contrasts with ongoing debates in the U.S., particularly regarding the compatibility of ESG investing and fiduciary duties under ERISA.

In terms of active ownership and shareholder voting, the U.S. has seen institutional investors actively supporting smaller activists and engaging in collaborative efforts using shareholder proposals, perhaps partly driven by the SEC's more lenient stance on climate-related proposals. However, in Europe, despite the strong emphasis on sustainable finance, the national frameworks of member states do not align with European goals, necessitating a reevaluation. To bridge these gaps and cultivate a more harmonized and effective approach to sustainable investment, we advocate for aligning European aspirations for capital allocation with an increased emphasis on sustainability voice in member states, potentially through the forthcoming proposal for the next Shareholder Rights Directive (SRD III). This Directive could specifically aim at harmonizing European member states' rules with the European Green Deal framework, particularly in terms of institutional investor ESG duties. The introduction of a Say-on-Climate mechanism and a concerted effort to amplify shareholder voice within member states can substantially contribute towards aligning European goals for capital allocation with sustainable investments.

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