Shareholder Engagement for Sustainability – an Evaluation of the EU Framework

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I. Introduction

My research looks into the question whether and how shareholder engagement can contribute to the EU's goal of climate neutrality by 2050 and an overall transition to a sustainable economy. Investors might be able to contribute to this transition through shareholder engagement: by actively monitoring companies and engaging in dialogue, exercising shareholder proposal and voting rights and through cooperation with other shareholders. With these tools they can encourage companies to boost innovation and align their business model with the EU's sustainability goals.

The EU currently aims to incentivize this type of shareholder engagement (or stewardship) through the Shareholder Rights Directive II, as well as various provisions adopted as part of the sustainable finance framework. In my research I describe and evaluate the current legislation on shareholder engagement. I raise the question whether shareholders have the necessary tools and incentives to engage on these topics and if all relevant players are sufficiently addressed by the existing legislation. I then explore which other policy options exist and how a renewed approach to sustainable shareholder engagement could look like.

II. Overview of the research project

The overall objective of the research is to evaluate the EU's legal framework on its effectiveness in fostering sustainable shareholder engagement, and proposing amendments, where needed. In order to do so, the following main research question will be answered:

> *Are the EU measures for shareholder engagement effective in light of the sustainability goals expressed by the EU? If not, how could they be amended to more effectively reach those goals?*

The question can be further broken down in several sub-research questions:

(1) *What are the EU's sustainability and sustainable finance goals? (descriptive) [Part 1]*

(2) *How does the EU currently regulate shareholder rights and engagement (esp. under the SRD II)? (descriptive/doctrinal) [Part 2]*

(3) *What is the rationale behind shareholder engagement in general and for sustainability in particular? (explanatory) [Part 3]*

(4) *What role do shareholders currently play in increasing the sustainability of companies? (descriptive/doctrinal) [Part 3]*

(5) *Are the EU's measures for shareholder engagement effective in light of the EU's sustainability goals and which challenges persist? (evaluative) [Part 4]*

(6) *Could the EU's approach be amended to more effectively reach its sustainability goals and if so, how and what are the trade-offs? (normative) [Part 5]*

In order to answer these questions, the PhD is divided in five parts. In this paper I will briefly discuss all of them, but mainly focus on my evaluation.

III. Part 1 – Sustainability

1. Situating shareholder engagement in the sustainable finance debate

To meet the EU's sustainability goals, an overall transition to a sustainable economy is necessary. Sustainable finance can contribute to this transition by utilizing financial market mechanisms. The first "wave" of sustainable finance legislation[1] with the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation (SFDR) at its center focused on defining sustainable investments and setting the necessary standards. These standards and disclosure requirements provide incentives for companies to adapt their business and be included in sustainable investment products. The focus lies largely on redirecting capital flow towards "green" companies and projects. While this is undoubtably crucial, sufficient attention should also be paid to how those companies which currently do not comply with those standards can be encouraged to adapt. A stronger focus on the transitionary aspect of sustainable finance might be required. Investors can contribute to the transition towards a sustainable economy by allowing and encouraging companies to take the necessary steps to boost innovation and align their business model with the EU's sustainability goals.[2]

The existing legislation around sustainable finance in turn assists them with this endeavor. The Corporate Sustainability Reporting Directive (CSRD) applies to European companies that meet specific criteria related to revenue, assets, and employee count, as well as non-EU companies with significant activity in the EU. Companies falling under the scope of the CSRD are required to disclose information on sustainability matters, including the resilience of their business models and strategies in addressing sustainability risks. Investors can use this information to better understand the sustainability of their investee companies and adapt their engagement accordingly.

The proposed Corporate Sustainability Due Diligence Directive (CSDDD) has the objective of promoting responsible and sustainable global value chains. It mandates companies to conduct due diligence on environmental and human rights impacts, mitigate risks, develop policies and procedures, report their efforts and evaluate due diligence procedures annually. The European Parliament recently introduced an amendment that includes specific requirements for investors as well. If adopted, institutional investors and asset managers should 'induce their investee companies to bring actual adverse impacts to an end' or 'minimise the extent of such an impact'. The proposed provision furthermore creates a direct link to the SRD II's engagement requirements, stating that investors should use their engagement and voting rights to accomplish the above-mentioned tasks.[3]

The SFDR applies directly to the financial services sector and requires, inter alia, that asset managers disclose to their clients the level of sustainability of the various investment products they offer. The clients may even choose financial products with a core sustainability objective (so called 'Article 9 products'). This in turn forms the asset managers fiduciary duty and can mean that they can or must prioritize sustainability over profitability.

Apart from investing and divesting, shareholder rights and engagement can be crucial tool for delivering on these client objectives.

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[1] EC, "Action Plan Financing Sustainable Growth" (COM (2018) 9797) (2018 Sustainable Finance Action Plan).
[2] Pacces, A., "Sustainable Corporate Governance: The Role of the Law", ECGI Working Paper, November 2020.
[3] Proposed Article 8a CSDDD.

2. Defining the EU's sustainability goals

In order to evaluate the legislation against its effectiveness in reaching the proclaimed EU sustainability goals I define these goals in the context of this PhD. I therefore mapped out the different sustainability goals of the EU and its related ambitions in the field of sustainable finance and corporate governance. I've defined one overarching definition of the EU's sustainability goal, namely the *transition to a sustainable economy*, which includes the specific emission targets set out in the European Green Deal.

Furthermore, I've linked it to the intermediate goals that I've defined for sustainable finance and corporate governance. Financial law can contribute to this transition of the real economy by *utilizing the mechanisms of the financial industry*. One of these potentials lies with the role of the shareholders, as they can positively influence companies to become more sustainable. In that regard, it might be necessary to *improve shareholder engagement* provisions.

I limit my scope to environmental sustainability, acknowledging the fact that the EU itself has identified environmental sustainability as a priority in some of its policy documents.[4] Furthermore, environmental sustainability is easier to measure than social or governance aspects, leading to more available data and empirical research. More EU policies concerning it are already in place, such as the Taxonomy Regulation, which for now only defines environmental sustainability.

As I evaluate the effectiveness of existing policy measures related to shareholder engagement and recommend adjustments, I will place them in context with the EU sustainability goal defined above. A policy measure would not be considered effective if it does not help with the transition to a sustainable economy. This could for example be the case if it does not sufficiently incentivize shareholders to consider ESG measures in their engagement strategies, disregards important groups of shareholders, does not enforce compliance with the measures in place or leaves opportunities to greenwash engagement polices.

IV. Part 2 – Shareholder engagement in the law

Companies and the way they are being run play an important role in the transition to a sustainable economy. Shareholders make up one important pillar in those companies and their supposed interest in value maximization has dominated corporate law and corporate decisions-making for decades.

In the EU, shareholders enjoy a number of rights, such as the right to information prior to the general meeting,[5] the right to add items on the agenda of the meeting and to draft resolutions[6], to participate in those general meetings[7], to ask questions[8] and to vote[9]. Certain shareholders are furthermore expected to utilize those rights by actively monitoring companies, voting and engaging in dialogue with the company's board, with the objective of improving the company's long-term value creation.[10] These additional duties, though not explicitly called that way, are very similar to

[4] Recital 59 Taxonomy Regulation.
[5] Article 5 SRD II.
[6] Article 6 SRD II.
[7] Article 7 SRD II.
[8] Article 9 SRD II.
[9] Article 7 and 8 SRD II.
[10] Article 3g and Article 3h SRD II.

requirements found in stewardship codes, as they include the requirement to adopt an engagement policy and to integrate it into the overall investment strategy. [11]

In the last decade, stewardship codes were issued all over the world, introducing the notion that investors have a responsibility to engage with their investee companies. With SRD II this concept turned from a voluntary suggestion into a more 'binding' requirement, which now applies to institutional investors and asset managers all over Europe. This legal requirement to engage is reflected in several provisions. Article 3g SRD II establishes what the engagement policy should entail. A number of requirements for the engagement policy can be deducted from the provision. The policy should include (1) how engagement in integrated in the overall investment strategy, (2) how they monitor their investee companies on important topics, such as capital structure, strategy, financial and non-financial risks and performance, including their environmental and social impact and corporate governance, (3) how they communicate with these companies, (4) exercise their voting rights, (5) cooperate with other shareholders, (6) communicate with other relevant stakeholders and (7) how they aim to manage actual and potential conflicts of interest. I elaborate more on the exact scope of each of these requirements in my PhD.

Furthermore, Article 3h SRD II requires that institutional investors ensure that their asset managers policy aligns with their own. Lastly, Article 3i requires asset managers to disclose their engagement strategy to the institutional investor they investor for.

The introduction of SRD II brought along a number of positive effects. It sends a clear signal to the market that shareholder engagement is important and a requirement for certain shareholders. It furthermore confirms that engagement on ESG topics is not only possible but should be part of the overall investment strategy.

V. Part 3 – Shareholder engagement in practice

Part 3 focuses on the reality of shareholder engagement. The first section provides an overview of the ownership structure in European companies, showing which types of investors tend to hold how many shares and how much voting power is attached to them. Contrary to what SRD II suggests, institutional investors and asset managers are not as influential on a an individual company level. They do however hold small amounts of shares in virtually all listed European companies. The second section then goes on to illustrate the different types of shareholder engagement, from behind-the-scenes conversation to divestment, and how and by whom they tend to be exercised, how effective they are according to empirical research and which types are favored for ESG engagement. In the third section I discuss the different incentives various types of shareholders have to engage on ESG topics. This overview of the incentives is then complemented by some practical examples of ESG engagement by different types of investors in the past.

This chapter is still in development and therefore not included in this summary. Some of the key findings do however inform the analysis below, for example by drawing more attention to the role of controlling shareholders.

[11] The UK Stewardship Code 2020 defines stewardship as *"the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society"*, p.4. SRD II equally contains requirements on an engagement policy (Article 3g), but also a wider investment strategy (Article 3h SRD II) and investment management requirements (Art. 3g, Art. 3a-c).

VI. Part 4 – Challenges

In Part 4 I draw from the previous chapters and identify the biggest problems or challenges shareholder engagement currently faces. Often these problems arise from a lack of precision in the law and/or its application in practice. In the following I outline some examples of the challenges I discuss in this part of my PhD.

1. Legal

Despite the shift in perspective that shareholder engagement legislation provides, there are also many loopholes and pitfalls. This paper highlights the main points of criticism I've identified in my PhD.

a) Shareholder proposals

While SRD II ensures that shareholders have the right to submit shareholder proposals, this right is limited in a number of ways.[12] In order to discuss a new item, shareholders need to add it to the agenda of the general meeting. These agenda-setting rights require a certain percentage of shareholder votes, ranging from 3-5%, depending on the Member State. The topics can be excluded if they are deemed illegal, harmful, or beyond the competence of the shareholders' meeting. Specifically this last point is crucial, as many sustainability-related issues are not deemed to fall into the shareholders' competence. It is possible to have non-binding votes on matters that fall outside the shareholders' competence, for example in Germany, Belgium, and France, but the practice is not common. Typical competences of shareholder relate to amending the articles of association, electing and removing board members, as well as advisory votes on remuneration. Strategy, including sustainability strategy, is often not considered a shareholders competence. These limits vary depending on the jurisdiction and company in question, but the overall tendency is that sustainability-related shareholder proposals are difficult to submit in most of the EU and are therefore more rare than for example in the US.

b) Shareholder cooperation and communication

One problem relates to the ability of shareholders to communicate with each other. While SRD II encourages shareholder cooperation, shareholder identification thresholds in SRD and the Takeover and Transparency Directive can hamper it. Shareholders may fear to trigger provisions in the Takeover Directive that would force them to buy up all other shares when they cooperate with other shareholders. The Takeover Directive sets up protection mechanisms against acting in concert.[13] Article 5(1) Takeover Directive requires shareholder that act in concert to make a mandatory bid to the minority shareholders. Shareholders that reach a threshold of votes and coordinate among themselves may trigger this provision. To sidestep having to abide by this requirement shareholders may choose to rather not cooperate and communicate with each other. ESMA has published a white list in that regard which clarifies which behavior is considered shareholder cooperation under the engagement requirements and does not in and of itself lead to acting in concert. [14] This list includes discussions about matters to be raised with the board, discussion with the board itself about the company's policies, practices or specific actions, the

[12] Sofie Cools, 'Shareholder proposals shaking up shareholder say', forthcoming.

[13] Article 2 (2) (d) Takeover Directive 'A person who cooperates with the offer or offeree company on the basis of an agreement, either express or tacit, either oral or written, aimed either at acquiring control of the offeree company or at frustrating the successful outcome of a bid.'

[14]https://www.esma.europa.eu/sites/default/files/library/esma-2014-677-rev_public_statement_concerning_shareholder_cooperation_and_acting_in_concert.pdf

exercise of shareholder rights unrelated to the appointment of board members and agreements to vote together on a resolution. Any joint action concerning the appointment of board members is more sensitive and line between cooperation and acting in concern needs to be determined case-by-case and based on the Member State's law. Shareholder cooperation concerning ESG issues should therefore generally not lead to acting in concert and can be practiced freely. More caution is however needed when the cooperation concerns the replacement of a board member with another who aligns more with the shareholder's ESG expectations for the company.

Another way how shareholder cooperation and also participation could be facilitated is through digital tools. While SRD does not prevent digital participation, for example in general meetings, it does not truly encourage it either. Member States are free to reduce digital access to an absolute minimum. Companies might be inclined to choose this minimal digital approach as they fear that an easier access to general meetings may facilitate shareholder activism and unwelcomed requests by minority shareholders. While digital shareholder meetings were necessary during the lockdowns of the Covid-19 pandemic in 2020 and 2021, many companies have since gone back to mainly in-person meetings.[15] Better use of digital options could not only facilitate the general meetings but could also be used for investors and investee companies to communicate on a regular basis. One option would be to introduce a "members" section on the company's website where shareholders are updated but can also indicate their own views on important topics relevant to the company. Digital tools can furthermore facilitate the communication along the investment chain. Intermediaries need to fulfil a number of requirements, listed in Article 3a-3f SRD II. Communication along the investment chain on record dates and agenda amendments could be simplified and procedural costs reduced if proper communication channels are put in place. Smaller shareholders or end-investors are often held back from voting their shares because the information and decision-making cost for them is disproportionally high. Larger shareholders such as institutional investors on the other hand typically hold the information necessary to make an informed voting decision, as it is part of their normal research and analysis. Easier distribution of this information would reduce the information cost for smaller or end-investors. Some institutional investors have already started to distribute their information more regularly to their customers and offer them the possibility to share their opinion or vote their shares directly.[16]

c) Comparability of reports, supervision and enforcement

A large point of criticism is the lack of guidance and enforcement when it comes to the engagement provisions. While SRD II presents itself as the first hard law on stewardship, the scope, threshold and supervision is in fact so low for now that it remains largely 'toothless'. The lack of guidance for and comparability of engagement policies is problematic in two ways. It makes supervision more complicated and can therefore lead to limited enforcement and limited protection of end-investors from false or misleading statements. Furthermore it can be discouraging for institutional investors and asset managers which have to comply with the legislation when they don't know how to do so. Would it therefore be useful to add stricter disclosure requirements and more harmonized supervision and enforcement? A number of downsides could follow from this.[17] It could discourage any engagement practices which do not fit into the provided template, it could lead to box-ticking and it could furthermore give a false sense of approval to every engagement which is not actively

[15] See for example study https://betterfinance.eu/publication/the-future-of-general-shareholder-meetings-a-better-finance-dsw-study-on-the-2020-virtual-shareholder-meetings-in-the-eu/]

[16] See e.g. BlackRock https://www.blackrock.com/corporate/about-us/investment-stewardship/blackrock-voting-choice/proxy-voting-power-of-choice

[17] Birkmose, Hanne, Sergakis, Konstantinos, The Shareholder Rights Directive II – A Commentary, 2021, p. 337-342.

flagged by the supervisors as non-compliant. Better market enforcement could be an alternative, especially with a growing industry of ESG rating agencies and proxy advisors.[18] The UK had introduced a tiering system which ranked the level of compliance with the stewardship codes and therefore provided incentives for applicants to improve their compliance level. This tiering system was however not without flaws and may not be easily transferable to the EU's system. The different options for better comparability and enforcement and the likelihood of their success are analyzed more closely in Part 3 and 4 of the PhD.

d) Member State implementation and additional stewardship codes

Another problem is linked to the minimum harmonization approach of the Directive and the way it has been implemented by the Member States. Though SRD II provided the option to add and adapt the requirements to national law no Member State really took this opportunity. Instead the implementation took place in a minimal and literal way. On the upside this allows for better comparison in theory. The supervision however is also left to the Member States and here we can observe deviating approaches. This ultimately leads to law which is not tailored to the conditions in the jurisdiction and therefore less powerful. At the same time applicants are treated very differently given that they receive different levels of guidance and their output it scrutinized differently. While additional stewardship codes could bridge the gap between SRD II and the individual jurisdictions characteristics, very few Member States have made us of them. Whether a different implementation or more tailor-made stewardship codes could aid with the overall success of shareholder engagement and SRD II will be discussed in Part 4 of the PhD.

e) Unclear on extend of ESG considerations

Another point of criticism is that, while SRD II introduces ESG considerations, it is not entirely clear what is meant by them, nor to what degree they can be considered by institutional investors and asset managers. The lack of a precise definition is due to the ambiguous nature of ESG as a term. Not only the exact scope is unclear, but also the underlying philosophy. Some view ESG as a financial term that can be incorporated in decision-making to improve profits. Others interpret it wider and also see elements of corporate social responsibility in it, meaning ESG can also be a consideration next to profits and not just for the sake of them. Since 2017, when SRD II was adopted, sustainable finance has developed in rapid speed. The idea to incorporate ESG for the sake of better returns and risk management is no longer unusual, but may even be seen as a legal requirement. The SFDR debate over Articles 8 and 9 funds show that sustainability can be the core objective of an investment strategy and not just an afterthought. In the midst of these far-reaching changes to financial and corporate law it is difficult to place SRD II and its objectives.

We can imagine all kinds of scenarios: An institutional investor or asset manager (1) is not allowed to consider ESG, (2) is allowed to monitor ESG for the sake of shareholder value maximization (SVM), (3) is encouraged to monitor and engage on ESG for the sake of SVM, (4) is encouraged to monitor and engage on ESG as an objective which must not be secondary to SVM (5) should monitor and engage on ESG as an objective which must not be secondary to SVM if clients specifically indicate this as their wish to (6) must monitor and engage on ESG as an objective which must not be secondary to SVM (if clients specifically indicate this as their wish). Depending on who is asked we can observe interpretations ranging from (2) to (6). The newly proposed Article 8a in the CSDDD adds further complexity to this, as it can be interpreted in a way that asset

[18] Ibid p. 341.

managers may have to use engagement to bring actual adverse impact of an investee company to an end even if this is not explicitly the wish of their clients.

It could be a boon and curse at the same time that SRD II remains a little vague here. It allows for the interpretation to grow along with the sustainable finance legislation without being restricted by a narrow understanding of the past. On the other hand it leaves investors with less guidance and more possibilities to greenwash their engagement strategies. SRD II opens up the door for investors to engage on ESG topics, but it does not push anyone through it. From a corporate law perspective this might be advisable, from an environmental and social perspective it is likely not enough to truly change behavior and therefore aid substantially with the transition to a sustainable economy.

2. Conceptual

Apart from the above-identified legal flaws there are a number of issues more closely related to the underlying concepts of corporate governance and the role of specific shareholders.

a) The role of controlling shareholders

SRD II takes inspiration from Stewardship codes, in particular the UK Stewardship Codes, which all focus on institutional investors and asset managers as the most "influential" shareholders. [19] While this might be true in the Anglo-Saxon world, ownership structures in EU countries are usually much more concentrated than that in the US or the UK. Institutional investors and asset managers combined on average do not hold a controlling majority of shares and have therefore much less direct influence on the company when measuring voting power. Instead, controlling shareholder such as the founder or founding family, but also other (holding) companies and the government play a larger role.[20] Yet, none of these groups are covered by the SRD II or any other national code. The exact influence of those shareholders further depends on the share structure. In some Member States dual-class or loyalty shares can be issued, leading to a divergence between shares held and the voting power of that shareholder. Oftentimes loyalty shares, which aim to award long-time holding periods de facto lead to an even stronger concentration of power with the already powerful founder or early investor in a company. It is therefore important to further analyze their incentives.

Controlling shareholders are typically long-term oriented.[21] This may lead them to consider ESG risks which could affect the long-term value and reputation of their company. They have more power to follow their vision, be more daring than professional managers and bet on innovative technologies crucial for the future.[22] They can persevere even when the stock markets undervalues the company. Given the declining marginal utility of wealth, controlling shareholders may prioritize reputation over additional profits. This might be in particular the case when the family or founder's name is closely intertwined with the company.

Yet, controlling shareholders' wealth is typically concentrated. This leaves them with fewer incentives to address economy-wide risks such as climate change. We can also imagine some

[19] Puchniak, "The False Hope of Stewardship in the Context of Controlling Shareholders: Making Sense Out of a Global Transplant of a Legal Misfit", EGCI Law Working Paper, June 2021, p. 1-53.
[20] De La Cruz, Medina and Tang, "Owners of the World's Listed Companies", OECD Capital Market Series, 2019.
[21] The following paragraphs can also be found in the my ECGI newsletter from May 2023. (forthcoming)
[22] Alessio M Pacces, 'Controlling Shareholders and Sustainable Corporate Governance: The Role of Dual-Class Shares'.

controlling shareholders whose initial objective may be to extract personal wealth from the company; in such cases this runs the risk of an excessive focus on short-term value. The desire to be perceived as responsible or sustainable may furthermore be just as well fulfilled by clever marketing and greenwashing, rather than substantial business decisions.

A number of studies can aid to further outline the specificities of controlling shareholders. A study conducted on Norwegian firms found a profitability premium of family firms, which 'increases with lower agency conflicts rooted in the family firm's controlling family, but also with stronger financial constraints caused by limited family wealth, undiversified family wealth, and low liquidity of the family firm's equity.' [23] This can lead to underinvestment in the firm.

Other recent empirical research on corporate ownership and ESG performance finds that ownership by founding families or individual investors is negatively associated with ESG performance.[24] This effect is reversed once a family member serves as CEO, in which case companies have the strongest ESG performance. Ownership by government entities or a non-family manager is also positively associated with ESG performance.

Other research explores the incentives that controllers have to reduce negative externalities produced by their controlled company.[25] The researchers argue that investments in other companies, which are negatively affected by the controlled company's externalities, provide an incentive for the controller to reduce those externalities. The more diversified the controller's wealth, the higher the chances that they will want to reduce externalities. Dual-class shares may be an option for controllers to diversify their wealth while remaining in control, yet in practice this desired effect fails to materialize according to those researchers.

Ownership by a foundation generally appears to have a positive effect on the long-term orientation of the company.[26] The relationship between control and short-termism is multi-faceted.[27] Long-term oriented controlling shareholder can mitigate short-termism. Strengthening their participation, for example through dual-class or loyalty shares, could enhance this effects. If controlling shareholders are however short-termist themselves their presence can have the contrary effect, as they might for example extract wealth through shareholder pay-outs.

How exactly controlling shareholders can be incentivized to engage on sustainability topics remains to be explored. Some existing measures may already stimulate controlling shareholders, such as increased disclosure and reporting obligations imposed on companies or engagement by other investors. It would be interesting to examine how investor engagement in the face of a controlling shareholder can be optimized. Proponents of controlling shareholders' influence may want to magnify their power with dual-class or loyalty shares. Skeptics on the other hand may fear that this further limits the controller's accountability and entrench the controller, allowing them to pursue private benefits which are not shared with minority shareholders. Any such measures would need to be carefully balanced with minority protection. The engagement principles and accountability mechanisms applicable to investors in the form of stewardship codes could serve as an inspiration.

[23] Janis Berzins and others, 'The Family in the Family Firm Premium: Agency Conflicts and Personal Financial Constraints', 50.

[24] Villalonga et al, corporate ownership and ESG performance, forthcoming.

[25] Dhammika Dharmapala and Vikramaditya S Khanna, 'Controlling Externalities: Ownership Structure and Cross-Firm Externalities' [2021] SSRN Electronic Journal.

[26]. Thomsen et al., Foundation Ownership and Sustainability International Evidence, 2018, https://www.ecgi.global/sites/default/files/Paper:%20David%20Schroeder,%20Steen%20Thomsen.pdf

[27] Tom Vos, 'Controlling Shareholders in Corporate Governance: Cure or Cause for Short-Termism?' [2022] SSRN Electronic Journal

Controlling shareholders could be addressed by specific codes tailored to their position, similarly to the Singapore Family Stewardship Code[28], which contains recommendation of values and principles for family-controlled companies.

I develop these various ideas on how to specifically address controlling shareholders in Part 5 of my PhD.

b) Incentives of institutional investors

Given that most voting power does not lie with institutional investors and asset managers, requiring only them to take sustainability aspects into consideration may not have such an impact on the companies as the SRD II suggests. On the contrary, institutional investors and asset managers may be ill-matched for this type of firm-specific engagement. Particularly passive index funds, a rapidly growing part of investment funds, are held back by a number of incentives not to engage. [29] They compete on the basis of low costs and all track the same or a very similar combination of companies. Engaging with those companies it directly and equally benefits the funds' competitors, who hold the same index of companies (free-riding-problem). As shareholder engagement bears a cost and index-tracking funds typically compete for their customers on the basis of low fees, they lack incentives to engage.[30]

Despite these apparent counterincentives we can observe some engagement on sustainability topics by institutional investors in practice, as I extensively discuss in Part 3 of my PhD. In order to identify which of this engagement is truly beneficial and should be supported by legislation, it is necessary to analyze the underlying incentives.

Greenwashing. One explanation for investor's stewardship efforts this could be mainly linked to greenwashing. Since regulators and their clients show increasing interest in ESG topics and require some disclosure and action, funds do not stay silent. Greenwashing their commitments however allows them to counter some of that pressure without actually adapting their engagement or voting practices. [31] Greenwashing engagement policies could be mitigated by enhanced disclosure and monitoring and actual enforcement of the fine system set up by some Member States. The problem of greenwashing is further linked to the wider sustainable finance framework and must therefore be analyzed with a wider perspective.

Systematic stewardship. Another explanation as to why investors engage on ESG topics is provided by the theory of 'systematic stewardship.[32] Broadly diversified asset managers, such as BlackRock, Vanguard or State Street, are 'universal owners', meaning they manage an economy-mirroring portfolio of assets. This makes their portfolio vulnerable to economy-wide risks. The effects of climate change will have disastrous effects on our world's economy. These risks are too widespread to be diversified away, leaving portfolios mirroring large parts of the economy heavily

[28]https://stewardshipasia.com.sg/what-we-do/engagement-and-outreach/stewardship-principles-for-family-businesses

[29] Bebchuk, Cohen and Hirst, "The Agency Problems of Institutional Investors", 31 J. Econ Perspectives, 2017; Alvaro, Maugeri and Strampelli, "Institutional investors, corporate governance and stewardship codes - Problems and perspectives", CONSOB Legal Papers, January 2019.

[30] Bebchuk, Cohen and Hirst, "The Agency Problems of Institutional Investors", 31 J. Econ Perspectives, 2017; Barzuza, Curtis and Webber, "Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance", ECGI Law Working Paper, October 2020.

[31] Christie, "The Agency Cost of Sustainable Capitalism", Legal Studies Research Paper Series University of Cambridge, 2021.

[32] The following paragraphs can also be found in the my ECGI newsletter from April 2023.

exposed. It is therefore in the asset managers' own interest to 'internalize intra-portfolio negative externalities through climate change related activism'.[33]

This appears to be at odds with the assumption that large diversified funds have little incentives to engage with investee companies.[34] Yet there is a difference between 'micro' or company-specific stewardship' and this 'systematic stewardship', where the motivation derives from a portfolio-level rather than firm-level view. Systematic stewardship argues that large diversified funds do have an interest in engineering a particular outcome in the economy, namely one which benefits their portfolio's profitability in the long run.[35] In order to achieve this goal they may engage with specific companies or industries in a manner that can potentially be detrimental to individual companies' profits (at least in the short term), as long as it benefits the performance of the overall portfolio over time. The risks which the stewards want to reduce can be climate change risk, but also social stability risk or systemic risk arising from the financial sector. An asset manager may for example prefer to sacrifice some of a bank's profitability in favor of stability, to avoid bank failure and contagion throughout the economy. Climate risk is very complex and entire industries contribute to it. Divesting from highly-emitting companies may remove them from an investor's portfolio, but it does not restrain the economy-wide risks. One way out of this predicament for the asset manager is to encourage investee companies to fade out practices that heavily contribute to climate change.

There are a number of other theories that can explain why investors would engage on sustainability topics, as outlined in Part 3 of my PhD. One is that investors care about sustainability because it impacts long-term financial performance and they want to pre-empt losses due to changing legislation by encouraging companies to adapt in time. Another is that asset managers want to attract clients which specifically care about sustainability topics. This for example appears to be the case with large parts of the Millennial generation.[36]

The challenge is that the suitable policy instrument changes depending on which theory one follows. Some of the theories also not mutually exclusive but rather seem to apply simultaneously. The ideal policy proposal should therefore be one that can apply to all instances and balance the various incentives and counterincentives.

3. Part 5 – Policy proposals

In the normative part of my PhD I'll propose a number of policy options. For each policy I analyse the possible outcome and its benefits as well as possible trade-offs.

The goal of my research is to provide a basis for possible further policy measures. I will therefore explain which actions could be taken to promote the sustainability goals, and which effects and side-effects those might have, but my aim is not to provide an answer as to which policy action would be the best overall. I won't attempt to put them in a hierarchical order with other goals of financial or company law.

Among the topics that I will cover are:

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[33] Madison Condon, 'EXTERNALITIES AND THE COMMON OWNER' (no date) 95 WASHINGTON LAW REVIEW 81.

[34] Lucian A Bebchuk and others, 'The Agency Problems of Institutional Investors' (2017) 31 Journal of Economic Perspectives 89.

[35] Jeffrey N Gordon, 'Systematic Stewardship' [2021] SSRN Electronic Journal.

[36] Michal Barzuza and others, 'Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance' [no date] 80.

- Increased disclosure and monitoring of the requirements in place
- Facilitating the use of shareholder rights, including shareholder proposals on sustainability and shareholder communication
- Addressing other groups of shareholders beyond EU-based institutional investors and asset managers
- Soft-law vs. hard law approach to shareholder engagement
- Shareholder platforms and cooperation
- …

4. Conclusion

To conclude it can be said that the current EU framework does not reflect the reality of ownership and engagement in the EU. Due to the diverse company law structures a one-size-fits-all approach would be difficult to find. Given the positive evidence on the effects of sustainable shareholder engagement it is desirable to maintain and improve shareholder engagement as a policy tool.

Based on my research done so far I believe that a number of steps could be advisable. Shareholder rights in relation to shareholder proposals should be strengthened. The existing shareholder engagement requirements in SRD II should be clarified through additional delegated acts and templates. Supervision needs to be strengthened significantly and harmonized across Member States. A tiering system could add additional transparency and provide further incentives to comply. The legislation could be extended and the ESG aspects increased and clarified, especially in relation to other sustainable finance legislation. Investor cooperation should be facilitated, as coordinated engagement has proven to be more effective, especially when facing a controlling shareholder. Specific engagement provisions for controlling shareholders in the form of soft law could also be considered. As the research has shown, shareholders are a diverse group with very differing interests and objectives. Simply extending shareholder rights, for example through loyalty or dual-class shares, without linking these specifically to ESG goals could thus be counterproductive. The focus should therefore rather be on providing tools and incentives for sustainable engagement. Any legislation that facilitate or restrict shareholder power more broadly would need to be carefully considered and balanced.