The Agency Costs of Sustainable Capitalism

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The passive index investing revolution and the demand for bespoke environmental, social, and governance ("ESG") investment products are the most monumental changes to shape the investor landscape for many years. These developments have been accompanied by an unprecedented concentration of power among BlackRock, Vanguard, and State Street (the "Big Three" asset managers). Inevitably, the Big Three are among the most powerful shareholders of the companies that have been identified as major contributors to the climate crisis. Due to the failure of governments to take effective action in the global effort to combat climate change, there has been

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intense pressure directed at the Big Three to provide investor-driven solutions. The Big Three have increasingly purported to assume what I call the role of "sustainable capitalists."

In this Article, I build upon Gilson and Gordon's "agency capitalism" framework to put forward a new agency-costs theory of sustainable capitalism. In this "sustainable capitalism" framework, I show that the Big Three still exhibit some form of "rational reticence," especially with respect to firm-specific sustainability activism. There is also a risk that the Big Three may engage in "rational hypocrisy," similar to corporate greenwashing. The combination of "rational reticence" and "rational hypocrisy" could result in a dual-monitoring shortfall — the "agency costs of sustainable capitalism."

In the agency capitalism framework, the best solution that emerged was for specialist activist hedge funds to fill the monitoring shortfall by initiating firm-specific activism as "governance arbitrageurs." In this context, activist hedge funds adapted their strategies to gain crucial support from longer-term institutional investors. Analogously, in the sustainable capitalism framework, ESG hedge funds have the potential to initiate firm-specific ESG activism as "ESG arbitrageurs" in a manner that appeals to, and mobilizes, the sustainable capitalism of the Big Three. Most prominently, ESG hedge funds can play a unique role in nominating specialist climate directors to corporate boards, with the Big Three lending their support to credible nominees. Activist hedge funds already have significant expertise in board representation campaigns and the Big Three have shown willingness to support board changes.

Other "responsible activists," focusing more on portfolio-wide ESG issues, are also candidates for the role of "ESG arbitrageurs". However, implementing meaningful strategic changes or board reform using the shareholder proposal mechanism has proven to be much more challenging. Therefore, a valuable role that other responsible activists can play in the ESG investor ecosystem is to focus on the problem of rational hypocrisy and target their activism at the Big Three themselves.

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INTRODUCTION

The passive index investing revolution and the surge in demand for environmental, social, and governance ("ESG") investment products are the most monumental changes to sweep across the investor landscape for many years.[1] The genesis of this unprecedented transformation in investor behavior can be traced back to the demise of

[1] On the passive index investing revolution, see Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2033 (2019) [hereinafter *Index Funds*] (noting that "the proportion of equities held by index funds has risen dramatically over the past two decades and can be expected to continue growing strongly"); Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 19 (2019) (noting that "[p]assive investors . . . are the new power brokers of modern capital markets"); John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 2 (Harv. Pub. L., Working Paper No. 19-07, 2018), https://ssrn.com/abstract=3247337 [https://perma.cc/3ZBT-DQPS] (noting that indexing is one of three "ongoing mega-trends" that are "reshaping corporate governance"). On the surge in demand for ESG products, see Attracta Mooney & Patrick Mathurin, *ESG Funds Defy Havoc to Ratchet Huge Inflows*, FIN. TIMES (Feb. 5, 2021), https://www.ft.com/content/8e9f8204-83bf-4217-bc9e-d89396279c5b [https://perma.cc/G7V9-XC9N] (noting that 2020 "was the year ESG came of age" and that by the end of 2020, total assets in sustainable funds hit a record of almost $1.7 trillion, up 50% over the year). *See also* Larry Fink, *Letter to CEOs*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 30, 2021), https://corpgov.law.harvard.edu/2021/01/30/letter-to-ceos/ [https://perma.cc/BF8J-SBN4] (noting a "tectonic shift" in investor behavior towards sustainable investment options).

the archetypal "Berle-Means corporation."[2] Epitomized by the dichotomy between powerful managers and powerless, dispersed shareholders,[3] the decades-long reconcentration of institutional investor ownership largely displaced the traditional account of the corporation in Anglo-American corporate governance.[4] Particularly in the aftermath of the global financial crisis, there has been an escalating shift from active to passive investment strategies.[5] This culminated in 2019 with assets under management in passive equity funds in the U.S. officially overtaking the corresponding holdings in active equity funds.[6]

Although the active fund industry remains relatively fragmented, the passive index fund industry is extremely concentrated.[7] Consequently, the change in investor ideology has been accompanied by a massive

[2] *See generally* ADOLF A. BERLE, JR. & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (observing that the separation of ownership and control can result in powerful managers being unconstrained by powerless shareholders, who are unable to effectively monitor managers). The term "Berle-Means corporation" was popularized by Mark Roe in 1991. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 11 (1991).

[3] *See generally* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1996) (describing the political economy of the separation of ownership from control in the U.S.).

[4] *See generally* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV 520 (1990) (discussing how traditional conceptions of corporate power, based on the assumption of small individual shareholders, have been upset by rise of institutional investors that hold a significant portion of shares); Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994) (exploring British corporate governance as a possible model for American markets controlled by institutional investors); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991) (examining some of the issues raised by increased ownership by institutional investors).

[5] *See generally* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298 (2017) (describing the rise of passive index funds held by the "Big Three"). Passive investing generally involves replicating the performance of a specific stock market index, whereas active investing involves actively trading stocks based on assessments of firm value. *See* discussion *infra* Part I.A.

[6] As of August 31, 2019, passive U.S. equity assets surpassed U.S. equity fund assets by about $25 billion. $4.27 trillion (50.15%) of equity assets (in open-end and exchange-traded funds ("ETFs")) were held in passive funds compared to $4.25 trillion (49.85%) held in active funds. Over the past 10 years, active U.S. equity funds have had $1.3 trillion in outflows and their passive counterparts nearly $1.4 trillion in inflows. *See* MORNINGSTAR RSCH., MORNINGSTAR U.S. FUNDS FLOWS: FED RATE CUT DOESN'T SPUR INFLOWS 1-2, 5 (2019), https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Fund_Flows_August2019_Final.pdf? [https://perma.cc/WT9F-XQVC].

[7] *See* Coates, *supra* note 1, at 2 (detailing the "Problem of Twelve," where control of most public companies will soon become concentrated in the hands of a dozen or fewer people).

aggregation of power among the largest asset managers who offer passive index funds at the lowest cost. The "Big Three" asset managers — BlackRock, Vanguard and State Street — are now the largest investors in the vast majority of economically significant companies in the U.S.,[8] and to an increasing extent, worldwide.[9] Although all large companies have a major role to play in mitigating the effects of climate change, a relatively small number of companies have been identified as the key perpetrators of global warming.[10] Largely due to their passive index fund offerings — that mechanically track stock market indices such as the S&P 500 in the U.S. or the FTSE 100 in the U.K. — the Big Three are often the biggest shareholders, and common owners, of these offending companies. This tremendous concentration of ownership means that the Big Three have the potential to wield considerable power over the primary perpetrators of climate change as they control a significant proportion of the shares and thus the votes at those companies. With great power comes great responsibility. Calls for asset managers to exercise greater social and environmental responsibility have led to the Big Three increasingly purporting to assume what I call the role of "sustainable capitalists."[11] Namely, because Governments have failed to take swift and effective action in the global effort to combat issues such as climate change, there has been increased pressure not only on companies but also on institutional investors to provide market-driven solutions.[12]

The quintessential agency problem in the traditional Berle-Means corporation arose due to the divergence of interests between managers and shareholders.[13] Gilson and Gordon later developed an "agency

[8] *See* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 732-37 (2019) [hereinafter *The Specter*].

[9] *See* Fichtner et al., *supra* note 5, at 311.

[10] *See* PAUL GRIFFIN, THE CARBON MAJORS DATABASE: CDP CARBON MAJORS REPORT 2017, at 8 (2017), https://b8f65cb373b1b7b15feb-c70d8ead6ced550b4d987d7c03fcdd1d.ssl.cf3.rackcdn.com/cms/reports/documents/000/002/327/original/Carbon-Majors-Report-2017.pdf?1499691240 [https://perma.cc/32TD-VXH4].

[11] The concept of sustainable capitalism involves companies and investors mobilizing capital to overcome sustainability challenges. *See infra* Part I.D (discussing the potential role of the Big Three as sustainable capitalists).

[12] Prominent figures including Al Gore have criticized the Big Three and other institutional investors and activists have submitted shareholder proposals to the Big Three to induce them to take sustainability issues more seriously. *See infra* Part I (discussing Al Gore's criticisms of the Big Three and his push for sustainable capitalism).

[13] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-09 (1976) (discussing the relationship between managers and stockholders as an agency

capitalism" framework where they theorized a new agency problem that arose from the divergence of interests between institutional investors and ultimate beneficial owners.[14] In this Article, I build upon Gilson and Gordon's agency capitalism framework to put forward a new agency-costs theory of sustainable capitalism that accounts for the major shift to passive index investing and ESG investing. In the new "sustainable capitalism" framework, the Big Three act on behalf of diversified index investors — who are largely thought of as a proxy for wider society — and they also represent investors who have explicitly chosen to prioritize social and environmental values by investing in ESG funds.

Potential divergence between the interests of the Big Three and the ultimate index investors or ESG investors gives rise to what I call "the agency costs of sustainable capitalism."[15] Gilson and Gordon described institutional investors in the agency capitalism framework as "rationally reticent," as they would only respond to proposals submitted by other shareholders, rather than being proactive themselves.[16] In the sustainable capitalism framework — where the Big Three act as agents for passive index investors and ESG investors — I identify a potential dual-problem. The Big Three will most probably remain rationally reticent, especially with regard to firm-specific intervention, as many of the problematic incentives in the agency capitalism framework still persist in the new passive investing and sustainability context. However, I also theorize a second problem that might present itself in the sustainable capitalism framework — the risk of the Big Three exhibiting what I call "rational hypocrisy." Similar to corporate greenwashing, the Big Three might act in a rationally hypocritical manner, as there may be incentives to claim that they uphold a higher commitment to sustainability than is actually the case.

One major difference between the sustainable capitalism framework and the agency capitalism framework is that intervention on climate

relationship). *See generally* John Armour, Henry Hansmann, Reinier Kraakman & Mariana Pargendler, *What is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW 1, 2 (Reinier Kraakman et al. eds., 3rd ed. 2017) (discussing the various interests of managers and shareholders).

[14] *See generally* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013) (analyzing the new agency problem and the role of activist shareholders as governance intermediators who ultimately reduce agency costs).

[15] *See infra* Part II (discussing the agency costs of sustainable capitalism).

[16] Gilson & Gordon, *supra* note 14, at 889, 895.

issues concerns systematic as well as idiosyncratic (firm-specific) risk.[17] Environmental issues represent a portfolio-wide or market-wide problem in contrast to the firm-specific risks that received attention in the agency capitalism framework. Mirroring some of the successful interventions by the Big Three in portfolio-wide governance issues (such as board gender diversity),[18] there may be some promise for the Big Three in their assumed role as sustainable capitalists.

A parallel can be drawn between the sustainable capitalist framework and the agency capitalism framework, as a monitoring shortfall persists. The solution that was identified by Gilson and Gordon to reduce the agency costs of agency capitalism was for activist hedge funds to fill the monitoring shortfall left by institutional investors. Such activists were described as playing the role of governance intermediaries or arbitrageurs.[19] Similarly, in the realm of sustainable capitalism, a vocal minority of activist hedge funds have already transitioned to focus on ESG activism.[20]

In the agency capitalism framework, the combination of activist shareholders as initiators and institutional investors as arbiters proved to be a successful means of mitigating the agency costs of agency capitalism.[21] This may have been due to a general complementarity of the interests and incentives of activist hedge funds and the institutional investors who are pivotal in supporting their campaigns. Put simply, if the activist hedge fund intervention were successful, both the activist's position and the institutional investor's position would increase in value. Both sets of shareholders ultimately sought to increase shareholder value. There was some level of conflict inherent in whether the appropriate focus was on short-term or long-term shareholder wealth maximization.[22] However, over time, these conflicts in time

17 *But see* John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 36 (2014) (noting that "the portfolios of diversified shareholders are insulated from the effects of idiosyncratic (firm-specific) risks").

18 *See* Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1265-69 (2020).

19 *See* Gilson & Gordon, *supra* note 14, at 896-902.

20 *See infra* Part III.C (discussing ESG activism on the part of hedge funds).

21 Gilson & Gordon, *supra* note 14, at 897-98.

22 BlackRock, Vanguard, and State Street all issued statements supporting long-term investment and criticizing financial engineering that creates short-term profits at the expense of sustainable value. Martin Lipton, *Some Thoughts for Boards of Directors in 2017*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 8, 2016), https://corpgov.law.harvard.edu/2016/12/08/some-thoughts-for-boards-of-directors-in-2017 [https://perma.cc/5C4L-H4G8].

horizons were resolved to some extent. Activist hedge funds' tactics evolved to incorporate a longer-term perspective, presumably to appease the institutional investors who provided crucial support to their campaigns.[23]

In the sustainable capitalism framework, I argue that ESG hedge funds may fulfil a role that no other actor is well positioned to fill. As we have seen in the agency capitalism framework, activist hedge funds are specialists in *firm-specific* intervention. Although the Big Three should rationally be more concerned with *portfolio-wide* risk in the context of climate change,[24] they could still be expected to support firm-specific sustainability initiatives advancing that goal. Therefore, ESG hedge funds could successfully mitigate the problem of rational reticence with respect to firm-specific sustainability activism.

The most valuable contribution that ESG hedge funds may make to mitigate the agency costs of sustainable capitalism is to nominate specialist directors — for example those with renewable energy or climate transition expertise — to corporate boards.[25] The Big Three, in their assumed role as sustainable capitalists, can then lend their support to credible alternative board nominees. ESG hedge funds are well positioned to play this unique role, as activist hedge funds already have significant expertise in executing successful board representation campaigns over the past decade.[26] The Big Three have also shown enthusiastic willingness to support board changes, for example in board gender diversity.[27]

Other intermediaries are also candidates for the role of "ESG arbitrageurs."[28] A range of different "responsible activists" already

[23] *See infra* Part III.B (discussing activist board representation).

[24] *See infra* Part II.A.1 (discussing climate risk as systematic portfolio-risk).

[25] *See infra* Part IV.B (discussing the potential for ESG hedge funds to nominate climate directors to corporate boards); *see also* Anna Christie, *Battle for the Board: Climate Rebellion at Exxon Marks a New Era of Shareholder Activism*, OXFORD BUS. L. BLOG (July 12, 2021), https://www.law.ox.ac.uk/business-law-blog/blog/2021/07/battle-board-climate-rebellion-exxon-marks-new-era-shareholder [https://perma.cc/A22G-B6NR].

[26] *See infra* Part III.B (discussing activist hedge fund board representation).

[27] *See* Barzuza et al., *supra* note 18, at 1265-69. *See generally* Todd A. Gormley, Vishal K. Gupta, David A. Matsa, Sandra C. Mortal & Lukai Yang, *The Big Three and Board Gender Diversity: The Effectiveness of Shareholder Voice* (Eur. Corp. Governance Inst. Fin., Working Paper No. 714/2020, 2021), https://ssrn.com/abstract=3724653 [https://perma.cc/6N64-WKS9] (discussing the success of Big Three campaigns to increase gender diversity on corporate boards).

[28] In the agency capitalism framework, Gilson and Gordon outlined that the rational reticence of institutional investors left a governance gap or shortfall in the monitoring of managerial agency costs. Specialist activist hedge funds could then act as "governance arbitrageurs" by taking advantage of the arbitrage opportunity created by the existence

submit ESG-related shareholder proposals to large corporations.[29] ESG hedge funds will likely only pursue ESG strategies that will contribute to the "double bottom-line" of generating a significant profit as well as being environmentally or socially beneficial. Focusing more on portfolio-wide ESG issues, responsible activist organizations ordinarily have different incentives to activist hedge funds, as their primary focus will usually be mitigating climate or other sustainability risks. However, there are clear limitations to this approach, as the shareholder proposal mechanism is a notoriously slow means of effecting change and such investors may also lack the reputation, clout, expertise,[30] and funding that the most formidable hedge funds have amassed in order to effectively challenge some of the world's most economically significant corporations. Ultimately, it may be that the most important role that these responsible activists can play in the investor ecosystem is by addressing any rational hypocrisy, including by targeting the Big Three themselves. Holding the Big Three accountable can mitigate the agency costs of sustainable capitalism.

This Article proceeds as follows. Part I introduces the concept of sustainable capitalism. It discusses how the momentous growth of passive index investing has resulted in a significant concentration of power among the largest asset managers, specifically the "Big Three." It also considers how the Big Three have assumed the role of "sustainable capitalists," given that they are now the largest common owners of the vast majority of globally significant corporations.

Part II focuses on the agency costs of sustainable capitalism. It introduces the dual problem that presents itself in the sustainability context, namely, the persistence of "rational reticence" (particularly with regard to firm-specific sustainability activism) and the risk of "rational hypocrisy."

Part III tracks the evolution of the original governance arbitrageurs identified in Gilson and Gordon's agency capitalism framework — activist hedge funds. It highlights how such activists have evolved and adapted their strategies over time to appeal to the long-term

of the governance gap. *See* Gilson & Gordon, *supra* note 14, at 896. Similarly, in the sustainable capitalism framework, the rational reticence of the Big Three and other asset managers leaves a gap or shortfall in terms of ESG activism. Thus, there is a parallel ESG arbitrage opportunity which a number of actors may be well positioned to fill as "ESG arbitrageurs."

29 *See infra* Part IV.C (discussing ESG shareholder proposals).

30 *See generally* C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. CORP. FIN. 296 (2016) (discussing how top activist hedge funds have succeeded in part due to establishing a reputation for "clout and expertise").

institutional investors who are the ultimate arbiters of their campaigns, including a consideration of hedge funds' most recent foray into ESG activism.

Part IV delves more deeply into the role of ESG hedge funds as the new ESG arbitrageurs in the sustainable capitalism framework. It demonstrates how well positioned ESG hedge funds are to nominate climate directors to corporate boards, a tactic that should attract the support of the Big Three.

Part V considers the role of other responsible activists in the sustainable capitalism framework. It highlights the limitations of the shareholder proposal mechanism to effect strategic or board-level change and ultimately concludes that responsible activists may be best placed to hold the Big Three accountable and address any rational hypocrisy.

I. SUSTAINABLE CAPITALISM AND THE BIG THREE

> *"It is the essence of revolutions of the more silent sort that they are unrecognized until they are far advanced"*[31]
>
> — *Adolf Berle & Gardiner Means*

At the World Economic Forum in Davos in January 2020, Larry Fink — the chief executive of the world's largest asset manager, BlackRock Inc — wore a scarf themed around climate change data.[32] The scarf was designed by the 2 Degrees Investing Initiative and featured the "warming stripes"[33] visual created by U.K. climate scientist Ed Hawkins, where the color of the stripes represents the annual average temperatures of planet earth from 1850 to 2019.[34] Fink was being interviewed about his 2020 letter to CEOs, which focused on climate risk and ESG investing. In January 2020, BlackRock also signed up to join Climate Action 100+,[35] a global investor-led initiative (with its

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[31] BERLE & MEANS, *supra* note 2, at vii.

[32] Emily Chasan, *Even Larry Fink's Davos Scarf Is All About Climate Change*, BLOOMBERG L. (Jan. 23, 2020, 12:00 AM), https://www.bloomberg.com/news/articles/2020-01-23/even-larry-fink-s-davos-scarf-is-all-about-climate-change [https://perma.cc/DP62-NPS5].

[33] Chasan, *supra* note 32; Ed Hawkins, *Warming Stripes for GLOBE from 1850-2020* (image), #SHOWYOURSTRIPES, https://showyourstripes.info (last visited Aug. 31, 2021) [https://perma.cc/6RMA-9EH2].

[34] Chasan, *supra* note 32.

[35] CLIMATE ACTION 100+, https://www.climateaction100.org (last visited Aug. 31, 2021) [https://perma.cc/X4SS-3BGL]. BlackRock (and Vanguard) had voted against all of the U.S. shareholder proposals backed by Climate 100+ until September 2019. *See*

members now managing over $35 trillion in assets) which aims to ensure that the world's largest corporate greenhouse gas emitters take necessary action on climate change.[36] These bold announcements followed a period of intense pressure directed at BlackRock and other large asset managers, which urged them to take responsibility for their role in the climate crisis. Only a few weeks earlier, a coalition of shareholders had filed resolutions at BlackRock and Vanguard calling for the asset managers to review their voting policies on climate change issues, given their consistent record for voting against climate-oriented proposals.[37] Other prominent figures, including former U.S. vice president Al Gore, similarly criticized BlackRock and Vanguard, accusing them of financing "the destruction of human civilization."[38] Even activist hedge fund managers were vocal in their criticism. In December 2019, Christopher Hohn of TCI accused the asset manager of being "full of greenwash."[39] Thus in early 2020, BlackRock strengthened its commitment to "sustainability and climate-integrated portfolios," vowing to use its significant power as the world's largest asset manager as a force for good.[40] This Part explains how the growth of passive investing and the concentration of power among large asset

MAJORITY ACTION, CLIMATE IN THE BOARDROOM: HOW ASSET MANAGER VOTING SHAPED CORPORATE CLIMATE ACTION IN 2019, at 4 (2009), https://static1.squarespace.com/static/5d4df99c531b6d0001b48264/t/5d8006692e5b035cf0d2b17f/1568674165939/assetmanagerreport2019.pdf [https://perma.cc/L4UV-U5RU] [hereinafter 2019 CORPORATE CLIMATE ACTION].

36 Richard Henderson, *BlackRock Joins Climate Action Group After 'Greenwash' Criticism*, FIN. TIMES (Jan. 9, 2020), https://www.ft.com/content/16125442-32b4-11ea-a329-0bcf87a328f2 [https://perma.cc/ZY8Z-PDS4].

37 Mercy Investment Services (the investment program of the Sisters of Mercy of the Americas, a group of Catholic nuns) filed the resolution ahead of BlackRock's annual meeting, stating that BlackRock only supported six of fifty-two climate-related resolutions in 2019. *See* Attracta Mooney, *Nuns Take on BlackRock over Climate Change*, FIN. TIMES (Dec. 14, 2019), https://www.ft.com/content/9f84e865-31ad-4a13-9398-8781e2cb0581 [https://perma.cc/UQ6E-6729].

38 Gillian Tett, Billy Nauman, Patrick Temple-West, Leslie Hook, Mehreen Khan, Anna Gross, Tamami Shimizuishi & Andrew Edgecliffe-Johnson, *Moral Money: Al Gore Blasts BlackRock, Brussels Breakdown, Rewild the UK*, FIN. TIMES (Dec. 11, 2019), https://www.ft.com/content/92c728e6-1ba3-11ea-97df-cc63de1d73f4 [https://perma.cc/37SN-DU9X].

39 Leslie Hook & Gillian Tett, *Hedge Fund TCI Vows to Punish Directors over Climate Change*, FIN. TIMES (Dec. 1, 2019), https://www.ft.com/content/dde5e4d4-140f-11ea-9ee4-11f260415385 [https://perma.cc/FE4J-XTZN].

40 Letter from Larry Fink, Chairman and Chief Exec. Officer, BlackRock, to CEO, https://www.blackrock.com/uk/intermediaries/larry-fink-ceo-letter (last visited Oct. 28, 2021) [https://perma.cc/J9Y7-D7DJ] [hereinafter 2020 Letter from Larry Fink].

managers has led to pressure for the Big Three to provide investor-driven solutions to climate change risk.

A. The Passive Index Investing Revolution

How did asset managers such as BlackRock, Vanguard and State Street amass such power? Much of their dominance is a by-product of the passive index investing revolution. In 1975, John Bogle and the Vanguard Group created the first index mutual fund, named the First Index Investment Trust.[41] On inception, the index fund (nicknamed "Bogle's folly" after its creator) was denounced as "un-American" and "a sure path to mediocrity."[42] It took two full decades before index funds began to earn broad acceptance in the mid-1990s.[43]

Index funds are a type of investment fund that pools the assets of multiple investors to invest in a diversified portfolio of securities.[44] The funds replicate the performance of a specific benchmark stock market index (such as the S&P 500 index in the U.S. or the FTSE 100 index in the U.K.) or track a specially designed bespoke index.[45] This passive investment approach can be contrasted with the "stock picking" strategy utilized by actively managed investment funds, where shares are actively traded based upon fund managers' firm-specific analysis which aims to uncover whether companies are undervalued or overvalued.[46] Passive index funds can take the form of traditional

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41 The fund is now the Vanguard 500 Index Fund. The inspiration for the idea of the index fund came in 1951 from Bogle's Princeton University senior thesis where he noted that mutual funds "could make no claim to superiority over the market averages." John C. Bogle, *The Index Mutual Fund: 40 Years of Growth, Change, and Challenge*, 72 FIN. ANALYSTS J. 9, 9 (2016). The creation of the fund in 1975 also followed the recent publication of two influential finance works that supported indexing as an investment strategy: BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET: THE TIME TESTED STRATEGY FOR SUCCESSFUL INVESTING (1973) and Paul A. Samuelson, *Challenge to Judgment*, 1 J. PORTFOLIO MGMT. 17 (1974).

42 Tanza Loudenback, *When Vanguard's Founder First Invented the Index Fund, It Was Ridiculed as 'Un-American,' but 40 Years Later It's Clear His Critics Were Wrong*, BUS. INSIDER (Jan. 18, 2019, 5:43 AM), https://www.businessinsider.com/vanguard-jack-bogle-first-index-fund-criticism-2019-1?r=US&IR=T [https://perma.cc/BDA8-992Y].

43 Bogle, *supra* note 41, at 9.

44 *See* Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2043-44; Fisch et al., *supra* note 1, at 22.

45 Jan Fichtner & Eelke M. Heemskerk, *The New Permanent Universal Owners: Index Funds, Patient Capital, and the Distinction Between Feeble and Forceful Stewardship*, 49 ECON. & SOC'Y 493, 494 (2020); *see* Fisch et al., *supra* note 1, at 21 (citing Adriana Z. Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, 36 YALE J. ON REGUL. 795, 821 (2019) (explaining the nature of bespoke indices)).

46 *See* Bechuk & Hirst, *Index Funds, supra* note 1, at 2043-44.

mutual funds, exchange traded funds ("ETFs"),[47] or any other investment vehicle that algorithmically tracks a pre-defined index.[48] This can include bespoke ESG index funds.

The principle of indexation is grounded in Modern Portfolio Theory[49] and reflects the ideology that few investors can reliably and consistently "beat the market" with a more active stock picking strategy.[50] Empirical studies comparing the performance of active and passive funds reveal that the majority of active funds have not been able to generate higher returns compared with benchmark indices such as the S&P 500.[51] As a result, diversifying an investor's portfolio to hold virtually the entire stock market for the long-term is generally thought to earn the highest risk-adjusted return. This is particularly the case after the deduction of investment costs such as advisory fees, as indexation minimizes portfolio turnover and thus operating costs.[52] Index funds are advantageous to ultimate investors for a multitude of reasons, including reduced risk through diversification and very low, or even non-existent,[53] management fees.

The "momentous rise" of passive index funds has been described as a "pivotal shift" in capital migration from active to passive asset management.[54] In August 2019 it was reported that passive equity funds in the U.S. had officially overtaken active equity funds in terms of assets

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47 Index funds are traded only once a day after markets have closed whereas ETFs can be bought and sold continuously during the entire trading day. *See* Benjamin Braun, *From Performativity to Political Economy: Index Investing, ETFs and Asset Manager Capitalism*, 21 NEW POL. ECON. 257, 266 (2016).

48 *See* Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2044 (citing LOIS YUROW, TIMOTHY W. LEVIN, JOHN W. MCGUIRE & JAMES M. STOREY, MUTUAL FUNDS REGULATION AND COMPLIANCE HANDBOOK § 4:1 (2017) and William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 76-86 (2008) (noting rules governing mutual funds and ETFs)).

49 Modern Portfolio Theory is based on economist Harry Markowitz's theory which outlines that investors can maximize their return and reduce idiosyncratic (firm-specific) risk by diversifying their assets using a quantitative method. *See* Harry Markowitz, *Portfolio Selection*, 7 J. FINANCE. 77, 77 (1952).

50 Coates, *supra* note 1, at 5.

51 Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 506 (2018).

52 *See* Bogle, *supra* note 41, at 9.

53 In late 2018, Fidelity announced a series of zero-fee investment products, while also dropping the charges on all its index funds to historic lows and removing minimum capital requirements. *See* Owen Walker, *Fidelity's Zero-Fee Campaign Spurs $6.6bn of Inflows*, FIN. TIMES (Nov. 26, 2018), https://www.ft.com/content/d8569037-98fa-35bd-b3e5-861e8168161d [https://perma.cc/DH69-TGMN].

54 *E.g.*, Fichtner et al., *supra* note 5, at 300.

under management.[55] One newspaper report went so far as to proclaim that index funds are "eating the world."[56] This dramatic shift in investor behavior became particularly pronounced in the years following the 2008 financial crisis, when both individual and institutional investors "massively shifted capital from expensive, actively managed mutual funds to cheap, index mutual funds and exchange traded funds."[57] At the beginning of 2010, there was about $2.3 trillion in index funds whereas at the end of 2019, the global passive index investing market was worth $11.4 trillion.[58] The gravitation towards index funds has been driven by growing recognition of their low costs and tax benefits, together with increasing evidence that they outperform the majority of actively managed equity mutual funds.[59] For these reasons, index funds at least "seem to be a rare case of financial innovation that actually helps regular people" and have been described as "a populist victory, as finance goes."[60]

The transition from active to passive investing is likewise taking place in the U.K. and Europe, although the ascendancy of index investing is generally less pronounced than in the U.S., where the concept was pioneered. In the U.K., around 26% of assets are held in passive index funds.[61] In Europe, passive index funds make up around 20% of the assets under management, with individual European countries varying significantly (e.g., Switzerland 58.7%, Germany 11.1%, and Italy 0.05%).[62] Although the rise of passive investing in Europe is less

[55] *See* MORNINGSTAR RSCH., *supra* note 6, at 2.

[56] Jason Zweig, *Are Index Funds Eating the World?*, WALL ST. J.: MONEYBEAT BLOG (Aug. 26, 2016, 11:46 AM ET), https://blogs.wsj.com/moneybeat/2016/08/26/are-index-funds-eating-the-world [https://perma.cc/9UKS-WUN2].

[57] Fichtner et al., *supra* note 5, at 298-99.

[58] Robin Wigglesworth & Alex Janiaud, *Index Funds Break Through $10tn-in-Assets Mark*, FIN. TIMES (Jan. 8, 2020), https://www.ft.com/content/a7e20d96-318c-11ea-9703-eea0cae3f0de [https://perma.cc/V5MA-79NZ] (citing MORNINGSTAR RSCH., *supra* note 6).

[59] Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 94 (2017) (citing Kenneth R. French, *Presidential Address: The Cost of Active Investing*, 63 J. FIN. 1537 (2008)).

[60] Frank Partnoy, *Are Index Funds Evil?*, ATLANTIC (Sept. 2017), https://www.theatlantic.com/magazine/archive/2017/09/are-index-funds-evil/534183/ [https://perma.cc/MF8H-CZND].

[61] Steve Johnson, *Passive Funds' Share of European Investment Market Jumps to 20%*, FIN. TIMES (Dec. 7, 2020), https://www.ft.com/content/0b5325da-585f-41ad-8267-0741e9693a7a [https://perma.cc/P2X8-8MDF].

[62] *Id.*

dramatic than the U.S., it has nevertheless experienced significant growth in the past decade.[63]

B. *Concentration of Asset Managers — The Big Three*

The fundamental shift in investor ideology described in Section A above has led to a significant aggregation of power among the largest asset managers who offer passive index funds at the lowest cost.[64] Although the active fund management industry is relatively fragmented, the index fund industry is extremely concentrated. The "Big Three" asset managers are now the largest investors in the vast majority of economically significant companies. Collectively, they have global assets under management of over $19 trillion, with BlackRock's portfolio amounting to $8.68 trillion,[65] Vanguard's $7.2 trillion,[66] and State Street's $3.9 trillion.[67] To put that into perspective, the GDP of the world's largest three economies is $20.94 trillion[68] for the U.S., $14.72 trillion for China,[69] and $5.06 trillion for Japan.[70] The Big Three's concentration of power is also accelerating rapidly. From 2016 to 2020,

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63 *See* Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV. 803, 811-12 (2018) (outlining that this growth is expected to continue given regulatory changes in EU financial markets).

64 *See* Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2044; Bebchuk & Hirst, *The Specter*, *supra* note 8, at 729-31.

65 Global assets under management as of December 31, 2020. *See About BlackRock*, BLACKROCK, https://www.blackrock.com/sg/en/about-us (last visited Sept. 1, 2021) [https://perma.cc/VS4H-PDA5].

66 Global assets under management as of January 31, 2021. *Fast Facts About Vanguard*, VANGUARD, https://about.vanguard.com/who-we-are/fast-facts/ (last visited Sept. 1, 2021) [https://perma.cc/V6ZB-X2RG].

67 Global assets under management as of June 30, 2021. *See* Press Release, State St., State St. Reports Second-Quarter 2021 Financial Results (July 16, 2021), https://newsroom.statestreet.com/press-releases/press-release-details/2021/State-Street-Reports-Second-Quarter-2021-Financial-Results/default.aspx [https://perma.cc/2Q58-GUWH].

68 *GDP (Current US$) - United States*, THE WORLD BANK, https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=US (last visited Sept. 1, 2021) [https://perma.cc/C3KJ-6EMF].

69 *GDP (Current US$) - China*, THE WORLD BANK, https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=CN (last visited Sept. 1, 2021) [https://perma.cc/HSZ2-AFY8].

70 *GDP (Current US$) - Japan*, THE WORLD BANK, https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=JP (last visited Sept. 1, 2021) [https://perma.cc/TY4B-DMMX].

their assets under management grew by over 125%.[71] There is unlikely to be a serious challenge to the market power of the Big Three, which led Bebchuk and Hirst to predict that "the Big Three will likely continue to grow into a 'Giant Three.'"[72] One of the main reasons for this continuing concentration of asset managers is that passive index investing is a business of scale[73] and the Big Three have the benefit of first-mover advantage. They now dominate the market, managing over 90% of all assets under management in passive equity funds.[74] Therefore, they occupy a "quasi-monopolistic"[75] position and form an "oligopoly."[76] It would be extremely difficult for new entrants or even large pre-existing asset managers to make meaningful inroads into that level of market power.

Due to their passive index fund holdings, the Big Three are now permanent shareholders in the majority of companies globally. In the U.S., they control more than 20% of the shares of the average S&P 500 company, which translates into more than 25% of shares voted in such companies.[77] After the U.S., the U.K. is the jurisdiction with the next most significant blockholdings held by the Big Three, amounting to

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[71] *See* Bebchuk et al., *supra* note 59, at 94 (noting that BlackRock, Vanguard and State Street Global Advisors had assets under management of $3.1 trillion, $2.5 trillion and $1.9 trillion, respectively, in 2016).

[72] Bebchuk & Hirst, *The Specter*, *supra* note 8, at 723.

[73] *See generally* Patrick Jahnke, *Ownership Concentration and Institutional Investors' Governance Through Voice and Exit*, 21 BUS. & POL. 327 (2019) (discussing the relationship between increased concentration of assets and economies of scale).

[74] *See* Fichtner et al., *supra* note 5, at 304.

[75] Jan Fichtner, Eelke Heemskerk & Javier Garcia-Bernardo, *These Three Firms Own Corporate America*, CONVERSATION (May 10, 2017, 2:14 AM EDT), https://theconversation.com/these-three-firms-own-corporate-america-77072 [https://perma.cc/7MU6-A7L5].

[76] Julie Segal, *There's an Oligopoly in Asset Management. This Researcher Says It Should Be Broken Up*, INST. INV. (Nov. 24, 2020), https://www.institutionalinvestor.com/article/b1pcwthdczlycw/There-s-an-Oligopoly-in-Asset-Management-This-Researcher-Says-It-Should-Be-Broken-Up [https://perma.cc/J7J8-FQPM].

[77] Bebchuk & Hirst, *The Specter*, *supra* note 8, at 724 (stressing that because the Big Three generally vote all of their shares, whereas not all of the non-Big Three shareholders do so, the shares held by the Big Three translate into even greater voting power); *see also* José Azar, Miguel Duro, Igor Kadach & Gaizka Ormazabal, *The Big Three and Corporate Carbon Emissions Around the World* 20 (Eur. Corp. Governance Inst., Finance Working Paper No. 715/2000, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3553258 [https://perma.cc/E3PA-8P7H] (noting that this measure of Big Three ownership is a lower bound estimate of the total amount of claims owned directly or indirectly by these institutions).

more than 10% of the shares of the average FTSE 100 company.[78] Therefore, unlike the traditional Berle-Means corporation which was characterized by strong managers and weak owners,[79] the Big Three are in principle extremely strong shareholders of the member firms of the major U.S. and U.K. stock market indices. Even before the exponential rise of passive index investing as an investment strategy, Gilson and Kraakman opined that "we lack a normative model for how shareholders who invest 'in the market' should behave towards the companies in which they invest."[80] This is particularly important in the current climate crisis, as discussed in Section C below.

C. *Who Fuels the Fossil Fuel Industry?*

Since 1988,[81] it is estimated that over half of global emissions have been caused by only twenty-five corporate and state entities (a list that includes U.S. companies ExxonMobil, Chevron and ConocoPhillips and U.K. companies Shell and BP).[82] Therefore, a relatively small number of companies have been identified as the key corporate perpetrators of global warming. Each of the U.S. and U.K. companies identified on the list of the key twenty-five perpetrators is either a constituent of the U.S. S&P 500 index or the U.K. FTSE 100 index.[83]

The implications of the massive shift to passive investing need to be understood in the context of the risk posed by climate change. In recent years, pressure on university endowments, pension funds and other institutions to divest from fossil fuel companies has intensified. Divestment campaigns and protests are increasingly successful and large numbers of funds continue to actively divest (or commit to divest) from fossil fuels.[84] Given the continuing mass exodus of actively

[78] *See* Fichtner & Heemskerk, *supra* note 45, at 502; *see also* Suren Gomtsian, *Voting Engagement by Large Institutional Investors*, 45 J. CORP. L. 659, 671-72 (2020) (noting that in 2017 BlackRock and Vanguard were among the top ten shareholders in 90% of FTSE 100 companies with average shareholdings of 6.49% and 2.09%, respectively, and noting that BlackRock was the largest shareholder in almost half of those companies, sometimes with shareholdings above 10%).

[79] *See* ROE, *supra* note 3, at 6-7.

[80] Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 864 (1991).

[81] The year the Intergovernmental Panel on Climate Change was established.

[82] *See* Griffin, *supra* note 10, at 8.

[83] The relevant U.S. companies are ExxonMobil, Chevron, and ConocoPhillips (all constituents of the S&P 500 index) and the relevant U.K. companies are Shell and BP (both constituents of the FTSE 100 index). *See id.*

[84] To date, it is estimated that over 1,500 institutions have either divested or committed to divest approximately $39.88 trillion from fossil fuels. *See* GLOB. FOSSIL

managed portfolios from fossil fuel investments, and the continued rise of passive index funds that track the major stock market indices, the biggest shareholders of the prominent fossil fuel companies are now passive index funds. In terms of fossil fuel investments, index funds are becoming "the holders of last resort".[85] To illustrate, Table 1 shows that the Big Three collectively manage more than 20% of the stock of all eight oil and gas exploration and production companies in the S&P 500.

Table 1: Percentage of Stock in Eight Largest U.S. Oil and Gas Exploration and Production Companies held by the Big Three[86]

Corporation (by market value)	*Percentage of Stock Held*			
	BlackRock	*Vanguard*	*State Street*	*Big Three collectively*
ExxonMobil Corp	6.37%	8.34%	5.96%	20.67%
Chevron Corp	7.05%	8.35%	7.22%	22.62%
ConocoPhillips	8.37%	8.27%	5.41%	22.05%
Marathon Petroleum Corp	10.18%	9.91%	6.77%	26.86%
Occidental Petroleum Corp	6.35%	10.24%	5.95%	22.54%
Hess Corp	7.05%	9.59%	5.89%	22.53%
Devon Energy Corp	7.78%	11.14%	5.96%	24.88%
APA Corp	6.41%	11.98%	6.63%	25.02%

These holdings are largely comprised of passive index funds. It was reported in 2019 that 98.2% of Vanguard's fossil fuel investments are held in passive funds, with the corresponding figures for BlackRock and State Street being 88.7% and 99%, respectively.[87]

FUEL DIVESTMENT COMMITMENTS DATABASE, https://divestmentdatabase.org/ (last visited Nov. 26, 2021) [https://perma.cc/2KVM-U7C4].

[85] *See generally* Patrick Jahnke, *Holders of Last Resort: The Role of Index Funds and Index Providers in Divestment and Climate Change* (Mar. 9, 2019) (unpublished manuscript) (available at https://ssrn.com/abstract=3314906 [https://perma.cc/LQ7Y-2DKK]) (discussing how index funds are among the last holders of fossil fuel investments and providing possible ways for them to reduce the "carbon intensity" of their holdings).

[86] Ownership data as of June 30, 2021, extracted from Fidelity Stock Research Center. *Stock Research Center*, FIDELITY, https://eresearch.fidelity.com/eresearch/landing.jhtml (last visited Sept. 3, 2021) [https://perma.cc/HQP6-C7YX].

[87] Patrick Greenfield, *World's Top Three Asset Managers Oversee $300bn Fossil Fuel Investments*, GUARDIAN (Oct. 12, 2019, 7:00 AM EDT), https://www.theguardian.com/environment/2019/oct/12/top-three-asset-managers-fossil-fuel-investments [https://perma.cc/RYN7-4HEL].

Climate Action 100+ also keeps an up-to-date list of "focus companies" that are key to driving the global net-zero emissions transition. At present, they have selected 167 focus companies for engagement, which account for over 80% of corporate industrial greenhouse gas emissions.[88] Of the nine U.K. companies on this list, eight are in the FTSE 100 index and one is in the FTSE 250 index. Of the forty-five U.S. companies on the list, forty-three are in the S&P 500 index.[89] All of these "focus companies" will have a high percentage of shares owned by the Big Three in passive index funds. In addition to a focus on the companies that directly contribute to climate change through their operations, there has also been a more recent movement to target the financiers of the fossil fuel industry — large commercial banks.[90] Again, the major shareholders of these banks will include the Big Three. This underscores the role of the Big Three as the primary agents who are most invested in the major companies fueling the climate crisis.

D. *The Big Three as Sustainable Capitalists?*

Due to increased scrutiny of their role in the climate crisis, the Big Three have begun to assume what I call the role of "sustainable capitalists." The concept of "sustainable capitalism" was advanced in a manifesto by Al Gore and David Blood in 2011 as "a framework that seeks to maximize long-term economic value by reforming markets to address real needs while integrating environmental, social and governance (ESG) metrics."[91] In particular, Gore and Blood stressed that "businesses cannot be asked to do the job of governments, but companies and investors will ultimately mobilize most of the capital needed to overcome the unprecedented challenges we now face."[92] In the last few years, the Big Three have begun to release public statements echoing these sentiments. Larry Fink's 2020 letter to CEOs advocated "achieving a more sustainable and inclusive capitalism," noting that

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88 *Companies*, CLIMATE ACTION 100+, https://www.climateaction100.org/whos-involved/companies/ (last visited Sept. 2, 2021) [https://perma.cc/2MAK-XMMR].

89 The only two focus companies not in the S&P 500 are Bunge Limited and Vistra Energy.

90 One notable campaign is "Fossil Banks No Thanks." FOSSIL BANKS NO THANKS, https://www.fossilbanks.org (last visited Sept. 2, 2021) [https://perma.cc/7LME-Z5ZE].

91 Al Gore & David Blood, *A Manifesto for Sustainable Capitalism: How Businesses Can Embrace Environmental, Social and Governance Metrics*, WALL ST. J. (Dec. 14, 2011), https://www.wsj.com/articles/SB10001424052970203430404577092682864215896 [https://perma.cc/GTZ6-9CF8].

92 *Id.*

"while government must lead the way in this transition, companies and investors also have a meaningful role to play."[93] Moreover, State Street outlined the "important role" institutional investors have to play in sustainable capitalism, stating that "capitalism works best when there is a healthy balance of power across the state, the market and civil society."[94]

The global problem of the climate crisis should, most appropriately, be addressed by democratically elected national governments and international cooperation, by way of environmental regulation and international treaties.[95] It has also long been recognized by corporate law scholars that "the most efficacious legal mechanisms for protecting the interests of non-shareholder constituencies . . . lie outside of corporate law . . . . For the public at large, it includes environmental law and the law of nuisance and mass torts."[96] As noted by Armour and Gordon, "the consensus view is that the appropriate techniques for controlling externalities are themselves *external* to firms: that is they do not involve any modification to internal corporate governance commitments."[97] However, as Davies highlights, "faith in both these extra-corporate legal mechanisms seems to have waned over the past decade."[98] Much like "the ability of external mechanisms to impound social costs in systematically important financial firms' profit functions," regulation dealing with the problem of climate change has similarly turned out to be "highly incomplete."[99] The climate campaigner Greta Thunberg has pointed out that "political leaders have wasted decades through denial and inaction"[100] and even in 2021 — a time when the urgency of the climate crisis is much more universally

[93] 2020 Letter from Larry Fink, *supra* note 40.

[94] *Milken Institute 2020 Global Conference, The Future of Capitalism: A Panel Discussion with Ron O'Hanley*, STATE ST. (Oct. 2020), https://www.statestreet.com/ideas/articles/ohanley-future-of-capitalism-milken.html [https://perma.cc/QT8Q-ZFLY].

[95] As climate change is a global emergency that goes beyond national borders, it requires international cooperation and coordinated solutions. *See The Paris Agreement*, UNITED NATIONS, https://www.un.org/en/climatechange/paris-agreement (last visited Sept. 3, 2021) [https://perma.cc/H8DY-42HF] (explaining the United Nation's Paris Agreement, signed in 2015).

[96] Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 442 (2001).

[97] Armour & Gordon, *supra* note 17, at 44.

[98] PAUL DAVIES, INTRODUCTION TO COMPANY LAW 340 (3d ed. 2020).

[99] Armour & Gordon, *supra* note 17, at 44.

[100] Jennifer Rankin, *Greta Thunberg Tells EU: Your Climate Target Needs Doubling*, GUARDIAN (Feb. 21, 2019, 8:22 AM EST) https://www.theguardian.com/environment/2019/feb/21/greta-thunberg-tells-eu-your-greenhouse-gas-targets-are-too-low [https://perma.cc/G48K-2Q6B].

accepted and is increasingly visible through extreme weather patterns and the resulting devastation — government action still remains woefully inadequate. This may justify a mandate for investor intervention. In this vein, Hart and Zingales argue that "if political change is hard to achieve, action at the corporate level is a reasonable substitute."[101] Similarly, Azar, Duro, Kadach and Ormazaball stress that "since a full-scale regulatory solution to the emissions externality problem faces severe coordination frictions across countries, corporate governance is regarded as an alternative way of addressing climate change."[102]

The Big Three themselves, together with other investors, have criticized the failure of governments to adequately address the climate crisis. In 2018, Larry Fink stated that "we see many governments failing to prepare for the future," so it falls to the private sector to "respond to broader societal challenges."[103] He also reiterated a similar message in 2019, noting that due to the "failure of government to provide lasting solutions, society is increasingly looking to companies, both public and private, to address pressing social and economic issues."[104] Further, Christopher Hohn of the activist hedge fund TCI argued in December 2019 that "investors don't need to wait on regulators who are asleep at the switch and unwilling or unable to regulate emissions properly . . . [t]hey can use their voting power to force change on companies who refuse to take their environmental emissions seriously. Investors have the power, and they have to use it."[105]

There are various reasons why the Big Three may voluntarily assume the role of sustainable capitalists or "surrogate regulators"[106] engaging in "private environmental governance."[107] Firstly, it could reflect the rise in consumer demand for ESG funds and a desire on the part of the

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101 Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L., FIN., & ACCT. 247, 249 (2017) (citing Roland Bénabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 ECONOMICA 1 (2010)).

102 Azar et al., *supra* note 77, at 6.

103 Larry Fink, *A Sense of Purpose,* HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 17, 2018) https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/ [https://perma.cc/5BGV-CFKU].

104 Letter from Larry Fink, Chairman and Chief Exec. Officer, BlackRock, to CEO, https://www.blackrock.com/americas-offshore/en/2019-larry-fink-ceo-letter (last visited Aug. 22, 2021) [https://perma.cc/4EWN-XT5F].

105 Hook & Tett, *supra* note 39.

106 *See* Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 73 (2020).

107 *See id.* at 72 (citing Michael P. Vandenbergh, *Private Environmental Governance*, 99 CORNELL L. REV. 129, 174 (2013)).

Big Three to attract and retain (millennial) investors who care about issues such as climate change.[108] Secondly, it could be a response to backlash from environmental activists who have targeted the Big Three for their poor record on climate voting.[109] Thirdly, and relatedly, it could be due to pressure from other investors the Big Three interacts with, such as pension funds. Fourthly, it could be a precaution to avoid bad publicity and pre-empt regulation that might restrict the Big Three's power.[110] Finally, it could be based on "diversified investor self-interest" to mitigate the negative impact that climate change risk could have on a fully diversified index investment portfolio.[111]

As a final point, one advantage of efforts to mitigate climate change at the company and investor level is that large asset managers such as the Big Three invest in portfolio companies worldwide.[112] Their engagement and activism can transcend national borders and operate on a global scale. By contrast, governmental and regulatory efforts on climate change will either be limited to the national level or face signification coordination, collective action, and free rider problems on an international level. That said, it has also been noted by Condon that institutional investors' "economic incentive to mitigate the harms climate change impose on their portfolios . . . is not aligned with the *socially* optimal level of emissions reduction. Many of the most extreme costs of climate change will be borne by those that do not participate in the global economy, and certainly not the economy that is reflected in

[108] *See generally* Barzuza et al., *supra* note 18 (arguing that index funds are competing to accumulate assets of the millennial generation who place a "significant premium" on social issues).

[109] *See supra* text accompanying note 37.

[110] *See* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1798 (2020) ("Given the historical suspicion of concentrated economic power in the United States, BlackRock's CEO must worry about the prospect of regulation. The best way to avoid regulation is to be viewed by relevant audiences as a responsible steward.").

[111] *See* Condon, *supra* note 106, at 73.

[112] For example, BlackRock's Investment Stewardship Team has eight global offices and votes shares in more than eighty-five global markets. *Investment Stewardship: Acting on Behalf of Our Clients for the Long-Term*, BLACKROCK, https://www.blackrock.com/corporate/about-us/investment-stewardship (last visited Aug. 23, 2021) [https://perma.cc/956M-LZ8A]. BlackRock also publishes an Investment Stewardship Global Engagement Summary Report, which highlighted that in the calendar year 2020, the asset manager had engaged with 1,740 companies in the Americas, 801 companies in Europe, Middle East, and Africa, and 960 companies in Asia Pacific. BLACKROCK, INVESTMENT STEWARDSHIP GLOBAL ENGAGEMENT SUMMARY REPORT 1 (2020), https://www.blackrock.com/corporate/literature/press-release/blk-engagement-summary-report-2020.pdf [https://perma.cc/EJG7-EW9V].

asset valuation."[113] Consequently, "investor action to combat climate change will most certainly not be 'enough' from the perspective of the global population."[114] It is clear, therefore, that any action by the Big Three to adopt the role of sustainable capitalists — where they utilize their significant investor power to mitigate the effects of the climate crisis at the corporate level — can never be a complete solution. To be sure, Big Three intervention, or ESG investing, cannot be a substitute for a strong regulatory framework.[115] Moreover, the fact that the Big Three have the power to act as quasi-regulators also raises "important questions regarding democratic accountability and the potential to displace the role of 'traditional government,'"[116] as "the power to 'self-regulate' is the power to play a government-like role without the government's accountability to a democratic electorate."[117] BlackRock has already been called "the fourth branch of government"[118] and "the de-facto government based on Wall Street"[119] due to its immense power. However, given the urgency of the situation, and the relative inertia of governments to properly address the global climate crisis in a meaningful and urgent way, any progress that investors can make to mitigate corporate climate change damage would in itself be a valuable contribution to society.

113 Condon, *supra* note 106, at 67-68; *see also* Partnoy, *supra* note 60 (noting that "only about half of Americans own any stocks at all"). *See generally* Sanna Markkanen & Annela Anger-Kraavi, *Social Impacts of Climate Change Mitigation Policies and Their Implications for Inequality*, 19 CLIMATE POL'Y 827 (2019) (citing literature for the proposition that the poorest and marginalized populations — who are least responsible for past greenhouse gas emissions — are most vulnerable to climate change).

114 Condon, *supra* note 106, at 68.

115 *See* Ann M. Lipton, *ESG Investing, or, If You Can't Beat 'Em, Join 'Em*, *in* RESEARCH HANDBOOK ON CORPORATE PURPOSE AND PERSONHOOD 130, 146 (Elizbeth Pollman & Robert B. Thompson eds., 2021).

116 Condon, *supra* note 106, at 65.

117 *Id.* at 72.

118 Annie Massa & Caleb Melby, *In Fink We Trust: BlackRock Is Now 'Fourth Branch of Government'*, BLOOMBERG BUSINESSWEEK (May 21, 2020, 2:00 AM PDT), https://www.bloomberg.com/news/articles/2020-05-21/how-larry-fink-s-blackrock-is-helping-the-fed-with-bond-buying [https://perma.cc/YA4Z-AV3D].

119 Bill McKibben, *Can Wall Street's Heaviest Hitter Step Up to the Plate on Climate Change?*, NEW YORKER (Dec. 23, 2020), https://www.newyorker.com/news/annals-of-a-warming-planet/can-wall-streets-heaviest-hitter-step-up-to-the-plate-on-climate-change [https://perma.cc/4SY4-YJ3H].

II. THE AGENCY COSTS OF SUSTAINABLE CAPITALISM

> *"The large passive managers have a real difficult decision to make. Do they want to continue to finance the destruction of human civilization, or not?"*[120]
>
> *— former U.S. Vice President, Al Gore*

Part I introduced the Big Three in their assumed role as sustainable capitalists. This Part considers the agency costs associated with that assumption of responsibility. As passive index investors are fully diversified, they can generally be thought of as a proxy for the interests of the economy or society more broadly. The gap between the interests of index investors and the interests of the Big Three represents an agency cost. This Part theorizes a dual problem that could be present in the sustainability context: the persistence of "rational reticence" among the Big Three (in some respects); and the emergence of a second potential problem, "rational hypocrisy." When considering rational reticence, an important distinction is drawn between reticence with regard to portfolio-wide sustainability initiatives and reticence with regard to firm-specific sustainability activism. The relevant monitoring shortfall that remains (either firm-specific or portfolio-wide activism), then affects the role ESG hedge funds and other responsible activists can play in addressing this, as discussed in Parts IV and V.

A. Rational Reticence

In the archetypal Berle-Means corporation, shareholders were described as "rationally apathetic," due to collective action problems and coordination costs that inhibit widely dispersed shareholders from engaging in monitoring or activism.[121] As a result of the reconcentration of ownership among institutional investors,[122] Gilson and Gordon

120 Tett et al., *supra* note 38.

121 Black, *supra* note 4, at 527 (noting that "[t]he cost and futility of becoming informed leads shareholders to choose rational apathy"); *see* ROBERT C. CLARK, CORPORATE LAW 390-96 (1986) (noting that coordination costs for dispersed shareholders lead to rational apathy).

122 By the 1990s in the U.S., the "Berle-Means Corporation" was an oversimplification of the reality of the majority of U.S. public companies. *See* Black, *supra* note 4, at 574 (noting that "the model of public companies as owned by thousands of anonymous shareholders simply isn't true. There are a limited number of large shareholders, and they know each other"); *see also* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1291 (1991) (noting that "[i]nstitutional ownership is disproportionately heavy at the upper end of corporate America"). In the intervening years, institutional ownership became

recharacterized institutional investors as "rationally reticent."[123] Rational reticence describes a scenario where institutional investor intermediaries "have business models that limit their incentives and capacity to monitor the business choices of their portfolio companies," leading them to rationally prefer to exit a stock rather than exercise governance rights.[124] The underlying explanation for this reticence can be explained by reference to the competitive pressures that these funds are subject to. In essence, the portfolio managers of key investment intermediaries such as actively managed mutual funds and pension funds are incentivized to focus on relative performance at the lowest cost.[125] Even if it might be in the ultimate interests of the beneficiaries for the fund managers to engage in activism to improve the absolute performance of the fund, fund managers only capture a small fraction of the benefits from activism while bearing the full costs.[126] As the benefits will be enjoyed by all shareholders, other funds could free-ride on the activists' efforts without bearing any of the costs. Therefore, the incentive for any individual fund manager to engage in costly monitoring of portfolio companies, or to initiate firm-specific activism, is extremely limited.

This divergence in incentives results in institutional investors assigning "a low value to governance rights since their proactive exercise will not improve the relative performance on which the institutional investor's profitability and ability to attract assets depends."[127] Consequently, Gilson and Gordon theorized that such institutions would only "respond to proposals but are unlikely themselves to create them"[128] and that, at most, they "might engage in

even more pronounced. *See* Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 87 (2011) (noting that "[t]he proportion of shares of U.S. public companies held by domestic institutional investors rose from 14% in 1965 to 45% in 1985 and again to 65% in 2002"); *see also* Jennifer G. Hill, *The Trajectory of American Corporate Governance: Shareholder Empowerment and Private Ordering Combat*, 2019 U. ILL. L. REV. 507, 512 (2019) (noting that individual investors in the U.K. now hold only around 10% of listed U.K. equities); Charles McGrath, *80% of Equity Market Cap Held by Institutions*, PENSIONS & INVS. (Apr. 25, 2017, 1:00 AM), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions [https://perma.cc/5AWP-7EWG] (noting that by 2017, institutional investors owned approximately 78% of the market value of U.S. companies and 80% of the S&P 500 index).

123 Gilson & Gordon, *supra* note 14, at 867, 895.

124 *Id.* at 865.

125 *Id.* at 889-95.

126 Bebchuk et al., *supra* note 59, at 96-97; Gilson & Gordon, *supra* note 14, at 889-90.

127 Gilson & Gordon, *supra* note 14, at 895.

128 *Id.* at 867.

'governance activism' not 'performance activism.'"[129] This gap between the interests of institutional investors and beneficial owners is described by Gilson and Gordon as "the agency costs of agency capitalism."[130]

As explained in Part I, there have been rapid changes to the investor landscape since Gilson and Gordon's theory on agency capitalism was advanced. Any new framework therefore needs to appropriately account for the rise of passive investing, the common ownership of the Big Three asset managers, and the growth of ESG investing. These developments warrant a reconsideration of the problem of rational reticence that was exhibited by the active fund managers who were the focal point of Gilson and Gordon's agency capitalism theory.

When developing the concept of rational reticence, Gilson and Gordon highlighted three characteristics of (actively managed) mutual funds, with respect to power, reticence and responsiveness.[131] Firstly, in theory, mutual funds are incredibly powerful due to the significant levels of ownership concentration among institutional investors in recent decades. Secondly, in contrast, mutual funds are not proactive at all in terms of shareholder proposals. Thirdly, mutual funds are not entirely passive shareholders as they frequently oppose management on corporate governance issues such as poison pills and staggered boards.[132] Ultimately, Gilson and Gordon characterized such funds as "stubbornly responsive but not proactive."[133]

The general characteristics that Gilson and Gordon use to describe actively managed funds in terms of power, reticence and responsiveness also seem to hold true for passively managed funds generally and the Big Three asset managers specifically. Firstly, such funds potentially have immense power, especially given the increasing concentration of ownership among the Big Three. In fact, the Big Three's power and influence far exceeds that of smaller, actively managed mutual funds because the Big Three are now the largest shareholders in most economically significant corporations. Secondly, the Big Three are similarly not proactive in terms of putting forward shareholder proposals. In an empirical study, Bebchuk and Hirst noted that from 2007 to 2018, the Big Three have never submitted a single shareholder proposal.[134] Thirdly, the Big Three have demonstrated the potential to

[129] *Id.* at 889.

[130] *Id.*

[131] *Id.* at 886.

[132] *Id.* at 886-87.

[133] *Id.* at 888.

[134] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2104; *see also* Paul Rissman & Diana Kearney, *Rise of the Shadow ESG Regulators: Investment Advisers, Sustainability*

be more active in terms of portfolio-wide issues. Board gender diversity is the most prominent example of this.[135]

More specifically, however, the Big Three — predominantly managing passive index funds — may have some different incentives than active fund managers. There has been a lively academic debate regarding the incentives of passive index fund managers outside of the context of sustainability[136] and there is also some scholarship on the incentives of passive index fund managers in the ESG context.[137] As a

Accounting, and Their Effects on Corporate Social Responsibility, 49 ENV'T L. REP. 10155, 10173 (noting that "universal owners rarely, if ever, file shareholder resolutions, even for governance issues"); Attracta Mooney, *BlackRock Takes on Proxy Advisers in Dispute over Investor Rights*, FIN. TIMES (Nov. 24, 2018) https://www.ft.com/content/44110919-84d9-30d5-a346-e9ac30eef204 [https://perma.cc/H5VR-K73Z] (noting that BlackRock has never filed a shareholder resolution).

135 *See* Barzuza et al., *supra* note 18, at 1265-69. *See generally* Gormley et al., *supra* note 27 (discussing "The Big Three" institutional investors' campaigns to increase gender diversity on corporate boards).

136 *See generally* Bebchuk & Hirst, *Index Funds*, *supra* note 1 (arguing that index fund managers have strong incentives to underinvest in stewardship and to be excessively deferential to corporate managers); Bebchuk & Hirst, *The Specter*, *supra* note 8 (noting that the Giant Three scenario increases the importance of the agency problems afflicting passive index fund managers); Coates, *supra* note 1 (arguing that index funds have real influence and greater practical importance than simpler analytical approaches might suggest); Fichtner et al., *supra* note 5 (noting that the Big Three utilize coordinated voting strategies and follow a centralized corporate governance strategy and that they may exert "hidden power" through other channels); Fichtner & Heemskerk, *supra* note 45 (arguing that the ongoing debates on the rise of passive investing do not fully appreciate the transformative effect the Big Three could have as Permanent Universal Owners); Fisch et al., *supra* note 1 (arguing that as passive funds compete on both price and performance with other investment options, and benefit from economies of scale, they have a variety of incentives to engage effectively with companies in their portfolio); Kahan & Rock, *supra* note 110 (arguing that due to the enormous scale of their investments and the pivotal nature of their votes, the Big Three have the strongest incentives to ensure that companies in their portfolios are well run); Lund, *supra* note 51 (arguing that passive fund will rationally adhere to low cost governance interventions as they lack a financial incentive to ensure that their portfolio companies are well-run); John D. Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407 (2019) (arguing that the biggest investment managers are too big to be activists).

137 *See generally* Barzuza, Curtis & Webber, *supra* note 18 (arguing that the notion that index funds are passive owners overlooks that index funds have taken a leading role in challenging management and voting against directors in order to advance board diversity and corporate sustainability); Condon, *supra* note 106 (arguing that diversified investors should rationally be motivated to internalize intra-portfolio negative externalities and thus institutional investors can influence managerial decisions at the firm level for the benefit of their broader portfolio); Caleb N. Griffin, *Environmental and Social Voting at Index Funds*, 44 DEL. J. CORP. L. 167 (2020) (noting that despite the considerable marketing efforts of the Big Three with respect to their environmental and social efforts, overall support for environmental and social proposals is low at the Big

general principle, passive index funds cannot exit a stock that is a constituent of an index that the fund tracks. As noted by Vanguard's CEO, "our index funds cannot choose the shares in which they invest. We are essentially permanent capital and cannot turn the S&P 500 into the S&P 499."[138] The "exit" or "Wall Street Walk" option from Albert Hirschman's treatise on "exit, voice, and loyalty"[139] is not open to passive index funds. Pursuant to Hirschman's theory, "exit was shown to drive out voice . . . and it began to look as though voice is likely to play an important role in organizations only on condition that exit is virtually ruled out."[140] This point was also made vividly by a principal at Vanguard, who noted "We're riding in a car we can't get out of, governance is the seat belt and air bag."[141] At first sight, therefore, it may seem as if passive investors would be *more* likely to utilize voice, given the unavailability of exit. Crucially, though, passive index funds do not compete on performance, as they offer what is essentially a commoditized product to investors.

In the context of the Big Three, a more nuanced examination of rational reticence is timely, as the incentives to engage in portfolio-wide sustainability initiatives may be much stronger than the incentives to initiate firm-specific ESG activism.

1. Portfolio-wide ESG Initiatives

The Big Three differ from the actors examined in the agency capitalism framework as they are common owners, and they

Three); Giovanni Strampelli, *Can BlackRock Save the Planet? The Institutional Investors' Role in Stakeholder Capitalism*, 11 HARV. BUS. L. REV. (forthcoming) (arguing that there are reasons to doubt that institutional investors can perform a public function for the benefit of society at large and replace governmental or regulatory intervention).

138 Cyrus Taraporevala, *Index Funds Must Be Activists to Serve Investors*, FIN. TIMES (July 24, 2018) https://www.ft.com/content/4e4c119a-8c25-11e8-affd-da9960227309 [https://perma.cc/B8K3-UK46].

139 *See* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINES IN FIRMS, ORGANIZATIONS, AND STATES 21-29 (1970); *see also* Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55, 56 (2007) [hereinafter *Evolution of Shareholder Activism*].

140 HIRSCHMAN, *supra* note 139, at 76; *see also* Coffee, *supra* note 122, at 1288 (noting that "if 'exit' is blocked, the members will become more interested in exercising a 'voice' in governance decisions").

141 Sarah Krouse, David Benoit & Tom McGinty, *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 24, 2016, 10:41 AM ET) https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101 [https://perma.cc/VH84-MQQ9].

increasingly manage ESG funds.[142] These factors could prompt the Big Three to engage in more active monitoring, at least on portfolio-wide ESG issues. A key principle of Modern Portfolio Theory is that investors can mitigate idiosyncratic (firm-specific) risk by diversifying their portfolios.[143] This is one of the major benefits of passive index funds, as investors are diversified across a huge range of companies. The Capital Asset Pricing Model also teaches us that investment involves two types of risk: systematic risk and unsystematic risk (or specific risk).[144] Diversification does not solve the problem of systematic risk, as even a portfolio holding all of the shares in the stock market cannot eliminate systematic risk.[145] Climate change has been described both as a systematic risk[146] and a systemic risk.[147] It "cannot be eliminated through diversification because its effects are felt economy-wide."[148] The climate crisis — if it continues unabated — will inevitably impose devastating losses on society, both in economic and other terms. Similar to the losses imposed by a financial crisis, the losses caused by climate change are likely to be "characteristically widely diffused, indirect and inaggregate very large."[149] As Armour and Gordon have noted, "the firm's majoritarian diversified shareholders," cannot eliminate systemic

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142 During 2020, sustainable funds in the United States continued to dominate fund flows, with assets under management reaching $236 billion due to inflows of $51.1 billion. BlackRock's iShare suite of ESG ETFs attracted $23.1 billion (or 45% of all sustainable fund flows) for the year. *See* Jon Hale, *A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights*, MORNINGSTAR (Jan. 27, 2021) https://www.morningstar.com/articles/1019195/a-broken-record-flows-for-us-sustainable-funds-again-reach-new-heights [https://perma.cc/BXE4-XV72].

143 *See* Markowitz, *supra* note 49, at 89-90; *see also* Armour & Gordon, *supra* note 17, at 36.

144 WILLIAM SHARPE, PORTFOLIO THEORY AND CAPITAL MARKETS 139-40 (1970).

145 *See* John C. Coffee, *The Future of Disclosure: ESG, Common Ownership, and Systemic Risk* 11 (Eur. Corp. Governance Inst., Working Paper No. 541/2020, 2021) (citing RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 168-70 (10th ed. 2011).

146 *Id.* at 14 (noting "[c]limate change probably presents the clearest example of systematic risk").

147 Although these terms are often used interchangeably, they refer to different risks. Systematic risk involves vulnerability to events which affect aggregate outcomes such as broad market returns, including major weather catastrophes and pandemics. Systemic risk is the risk of collapse of an entire market. It is typically associated with financial crises that have a cascading effect on the market.

148 Condon, *supra* note 106, at 17 (citing Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 200 (2008) ("To the extent systemic risk affects markets, however, it is positively correlated with the markets and cannot be diversified away.")).

149 Armour & Gordon, *supra* note 17, at 40 (describing the losses caused by the global financial crisis).

risk and thus "would prefer that the managers did not impose systemic externalities."[150] Therefore, it is clear that the interests of different types of shareholders — especially with regard to portfolio-wide risk — are not homogenous.[151] The interests of fully diversified passive index investors can differ markedly from the interests of more concentrated shareholders who may be primarily concerned with increasing firm-specific value, due to their active, stock-picking, investment strategies.

Hart and Zingales noted that shareholders with diversified portfolios are "interested in total market return rather than the value of a particular firm."[152] In a similar vein, Gilson and Kraakman argued that the "surest way to increase the value of an indexed stock portfolio is to increase the value of all of the companies in the portfolio."[153] They hypothesized that the "only plausible" way to do this is by "improving the corporate governance *system* rather than by attempting to improve the management of particular companies."[154] Beginning in the 1990s, institutional investors such as public pension funds protected the "system" by securing portfolio-wide governance improvements, including dismantling takeover defenses.[155] Similarly, portfolio-wide benefits can be pursued in relation to climate change risk.

The climate crisis — as well as being the most severe threat to life on earth — poses the most significant risk to the economy. Estimating the magnitude of the damage that climate change will inflict upon investment portfolios is a very challenging task, given that estimating the effect of climate change on the economy more broadly is also extremely difficult.[156] However, the expected damage to the Big Three's investment portfolios is likely to be vast.[157] As outlined above, this damage is not something investors can avoid by diversifying their portfolios, and in fact it is the most diversified investors — who broadly

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150 *Id.* at 39.

151 *See generally* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (arguing that the interests of public company shareholders are not in harmony with each other).

152 Hart & Zingales, *supra* note 101, at 251.

153 Gilson & Kraakman, *supra* note 80, at 867.

154 *Id.*

155 *Id.* at 867-71; *see also* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 877 (noting that in the early 2000s, four types of precatory resolutions did obtain support: proposals to repeal classified boards (average 62% of votes); proposals calling for the elimination of supermajority provisions (average 60% of votes); proposals calling for rescission of poison pills (average 59%); and proposals for shareholder approval of future golden parachutes (average 53%)).

156 Condon, *supra* note 106, at 43.

157 *See id.* at 45.

represent the economy and society — who should logically be the most concerned about such climate change risk.

As a result, Condon's conclusion that "institutional investors, contrary to the traditional assumptions of investor passivity, have both the incentive and the capacity to serve as monitors of corporate behavior, so long as returns are justified at the portfolio level" seems theoretically sound.[158] In particular, the effect of common ownership among index investors should rationally translate into a willingness to internalize negative externalities — specifically to minimize the risks associated with climate change, given its detrimental effect at the portfolio level.[159] Put simply by Condon, "[a]s 'universal owners,' it is in their financial self-interest to take action to reduce global emissions, including those generated by the publicly traded fossil fuel companies in which they invest."[160] Coffee similarly notes that "[g]iven high common ownership across a broad portfolio, it becomes rational and predictable that diversified institutional investors will make both investment and voting decisions on a portfolio-wide basis (rather than simply trying to maximize the value of individual stocks)."[161] It is rational for the Big Three to take action to try to reduce the risk of climate change on a portfolio-wide basis, even if such action causes losses to some companies in their portfolio.[162]

Therefore, if the Big Three properly account for the expected damage to portfolio-wide returns in the future due to the impact of climate change, they should be incentivized to mitigate climate risk at the portfolio level. Other commentators have likewise argued that "passive investors have meaningful monitoring incentives when it comes to cross-cutting issues such as sustainability," where large investors such as the Big Three can exploit economies of scale to make a meaningful impact.[163] The theoretical impact of this cannot be overstated. Coffee argues that "the advent of portfolio-wide decision-making (both as to investments and voting) may represent the most important contemporary change in institutional investor behavior,"[164] solving a

158 *Id.* at 10.

159 *Id.* at 12.

160 *Id.* at 6.

161 Coffee, *supra* note 145, at 5.

162 *Id.* at 15.

163 Azar et al., *supra* note 77, at 6 (citing Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111 and Gormley et al., *supra* note 27).

164 Coffee, *supra* note 145, at 42.

"problem that has frustrated legal scholars for decades" and finding "a strategy to make public corporations behave more virtuously."[165]

To conclude, when analyzing rational reticence in the context of sustainable capitalism, theoretically the Big Three should exhibit less rational reticence on portfolio-wide sustainability issues than their active fund manager counterparts. It makes rational sense for the Big Three to replicate or even go beyond the successful portfolio-wide governance changes that were proposed by institutional investors in earlier decades.

2. Firm-specific ESG Activism

Compared to an actively managed fund that could, theoretically, improve its relative performance by overweighting a specific stock then investing in activism or engagement,[166] a passive index fund manager has minimal incentives to engage in firm-specific monitoring and activism, as there is no real way for passive funds to compete on the basis of performance with other index funds that mechanically track the same index. The business model of passive index investing is simply to replicate the performance of specific stock market indices and to minimize the costs for end investors. Unlike actively managed funds, index funds are "essentially commodities"[167] that compete on cost rather than relative performance. Davies has noted that "the incentives for managers of index funds to engage at a deep level appears to be very low, even non-existent, despite the fact that such funds are locked in long term to the relevant index."[168] Despite the inability to exit, passive index fund managers may be much less likely than active fund managers to engage in firm-specific performance activism. Therefore, when considering firm-specific monitoring and activism, the rise of passive investing and common ownership would, logically, appear to exacerbate the problem of rational reticence.

Condon does argue that institutions such as the Big Three have incentives to pursue firm-specific engagement in order to protect portfolio-wide returns.[169] This would appear to make sense, up to a point. Low-cost firm-specific intervention by the Big Three might be rational. However, free-rider problems loom large when it comes to

165 *Id.* at 43.
166 Lund, *supra* note 51, at 501.
167 Kahan & Rock, *supra* note 110, at 1783.
168 Davies, *supra* note 98, at 77.
169 Condon, *supra* note 106, at 61.

higher cost firm-specific activism.[170] There are ways to mitigate collective action and free rider problems. For example, institutional investors can form investor coalitions to coordinate action.[171] Coalitions such as Climate Action 100+ explicitly foster asset manager coordination.[172] Therefore, some minimal levels of firm-specific or coordinated sustainability activism may be rational on the part of the Big Three. However, this is very unlikely to stretch to firm-specific strategic or operational activism involving, for example, detailed and tailored energy transition plans at target companies. Predominantly, rational reticence with respect to firm-specific sustainability activism can be expected to prevail.

B. Rational Hypocrisy

The second problem that could afflict the Big Three specifically in the sustainable capitalism framework is what I call "rational hypocrisy." Hypocrisy is typically described as claiming to have higher standards or more noble beliefs than is actually the case in practice.[173] The concept of "corporate hypocrisy" is defined as "a firm that claims to be something that it is not."[174] In essence, a company will be perceived as insincere if it behaves in a manner that is inconsistent or that falls short of its self-proclaimed standards of social responsibility or if the company "says and does two different things."[175] In a similar vein, this Article introduces the concept of "rational hypocrisy" as a potential agency cost arising from the Big Three's assumed role as sustainable capitalists. In the media, BlackRock (in particular) has been regularly accused by various environmental activists as being hypocritical due to

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170 *See* Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2052 (noting the free-rider problem arises as "index fund investors will not fully capture the gains to the portfolio company from the investment in stewardship").

171 Condon, *supra* note 106, at 61.

172 *Id.* at 64.

173 "Hypocrisy" is defined in the Oxford English Dictionary as "[t]he assuming of a false appearance of virtue or goodness, with dissimilation of real character or inclinations."

174 Tillmann Wagner, Richard J. Lutz & Barton A. Weitz, *Corporate Hypocrisy: Overcoming the Threat of Inconsistent Corporate Social Responsibility Perceptions*, 73 J. MARKETING 77, 79 (2009) [hereinafter *Corporate Hypocrisy*]. The concept of "corporate hypocrisy" was first introduced in the marketing literature in 2009 but has also been examined in other disciplines such as management and organizational science, business ethics and social psychology. *See* Tillmann Wagner, Daniel Korschun & Cord-Christian Troebs, *Deconstructing Corporate Hypocrisy: A Delineation of Its Behavioral, Moral, and Attributional Facets*, 114 J. BUS. RSCH. 385, 391 (2020).

175 *See* Wagner et al., *Corporate Hypocrisy*, *supra* note 174, at 90.

discrepancies between its public statements on climate risk and its actions in practice. To cite some examples, in 2016 BlackRock and Vanguard were labelled "hypocritical" after they failed to support a shareholder resolution at ExxonMobil which put them at odds with their commitments as signatories of the Principles of Responsible Investment.[176] Similarly, BlackRock was accused of "climate change hypocrisy" after it refused to support two landmark environmental shareholder resolutions at Australian oil companies Woodside Energy and Santos that received high levels of support from other investors.[177] This led Majority Action to proclaim that "BlackRock joined Climate Action 100+ and enjoyed celebrity as a result of having done so, but has then made a mockery of its own commitment by voting to undermine its objectives."[178]

Various studies highlight that the Big Three's voting records with respect to climate-critical resolutions do not match the asset managers' public statements. For example, a 2019 study identified forty-one climate-critical resolutions submitted to corporations and highlighted that BlackRock only voted in favor of five and Vanguard only voted in favor of four.[179] In 2020, BlackRock was further criticized for its voting record which revealed that it had supported fewer climate resolutions than in previous years, despite Larry Fink's heavily publicized commitment to such initiatives at the beginning of the year.[180] A study by Griffin also concludes that the major motivation of the Big Three

[176] Laurie Havelock, *BlackRock, Vanguard Among 'Hypocritical' Investors Ditching PRI Agreement over Exxon Vote, Says AODP*, RESPONSIBLE INV. (Sept. 8, 2016), https://www.responsible-investor.com/articles/blackrock-vanguard-among-hypocritical-investors-ditching-pri-agreement-over [https://perma.cc/5BGV-X3LS].

[177] Attracta Mooney, *BlackRock Accused of Climate Change Hypocrisy,* FIN. TIMES (May 17, 2020), https://www.ft.com/content/0e489444-2783-4f6e-a006-aa8126d2ff46 [https://perma.cc/RZ58-793V].

[178] John Greenwood, *BlackRock 'Undermining Objectives of Climate Coalition It Just Joined' — Majority Action*, CORP. ADVISER (Dec. 14, 2020), https://corporate-adviser.com/blackrock-undermining-objectives-of-climate-coalition-it-just-joined-majority-action/ [https://perma.cc/BP8B-6P3H]; *see also* MAJORITY ACTION, CLIMATE IN THE BOARDROOM: HOW ASSET MANAGER VOTING SHAPED CORPORATE CLIMATE ACTION IN 2020, at 5 (2020) https://www.majorityaction.us/asset-manager-report-2020 [https://perma.cc/7EBN-KQQP] [hereinafter 2020 CORPORATE CLIMATE ACTION] (noting that BlackRock voted against ten of the twelve shareholder proposals flagged by Climate Action 100+ in 2020).

[179] MAJORITY ACTION, 2019 CORPORATE CLIMATE ACTION, *supra* note 35, at 4.

[180] Attracta Mooney, *BlackRock Criticized over Drop in Climate Votes*, FIN. TIMES (Oct. 4, 2020), https://www.ft.com/content/7a80f33b-a0ed-4dea-b2d3-ce56381f4084 [https://perma.cc/PA29-UV5M] (noting that BlackRock supported just 6% of environmental proposals filed by shareholders globally in the twelve months to June, down from 8% in the previous year).

may be to "be *perceived by potential customers* as taking positive action on E&S [environmental and social] issues."[181] Overall, an examination of the Big Three's voting records — and particularly the voting records of ESG funds which are often voted universally in tandem with ordinary index funds[182] — could be used to support the view that the Big Three do not sufficiently represent the interests of their ultimate investors, the economy, or society. An important caveat to this conclusion is that a focus on voting records alone may be misconceived as the Big Three favor engaging with companies over voting against management. It was reported in 2018 that "certain asset managers, including BlackRock, refuse to vote in favor of shareholder proposals if the companies concerned are engaging with the asset manager."[183] Despite the Big Three's failure to provide significant voting support to shareholder proposals related to climate change, there is some evidence that their more informal "engagement" with portfolio companies may be associated with lower greenhouse gas emissions. An empirical study by Azar, Duro, Kadach and Ormazabal finds that firms with higher CO_2 emissions are more likely to be the target of Big Three engagements and that engagements are followed by a reduction in CO_2 emissions. This provides preliminary evidence that the "engagement" efforts of the Big Three's stewardship teams may be associated with some positive climate action on the part of the worst corporate climate change offenders.

In any event, there are various reasons why the Big Three might be incentivized to engage in rational hypocrisy. Being *perceived* as environmentally or socially conscious could bring greater or equal benefit to the Big Three than going through the costly process of substantively challenging managers on tough issues in a meaningful way. The former approach could help the Big Three to attract investors' money. There has been a dramatic rise in ESG investment products in recent years. Throughout 2019 and 2020, record sums have been invested in socially responsible index funds.[184] The market share of ESG funds is still small relative to the $41 trillion held by investment funds

181 Griffin, *supra* note 137, at 170.

182 Scott Hirst, *Social Responsibility Resolutions*, 43 J. CORP. L. 217, 220 (2018) (highlighting that mutual funds could adopt policies whereby they would split their vote in proportions consistent with the preferences of their investors but noting that vote splitting is currently rare).

183 KIMBERLY GLADMAN, ASSET MANAGER CLIMATE SCORECARD 2018, at 1 (2018), https://5050climate.org/wp-content/uploads/2018/09/FINAL-2018-Climate-Scorecard-1.pdf [https://perma.cc/4PCY-5NYH].

184 Anna L. Christie, *A COVID-19 Index Fund — The New Fearless Girl?*, *in* COVID-19 AND BUSINESS LAW 33 (Horst Eidenmüller et al. eds. 2020).

worldwide, but it has grown exponentially in the last two years.[185] Assets under management in ESG funds exceeded the $1 trillion mark by mid-2020.[186] In Europe — which is the leading market for such funds — ESG funds are predicted to outnumber traditional funds as soon as 2025.[187] As noted by Barzuza, Curtis and Webber, "index funds are locked in a fierce contest to win the soon-to-accumulate assets of the millennial generation, who place a significant premium on social issues in their economic lives."[188] They posit that "signaling a commitment to social issues is one of the few dimensions on which index funds can differentiate themselves and avoid commoditization."[189] Bebchuk and Hirst argue that "index fund managers will have an incentive to avoid being perceived as inferior stewards" by their current and potential customers, and therefore will "have an incentive to emphasize their commitment to stewardship in their public communications."[190] They also note that this could "lead index fund managers to take positions on subjects that they expect to appeal to such investors, such as gender diversity on boards and climate change disclosure."[191] The impression of responsible stewardship could also mitigate consumer and employee backlash against the Big Three.

On the other hand, actually challenging corporate management on issues that may strike at the core of a company's business could be risky and controversial. As Choudhury and Petrin note, "environmental issues pose a unique challenge to business in that environmental protection may be fundamentally at odds with a specific corporation's core functions."[192] Therefore, an aggressive stance on these issues could jeopardize other business that the Big Three receive from the companies they invest in. Moreover, both politically and in the common ownership literature, the Big Three's escalating power is increasingly scrutinized.[193]

[185] Siobhan Riding, *ESG Funds Attract Record Inflows During Crisis*, FIN. TIMES (Aug. 9, 2020) https://www.ft.com/content/27025f35-283f-4956-b6a0-0adbfd4c7a0e [https://perma.cc/96DP-ALXU].

[186] *Id.*

[187] Siobhan Riding, *ESG Funds Forecast to Outnumber Conventional Funds by 2025*, FIN. TIMES (Oct. 17, 2020) https://www.ft.com/content/5cd6e923-81e0-4557-8cff-a02fb5e01d42 [https://perma.cc/R6HV-VD5T].

[188] Barzuza et al., *supra* note 18, at 1244.

[189] *Id.*

[190] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2072-73.

[191] *Id.* at 2073.

[192] BARNALI CHOUDHURY & MARTIN PETRIN, CORPORATE DUTIES TO THE PUBLIC 242 (2019).

[193] *See generally* José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018) (arguing that diversification and good

Intervening on firm-specific issues could heighten the risk of regulation curbing their power.

This Article generally proceeds on the assumption that fully diversified end investors — especially those who have explicitly chosen to invest in bespoke ESG index funds — should *rationally* care about climate change mitigation. However, it is important to acknowledge that it is possible, and perhaps likely, that some end investors themselves are similarly ambiguous or conflicted about the extent to which they wish the Big Three to pursue ESG objectives. This could be true even of investors who choose to invest in ESG funds. ESG funds have recently been marketed as performing better financially compared to non-ESG funds.[194] However, continued financial success is not guaranteed; "doing well" may not always align with "doing good." The preferences of end investors would be more apparent if a tradeoff was required between "doing well" and "doing good." The Big Three may be cautious to take bold steps towards sustainable capitalism if there is a risk of this adversely affecting financial performance as their ultimate investors may not be willing to promote ESG goals at the expense of higher returns. Therefore, the hypocrisy on the part of the Big Three may also be rational *because* it reflects the ambivalence of at least some end investors. In those cases, it would not be an agency cost because the approach would not conflict with the preferences of end investors.

governance come with the hidden cost of reduced competition because few large instititutional investors hold the majority of the market); Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016) (exploring how horizontal shareholding often can lead to anticompetitive market environment); Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017) (proposing that the Department of Justice and Federal Trade Commission should enforce the Clayton Act against institutional owners who own stakes in many competing firms); Graham Steele, *The New Money Trust: How Large Money Managers Control Our Economy and What We Can Do About It* (Am. Econ. Liberties Project, Working Paper Series on Corp. Power #8, 2020), https://www.economicliberties.us/wp-content/uploads/2020/11/Working-Paper-Series-on-Corporate-Power_8_FINAL.pdf [https://perma.cc/FRT5-KPBT] (discussing the issue of the growing dominance in financial markets by only few institutional investors, such as the Big Three).

[194] Siobhan Riding, *Majority of ESG Funds Outperform Wider Market over 10 Years*, FIN. TIMES (June 13, 2020), https://www.legis.nd.gov/assembly/67-2021/testimony/SNATRES-2291-20210204-4684-A-GAWRYLOW_DUSTIN_N.pdf [https://perma.cc/2VU4-5NQS].

III. The Original Governance Arbitrageur: Activist Hedge Funds

"Successful hedge funds will be entrepreneurial; it is the essence of the craft."[195]

— Paul Singer, founder of Elliott Management

Part II identified and theorized a dual problem that could arise from the Big Three's assumed role as sustainable capitalists — rational reticence and rational hypocrisy. Parallels can be drawn between the sustainable capitalism framework and the agency capitalism framework, as a monitoring shortfall similarly exists. In the agency capitalism framework, the solution that was identified by Gilson and Gordon was for activist hedge funds to fill the monitoring shortfall left by institutional investors.[196] Such activists played the role of governance intermediaries or arbitrageurs. Specifically, they were specialists in initiating firm-specific activist campaigns at companies where institutional investors were rationally reticent.[197] In the realm of sustainable capitalism, a vocal minority of activist hedge funds have already transitioned to focus on firm-specific ESG activism. In this respect, it is useful to track the evolution of activist hedge fund

[195] Joseph A. Giannone, *Hedge Funds Tip-Toe Toward an Uncertain Future*, REUTERS (Dec. 10, 2009, 3:58 AM), https://reuters.com/article/amp/idUSLNE5B902B20091210?edition-redirect=in [https://perma.cc/ME8Z-G88G].

[196] It is important to acknowledge that Gilson & Gordon's agency capitalism framework "provides a generally optimistic assessment of the potential role of institutional investors in contemporary corporate governance" whereas other commentators, such as Martin Lipton, have criticized institutional investor voting power as being "harnessed by a gaggle of activist hedge funds." *See* Hill, *supra* note 122, at 537 (citing Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 26, 2013), https://corpgov.law.harvard.edu/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/ [https://perma.cc/2LE5-NEEQ]).

[197] Anna L. Christie, *The New Hedge Fund Activism: Activist Directors and the Market for Corporate Quasi-Control*, 19 J. CORP. L. STUD. 1, 27 (2019) (noting that "activist hedge funds seeking board representation now often submit detailed business plans and proposals for long-term strategic and operational improvements at target companies"). Two examples of such campaigns are Starboard Value's campaign at Darden Restaurants in 2014, which included a very detailed 294-page turnaround plan for the Olive Garden restaurant chain and Trian Partners' campaign at Procter & Gamble in 2017, where Trian put forward a 93-page whitepaper on revitalizing P&G. *See* STARBOARD VALUE, TRANSFORMING DARDEN RESTAURANTS 193 (2014), http://www.shareholderforum.com/dri/Library/20140911_Starboard-presentation.pdf [https://perma.cc/LT8P-RURH]; TRIAN PARTNERS, REVITALIZE P&G TOGETHER 4 (2017), https://trianpartners.com/wp-content/uploads/2017/01/Trian-PG-White-Paper-9.6.17-1.pdf [https://perma.cc/SV7H-YBHN].

strategies to highlight how hedge funds adapted their strategies to fill the monitoring shortfall left by institutional investors. Especially important in this regard is how activist hedge fund campaigns evolved to effectively complement and appeal to the interests of the investors who will ultimately decide upon the success or failure of their campaigns.

A. Activism 1.0 — Financial Engineering

Armour and Cheffins draw a distinction between "offensive" and "defensive" shareholder activism, with hedge funds representing the archetypal offensive shareholder activist.[198] Activist hedge funds identify target firms and purposefully invest in them to pursue an activist agenda, whereas other institutional investors tend to be reactionary and will usually only engage in activism to protect existing holdings.[199] Whether activist hedge funds represent a positive or negative force is a polarizing topic.[200] Most commonly, activist hedge funds are criticized for having a "bias toward near-term gain, regardless of . . . the interests of long-term investors, and the productivity of the wider economy."[201] Here, I label the most commonly criticized form of hedge fund activism *Activism 1.0*. *Activism 1.0* is defined as activism involving financial engineering or balance sheet activism. These are the types of demands that politicians and the media most commonly (and most negatively) associate with hedge fund activism.[202] This form of activism generally involves a direct intervention on financial matters, such as pressuring the target company to increase leverage or return cash to shareholders via dividends or share buybacks.

In 2007, Bratton noted that hedge fund demands "likely include one or more actions assuring a quick return on investment."[203] This was demonstrated through an empirical study of activist hedge fund interventions from 2002 to 2006.[204] In the early 2000s, there was some

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198 Cheffins & Armour, *supra* note 122, at 56-57.

199 Christie, *supra* note 197, at 7.

200 *See* Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1871 ("Few topics are sexier among commentators on corporate governance now than whether activist hedge funds are good for, a danger to, or of no real consequence to public corporations and the people who depend upon them.").

201 William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1379 (2007).

202 *See* Christie, *supra* note 197, at 1-2.

203 Bratton, *supra* note 201, at 1379.

204 *See id.* at 1385-87.

evidence that activists may have "grabbed low-hanging fruit" and targeted cash rich companies to redistribute cash to shareholders.[205] Such financially-oriented strategies are also logically consistent with the business model of activist hedge funds as they seek to quickly generate abnormal returns in order to increase the value of their funds. Hedge funds pursue absolute returns, often over short time periods.[206] An easy target for an activist hedge fund would therefore be a cash-rich firm. Other tactics that can generate short-term gains for hedge funds include seeking to change the capital structure of the company by repurchasing shares or expanding leverage, or demanding companies dispose of assets or initiate cost-cutting measures.[207]

B. Activism 2.0 — Activist Directors

However, *Activism 1.0* is a simplistic and outdated view of modern-day hedge fund activism. Activist hedge fund tactics constantly evolve and have been adapted to appeal to the interests of long-term investors.[208] In the preceding decade, activist hedge funds have increasingly sought to secure minority representation on the boards of target companies, with this now being the most common form of hedge fund activism.[209] An empirical study conducted by the author shows that since 2010, over one hundred S&P 500 companies in the U.S. have been targeted by activist hedge funds seeking activist board representation.[210] Activist board representation campaigns are increasingly successful. Activist hedge funds secured at least one board seat in over 85% of the companies that were targeted.[211]

Activist hedge funds could not succeed in such bold campaigns to change the board structure and corporate strategy of major U.S. companies alone. The average activist hedge fund holding in such

[205] *Id.* at 1394-95.

[206] *See* John C. Coffee, Jr., & Darius Palia, *The Wolf at The Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 567, 572 (2016) (noting that "activists specialize in short-term interventions" and "few activist hedge funds have held their stock for anything approaching three years"); Strine, *supra* note 200, at 1892 (noting that "[t]he rise that most hedge funds seek must occur within a relatively short time period, because many activist hedge funds have historically retained their positions for only one to two years at most").

[207] IRIS H.-Y. CHIU, THE FOUNDATIONS AND ANATOMY OF SHAREHOLDER ACTIVISM 77 (2010).

[208] *See* Christie, *supra* note 197, at 37.

[209] *Id.* at 9.

[210] Hand collected dataset analyzing hedge fund activist board representations campaigns at S&P 500 companies from 2008-2020 (on file with author).

[211] *Id.*

campaigns at S&P 500 companies is just over 6%.[212] Therefore, support from the institutional investors who hold a much larger proportion of the shares is necessary. Activist board representation is a specific type of intervention that may appeal to long-term institutional investors. When activist hedge funds secure board representation, they hold shares for longer periods compared to cases where no board representation is involved. Board representation campaigns are also most often accompanied by the activist hedge funds submitting extremely detailed business plans and proposals for long-term strategic and operational improvements at target companies.[213] The longer-term, and more substantive, commitment on the part of hedge fund activist to the target company in *Activism 2.0* can thus mitigate some of the traditional concerns associated with the short-term "hit-and-run" motives and financial wizardry associated with activist hedge funds.[214] Given that hedge funds are acutely aware that they need the support of long-term investors to succeed in their campaigns,[215] the growth of activist board representation campaigns could be a reflection of activist hedge funds evolving and adapting to effectively mirror the incentives and priorities of institutional investors such as the Big Three.

Activist hedge funds are unique in pursuing this form of firm-specific activism that other investors neither have the capacity nor the incentives to initiate. No other type of activist specializes in the appointment of activist directors who focus on strategy, operations, and turnaround. These new strategies have therefore cemented activist hedge funds' position as the principal governance arbitrageurs in the corporate governance ecosystem. In the early 1990s, Gilson and Kraakman had proposed an agenda for institutional investors, envisaging that they could collectively nominate professional outside directors who would actively monitor public corporations in the shareholders' interest.[216] These aspirations did not materialize, and instead activist hedge funds adapted their strategies to fulfil this role. The Big Three (like other institutional investors) are also rationally reticent in this regard. They have not, to date, personally nominated directors to the boards of their portfolio companies. In an empirical study, Bebchuk and Hirst noted that from 2007 to 2018, the Big Three did not submit a single director nomination nor did they make any

[212] *Id.*

[213] Christie, *supra* note 197, at 27.

[214] *Id.*

[215] Institutional investors have been described as the "corporate equivalent of swing voters in politics." Hill, *supra* note 122, at 539-40.

[216] Gilson & Kraakman, *supra* note 80, at 883-84.

suggestions for particular directors to be added or removed through their engagement activities.[217]

As already noted, activist hedge funds combine minority board representation with detailed plans to implement operational and strategic turnarounds. Again, this is something that institutional investors, such as the Big Three, would lack the incentives and resources to do themselves. The Big Three are not in the business of analyzing portfolio companies' strategies and operations in depth and formulating alternative, complex, business plans. Jahnke has noted that "while the asset management industry demands good corporate governance and transparency, most investors stop short of demanding changes to companies' business strategy."[218] On the other hand, the Big Three may be appropriately placed to act as an arbiter when presented with conflicting plans from the incumbent management and the activists. Davies argues that while index investors do not appear to be reliable initiators, they may be as well placed as anyone else to evaluate the impact of an activist hedge fund proposal.[219]

Therefore, it is clear that activist hedge funds can fill the gap left by a lack of intensive, firm-specific monitoring by more traditional institutional investors. The form of monitoring pursued in *Activism 2.0* still fits with activist hedge funds' business model. Although they hold minority stakes in target companies, they are undiversified investors who hold concentrated positions in a small number of portfolio companies. As a result, they are willing to engage in "firm-specific agitation to a degree unheard of among traditional institutional investors."[220]

C. Activism 3.0 — ESG Activism?

Traditionally, activist hedge funds have not promoted sustainability goals, nor have they launched activist campaigns with environmental or social components. In a study conducted by the author of all activist hedge fund campaigns at S&P 500 companies since 2010, there were only four activist campaigns that were publicized as involving

[217] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2098.

[218] Jahnke, *supra* note 85, at 7.

[219] Paul L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?* 13-14 (Eur. Corp. Governance Inst., Working Paper No. 506/2020, 2020).

[220] Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1091-92 (2007).

environmental or social elements.[221] Each of those campaigns took place from 2018 onwards, which coincided with the launch of specialist ESG-focused activist funds. Previously, some companies may have hesitated to promote renewable energy or focus on long-term sustainability projects for fear of being an easy target for an activist hedge fund attack. One prominent example of this eventuality materializing is Elliott Management's campaign at NRG Energy in 2017. NRG Energy, America's biggest independent power producer, was targeted after its share price declined by 60% when it became a "champion of renewable energy."[222] Activists Elliott Management and Bluescape Energy Partners were successful in appointing two directors to NRG's board.[223] This led to conflicts with other shareholders, such as the New York City Pension Fund, as one of the nominees was a known climate-change denier who had repeatedly said global warming was not caused by carbon emissions and who labelled climate change a "hoax."[224] NRG ultimately announced a plan to divest its $4 billion renewable energy business, which caused a daily share price rise of around 25%[225] (increasing the value of Elliott's stake by approximately

[221] Data on file with author. The campaigns were: (1) ValueAct's January 2018 campaign at international power producer AES Corporation; (2) Jana's January 2018 campaign at Apple; (3) Elliott Management's 2020 campaign at Evergy; and (4) Engine No. 1's 2020 campaign at ExxonMobil. ValueAct's campaign at AES coincided with the launch of its new ValueAct Spring Fund and Jana's campaign at Apple coincided with the launch of Jana Impact Capital. There was one additional campaign by Trian Fund Management in October 2018 at the paint company PPG that referred to "ESG" goals. However, on closer examination, the campaign appeared to be entirely focused on governance, rather than any environmental or social factors. *See* TRIAN PARTNERS, PPG: MORE THAN A FRESH COAT OF PAINT 3, 37 (2018), https://www.10xebitda.com/wp-content/uploads/2020/03/Trian-PPG-Presentation-October-2018.pdf [https://perma.cc/HKT8-DVBZ].

[222] David Gelles, *How Producing Clean Power Turned Out to Be a Messy Business*, N.Y. TIMES (Aug. 13, 2016), https://www.nytimes.com/2016/08/14/business/energy-environment/how-producing-clean-power-turned-out-to-be-a-messy-business.html [https://perma.cc/HN9K-SLPY].

[223] Michael Flaherty, *UPDATE 1-NRG Names Two Directors in Deal with Elliott and Bluescape*, REUTERS (Feb. 13, 2017, 6:31 AM), https://www.reuters.com/article/nrg-energy-elliott-idCNL4N1FY3Z8 [https://perma.cc/QB77-6DY9].

[224] Ed Crooks, *Activists Clash over Direction for NRG Energy*, FIN. TIMES (Apr. 9, 2017), https://www.ft.com/content/89417ba2-1d3e-11e7-a454-ab04428977f9 [https://perma.cc/8A2K-92M4].

[225] Tom DiChristopher, *Hedge Fund Titan Paul Singer Scores Big Win After NRG Energy Surges 25% in Single Day*, CNBC (July 12, 2017, 8:15 PM EDT), https://www.cnbc.com/2017/07/12/hedge-fund-titan-paul-singer-scored-a-big-win-with-this-energy-bet.html [https://perma.cc/84XT-V5UH].

$58 million in one day).[226] Following the intervention, the company's shares were the best performing stock in the S&P 500 in 2017.[227] Elliott received similar criticism for its campaign at S&P 500 company Sempra energy in 2018, which partly focused on the firm divesting renewable energy assets.[228] Therefore, based on this anecdotal evidence, activist hedge funds may not seem to be the most likely candidates to pursue environmental or social goals.

However, the tides began to turn in 2018. In the last few years, activist hedge funds have begun to launch bespoke ESG funds and initiate campaigns where ESG issues are the primary or a core focus.[229] One of the first forays by activist hedge funds into the ESG investing space was witnessed in January 2018 when hedge fund Jana Partners announced the launch of Jana Impact Capital.[230] In a highly publicized endeavor, Jana enlisted the help of social activists, rock star Sting, and a former fund manager of BlackRock for its new impact fund, which was described in the press as "a convergence of Wall Street's roughest fighters and its do-gooders."[231] The fund's first headline activist campaign was conducted in partnership with the pension fund California Teachers' Retirement System ("CalSTRS") and targeted the world's most valuable publicly traded company, Apple. This campaign raised concerns regarding the psychological damage to children and

[226] Tina Davis, *Paul Singer Made $57.6 Million in One Day on This Bet*, BLOOMBERG (July 12, 2017, 10:53 AM EDT), https://www.bloomberg.com/news/articles/2017-07-12/singer-s-elliott-made-57-6-million-on-one-bet-in-one-day-chart [https://perma.cc/5DKA-WJFD].

[227] Ed Crooks & Lindsay Fortado, *Elliott Takes Stake in Sempra Energy, Calls for Strategic Review and Board Shake-Up*, FIN. TIMES (June 11, 2018), https://www.ft.com/content/d00fc274-6d82-11e8-852d-d8b934ff5ffa [https://perma.cc/TT2D-VFL8].

[228] Tom DiChristopher, *Activist Investor Paul Singer Just Chose Sempra Energy as His Next Turnaround Project*, CNBC (June 11, 2018, 11:58 AM EDT), https://www.cnbc.com/2018/06/11/elliott-management-launches-bid-to-overhaul-sempra-energy.html [https://perma.cc/G85J-2L6W].

[229] *See, e.g.*, David Faber, *Jeff Ubben's ValueAct Launching Fund with Social Goals, Following Similar Moves by Jana, BlackRock*, CNBC (Jan. 19, 2018, 1:45 PM EST), https://www.cnbc.com/2018/01/19/jeff-ubbens-valueact-launching-fund-with-social-goal.html [https://perma.cc/PA7G-2W3Q] (describing ValueAct Capital's early 2018 launch of a fund "focused on providing environmental and social goals for the companies it invests in").

[230] David Benoit, *Wall Street Fighters, Do-Gooders — And Sting — Converge in New Jana Fund*, WALL ST. J. (Jan. 7, 2018, 4:10 PM ET), https://www.wsj.com/articles/wall-street-fighters-do-goodersand-stingconverge-in-new-jana-fund-1515358929 [https://perma.cc/98BE-74PP].

[231] *Id.*

teenagers of too much "screen time."[232] In a public letter to Apple, the activists demanded stronger parental controls on devices such as the iPhone.[233] In response, Apple unveiled a new "screen time" feature on its devices less than six months later.[234]

Around the same time, in January 2018, another ESG campaign was initiated by ValueAct Capital's newly launched Spring Fund at international power producer AES. This involved ValueAct founder Jeffrey Ubben joining the board of AES in order to provide support to the company to increase its focus on renewable energy and sell its legacy coal assets.[235] Ubben noted that the Spring Fund was built on the premise "that there is not just a societal good to be done, but excess return to be captured in identifying and investing in businesses that are emphasizing and addressing environmental and societal problems."[236] In June 2020, Jeffrey Ubben announced that he would leave ValueAct to launch Inclusive Capital Partners, a new environmentally and socially-focused hedge fund.[237] This firm is expected to grow well beyond the Spring Fund in terms of assets under management. Prior to the shift, ValueAct Capital Partners had assets under management of around $16 billion, with the Spring Fund making up $1 billion.[238] The separation of the Spring Fund from ValueAct provides some preliminary evidence of ESG hedge fund activism progressing from being a niche

[232] *See* Attracta Mooney, *Activists Don Sustainability Cloak to Whip up Support*, FIN. TIMES (May 13, 2018), https://www.ft.com/content/b74d2adc-2b8e-11e8-97ec-4bd3494d5f14 [https://perma.cc/DG7X-BXXJ].

[233] Anne Sheehan, *Letter from JANA Partners & CalSTRS to Apple, Inc.*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 19, 2018), https://corpgov.law.harvard.edu/2018/01/19/joint-shareholder-letter-to-apple-inc/ [https://perma.cc/4M32-EWTT].

[234] Sarah Perez, *Apple Unveils New Screen Time Controls for Children*, TECHCRUNCH (June 4, 2018, 11:22 AM PDT), https://techcrunch.com/2018/06/04/apple-unveils-new-screen-time-controls-for-children/ [https://perma.cc/Q6UL-2ZYS].

[235] Mark Chediak & Scott Deveau, *This Activist Is Taking a Stake in a Power Generator to Push for Clean Energy*, BLOOMBERG (Jan. 17, 2018), https://www.bloomberg.com/news/articles/2018-01-17/activist-valueact-takes-aes-stake-in-push-for-cleaner-energy [https://perma.cc/2A3F-5KNZ] (noting that Ubben would work with AES on the company's plan to sell coal assets, reduce debt and develop more solar power and battery storage).

[236] Faber, *supra* note 229 (citing a letter from Ubben to ValueAct's limited partners).

[237] Billy Nauman, *Jeff Ubben Quits ValueAct for Social Investing*, FIN. TIMES (June 23, 2020), https://www.ft.com/content/eaa28471-e295-44a9-a138-dda047db6d1c [https://perma.cc/3ZSP-JBA8].

[238] *Id.* (quoting Jeffrey Ubben, who stressed that having an impact fund and a traditional fund under the same roof at ValueAct was "confusing" for investors, as the two strategies could not peacefully coexist — those who opted for the impact vehicle worried they were leaving returns on the table, and those who opted for the flagship fund worried about being portrayed as environmentally or socially "unconscious").

subset of an established activist hedge fund's activities to an ESG hedge fund in its own right.

There is also evidence of formidable activists such as Elliott Management — who previously attracted condemnation for setting back ESG issues — focusing on ESG as part of its business model. In 2018, Elliott created a new role of head of investment stewardship[239] and in 2020 the hedge fund reached an agreement with the S&P 500 power supplier, Evergy Inc, to execute a five-year operational "sustainability transformation plan" aimed at speeding up the company's transition to clean energy, which lagged behind peers.[240] In keeping with the tactics used in *Activism 2.0*, Elliott appointed two representatives to Evergy's board. In a complete turnaround from the types of activities that were berated in *Activism 1.0*, Elliott even urged Evergy to suspend share buybacks.[241]

However, the real tipping point — which potentially marks a new era of ESG hedge fund activism — was Engine No. 1's successful proxy contest at ExxonMobil in 2021. Engine No. 1 is an impact hedge fund. It officially launched in December 2020 with a mission to "invest in companies that make money while also investing in jobs, workers, communities, and the environment."[242] The founding members of the firm include former executives from the activist hedge fund Jana Impact Capital and from BlackRock.[243] The fund's inaugural activist campaign was a particularly ambitious move to nominate four independent director candidates to the board of directors of the world's largest listed oil company, ExxonMobil, at the 2021 annual meeting of shareholders.[244] The shareholder vote at Exxon was entirely

239 Cara Lombardo, *Elliott Management Goes on Charm Offensive*, WALL ST. J. (Oct. 8, 2018, 5:30 AM EDT), https://www.wsj.com/articles/elliott-management-goes-on-charm-offensive-1538991001 [https://perma.cc/ZC3E-3N6Z].

240 Press Release, Evergy, Evergy Announces 'Sustainability Transformation Plan' (Aug. 5, 2020, 7:01 AM EDT), https://investors.evergy.com/news-releases/news-release-details/evergy-announces-sustainability-transformation-plan [https://perma.cc/3HWF-6ZXC].

241 Nikitha Sattiraju, *Elliott Puts More Stress on ESG*, THE DEAL (Sept. 28, 2020), https://www.thedeal.com/activism/elliott-puts-more-stress-on-esg/ [https://perma.cc/6VVF-95LN].

242 Svea Herbst-Bayliss, *Hedge Fund Veteran Launches Impact Firm with Former Jana, BlackRock Executives*, REUTERS (Dec. 1, 2020, 12:42 PM), https://uk.reuters.com/article/us-investment-funds-james/hedge-fund-veteran-launches-impact-firm-with-former-jana-blackrock-executives-idUSKBN28B6AO [https://perma.cc/V3M6-ER73].

243 *Id.*

244 Svea Herbst-Bayliss & Gary McWilliams, *Exxon Faces Proxy Fight Launched by New Activist Firm Engine No. 1*, REUTERS (Dec. 7, 2020, 5:00 AM), https://uk.reuters.com/article/exxon-shareholders-engine-no-1/exxon-faces-proxy-

unprecedented as Engine No. 1's proxy contest was the first boardroom battle to focus on the issue of climate change. The campaign and its implications are discussed further in Part IV below.

In summary, this Part has tracked the evolution of activist hedge fund campaigns from short-term financial activism to longer-term operational and strategic activism (achieved through activist board representation) and finally to the recent emergence of new ESG hedge funds launching ESG campaigns. Part IV more fully analyses the role ESG hedge funds can play as ESG arbitrageurs in the sustainable capitalism framework.

IV. ESG Hedge Funds as ESG Arbitrageurs

> *"Fight for the things that you care about, but do it in a way that will lead others to join you."*[245]
>
> — *former U.S. Supreme Court Justice, Ruth Bader Ginsberg*

In *Activism 2.0*, activist hedge funds amassed considerable expertise nominating specialist directors to corporate boards. In the ESG context, the same tactics can be used by ESG hedge funds to nominate specialist ESG directors — such as those with renewable energy or climate transition expertise — to boards. The Engine No. 1 proxy contest at Exxon vividly illustrates the unique role that ESG hedge funds can play as ESG arbitrageurs in the sustainable capitalism context. Like the role activist hedge funds played as governance arbitrageurs in the agency capitalism framework, ESG hedge funds can effectively mitigate the rational reticence of the Big Three in the sustainable capitalism framework. In fact, the effect in the ESG context may prove to be even stronger, due to the bold public commitments that the Big Three have made to sustainable capitalism.[246]

fight-launched-by-new-activist-firm-engine-no-1-idUKKBN28H1IO [https://perma.cc/H3QV-QRWU].

[245] Colleen Walsh, *Honoring Ruth Bader Ginsburg*, HARV. GAZETTE (May 29, 2015), https://news.harvard.edu/gazette/story/2015/05/honoring-ruth-bader-ginsburg/ [https://perma.cc/3EYR-63TW].

[246] BlackRock, in particular has been vocal in committing to sustainable capitalism. For example, in his 2020 Letter to CEOs, Larry Fink proposed "achieving a more sustainable and inclusive capitalism," 2020 Letter from Larry Fink, *supra* note 40, and in his 2021 Letter to CEOs, Fink asked companies to disclose a plan for how their business model will be compatible with a net zero economy, Fink, *supra* note 1.

A. Activist Hedge Funds as ESG Arbitrageurs

When describing the agency capitalism framework, Gilson and Gordon outlined that a "happy complementarity"[247] could be achieved where "responsibility to beneficial owners for maximizing performance is split between specialists: Activist investors specialize in monitoring portfolio company strategy and formulating alternatives when appropriate for presentation to the institutional investors; in turn, institutional investors specialize in portfolio management and in evaluating proposals presented by activist investors."[248] This complementarity arose as activist hedge funds could "identify strategic and governance shortfalls with significant valuation consequences" and "present reticent institutions with their value proposition: a specified change in the portfolio company's strategy or structure."[249]

In the agency capitalism framework, activist hedge funds proved to be the "key intermediary".[250] In *Activism 2.0*, they focused on activist board representation, together with detailed, firm-specific, strategic and operational changes. Through these campaign strategies, activist hedge funds became increasingly successful in carving out a governance arbitrageur niche where they filled a monitoring gap that no other actor had the capacity or incentives to fill. The symbiotic relationship between activist hedge funds (as initiators) and institutional investors (as arbiters) that resulted is arguably successful in mitigating rational reticence.

Hedge fund activists and institutional investors were able to co-exist in relative harmony because activist hedge funds adapted their campaigns to align their goals with those of the institutional investors. Simplistically, both activist hedge funds and active mutual funds and pension funds were generally aligned to seek increases in shareholder value. Thus, activist hedge funds could act as governance arbitrageurs to pursue outcomes that were beneficial both for themselves and for shareholders more broadly. Some conflicts in these campaigns did arise

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[247] Gilson & Gordon, *supra* note 14, at 898 (noting that the "happy complementarity" requires an adequate supply of shareholder activists and thus a high enough return to activists to warrant their efforts).

[248] *Id.* at 897. *But see* John C. Coffee, Jr., Robert J. Jackson, Jr., Joshua R. Mitts & Robert E. Bishop, *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board*, 104 CORNELL L. REV. 381, 387-88 (2019) (outlining that a more skeptical view of activism may be necessary because the governance by referendum process does not actually work as simply as described, given the rarity of votes and the prevalence of settlements with activists).

[249] Gilson & Gordon, *supra* note 14, at 896.

[250] Coffee et al., *supra* note 248, at 385 (citing Gilson & Gordon, *supra* note 14, at 863).

with the growth of the Big Three. For example, there were some complaints from the Big Three that activist hedge fund settlements with companies disenfranchised longer-term investors and prioritized short-term gains over long-term value.[251] However, a closer look at *Activism 2.0* campaigns reveals that activist hedge funds adapted their campaigns to pursue strategies that would enable them to secure the critical support of the institutions. This primarily involved appointing directors to boards and advocating for strategic and operational changes following detailed research on the corporate target. The result was that the institutional investors' long-term orientation balanced out and mitigated some of the traditional criticisms of hedge fund activism, such as short-termism.[252]

As *Activism 3.0* campaigns are in their infancy, it may be difficult to predict exactly how the relationship between ESG hedge funds and pivotal asset managers such as the Big Three will evolve. There are, however, indications that activist hedge funds' transition to ESG has emulated some of the public statements made by the Big Three. Following BlackRock's CEO letters highlighting the importance of ESG, many activist hedge funds released similar statements on their websites regarding their own approach to ESG.[253] Therefore, preliminary evidence suggests that activist hedge funds are again attempting to adapt their strategies to capitalize on the new wave of Big Three interest in sustainable capitalism. By aligning their activism with the priorities of their pivotal voters, activist hedge funds can successfully pursue ESG goals.

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[251] John C. Coffee, Jr., *The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality* 14 (Eur. Corp. Governance Inst., Law Working Paper No. 373/2017, 2017), https://ssrn.com/abstract=3058319 [https://perma.cc/Z8ED-V5V9] (noting that the Big Three have all publicly criticized hedge fund activists and board representation settlement processes, suggesting that they perceive themselves to have been excluded from these private agreements); *see also* Rakhi Kumar & Ron O'Hanley, *Protecting the Interests of Long-Term Shareholders in Activist Engagements*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 17, 2016), https://corpgov.law.harvard.edu/2016/10/17/protecting-the-interests-of-long-term-shareholders-in-activist-engagements/ [https://perma.cc/C4NE-R4QG] (noting that "a recent rise in settlement agreements entered into rapidly between boards and activists without the voice of long-term shareholders concerns us, as we see evidence of short-term priorities compromising longer-term interests").

[252] Christie, *supra* note 197, at 12.

[253] *See, e.g.*, Charles Nathan, *Activists and Socially Responsible Investing*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 31, 2018), https://corpgov.law.harvard.edu/2018/01/31/activists-and-socially-responsible-investing/ [https://perma.cc/PHP5-HZU2] (noting that the ESG statement that Trian Partners added to its website in 2017 was similar to the ESG investment policies of the Big Three).

The use of *Activism 2.0* strategies in an ESG context is strikingly evident from Engine No. 1's campaign at Exxon. As noted above, this proxy contest was the first of its kind, due to the focus on climate issues. It was also remarkable because Engine No. 1 was not a well-established hedge fund with a formidable reputation for activism. It conducted its audacious campaign with only $250 million in capital, which was supplied by its founder Chris James.[254] By way of contrast, Elliott Management — the biggest activist hedge fund in the US — manages approximately $48 billion in assets.[255] Even if Engine No. 1 was not a typical activist hedge fund protagonist, Exxon was in many respects an obvious target.[256] Despite its status as an energy behemoth, Exxon stood out for its staggering long-term financial underperformance. In 2021, it recorded a $22 billion loss[257] and was removed from the S&P Dow Jones Industrial Average for the first time in almost a century.[258] Financial performance ordinarily translates into unhappy shareholders. However, in Exxon's case, shareholder discontent was much more deeply rooted. The board was notoriously indifferent to the concerns of shareholders and historically refused to engage with its largest investors.[259] Previous prominent *Activism 2.0* campaigns have exposed the risk of disregarding the legitimate concerns of shareholders. A similar approach had already proved fatal to the incumbent management of S&P 500 constituent Darden Restaurants in 2014, enabling the activist hedge fund Starboard

[254] Saijel Kishan, *Hedge Fund Veteran Chris James to Start Impact-Investing Firm*, BLOOMBERG (Dec. 1, 2020, 1:00 PM GMT), https://www.bloomberg.com/news/articles/2020-12-01/hedge-fund-veteran-chris-james-to-start-impact-investing-firm [https://perma.cc/6RKF-6CW3].

[255] *About Elliott*, ELLIOTT MGMT., https://www.elliottmgmt.com/about-elliott/ (last visited Sept. 3, 2021) [https://perma.cc/9S85-YDFD].

[256] Martin Whittaker & Richard Feloni, *'We Always Believed We Had a Compelling Case for Change' — JUST Interviews Activist Investor Engine No. 1 After Exxon Victory*, JUST CAPITAL (June 2, 2021), https://justcapital.com/news/engine-no-1-discuss-exxonmobil-board-victory/ [https://perma.cc/22CX-Q8C5].

[257] Jennifer Hiller, *Pandemic Pushes Exxon to Historic Annual Loss, $20 Billion Cut in Shale Value*, REUTERS (Feb. 2, 2021, 1:00 PM), https://www.reuters.com/article/us-exxon-mobil-results-idUSKBN2A21LN [https://perma.cc/9US2-QZ98].

[258] Eric Platt, *ExxonMobil Booted from the Dow After Close to a Century*, FIN. TIMES (Aug. 24, 2020), https://www.ft.com/content/76ecd406-b08e-4c2c-8643-cd23acb7cf2c [https://perma.cc/46DB-SBJL].

[259] Justin Baer, Dawn Lim & Cara Lombardo, *Investors Give Exxon Payback for Frustrations on Strategy and Climate*, WALL ST. J. (May 28, 2021, 4:34 PM ET), https://www.wsj.com/articles/investors-give-exxon-payback-for-frustrations-on-strategy-and-climate-11622227480 [https://perma.cc/LB2D-DKMS].

Value to succeed in replacing the entire board.[260] Notably, Exxon was also a clear industry laggard with respect to the energy transition. Due to decades of denial and misinformation about the impact of climate change, the company had long been referred to as a "fossil fuel dinosaur."[261] More recently, investors grew uneasy about its outlier status in failing to take any meaningful steps towards energy transition. These factors combined to create the conditions necessary for a perfect storm that resulted in Engine No. 1 ousting three incumbent directors from the board.[262]

Engine No. 1's substantive campaign mainly focused on capital allocation, with the fund urging Exxon to cut investment on projects based on unrealistic oil and gas prices and to focus on growth areas such as renewable energy. The campaign was not limited to operational ESG matters, however, with Engine No. 1 stating that its proposals were designed to help the company secure its dividend for shareholders.[263] Engine No. 1 could not have emerged victorious from its boardroom rebellion alone and its campaign was launched with the support of powerful allies. It had strong support from influential institutional investors, including the California State Teachers' Retirement System and other large U.S. pension funds.[264] To successfully elect its dissident slate of nominees, the activist needed to secure the pivotal votes of the Big Three asset managers. In Exxon's case, the Big Three controlled almost 21% of the shares[265] which translated into collective voting

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[260] Stephen Foley, *Starboard Sweeps Away Entire Darden Board*, FIN. TIMES (Oct. 10, 2014), https://www.ft.com/content/1be89158-5086-11e4-9822-00144feab7de [https://perma.cc/ULA5-8TEW].

[261] Terry Macalister, *Shell Chief Delivers Global Warming Warning to Bush in His Own Back Yard*, GUARDIAN (Mar. 12, 2003, 1:14 PM GMT), https://www.theguardian.com/environment/2003/mar/12/usnews.business [https://perma.cc/YE7Y-PXPC].

[262] Jennifer Hiller & Svea Herbst-Bayliss, *Engine No. 1 Extends Gains with a Third Seat on Exxon Board*, REUTERS (June 3, 2021, 1:03 AM), https://www.reuters.com/business/energy/engine-no-1-win-third-seat-exxon-board-based-preliminary-results-2021-06-02/ [https://perma.cc/735H-F2RC].

[263] Ortenca Aliaj, Derek Brower & Myles McCormick, *ExxonMobil Under Pressure as Church of England Joins Investor Campaign*, FIN. TIMES (Dec. 10, 2020), https://www.ft.com/content/c0639fb0-d81f-4ee9-8d58-d8e8da05c454 [https://perma.cc/GM83-VMMJ].

[264] *See* Statement by Karen Doron, CalSTRS, Statement on Alternate Board Members for ExxonMobil (Dec. 7, 2020), https://www.calstrs.com/statement/statement-alternate-board-members-exxonmobil [https://perma.cc/GB7M-P3Y2]; Svea Herbst-Bayliss & Jennifer Hiller, *Tiny Activist Investor's Arguments Against Exxon Draw Crowd to Its Side*, REUTERS (Dec. 11, 2020, 4:45 PM), https://uk.reuters.com/article/exxon-activist/tiny-activist-investors-arguments-against-exxon-draw-crowd-to-its-side-idUKKBN28L27G [https://perma.cc/GNB7-A9F5].

[265] *See supra* Part I.C, Table 1, at 117.

power of 31% in the proxy contest.[266] Why did Engine No. 1 — as a 0.02% shareholder — think it could secure the support of the Big Three? Like other institutional investors, the Big Three had expressed frustration with Exxon in the past. As one example, BlackRock lost patience with Exxon in 2016 and voted against key directors due to a board policy that prohibited direct engagement with shareholders.[267] In addition, of course, the Big Three had recently strengthened their public commitments to sustainable capitalism and BlackRock, for example, had warned companies that the asset manager would be increasingly disposed to vote against directors who failed to make sufficient progress on climate change.[268] In this respect, Engine No. 1's campaign was perfectly timed and executed to test the credibility of the Big Three's recent public commitments to sustainable capitalism.

An ESG proxy contest of this nature is completely unprecedented by an activist hedge fund. It draws clear parallels with the activist director campaigns that have become increasingly prevalent, and increasingly successful, at S&P 500 companies in the past decade. Here, the hedge fund is filling an ESG monitoring shortfall that arises from the most pronounced form of rational reticence, namely the Big Three's lack of incentives to initiate firm-specific ESG initiatives. It is unheard of for the Big Three to personally seek to appoint new independent directors to the board who have renewable energy or climate transition expertise or for them to intervene with detailed business plans for the strategy and operations of such a major S&P 500 oil and gas company.[269] Firm-specific activism of this nature would clearly fulfil an ESG arbitrageur role in a sustainable capitalism framework by mitigating the most pronounced form of rational reticence.

Engine No. 1's victory at Exxon is therefore a defining moment for ESG hedge fund activism. It illustrates how an activist with an extremely modest stake can campaign on a platform of climate issues to galvanize support from the Big Three and effect major board changes. This case makes it clear that the strategies used in *Activism 2.0* can

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266 *See* Exxon Mobil Corporation, Current Report (Form 8-K) (May 26, 2021), https://ir.exxonmobil.com/static-files/6e0b2aef-43eb-4a52-bd34-92b283783b6c [https://perma.cc/9HLF-UGL2].

267 Ross Kerber, *BlackRock Withheld Support from Two Key Exxon Directors: Filings*, REUTERS (Aug. 29, 2016, 5:03 AM), https://www.reuters.com/article/us-exxon-directors-blackrock-idUSKCN11417F [https://perma.cc/VGK7-2CYH].

268 2020 Letter from Larry Fink, *supra* note 40.

269 *See* Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2098 (noting that "there were approximately 3,800 director nominations at U.S. companies during the twelve-year period from 2007 through 2018 . . . . *not a single nomination* was made by any of the Big Three").

effectively be used in the ESG context. In particular, the appointment of climate directors — as an analogy to the activist directors who feature prominently in activist hedge fund campaigns in the agency capitalism framework — could prove to be activist hedge funds' unique contribution to mitigating the agency costs of sustainable capitalism.

B. Climate Directors

In the agency capitalism framework, hedge fund activism evolved to the point where the most common strategy of activist hedge funds is now the nomination of minority directors to the board.[270] Institutional investors are often willing to lend their support to campaigns to nominate minority board directors, especially when the nominees are non-affiliated industry experts or turnaround specialists. Institutional investors even, on occasion, request that hedge funds pursue board appointments.[271] It is argued in this Section that it would be especially valuable for ESG hedge funds to emulate these tactics in the sustainable capitalism context. A fruitful course of action would be for activists to nominate climate-focused or specialist energy transition directors to corporate boards, as seen in the Engine No.1 proxy contest. This solution would be targeted at mitigating the firm-specific rational reticence of the Big Three and other asset managers. Making institutional investors the arbiters on ESG board nominees is reminiscent of the proposal made by Gilson and Kraakman in the early 1990s, which envisaged that institutional investors could nominate professional outside directors.[272]

The only publicized case of a successful ESG campaign by institutional investors themselves nominating a climate expert director to a company board appears to be the case of the Italian energy company Enel, in summer 2020. In this case, the Dutch asset manager Robeco successfully appointed a climate transition expert, Samuel Leupold (the former CEO of Wind Power at Ørsted), to the board of Enel.[273] This

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[270] Hand collected dataset analyzing activist hedge fund campaigns at S&P 500 companies from 2010–2019 (on file with author)*; see also* Christie, *supra* note 197, at 9 (noting that "board representation is an objective of around 50% of [hedge fund activist] campaigns").

[271] Christie, *supra* note 197, at 12-13 (citing OWEN WALKER, BARBARIANS IN THE BOARDROOM: ACTIVIST INVESTORS AND THE BATTLE FOR CONTROL OF THE WORLD'S MOST POWERFUL COMPANIES 49, 70, 147-48 (2016)).

[272] *See* Gilson & Kraakman, *supra* note 80, at 883-84*; see also* text accompanying *supra* note 216.

[273] Sophie Robinson-Tillett, *Board Senseless? The Investor Fight Against Climate Incompetence*, RESPONSIBLE INV. (June 11, 2020), https://www.responsible-

campaign was made possible by what Belcredi and Enriques describe as a "peculiar feature of current Italian corporate governance regulation," where minority shareholders can submit a slate of candidates to Italian companies and have the right to have at least one candidate appointed, even where another slate gains a higher number of votes.[274] In this particular instance, the asset manager joined the Executive Committee of Assogestioni which is the representative association of the Italian investment management industry that assists its members to present candidates for election to boards.[275]

As in the *Activist 2.0* cases involving activist board directors, the Big Three are extremely unlikely to nominate climate directors to companies themselves. The Big Three do, however, care about board-related issues. The board of directors is and always has been a key focus for the Big Three. Campaigns to nominate climate directors are therefore precisely the types of campaigns that may be supported by the Big Three, thus serving to mitigate the problem of firm-specific rational reticence. Support might be anticipated from the Big Three for a number of reasons. Firstly, they have made a number of statements regarding the need for board directors to be better educated on climate issues. In 2019, Vanguard stated that companies need to "better educate their boards on climate-risk-related topics."[276] Similarly, State Street noted in 2017 that companies should "ensure that directors have some knowledge, expertise or training on material sustainability or climate risks facing the company."[277] Secondly, there is a prominent precedent

investor.com/articles/board-senseless-the-investor-fight-against-climate-incompetence [https://perma.cc/E4EX-7DDH] (noting that "Samuel Leupold was CEO of Wind Power at DONG Energy, which stood for Danish Oil and Natural Gas, during its transformation into one of the world's largest pureplay offshore wind developers, now named [Ø]rsted" and quoting the Head of Active Ownership at Robeco, Carola van Lamoen, who explained that "the Italian system lends itself to this kind of campaign" but that "'[t]hese moves may be difficult to achieve at a large scale because not all jurisdictions make it possible'").

[274] Massimo Belcredi & Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, 386, 393-95 (Jennifer G. Hill & Randall S. Thomas eds., 2015).

[275] Robinson-Tillett, *supra* note 273.

[276] VANGUARD, INVESTMENT STEWARDSHIP 2019 ANNUAL REPORT 22 (2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf [https://perma.cc/HU3L-UJJ8].

[277] STATE ST. GLOB. ADVISORS, SSGA'S PERSPECTIVES ON EFFECTIVE CLIMATE CHANGE DISCLOSURE 2 (2017), https://www.ssga.com/investment-topics/environmental-social-governance/2017/perspectives-on-effective-climate-change-disclosure.pdf [https://perma.cc/WGM2-7SFM].

of the Big Three pushing major ESG board-related agendas on the issue of board gender diversity[278] and there are early signs that the Big Three will similarly push for racial board diversity in the near future.[279] The primary case study that supports the thesis that the Big Three may be enthusiastic supporters of proposals by ESG hedge funds to nominate climate directors is the progress made by the Big Three on gender diversity on corporate boards.[280] There is a panoply of evidence to support the contention that the Big Three have been key activists in this portfolio-wide effort at U.S. companies. Undoubtedly the most high-profile, viral, marketing initiative on board gender diversity was State Street's "Fearless Girl" campaign which was launched on International Women's Day in 2017. The Big Three asset manager commissioned a bronze statute to be installed opposite the Wall Street Charging Bull to advertise its new bespoke ESG index fund (denoted by the ticker symbol "SHE") that is dedicated to investing in companies with gender-diverse boards.[281] Barzuza, Curtis, and Webber argue that this campaign should not be dismissed as a marketing gimmick, as it was followed up by concrete action on the part of State Street.[282] The Big Three asset manager pledged to vote against the chair of the nominating committee of boards that lacked any female board representation and failed to improve their record on gender diversity.[283] Ultimately, in 2017, State Street proceeded to vote against directors at 400 of the 476 companies in its portfolio that had no female directors.[284] BlackRock responded in

278 *See* Barzuza et al., *supra* note 18, at 1265-69; Gormley et al., *supra* note 27, at 4.

279 Cyrus Taraporevala, *CEO's Letter on SSGA 2021 Proxy Voting Agenda*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 13, 2021), https://corpgov.law.harvard.edu/2021/01/13/ceos-letter-on-ssga-2021-proxy-voting-agenda/ [https://perma.cc/REC7-SXEA] (noting that in 2021 State Street will vote against the Chair of the Nominating & Governance Committee at companies in the S&P 500 and FTSE 100 that do not disclose the racial and ethnic composition of their boards).

280 Barzuza et al., *supra* note 18, at 1265-72.

281 Christie, *supra* note 184, at 33 (citing Jenny Rooney, *'Fearless Girl': State Street Global Advisors' CMO on the Rationale, the Controversy and What's Next*, FORBES (Apr. 21, 2017, 9:30 AM EDT), https://www.forbes.com/sites/jenniferrooney/2017/04/21/fearless-girl-state-street-global-advisors-cmo-on-the-rationale-the-controversy-and-whats-next/ [https://perma.cc/8CCV-MCGT]).

282 Barzuza et al., *supra* note 18, at 1266-68.

283 *Id.* at 1266 (citing Joann S. Lublin & Sarah Krouse, *State Street to Start Voting Against Companies That Don't Have Women Directors*, WALL ST. J. (Mar. 7, 2017, 12:01 AM ET), https://www.wsj.com/articles/state-street-says-it-will-start-voting-against-companies-that-dont-have-women-directors-1488862863 [https://perma.cc/XS8Y-8NWM]).

284 *Id.* at 1248, 1268 (citing Justin Baer, *State Street Votes Against 400 Companies Citing Gender Diversity*, WALL ST. J. (July 25, 2017, 8:38 PM ET),

2018 by going one step further, announcing that it would vote against the entire nominating committee if companies did not show sufficient progress on gender diversity. It also stated that it expected firms to have at least two female directors on the board.[285] This seems to be compelling evidence of the Big Three committing to, and competing on the basis of, ESG platforms, especially with respect to board composition and expertise.[286]

These commitments have also been echoed in the climate context. The Big Three have pledged to vote against directors who fail to make meaningful progress on climate change. BlackRock has reiterated that it will vote against directors where companies fail to deal with environmental and social concerns appropriately. Its 2021 voting guidelines state "where we believe companies are not moving with sufficient speed and urgency, our most frequent course of action will be to hold directors accountable by voting against their re-election."[287] In September 2020, BlackRock disclosed that it had voted against fifty-five directors at forty-nine companies for failing to make progress on climate change. The list of those it voted against was focused mainly on energy companies, including S&P 500 constituents ExxonMobil and Chevron.[288] In its 2021 Stewardship Expectations report, BlackRock outlined that in some instances where it had voted against climate risk shareholder proposals for being too prescriptive, it still voted against directors for insufficient disclosure on climate issues.[289] Therefore, there is evidence that the Big Three are willing to vote against directors on ESG issues. Logically, therefore, it seems likely that the Big Three would be willing to support campaigns for the nomination of climate experts to boards, especially given their sustainable capitalist

https://www.wsj.com/articles/state-street-votes-against-400-companies-citing-gender-diversity-1501029490 [https://perma.cc/C6T4-TW9C]).

[285] *Id.* at 1269 (citing Sarah Krouse, *BlackRock: Companies Should Have at Least Two Female Directors*, WALL ST. J. (Feb. 2, 2018, 2:06 PM ET), https://www.wsj.com/articles/blackrock-companies-should-have-at-least-two-female-directors-1517598407 [https://perma.cc/U5DL-25R2]).

[286] *Id.* at 1269-72.

[287] BLACKROCK, OUR 2021 STEWARDSHIP EXPECTATIONS: GLOBAL PRINCIPLES AND MARKET-LEVEL VOTING GUIDELINES 4 (2021), https://www.blackrock.com/corporate/literature/publication/our-2021-stewardship-expectations.pdf [https://perma.cc/48JX-N9L3] [hereinafter 2021 STEWARDSHIP EXPECTATIONS].

[288] Joanna Partridge, *BlackRock Votes Against 49 Companies for Lack of Climate Crisis Progress*, GUARDIAN (Sept. 17, 2020, 1:04PM EDT), https://www.theguardian.com/business/2020/sep/17/blackrock-votes-against-49-companies-for-lack-of-climate-crisis-progress [https://perma.cc/2UXK-JNK5].

[289] BLACKROCK, 2021 STEWARDSHIP EXPECTATIONS, *supra* note 287, at 22-23.

positioning and their expressed willingness to vote against boards that fail to make progress on climate issues.

The Engine No. 1 proxy contest was a test case that illustrates that the Big Three are, in practice, willing to vote against credible candidates who are nominated on a climate platform. Here, the director nominees were energy industry veterans, with backgrounds in traditional and renewable energy, especially energy transition.[290] Three of Engine No. 1's four nominees won seats on Exxon's board, primarily due to the voting choices of the Big Three. The Big Three voting reports revealed that BlackRock voted in favor of three of Engine No. 1's nominees,[291] with Vanguard[292] and State Street[293] each supporting two candidates.

The dramatic success of the closely watched battle at Exxon means that further ESG hedge fund activism is likely to proliferate. However, future campaigns may not need to take the form of high-profile shareholder votes. Again, drawing analogies with *Activism 2.0* campaigns, there were some early high-profile proxy battles, but in later years almost all campaigns were resolved via a settlement between the company and the activists. Excluding Engine No. 1's ESG proxy contest at Exxon, there have only been seven activist board representation campaigns at S&P 500 companies that actually culminated in a shareholder vote.[294] This is perhaps because running a proxy contest for board representation can prove to be incredibly costly, both for the activist and the target company. The average cost of a proxy fight in the

[290] Herbst-Bayliss & McWilliams, *supra* note 244. The nominees were: Gregory Goff (former CEO of San Antonio-based refiner Andeavor); Kaisa Hietala (former leader of the renewables business of Finnish refiner Neste Oyj); Alexander Karsner (former senior strategist of Alphabet's innovation lab who served in the Energy Department under President George W Bush); and Anders Runevad (former CEO of Danish wind turbine manufacturer Vestas).

[291] BLACKROCK, VOTE BULLETIN: EXXONMOBIL CORPORATION 1 (May 26, 2021), https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-exxon-may-2021.pdf [https://perma.cc/48JX-N9L3] [hereinafter EXXONMOBIL VOTE BULLETIN].

[292] VANGUARD, VOTING INSIGHTS: A PROXY CONTEST AND SHAREHOLDER PROPOSALS RELATED TO MATERIAL RISK OVERSIGHT AT EXXONMOBIL 1 (2021), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/Exxon_1663547_052021.pdf [https://perma.cc/U9AL-DX6A].

[293] Ross Kerber, *Top Exxon Investors State Street, Vanguard Backed Activist Nominees*, REUTERS (May 27, 2021, 4:06 PM PDT), https://www.reuters.com/business/energy/state-street-backed-two-activist-hedge-fund-nominees-exxon-board-2021-05-27/ [https://perma.cc/9H92-CEZ8].

[294] *See supra* note 210. The companies were Forest Laboratories (Icahn Enterprises) in 2011 and 2012, International Game Technology (Ader Group) in 2013, Darden Restaurants (Starboard Value) in 2014, DuPont (Trian Fund Management) in 2015, General Motors (Greenlight Capital Management) in 2017, Procter & Gamble (Trian Fund Management) in 2017 and Automatic Data Processing (Pershing Square) in 2017.

U.S. is in excess of $10 million.[295] Engine No. 1 is reported to have spent approximately $30 million on the campaign[296] which was almost equal to its $33 million investment in Exxon's shares. Exxon similarly spent at least $35 million in its defense. Given that this campaign demonstrated that even a small fledgling ESG fund could emerge victorious in battle with one of the world's most valuable and powerful corporations, it is likely that future target companies of ESG campaigns may choose to settle with the activist and work more collaboratively. Indeed, there have already been some more subdued examples of ESG activist board representation at S&P 500 companies, including Jeffrey Ubben joining the board of AES in 2018.[297] Elliott Management's campaign at S&P 500 power supplier Evergy is another example as it involved two of Elliott's proposed directors being appointed to the board, and a detailed strategic and operational five-year plan intended to catalyze Evergy's transition to clean energy.[298] Further, in its defense to Engine No. 1's campaign, Exxon announced the addition of three new board directors one of whom was Jeffrey Ubben of Inclusive Capital Partners.[299] This appeared to be an attempt to use the presence of a different ESG activist hedge fund as a form of "white knight" to protect management from further shareholder interference, a concept Brav, Lund, and Rock have labelled "validation capital."[300]

Prior to the Engine No. 1 proxy contest, it may have been thought that ESG hedge funds might exacerbate the rational hypocrisy of the Big Three, as even ESG hedge funds would pursue profit motives that environmental and social goals would need to be balanced against. This could lead some to argue that ESG hedge funds may be more focused

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295 Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence From a Sequential Decision Model*, 107 J. FIN. ECON. 610, 611 (2012) (noting that "[a] campaign ending in a proxy fight has average costs of $10.71 million"). However, it should be acknowledged that most activist hedge fund board representation campaigns — at least with the major activist hedge funds targeting S&P 500 companies — are settled and do not result in a proxy contest or shareholder vote.

296 Jennifer Hiller & Svea Herbst-Bayliss, *Exxon, Activist Spend Over $65 Mln in Battle for Oil Giant's Future*, REUTERS (Apr. 15, 2021, 1:44 PM PDT), https://www.reuters.com/business/energy/exxon-activist-spend-over-65-mln-battle-oil-giants-future-2021-04-15/ [https://perma.cc/66ZT-DKLR].

297 Chediak & Deveau, *supra* note 235.

298 Sattiraju, *supra* note 241.

299 Svea Herbst-Bayliss & Jennifer Hiller, *Exxon Names Ubben, Angelakis to Board Amid Investor Pressure for Change*, REUTERS (Mar. 1, 2021, 5:52 AM), https://www.reuters.com/article/us-exxon-mobil-board-idUSKBN2AT2K0 [https://perma.cc/NZP5-HTMM].

300 Alon Brav, Dorothy S. Lund & Edward B. Rock, *Validation Capital* 1, 8 (N.Y.U. Sch. of L., Law & Econ. Rsch. Paper Series, Working Paper No. 21-06, 2021), https://ssrn.com/abstract=3786161 [https://perma.cc/4HGM-6EBQ].

on profit, which may contradict the Big Three's professed commitment to sustainable capitalism in the portfolio-wide context. In this regard, if there were no rational hypocrisy on the part of the Big Three, we may have expected the Big Three to vote in favor of all four of Engine No. 1's nominees, in particular the nominees who had experience with renewable energy. However, the "greenest" board nominee in the Exxon proxy contest secured less than 10% of the shareholder vote[301] and was thus the only Engine No. 1 candidate who failed to secure a board seat or any votes from the Big Three. This is perhaps surprising given that the Big Three (as agents of diversified shareholders and shareholders who invested in ESG index funds) should be less concerned with idiosyncratic, firm-specific returns and more concerned with portfolio-wide risk and returns. Instead, the votes of the Big Three supported only the candidates with stronger backgrounds in traditional energy and the energy transition.

It is therefore also important to acknowledge that the Big Three's sustainable capitalism — for the moment, at least — has limits. Given that the successful board nominees have strong backgrounds in traditional energy, the extent to which the board overhaul will transform Exxon's overall business remains to be seen. What is clear, however, is that there is a growing tendency for activists and institutional investors to view climate risk as a major financial risk and thus ESG as a value-creation opportunity. During the Exxon campaign, Engine No. 1 itself stressed that it is a capitalist group and was upfront that its campaign focused on financial underperformance as well as climate.[302] Given the Big Three's voting behavior in this campaign, the result will have underpinned the importance of ESG activists emphasizing the financial benefits of any campaign, in addition to the environmental or social benefits. As specialist ESG funds will only be incentivized to intervene if climate goals align with the opportunity to capture financial returns, the potential for rational hypocrisy on the part of the Big Three remains.

To conclude, the appointment of climate experts to boards is a key area with a lot of potential for ESG arbitrageurs. It has already been demonstrated how successful the strategy of appointing activist directors has been in the traditional governance arbitrageur scenario and Engine No. 1's campaign at Exxon is the first ESG proxy contest to bear a striking resemblance to classic activist hedge fund tactics seen in

301 *See* Exxon Mobil Corporation, *supra* note 266, at 3.

302 Derek Brower, *Hedge Fund That Beat ExxonMobil Says It Will Have to Cut Oil Output*, FIN. TIMES (May 27, 2021), https://www.ft.com/content/52645b30-c378-49e3-8609-4f537284889a [https://perma.cc/59JH-MAH5].

Activism 2.0. Nominating climate directors could have a meaningful impact on firm-specific corporate sustainability strategies and thus could serve to genuinely promote sustainable capitalism. This is an area where ESG hedge funds could generate support from the Big Three. In fact, gaining Big Three support for ESG campaigns may be easier than securing their backing for more traditional financially oriented campaigns, due to the Big Three's strong public commitments to sustainable capitalism. Assuming the Big Three and other asset managers are not willing to personally take on the role of appointing directors, ESG hedge funds may be the only actors that could realistically afford to pursue such a strategy. The appointment of climate directors is a tactic waiting to be exploited in the ESG activism ecosystem, as the Engine No. 1 proxy contest demonstrates.

V. THE ROLE OF RESPONSIBLE ACTIVISTS

> *"Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."*[303]
>
> — *former U.S. Supreme Court Justice, Louis Brandeis*

As we saw in Part III, the role of activist hedge funds as governance arbitrageurs in the agency capitalism framework relied upon the activists identifying strategic or governance shortfalls and presenting reticent institutions with a value proposition to address those corporate failures.[304] Part IV similarly analyzed the unique role that ESG hedge funds can play as ESG arbitrageurs in the sustainable capitalism framework. This role is based on the ESG hedge funds presenting reticent asset managers with firm-specific sustainability proposals, most prominently through the nomination of specialist directors, such as climate directors. The question that is discussed in this final Part V is the role of other responsible activists in the ESG investor ecosystem.

A. *Responsible Activists as ESG Arbitrageurs*

The monitoring role exploited by ESG activist hedge funds focuses on firm-specific issues. Other responsible activists — such as non-profit non-governmental organizations, public pension funds, labor unions and religious organizations — have mainly sought to address portfolio-

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[303] Louis Brandeis, *What Publicity Can Do*, *in* OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (Richard M. Abrams ed., 1914).

[304] Gilson & Gordon, *supra* note 14, at 867.

wide ESG issues. There are a variety of strategies that responsible activists use to agitate for positive change in terms of the climate crisis but overwhelmingly the most common mechanism utilized to date has been shareholder proposals. As the Big Three have not, to date, submitted any shareholder proposals,[305] this mechanism could represent a monitoring shortfall or governance gap that responsible activists could suitably fill. The Big Three certainly can, and do, lend their voting support to shareholder proposals submitted by responsible activists. Therefore, such proposals could mitigate the problem of rational reticence on portfolio-wide sustainability issues. However, one difference with respect to this monitoring shortfall, and this ESG arbitrageur strategy, is that the rational reticence of the Big Three in the portfolio-wide context is not as strong as it is in the firm-specific context.[306] Indeed, the Big Three sometimes seek to bring about similar changes to those sought by responsible activists in shareholder proposals in their private "engagements" with corporate managers.[307] To some extent there might be a conflict between the Big Three and responsible activists if the Big Three prefer to engage with companies behind the scenes rather than lend voting support to a public shareholder proposal. There are, in fact, many examples of the Big Three refusing to support shareholder proposals specifically because they are engaging in a dialogue with the company on similar issues. Perhaps in the future this conflict will be less pronounced, particularly since the Big Three have now outwardly committed to supporting more proposals. BlackRock explicitly did so in their 2021 Stewardship Expectations report where they stressed that "[w]e see voting on shareholder proposals playing an increasingly important role in our stewardship efforts around sustainability."[308]

Compared to the strategies and tactics pursued by activist hedge funds, shareholder proposals have sometimes been considered a relatively weak disciplinary tool. Although mutual funds always vote their shares — so the Big Three are compelled to vote on each shareholder proposal submitted by responsible activists — most

[305] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2040, 2102, 2104-05.

[306] *See supra* Parts II.A.i–ii (discussing portfolio-wide and firm-specific rational reticence). For a specific example of rational reticence being less pronounced in the portfolio-wide context, see *supra* note 135.

[307] *See* GLADMAN, *supra* note 183, at 1, 6 (noting that BlackRock, in particular "has a long-stated disinclination to support shareholder proposals, preferring to conduct private engagement with companies and vote against management only when it believes such engagement has been ineffective").

[308] BLACKROCK, 2021 STEWARDSHIP EXPECTATIONS, *supra* note 287, at 7.

proposals seek relatively standardized commitments. These could include greenhouse gas reduction targets, reports on climate-transition plans and strategies, or disclosure of climate lobbying. Therefore, they largely address the less pronounced portfolio-wide rational reticence problem as opposed to the more pronounced firm-specific rational reticence problem. Sustainability activism has also proven to be a much more laborious process than profit-oriented hedge fund activism, as proposals are often filed multiple years in a row before gaining any traction or securing a commitment from target companies. Given the urgency of the climate crisis, change may not happen rapidly enough.

Neither the process of submitting shareholder proposals to companies nor the use of such proposals in an environmental or social context are recent innovations. There is a long history of individual investors using the shareholder proposal mechanism for governance interventions at large companies.[309] David Larcker and Brian Tayan explain that the roots of individual shareholder activism in the U.S. go back to the 1930s when the Gilbert Brothers proposed a multitude of shareholder resolutions to try to improve governance standards and accountability across American corporations.[310] These "corporate gadflies" still persistently target companies with shareholder proposals.[311] Some individuals are so ubiquitous that Nili and Kastiel outline that "in 2018 five individuals accounted for close to 40% of all shareholder proposals submitted to S&P 1500 companies."[312] Essentially, corporate gadflies fill a monitoring gap by initiating shareholder proposals that large institutional investors are willing to lend their voting support to, despite lacking strong incentives to submit the actual proposal themselves. These gadflies act as a form of governance arbitrageur, so this method of activism functions in parallel to the role played by activist hedge funds in the agency capitalism

309 *See* Harwell Wells, *Shareholder Power in America, 1800-2000: A Short History*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, *supra* note 274, at 22 (noting that "[s]o were born the shareholder 'gadflies,' the best-known being the Gilbert Brothers, Wilma Soss, and Evelyn Davis, who from the 1940s to the 1990s submitted literally hundreds of proposals to a range of companies").

310 DAVID F. LARCKER & BRIAN TAYAN, GADFLIES AT THE GATE: WHY DO INDIVIDUAL INVESTORS SPONSOR SHAREHOLDER RESOLUTIONS? 1 (2016), https://www.gsb.stanford.edu/sites/default/files/publication-pdf/cgri-closer-look-59-gadlies-at-gate.pdf [https://perma.cc/UC2H-BJ2N].

311 Yaron Nili & Kobi Kastiel, *The Giant Shadow of Corporate Gadflies*, 94 S. CAL. L. REV. 1, 2, 18 (forthcoming 2021), https://ssrn.com/abstract=3520214 [https://perma.cc/4KLF-6A2H] (citing *A Political Gadfly*, N.Y. TIMES, May 18, 1936, at 16).

312 *Id.* at 2.

framework.[313] Gadflies tend to focus on standardized governance proposals. As the large institutional investors (such as the Big Three) have already "expressed formulaic views on these governance matters in their voting guidelines," the gadflies can "tailor their proposals to the voting guidelines of proxy advisors and large institutional investors."[314]

Environmental and social proposals are similarly not a modern invention. Historically, shareholder proposals have been crucial in raising public awareness on environmental and social issues. In the 1950s, the U.S. Securities and Exchange Commission permitted companies to reject shareholder proposals "of a general political, social, or economic nature."[315] However, a 1970 U.S. federal court decision reversed this policy by allowing a shareholder proposal to forbid the sale of napalm by Dow Chemical, and thereafter a flurry of social responsibility proposals were allowed to proceed.[316] Cheffins has highlighted that such proposals were particularly common during the 1970s, where campaigns on issues such as the Vietnam War, pollution and apartheid South Africa grew in prominence.[317] By the 1980s, there were more than 100 socially responsible shareholder proposals a year in U.S. corporations.[318] More recently, similar momentum can be seen in relation to the climate crisis, as a wave of environmentally focused shareholder proposals are submitted to corporations around the world.[319]

The shareholder proposal mechanism varies in different jurisdictions. In the U.S., shareholder proposals are precatory (advisory and non-binding) even if they succeed in securing majority shareholder support. Proposals are legally binding in many other countries, such as the U.K.

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313 *Id.* at 32.

314 *Id.* at 30-31.

315 Wells, *supra* note 309, at 22 (citing JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (2003)).

316 Gillan & Starks, *supra* note 139, at 56 (citing HENRY G. MANNE & HENRY C. WALLICH, THE MODERN CORPORATION AND SOCIAL RESPONSIBILITY (1972)).

317 BRIAN R. CHEFFINS, THE PUBLIC COMPANY TRANSFORMED 124 (2018) (citing Donald E. Schwartz & Elliott J. Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 643-44 (1977)) (documenting the shareholder proposals submitted by church groups in the 1970s to influence the activities of U.S. corporations doing business in South Africa); *see* John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH L. REV. 72, 72 (1980).

318 Wells, *supra* note 309, at 22 (citing LAUREN TALNER, THE ORIGINS OF SHAREHOLDER ACTIVISM (1983)).

319 *See* Jonathan M. Gilligan, *Carrots and Sticks in Private Climate Governance*, 6 TEX. A&M L. REV. 179, 191 (2018) (noting that "[t]he last few decades have seen especially rapid growth in the use of shareholder resolutions on ESG issues").

and most of continental Europe. Compared to the U.S., shareholder proposals remain relatively infrequent in continental Europe.[320]

In the U.S., the Securities and Exchange Commission adopted the so-called "town hall" rule — what is now Rule 14a-8 — in 1942. This required a corporation to include, in its proxy and at its expense, proposals put forward by shareholders, together with a short supporting statement to be voted on at the annual meeting."[321] Until recently,[322] any shareholder holding more than $2,000 in stock or a 1% ownership stake in the company for at least one year had the right to submit a shareholder proposal. Unless the S.E.C. gives permission for the company to exclude the item from consideration,[323] "the company must add the shareholder proposal to the agenda for voting at the next annual or special meeting of shareholders."[324] If a proposal gains majority support (50% or more of the shareholder votes), it will pass, although any such proposal will still only be advisory. The first shareholder proposal filed by an institutional investor to be voted on was in 1986.[325] In the late 1980s and through the 1990s, it was common for public

[320] *See generally* Peter Cziraki, Luc Renneboog & Peter G. Szilagyi, *Shareholder Activism Through Proxy Proposals: The European Perspective*, 16 EUR. FIN. MGMT 738 (studying shareholder proposals in eight European countries between 1998 and 2008).

[321] Wells, *supra* note 309, at 22 (noting that "[a]s a means of forcing the corporation to do anything, it wasn't much; shareholders during this era almost always voted with management . . . and even if a proposal had won a majority vote it was merely precatory; management was not required to follow it"); *see* 17 C.F.R. § 240.14a-8 (2021).

[322] SEC. & EXCH. COMM'N, PROCEDURAL REQUIREMENTS AND RESUBMISSION THRESHOLDS UNDER EXCHANGE ACT RULE 14A-8, at 132, https://www.sec.gov/rules/proposed/2019/34-87458.pdf [https://perma.cc/VK55-7DF8]; Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Amendments to Modernize Shareholder Proposal Rule (Sept. 23, 2020), https://www.sec.gov/news/press-release/2020-220 [https://perma.cc/7MFE-VPSV] (Rule 14a-8(b) is amended so that a stockholder with at least $2,000 of stock will need to have held the stock for at least three years, a stockholder with at least $15,000 of stock will need to have held the stock for at least two years, and a stockholder with at least $25,000 of stock will only need to have held the stock for at least one year.

[323] Based on a survey of no-action letters submitted during the 2019 proxy season, 40% of shareholder proposals targeted for exclusion by companies were those relating to ESG matters. Of that group, the largest subgroup related to environmental matters, sustainability and climate change. Richard Alsop & Yoon-jee Kim, *Shareholder Proposals 2019 — ESG No-Action Letter Trends and Strategies*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 25, 2020), https://corpgov.law.harvard.edu/2020/03/25/shareholder-proposals-2019-esg-no-action-letter-trends-and-strategies/ [https://perma.cc/VN49-6UJQ].

[324] Griffin, *supra* note 137, at 179 (citing 17 C.F.R. § 240.14a-8 (2013)).

[325] ROBERT A. G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 199 (2011) (noting that in 1986, the proposal by the Teachers Insurance and Annuity Association-College Retirement Equities Funds ("TIAA-CREF") to put International Paper's poison pill to a shareholder vote was the first such proposal by an institutional investor to be voted on).

pension funds and other coordinated investor groups to file governance proposals (focusing on issues such as anti-takeover defenses).[326] Initially, very few of these proposals passed, although they were effective in publicizing issues and pressuring the board.[327] Governance proposals continued to increase in momentum and became much more successful over the years.

In the U.S., as well as in other jurisdictions around the world, it is now increasingly common for responsible activists to submit shareholder proposals to public companies to agitate for change on environmental or social issues. In 2020, 429 shareholder proposals on environmental, social and sustainable governance issues were filed at U.S. public companies, with ninety-three of those proposals being environmental ones.[328] Various types of responsible activists now submit shareholder proposals to major companies. Non-profit non-governmental organizations, public pension funds, labor unions and religious organizations feature especially prominently. In the past five years, the four U.S. companies listed in the Carbon Majors top twenty-five corporate and state global emitters (ExxonMobil, Chevron, ConocoPhillips, Shell, and BP)[329] have been targeted by non-profit organizations such as As You Sow and Follow This; public pension funds such as the New York State Common Retirement Fund; sustainable investment funds such as Arjuna Capital; labor unions such as the United Steelworkers of America; and various religious organizations.[330] In recent years some large asset managers have also begun filing or co-filing proposals, which illustrates the overlapping motives of responsible activists and large asset managers. For example, in 2019, Legal and General Investment Management — the U.K.'s

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326 Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, J. FIN. ECON. 275, 278 (2000) [hereinafter *Corporate Governance Proposals*]; Gillan & Starks, *Evolution of Shareholder Activism*, *supra* note 139, at 57.

327 Gillan & Starks, *Corporate Governance Proposals*, *supra* note 326, at 303; Wells, *supra* note 309, at 25 (noting that in 1994 "corporate governance proposals sponsored by institutions received on average almost 30 percent of votes cast").

328 *See* HEIDI WELSH & MICHAEL PASSOFF, PROXY PREVIEW, HELPING SHAREHOLDERS VOTE THEIR VALUES 1, 5 (2020), https://www.ussif.org/files/Proxy_Preview_2020_FIN6.pdf [https://perma.cc/R4AF-NHN3]. *See generally* Hirst, *supra* note 182, at 10 (noting that the most common social responsibility resolutions in 2014 related to political contributions and lobbying disclosure, greenhouse gas emissions, climate change and sustainability).

329 GRIFFIN, *supra* note 10, at 8.

330 *See Engagement Tracker*, CERES, https://engagements.ceres.org (last visited Aug. 27, 2021) [https://perma.cc/7MFM-4QT5] (containing data extracted from the Ceres Engagement Tracker database of shareholder proposals from 2016 to present).

biggest asset manager, with assets under management of £1.3 trillion[331] — co-filed their first ever shareholder resolution, calling on BP to explain how its strategy was consistent with the Paris Agreement on climate change.[332] Similarly, in 2020 and 2021, BNP Paribas Asset Management (who previously supported and voted in favor of similar resolutions) submitted shareholder proposals to Exxon Mobil and Chevron concerning climate lobbying.[333] The Big Three have not, to date, followed suit.

As noted above, shareholder proposals focusing on governance issues have been increasingly successful in recent decades. From 2006 to 2015, 85% of governance proposals to declassify the board received majority shareholder support.[334] One of the reasons these proposals often succeed is that the voting guidelines of institutional investors are largely uniform on such governance matters. Therefore, it is relatively easy for the filers of such proposals to tailor them to secure maximum votes from the institutions who will ultimately determine the proposal's success or failure. By contrast, during the same time period, 0% of environmental proposals received majority shareholder support.[335] Responsible activists initiating environmental and social proposals may face additional barriers, as the voting guidelines of the Big Three and other institutions in relation to these issues are often much less straightforward. In particular, voting guidelines often explain that environmental and social resolutions will be voted on a "case-by-case" basis.[336]

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[331] *Our Business*, LEGAL & GEN. INV. MGMT., https://www.lgim.com/uk/ad/about-us/our-business/ (last visited Aug. 24, 2021) [https://perma.cc/7WZC-WX5Q].

[332] *LGIM Active Ownership Report*, LEGAL & GEN. INVESTMENT MGMT. 1, 29 (Jun. 2020), https://www.lgim.com/uk/en/capabilities/investment-stewardship/active-ownership/ [https://perma.cc/87X4-QAEV].

[333] *See Engagement Tracker*, *supra* note 330.

[334] Larcker & Tayan, *supra* note 310, at 9 (noting the sample included all shareholder resolutions proposed by individual investors at Fortune 500 companies, 2006–2015).

[335] *Id.*

[336] Nili & Kastiel, *supra* note 311, at 31 (noting that "institutional investors have more diverse views on environmental and social matters, and many voting guidelines provide asset managers more discretion on proposals relating to such matters. For example, the voting guidelines of Vanguard state that its funds '*will vote* for proposals to declassify an existing board' . . . whereas any proposal regarding environmental and social disclosures will be voted on 'case-by-case . . . [and] evaluated on its merits.'" (citing *Proxy Voting Policy for U.S. Portfolio Companies*, THE VANGUARD GROUP, INC. 10, 16 (Apr. 1, 2020), https://about.vanguard.com/investment-stewardship/portfolio-co{mpany-resources/proxy_voting_guidelines.pdf [https://perma.cc/FF76-AL8D])).

Nevertheless, support for environmental and social resolutions is increasing. Although environmental proposals used to garner little support from shareholders, in the last few years they have attracted a much greater percentage of votes in their favor.[337] The Big Three are undoubtedly some of the most significant arbiters of shareholder proposals, given their substantial voting power in economically significant companies.[338] Before 2017, no climate change related shareholder proposal had ever received majority support at a U.S. company.[339] The first climate change shareholder proposal that secured majority voting support was a proposal submitted to Occidental Petroleum in 2017.[340] The proposal requested that Occidental issue an annual report assessing the impact of climate change on its business. This was also the first time that BlackRock voted in favor of an environmental shareholder proposal that management opposed.[341] This vote followed a shareholder resolution that was filed by socially responsible investors at BlackRock regarding its record on climate change. Crucially, the BlackRock resolution had the support of influential pension funds such as the Seattle City Employees' Retirement System which had $339 million invested in a BlackRock

[337] In 2021, the average voting support for climate resolutions in the U.S. was 51%, a record for these types of shareholder proposal. Fourteen (out of twenty-six) climate resolutions achieved majority support, including at prominent U.S. companies such as Chevron, ConocoPhillips, ExxonMobil, General Electric and Procter & Gamble. *See* Jackie Cook & Lauren Solberg, *The 2021 Proxy Voting Season in 7 Charts*, MORNINGSTAR (Aug. 4, 2021), https://www.morningstar.com/articles/1052234/the-2021-proxy-voting-season-in-7-charts [https://perma.cc/36WY-2LLA]. In addition to proposals that won majority support, eighty-two environmentally focused proposals were withdrawn, presumably because the target company agreed to meet at least some of the demands of the proposer. *See* Hannah Orowitz, Talon Torressen & Michael Maiolo, *An Early Look at the 2021 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 5, 2021), https://corpgov.law.harvard.edu/2021/07/05/early-insights-to-2021-annual-general-meetings-annual-corporate-governance-review/ [https://perma.cc/85VF-HPGN].

[338] The success of environmental resolutions in the 2021 proxy season was largely attributable to the voting support of the Big Three and other large asset managers. *See* Cook & Solberg, *supra* note 337.

[339] COURTNEY KEATINGE, MAX DARROW, KATELYN ROTH, KATE FLANAGAN & DIMITRI ZAGOROFF, GLASS LEWIS, 2020 PROXY SEASON REVIEW 21 (2020), https://www.glasslewis.com/wp-content/uploads/2020/09/2020-Proxy-Season-Review-Shareholder-Proposals.pdf [https://perma.cc/2PWP-ZLZZ].

[340] Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *How Investors Can (and Can't) Create Social Value*, 44 J. CORP. L. 205, 225 (2019) (citing Erin Ailworth, *Occidental Shareholders Vote for Climate Proposal*, WALL ST. J. (May 12, 2017, 5:09 PM ET), https://www.wsj.com/articles/occidental-shareholders-vote-for-climate-proposal-1494616669 [https://perma.cc/JTX7-N4FW]).

[341] *Id.*

index fund and joined as a co-filer.[342] Following discussions with the filers, "BlackRock promised to improve its focus on ESG when engaging with companies, and the resolution was withdrawn."[343] Very shortly thereafter, BlackRock also supported an environmental proposal at ExxonMobil (after previously voting against certain Exxon directors in 2016).[344] The proposal at Exxon gained support from over 62% of shareholders, including each of the Big Three.[345] In 2020, sixteen shareholder proposals concerning social or environmental issues gained more than 50% of the votes at U.S. companies.[346]

Despite the increasing prevalence and success of climate-oriented shareholder proposals in the U.S., the S.E.C. introduced controversial reforms to the rules on shareholder proposals, which will make it more difficult for responsible activists to submit environmental (or social) proposals. Under the new rules, which were introduced in September 2020 and take effect for proposals for meetings from 2022 onwards, shareholders may only submit a proposal if they have held $2,000 of company stock for at least *three* years (the previous requirement being *one* year), or higher amounts for shorter periods of time.[347] Aggregation of holdings for the purposes of satisfying the amended ownership thresholds is now also prohibited.[348] Crucially for environmental and social resolutions, the reforms also revise the levels of shareholder support a proposal must receive to be eligible for resubmission at future shareholder meetings from 3%, 6% and 10% for matters previously voted on once, twice or three or more times in the last five years to 5%, 15% and 25%, respectively.[349] When deliberating the reforms, the S.E.C. specifically noted that the proposed amendments to Rule 14a-8(i)(12) could have a greater adverse impact on shareholder proposals relating

[342] Rissman & Kearney, *supra* note 134, at 10174.

[343] *Id.* at 10175.

[344] Kerber, *supra* note 267.

[345] Diane Cardwell, *Exxon Mobil Shareholders Demand Accounting of Climate Change Policy Risks*, N.Y. TIMES (May 31, 2017), https://www.nytimes.com/2017/05/31/business/energy-environment/exxon-shareholders-climate-change.html [https://perma.cc/H2H9-3W8R].

[346] Patrick Temple-West, *Record Year for Environmental, Social Investor Petitions*, FIN. TIMES (June 9, 2020), https://www.ft.com/content/6dceb82a-1084-40bf-91cb-7cb6100f3992 [https://perma.cc/5RRT-SSGW].

[347] Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 322 (Rule 14a-8(b) is amended so that a stockholder with at least $2,000 of stock will need to have held the stock for at least three years, a stockholder with at least $15,000 of stock will need to have held the stock for at least two years, and a stockholder with at least $25,000 of stock will only need to have held the stock for at least one year).

[348] *Id.* (Rule 14a-8(b) amendments).

[349] *Id.* (Rule 14a-8(12) amendments).

to environmental and social issues compared to shareholder proposals on governance issues. This is because historically, shareholder proposals on environmental and social issues have tended to receive lower voting support than those on governance issues, and proposals on environmental and social issues are more likely to be resubmitted compared to proposals on governance issues.[350] These rules will to some extent impede the progress of environmental shareholder resolutions, especially resolutions that have repeatedly been submitted to companies. In many cases, resolutions are only successful in generating corporate change after multiple years of submission and activism, therefore this valuable route for responsible activists may encounter some more obstacles in future.[351]

B. Climate Directors

Part IV demonstrated that appointing climate directors is one of the most impactful contributions that ESG arbitrageurs can make to mitigate rational reticence on the part of the Big Three. It was argued that ESG hedge funds are in a unique position to further this goal, due to their expertise in appointing activist directors in *Activism 2.0* campaigns. Might responsible activists also be able to further this goal?

Responsible activist organizations have followed an alternative route to try and focus boards on climate issues. They have submitted shareholder proposals requesting that companies add climate experts to the board.[352] These proposals might be thought of as a lower-cost

[350] *See* SEC. & EXCH. COMM'N, *supra* note 322, at 132 .

[351] As one example, a majority (61%) of shareholders at Chevron voted in favor of a climate resolution submitted by Follow This, calling up on the oil major to reduce emissions. *See* Press Release, Follow This, 61% of Chevron Shareholders Support Follow This Climate Resolution (May 26, 2021), https://www.follow-this.org/61-of-chevron-shareholders-support-follow-this-climate-resolution/ [https://perma.cc/Y4NP-WA72]. Previous proposals calling for reduction in greenhouse gas emissions. Previous proposals for Chevron to adopt greenhouse gas reduction targets submitted by Investor Advocates for Social Justice in 2015 and 2016 had been unsuccessful at shareholder vote.

[352] For example, the New York State Comptroller submitted proposals to companies including Chevron, Freeport-McMoRan, Occidental Petroleum and Transocean, asking them to nominate environmental experts to the board of directors. *Engagement Tracker*, *supra* note 330; *see* Michael Garland & Rhonda Brauer, N.Y.C. Off. of the Comptroller, *Boardroom Accountability*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 1, 2018), https://corpgov.law.harvard.edu/2018/03/01/boardroom-accountability/ [https://perma.cc/N6YK-NVGK] (noting that the Boardroom Accountability Project 2.0, launched in 2017, "ratchets up pressure on companies to improve the quality of their boards of directors, with particular emphasis on diversity of gender and race and on climate competence").

alternative to an actual proxy fight. As detailed in Section A above, ESG shareholder proposals are not new. Strategies of this nature can be traced back to the 1970s when shareholder activists campaigned to add directors to boards to further social and environmental causes.[353] Of particular interest in the context of modern ESG activism is "Campaign GM," an activist campaign highlighted by Cheffins as "the most publicized instance of public interest lobbying by shareholders."[354] In that case, shareholders targeted General Motors and submitted shareholder proposals on topics such as "vehicle emissions, automobile safety, pollution from manufacturing plants and ownership of car dealerships by minority groups."[355] Campaign GM was a very early example of shareholders attempting to add three diverse and environmentally-oriented directors to GM's all-male, all-white board. The shareholder resolution specifically proposed electing three types of individuals — "an environmentalist, an Afro-American, and a female consumer advocate" — to the board.[356] Although the proposal was (like many other proposals of its era) "voted down by an overwhelming majority," GM's 1970 annual meeting was characterized as "the decisive event in the politicization of the corporation."[357] Although Campaign GM was unsuccessful, within three years the company had in fact added "a black community leader, a female bank executive, and an eminent scientist" to the board.[358]

In more recent times, proposals of a similar nature have been filed at fossil fuel companies such as ExxonMobil and Chevron.[359] In 2015 and 2016, a shareholder proposal was submitted to Exxon, calling for a climate expert to be elected to the board. Although the resolution itself did not achieve majority support (instead it won support from investors with 20.9% of the shares), the following year Exxon capitulated and

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[353] An early example is Honeywell's AGM in 1970, when anti-war campaigners proposed their own director candidates to Honeywell's board. Donald E. Shwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419, 423 (1971); *see* Sarah C. Haan, *Civil Rights and Shareholder Activism:* SEC v. Medical Committee for Human Rights, 76 WASH. & LEE L. REV. 1167, 1189 (2019).

[354] CHEFFINS, *supra* note 317, at 124 (citing *Campaign GM,* THE CORPORATION IN A DEMOCRATIC SOCIETY, 89, 89 (1975)).

[355] CHEFFINS, *supra* note 317, at 125.

[356] *Id.*

[357] *Id.*

[358] *Id.*

[359] From 2015 to 2017, the Province of St. Joseph, Capuchin Order filed proposals for Exxon to nominate an environmental expert to their board. From 2011 to 2018, the New York State Comptroller filed proposals for Chevron to nominate an environmental expert to their board. *Engagement Tracker*, *supra* note 330.

appointed a climate expert to its board.[360] However, such proposals are relatively rare. Of ninety-three environmental proposals submitted to U.S. companies in 2020, only two requested board committees on climate change.[361] No proposals requested nomination of board members with climate expertise.[362]

One major drawback of the shareholder proposal route is that these campaigns may not go far enough to foster the firm-specific, strategic, and operational change that is achieved when activist hedge funds appoint directors to boards. It can take a long time to secure climate expert board representation by way of the shareholder proposal mechanism. For example, in the case of Chevron, the New York State Comptroller filed shareholder proposals each year from 2011 to 2018 asking the company to nominate an environmental expert to the board.[363] There is also the problem of critical mass; one director with knowledge of, or expertise in, climate change, may not be enough to have a meaningful impact or generate lasting change at a fossil fuel company.[364] Commentary has highlighted that "[i]t's worth remembering that there has been a climate scientist on the board of ExxonMobil since 2017 . . . She was appointed by Exxon in response to shareholder concerns over climate, but clearly hasn't satisfied those concerns. It just goes to show, one person isn't enough to change the

360 Ed Crooks, *ExxonMobil Appoints Climate Scientist to Board*, FIN. TIMES (Jan. 25, 2017), https://www.ft.com/content/d87ce444-e388-11e6-8405-9e5580d6e5fb [https://perma.cc/N6SJ-7EMM] (noting that Exxon had appointed Susan Avery, a respected scientist who has worked extensively on climate change, to the board).

361 The establishment of board committees on climate change were the subject of resolutions at Chevron and ExxonMobil (both filed by Arjuna Capital). *See* Welsh & Passoff, *supra* note 328, at 61.

362 Only four resolutions requested nomination of experts to boards, and each related to nominating human rights experts (at Alphabet, CoreCivic, Facebook and Twitter, respectively). *See id.*

363 *Engagement Tracker*, *supra* note 330.

364 *See* Mark Granovetter, *Threshold Models of Collective Behavior*, 83 AM. J. SOCIOLOGY 1420, 1420 (1978) (explaining that "[m]odels of collective behavior are developed for situations where actors have two alternatives and the costs and/or benefits of each depend on how many other actors choose which alternative"); *see* Rosabeth Moss Kanter, *Some Effects of Proportions on Group Life*, 82 AM. J. SOCIOLOGY 965, 988 (1977) (noting that "[w]omen (or members of any other underrepresented second category) need to be added to total group or organization membership in sufficient proportion to counteract the effects of tokenism"). *See generally* Rosabeth Moss Kanter, *Men and Women of the Corporation Revisited*, MANAGEMENT REVIEW (1977) (demonstrating — in the context of gender diversity — that dominant group members usually control the group which prevents token group members from forming coalitions to create change).

board."[365] This situation is quite different to the scenario where one activist hedge fund nominee is appointed to a corporate board, as such nominees have the backup of the hedge fund as a "back office," and the enduring threat of further action from the activist hedge fund if sufficient progress is not made. Other responsible activists have taken more informal action to pressure companies to have a director responsible for climate change, in particular by forming coalitions of investors. Again, it is not clear how effective this is at changing corporate strategy with respect to climate issues. At present, thirty-eight of the forty-five U.S. companies on the Climate Change 100+ focus list, and all nine U.K. companies on the same list, now have a board member or board committee responsible for climate change.[366]

The main impediment to responsible activists nominating climate directors in an analogous manner to activist hedge funds is cost. Submitting shareholder proposals works well for responsible activists as often these actors are non-profit organizations with comparatively limited funding and resources. Filing a shareholder proposal is relatively inexpensive,[367] especially compared to the costs involved in nominating a director to the board. Although the vast majority of activist board representation campaigns now result in settlement, this is unlikely to be the case for responsible activists who would not have the reputational clout or the resources to back up a campaign for a climate director with a credible threat of a proxy contest.[368] Prohibitive cost may ultimately prove to be a barrier for other responsible activists pursuing the types of appointments achieved in the Engine No. 1 campaign.

C. Mitigating Rational Hypocrisy

The other important role responsible activists may play is in mitigating rational hypocrisy. Since 2003, U.S. based mutual funds are required to publicly disclose their voting policies and to publicly disclose how the fund voted on each resolution voted on at

[365] Robinson-Tillett, *supra* note 273.

[366] *Management Quality: All Sectors*, TRANSITION PATHWAY INITIATIVE, https://www.transitionpathwayinitiative.org/sectors (last visited Aug. 28, 2021) [https://perma.cc/6AYH-G5XP] (containing hand collected data detailing "has the company nominated a board member or board committee with explicit responsibility for oversight of the climate change policy"); *Companies*, *supra* note 88.

[367] Bebchuk, *supra* note 155, at 876.

[368] *See generally* Krishnan et al., *supra* note 30 (noting that the top hedge funds succeed because they acquire a reputation for what the authors label "clout and expertise").

companies.[369] This means that the Big Three's voting records are reported in a publicly available repository.[370] However, this information is not particularly useful to investors, as it is reported in an inaccessible format and there would be considerable time, effort and costs involved in collating and analyzing the data. Conditions may, therefore, be ripe for rational hypocrisy to thrive. As outlined by Hirst, "investors in mainstream mutual funds are likely to be unaware of the way their funds vote, and that those votes may not be consistent with their own preferences."[371] There is a "collective action problem of voting information gathering"[372] and the result is that the end investors do not have a clear picture of the manner in which their mutual fund votes. This lack of transparency can contribute to the problem of rational hypocrisy, as the Big Three may be more concerned with marketing themselves as good stewards or responsible investors, rather than committing more time and resources into ensuring they vote responsibly and robustly engage on key issues.[373]

The engagement activities of the Big Three have also historically been lacking in transparency. For many years, the Big Three have issued "Investment Stewardship Reports,"[374] which elaborate on the Big Three's behind-the-scenes engagement with companies. The Big Three's stewardship reports contain anecdotal evidence, with selective disclosure of engagements that the Big Three explicitly choose to draw

369 Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 (Feb. 7, 2003) (codified at 17 C.F.R. parts 239, 249, 270, 274). This must be reported in an S.E.C. filing on Form N-PX. Investment Company Act of 1940, 17 C.F.R. § 270.30b1-4 (2021); Hirst, *supra* note 182, at 222.

370 N-PX filings are available on the S.E.C.'s Edgar database. *Edgar Database*, SEC. & EXCH. COMM'N, https://www.sec.gov/edgar/searchedgar/n-px.htm (last visited Aug. 28, 2021) [https://perma.cc/873T-HH6A].

371 Hirst, *supra* note 182, at 235 (noting that although mutual funds disclose their voting policies, and although funds are required to disclose their actual votes, these policies and voting records are difficult to compare and interpret and thus comparing the approaches of multiple funds would require considerable effort).

372 *Id.* at 236.

373 *See* Griffin, *supra* note 137, at 212-16.

374 *See, e.g.*, BLACKROCK, INVESTMENT STEWARDSHIP ANNUAL REPORT 1 (2020), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2020.pdf [https://perma.cc/3R8W-8CJK] (providing an example of an Investment Stewardship Report); *see also* STATE ST. GLOB. ADVISORS, STEWARDSHIP REPORT 2018-19, at 1 (2019), https://www.ssga.com/library-content/products/esg/annual-asset-stewardship-report-2018-19.pdf [https://perma.cc/X5LG-2LLZ]; VANGUARD, INVESTMENT STEWARDSHIP: 2020 ANNUAL REPORT 1 (2020), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2020_investment_stewardship_annual_report.pdf [https://perma.cc/TTN6-NPPE].

attention to.[375] These stewardship reports mostly operate as a marketing exercise, rather than serving as a comprehensive and honest review of success and failure.

On a voluntary basis, the Big Three have promised to be more transparent with their stewardship activities and voting. BlackRock's Investment Stewardship Group[376] are increasingly publishing voting bulletins on high profile votes. In 2020, their Stewardship Report notes that they published forty-five vote bulletins to August 2020, which was four and a half times as many as they have issued in the past three years combined.[377] To cite an example from October 2020, BlackRock issued a press release explaining its rationale for voting in favor of a shareholder proposal at P&G requiring reporting on its effort to eliminate deforestation.[378] Reports were also issued by BlackRock and Vanguard regarding the Exxon proxy contest.[379]

The U.K. now goes much further than the U.S. in terms of asset manager disclosure.[380] In the 2020 Stewardship Code, there is a new emphasis on disclosure and reporting, with each Principle of the Code being followed by "Reporting Expectations."[381] Of particular relevance to asset managers is Principle 9 on "Engagement" which outlines that signatories to the U.K. Stewardship Code should disclose "the outcomes of engagement that is ongoing or has concluded in the preceding

[375] Griffin, *supra* note 137, at 186-87.

[376] BlackRock advertises that it has the largest global stewardship team in the industry with fifty plus people across eight offices. *See Investment Stewardship: Engagement Priorities*, BLACKROCK, https://www.blackrock.com/corporate/about-us/investment-stewardship#engagement-priorities (last visited Aug. 27, 2021) [https://perma.cc/242J-9DZA]. However, given the vast number of portfolio companies in BlackRock's portfolio, commentators insist that BlackRock underinvests in stewardship. *See* Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2050-59, 2076-80.

[377] BLACKROCK, INVESTMENT STEWARDSHIP ANNUAL REPORT (2020), *supra* note 374, at 5.

[378] BLACKROCK, VOTING BULLETIN: THE PROCTOR & GAMBLE COMPANY (Oct. 13, 2020), https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-procter-and-gamble-oct-2020.pdf [https://perma.cc/AC8X-WRGL].

[379] BLACKROCK, EXXONMOBIL VOTE BULLETIN, *supra* note 291; VANGUARD, VOTING INSIGHTS: A PROXY CONTEST AND SHAREHOLDER PROPOSALS RELATED TO MATERIAL RISK OVERSIGHT AT EXXONMOBIL 1 (2021), https://global.vanguard.com/documents/voting-insights-exxon.pdf [https://perma.cc/FEY9-TC6Z].

[380] The U.K. Stewardship Code 2020 sets higher standards of engagement and disclosure by asset managers than its predecessor, the Stewardship Code 2012.

[381] *See* FIN. REPORTING COUNCIL, THE U.K. STEWARDSHIP CODE 2020, at 5, https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf [https://perma.cc/M979-PM4V].

12 months."[382] The Big Three are all Tier 1 signatures to the U.K. Stewardship Code.[383] This reporting obligation has the potential to mitigate the problem of rational hypocrisy, as it applies to all engagements and focuses on outcomes. Davies argues that "since the ESG obligations for signatories to the [Stewardship Code] are essentially disclosure obligations, their impact on behavior is likely to be driven by the reputational consequences of reporting."[384] As noted by Katelouzou and Klettner, disclosure through stewardship codes can increase transparency and accountability across the investment chain.[385]

Due to the historical lack of transparency regarding the Big Three's voting policies and engagements, responsible activists have targeted the Big Three directly. As previously highlighted, coalitions of shareholders submitted shareholder proposals to BlackRock and Vanguard.[386] Moreover, there are organizations that focus specifically on improving asset manager accountability. These responsible activists essentially act as "information intermediaries," enforcing a system of reputational deterrence.[387] One such organization, Majority Action, runs a campaign to hold asset managers accountable on climate votes.[388] Majority Action has produced a number of reports which detail the voting records of the Big Three and other asset managers in an accessible format. This data is much more user-friendly for investors than the official data that asset

[382] *Id.* at 17 (describing Principle 9 of the U.K Stewardship Code 2020). Principle 10 also encourages collaborative engagement and similarly outlines that signatories should describe the outcomes of such collaborative engagement. *See* Davies, *supra* note 219, at 22.

[383] *Asset Managers*, FIN. REPORTING COUNCIL, https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements/asset-managers (last visited Aug. 27, 2021) [https://perma.cc/F3HB-J378] (listing the asset managers who have published a statement of commitment to the Stewardship Code). Tier 1 signatories "provide a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary." *Id.*

[384] Davies, *supra* note 219, at 147.

[385] Dionysia Katelouzou & Alice Klettner, *Sustainable Finance and Stewardship: Unlocking Stewardship's Sustainability Potential*, *in* GLOBAL SHAREHOLDER STEWARDSHIP: COMPLEXITIES, CHALLENGES AND POSSIBILITIES 1, 23 (Dionysia Katelouzou & Dan W. Puchniak eds., forthcoming,), https://ssrn.com/abstract=3578447 [https://perma.cc/N38F-CT4N].

[386] *See* Mooney, *supra* note 37.

[387] RAY SHAPIRA, LAW AND REPUTATION: HOW THE LEGAL SYSTEM SHAPES BEHAVIOR BY PRODUCING INFORMATION 26 (2020) (noting that reputational sanctions are determined by "information intermediaries" and the way these intermediaries screen, frame, certify and diffuse information dictates the effectiveness of reputational deterrence).

[388] *Holding Asset Managers Accountable on Climate Votes*, MAJORITY ACTION, https://www.majorityaction.us/asset-manager (last visited Sept. 23, 2021) [https://perma.cc/6ZM5-9TD6].

managers are obliged to disclose regarding their voting.[389] It therefore serves to increase transparency around the Big Three's voting in practice and thus hold the Big Three accountable.

In recent years, organizations such as Majority Action, ShareAction and Morningstar have published reports, rankings, and research on asset manager voting.[390] For example, ShareAction ranks the seventy-five most influential asset managers worldwide on responsible investment governance, climate change, biodiversity, and human rights.[391] European asset managers consistently top the list, with Robeco, BNP Paribas Asset Management, and Legal and General Investment Management taking the top three spots. Those asset managers are ranked "A–Leaders," which are defined as having "strong management of risks and opportunities, as well as impacts across multiple responsible investment themes."[392] BlackRock ranks 47th, Vanguard ranks 69th and State Street ranks 39th.[393] BlackRock and State Street are both ranked "D–Business as usual," which is defined as "little evidence of suggest adequate management of material responsible investment risks and opportunities."[394] Vanguard is ranked "E–Laggards," which is defined as "evidence suggests poor management of material responsible investment risks and opportunities."[395] These rankings can serve as good marketing for asset managers who genuinely have strong records of on sustainability issues. They can also cause reputational damage to asset managers who outwardly purport to prioritize these issues but have poor rankings in practice. Similarly, Majority Action has published blog posts outlining which key climate-related shareholder resolutions would have passed with BlackRock and Vanguard support. In 2019, they publicized that "BlackRock and Vanguard were among the asset managers least likely to support these critical climate-related resolutions," outlining that at least 16 critical

[389] *See supra* notes 369–371 and accompanying text (detailing that Form N-PX filings with the SEC are not user-friendly).

[390] MAJORITY ACTION, *2019* CORPORATE CLIMATE ACTION, *supra* note 35, at 1; MAJORITY ACTION, *2020* CORPORATE CLIMATE ACTION, *supra* note 178, at 1; Jackie Cook, *How Fund Families Support ESG-Related Shareholder Proposals*, MORNINGSTAR (Feb. 13, 2020), https://www.morningstar.com/insights/2020/02/12/proxy-votes [https://perma.cc/JVX2-ZRGV].

[391] SHAREACTION, POINT OF NO RETURNS: A RANKING OF 75 OF THE WORLD'S ASSET MANAGERS APPROACHES TO RESPONSIBLE INVESTMENT 4, 10 (2020), https://api.shareaction.org/resources/reports/Point-of-no-Returns.pdf [https://perma.cc/R9QR-CK5W].

[392] *Id.* at 11-12.

[393] *Id.* at 14-17.

[394] *Id.* at 11, 14-15.

[395] *Id.* at 11, 16-17.

climate votes would have received majority support if both of these asset managers had voted in favor of them."[396]

These publications and reports — by increasing transparency of the Big Three's activities in practice — serve the valuable function of directly addressing the problem of rational hypocrisy. If the Big Three are exposed when their actions do not match their rhetoric and marketing statements, the problem of rational hypocrisy will be mitigated. Therefore, this alternative approach on the part of responsible activists can be effective in holding the Big Three to account. Responsible activists therefore play a key role in mitigating rational hypocrisy and reducing the agency problems of sustainable capitalism.

Other corporate campaign groups have targeted their activism at BlackRock and other asset managers. For example, "BlackRock's Big Problem" is "a global network of NGO's and social movements that are pressuring asset managers like BlackRock to align their business practices with a climate-safe world."[397] Their website — which likens BlackRock to Goldman Sachs as the "New Vampire Squid," a "global financial giant with its tentacles in major asset classes all over the world"[398] — features a number of articles, reports and campaign strategies highlighting BlackRock's poor record with respect to the climate crisis and other issues.

Despite their massive power, the Big Three nevertheless operate in a delicate equilibrium. On the one hand, they are conscious to mitigate the risk of being subjected to greater regulation if they overreach their power.[399] There are already vocal calls for increased regulation, or break up, of the Big Three due to antitrust issues uncovered in the common ownership literature.[400] Coffee therefore argues that "the threat of

[396] Eli Kasargod-Staub & Majority Action, *Climate in the Boardroom*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 7, 2019), https://corpgov.law.harvard.edu/2019/10/07/climate-in-the-boardroom/ [https://perma.cc/3BWZ-FXU7].

[397] *About*, BLACKROCK'S BIG PROBLEM, https://www.blackrocksbigproblem.com/about (last visited Aug. 27, 2021) [https://perma.cc/PQE2-H87U] (noting that the initiative partners with other organizations such as Friends of the Earth U.S., Amazon Watch, and Sierra Club).

[398] *Id.* (citing Ellen Brown, *Meet BlackRock, the New Great Vampire Squid*, COMMON DREAMS (June 22, 2020), https://www.commondreams.org/views/2020/06/22/meet-blackrock-new-great-vampire-squid [https://perma.cc/6LS4-3P3B]).

[399] Kahan & Rock, *supra* note 110, at 1798.

[400] *See, e.g.*, Azar, Schmalz & Tecu, *supra* note 193, at 1 ("Theory thus predicts that common ownership implies reduced incentives to compete, pushes product markets toward monopolistic outcomes, and implies a deadweight loss for the economy and particularly adverse consequences for consumers."); *see also* Elhauge, *supra* note 193, at 1267 (recommending antitrust enforcement actions to undo anticompetitive

political retaliation will incline many institutional investors toward no more than reticent participation in attempts to curb externalities through collective action."[401] On the other hand, the Big Three may be anxious to avoid aggravating investors and society more generally by being perceived as failing to act as responsible stewards. As a result, they care about, and carefully cultivate, their reputation with investors, other institutional shareholders, and the general public. Hill has scrutinized changing attitudes to shareholder power over recent decades, noting that "around the time of the global financial crisis . . . attitudes to shareholder power became increasingly ambiguous and polarized.[402] Institutional investors were heavily criticized for failing to use their power effectively to mitigate the effects of the global financial crisis.[403] Similar polarization might be evident in the context of climate change and other ESG issues. As highlighted in Part I above, the Big Three face significant pressure to use their power responsibly to mitigate the effects of the global climate crisis. They risk losing their social mandate if they are perceived as abusing their power. Barzuza, Curtis and Webber have likewise argued that "each index fund faces pressure to make sure it is not perceived as less committed to social values than its competitors."[404] Name and shame campaigns on the part of responsible activists draw attention to this delicate balance. Therefore, such activism could prove to be particularly effective in closing the gap between the Big Three's rhetoric and their actions in practice. This has promise for mitigating the problem of rational hypocrisy and thus the agency costs of sustainable capitalism.

CONCLUSION

In 2020, BlackRock CEO Larry Fink argued that the climate crisis would trigger a "fundamental reshaping of finance."[405] By that stage, a fundamental reshaping of the investor landscape — featuring the

horizontal shareholdings and their adverse economic effects); Posner et al., *supra* note 193, at 1 (advocating for the adoption of the Clayton Act against institutional investors); Steele, *supra* note 193, at 7 (discussing the concerns that the three largest participants of the fund industry pose for corporate governance, competition, and financial market stability and exploring policy solutions to address these risks).

[401] Coffee, *supra* note 145, at 41.

[402] Jennifer G. Hill, *Images of the Shareholder — Shareholder Power and Shareholder Powerlessness*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, *supra* note 274, at 56.

[403] *Id.*

[404] Barzuza et al., *supra* note 18, at 1304.

[405] Fink, *supra* note 40.

incredible rise to power of the Big Three — had already passed the point of no return. In the absence of regulation to break up the Big Three, their future dominance is largely assured. The urgent global problem of the risk caused by the climate crisis is similarly going nowhere. The Big Three's assumed role as sustainable capitalists therefore becomes increasingly important not only for economic reasons, but also for the future of humanity. This Article sought to map the potential and perils involved in the Big Three assuming this role. It identified and analyzed the dual problem that potentially arises in the context of the Big Three's sustainable capitalism — rational reticence and rational hypocrisy. Rational reticence has long been recognized as afflicting institutional investors. The passive index investing revolution does not solve this problem, and indeed may exacerbate it in some respects. A monitoring shortfall therefore persists. Examining the wide gulf between the Big Three's rhetoric and their corresponding actions also revealed a potential new problem: rational hypocrisy. These dual problems give rise to what I have called the agency costs of sustainable capitalism. There is a divergence between the Big Three's actions in the climate context and the rational preferences of diversified index investors who represent society as a whole.

The Article then turned to the potential solutions to these problems by investigating the role different forms of ESG arbitrageurs could play in mitigating these agency costs. Through theory and practical examples, it was argued that ESG hedge funds focusing on firm-specific ESG activism could evolve to play an analogous role in the sustainable capitalism framework to the role that activist hedge funds play in the agency capitalism framework. In particular, ESG hedge funds are uniquely positioned to nominate specialist ESG directors such as climate directors and focus on firm-specific ESG strategies and operations. ESG hedge funds' role as ESG arbitrageurs could mitigate the rational reticence of the Big Three, as clearly demonstrated by the Engine No. 1 proxy contest at Exxon.

Other responsible activists could potentially pursue some of the same strategies, but through the more limited mechanism of shareholder proposals. Responsible activists generally lack the financing to take on target companies to the same level that formidable activist hedge funds do. Therefore, their activism is more likely targeted at portfolio-wide, rather than firm-specific, climate issues (albeit there is some overlap). The Big Three already pursue some of these goals themselves through their private engagements with companies, so there may be some conflict. Ultimately, a key role that responsible activists can play is to target the Big Three themselves, by holding them accountable and exposing any discrepancies between their words and actions in order to ensure that hypocrisy does not remain rational in future.