UNIVERSITY of VIRGINIA
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June 1, 2021

Dear Chair Gensler:

Thank you for the opportunity to respond to the Securities and Exchange Commission's request for public comment on climate-related financial disclosure issued by Acting Chair Allison Herren Lee on March 15, 2021.

We offer for your consideration our forthcoming article, "The New Separation of Ownership and Control: Institutional Investors and ESG," prepared for a Symposium on the Future of Securities Regulation sponsored by the Program in the Law and Economics of Capital Markets at Columbia University, which will be published later this year in the *Columbia Law & Business Review*.

Our article explains how climate-related and other Environmental, Sustainability and Governance (ESG) disclosure mandates would, if put into force, represent a substantial change in the Commission's approach to its stated mission of protecting "Main Street investors" and "maintaining fair, orderly, and efficient markets." As we discuss in detail in the article, ESG disclosure mandates risk eroding the Commission's reputation as an effective and respected nonpartisan regulator for the simple reason that such mandates may appear to prioritize the social and political views of the largest Wall Street asset management firms over the financial wellbeing of the households whose savings they manage.

Please let us know if we can be of assistance as the SEC considers this important issue.

Sincerely,

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The New Separation of Ownership and Control: Institutional Investors and ESG

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Abstract

Scholars and policy makers have long debated whether corporations should serve social purposes at the expense of shareholder wealth. The SEC was recently drawn into the debate as it faces calls to mandate environmental, social, and governance (ESG) disclosures. This Article urges the SEC to proceed with caution. The adoption of ESG disclosure mandates in order to serve environmental or social goals is not well-aligned with the SEC's stated mission of protecting Main Street investors and maintaining fair, orderly, and efficient markets. Accordingly, the SEC should decline to act absent a showing that ESG disclosures will serve the financial interests of the households for whom institutional investors are fiduciaries and whose retirement and other savings they manage.

I. Introduction

Scholars, public officials, corporate executives, money managers and others have long debated the merits of socially motivated investing and corporate management.[1] The Securities and Exchange Commission (SEC) was recently drawn into the debate. Two of the SEC's Commissioners and its Investor Advisory Committee have urged the SEC to require disclosures

* We thank Kevin Haeberle, Gabriel Rauterberg, Christina Parajon Skinner, and workshop participants at the University of Michigan Law School for helpful comments. Ari Anderson and Killian Wyatt provided outstanding research assistance.

[1] *See, e.g.*, ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133–36 (40th Anniversary ed. 2002) (1962) [hereinafter FRIEDMAN, CAPITALISM AND FREEDOM]; Nelson Lichtenstein, *Economic Royalists and Their Kingdom in the New Deal Era and Beyond*, *in* CAPITALISM CONTESTED: THE NEW DEAL AND ITS LEGACIES (Romain Huret, Nelson Lichtenstein & Jean-Christian Vinel eds., 2020); Milton Friedman, *A Friedman Doctrine—the Social Responsibility of Business Is To Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, at SM17 [hereinafter Friedman, *A Friedman Doctrine*]; *Greed Is Good. Except When It's Bad*, N.Y. TIMES: DEALBOOK (Sept. 13, 2020), https://www.nytimes.com/2020/09/13/business/dealbook/milton-friedman-essay-anniversary.html [https://perma.cc/9VGW-DPZE].

about a set of public policy issues that, although distinct, are grouped together under the umbrella term "Environmental, Social, and Governance," or ESG.[2] To date, the SEC has resisted those calls on the grounds that its existing framework, which focuses on risks material to a company's business, is better than a one-size-fits-all list of disclosures.[3]

The SEC's approach may soon change. In February 2021, its Acting Chair named a Senior Policy Advisor for Climate and ESG, indicating that the agency is actively considering implementing ESG disclosure requirements.[4] The Acting Chair also directed the SEC's Division of Corporation Finance to "enhance its focus on climate-related disclosure in public company filings."[5]

This Article sounds a note of caution. The adoption of ESG disclosure mandates in order to serve environmental or social goals is not well-aligned with the SEC's stated mission of protecting "Main Street investors" and "maintaining fair, orderly, and efficient markets."[6] The SEC has neither the expertise nor the political accountability to pursue climate, diversity, and other public policy goals. Moreover, by appearing to take sides in contentious policy disputes,

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[2] *See* Press Release, Allison Herren Lee & Caroline A. Crenshaw, Comm'rs, U.S. Sec. & Exch. Comm'n, Joint Statement on Amendments to Regulation S-K: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information (Nov. 19, 2020), https://www.sec.gov/news/public-statement/lee-crenshaw-statement-amendments-regulation-s-k [https://perma.cc/Q6QE-EP57] (urging the SEC to "establish requirements for standard, comparable, and reliable climate, human capital, and other ESG disclosures"); INV. ADVISORY COMM., U.S. SEC. & EXCH. COMM'N, RECOMMENDATION FROM THE INVESTOR-AS-OWNER SUBCOMMITTEE OF THE SEC INVESTOR ADVISORY COMMITTEE RELATING TO ESG DISCLOSURE 1 (2020), https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-of-the-investor-as-owner-subcommittee-on-esg-disclosure.pdf [https:/perma.cc/7L87-Z2VG] (favoring SEC regulation of ESG disclosures). One of the authors of this paper is a member of the Investor Advisory Committee and voted against its recommendation of SEC regulation of ESG disclosures. *See* INV. ADVISORY COMM., U.S. SEC. & EXCH. COMM'N, MINUTES OF THE MEETING OF MAY 21, 2020, at 3 n.2 (2020), https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac052120-minutes.pdf [https://perma.cc/KN3A-7M8N].

[3] *See, e.g.*, Eve Tahmincioglu, *SEC Chief Takes on Short-Termism and ESG*, DIRS. & BDS., https://www.directorsandboards.com/articles/singlesec-chief-takes-short-termism-and-esg [https://perma.cc/CH55-P7P2] (last visited Apr. 3, 2021) (quoting SEC Chair Jay Clayton: "My view is that in many areas we should not attempt to impose rigid standards or metrics for ESG disclosures on all public companies. Such a step would be inconsistent with our mandate, would be a departure from our long-standing commitment to a materiality-based disclosure regime, and could effectively substitute the SEC's judgment for the company's judgment on operational matters").

[4] *See* Press Release, U.S. Sec. & Exch. Comm'n, Satyam Khanna Named Senior Policy Advisor for Climate and ESG (Feb. 1, 2021), https://www.sec.gov/news/press-release/2021-20 [https://perma.cc/VA4G-USGJ].

[5] Allison Herren Lee, *Statement on the Review of Climate-Related Disclosure*, U.S. SEC. & EXCH. COMM'N (Feb. 24, 2021), https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure [https://perma.cc/767D-E9HN].

[6] *What We Do*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/about/what-we-do [https://perma.cc/959T-XR2K] (last modified Dec. 18, 2020).

the SEC risks eroding public trust in its capacity and willingness to serve as an apolitical, technocratic regulator of the capital markets.[7]

Supporters of mandatory ESG disclosures deny that their purpose is to pursue policy goals outside the SEC's ambit. Institutional investors who have joined environmental and social activists in supporting mandatory ESG disclosures argue that the disclosures will help them generate superior returns—that ESG investing is about "value, not values."[8] The SEC should recognize, however, that institutional asset managers could not make a social-value argument even if they wished to, for they are fiduciaries for their shareholders or beneficiaries. While individual investors may sacrifice return to invest in companies that share their values, and asset managers may assist them in doing so by offering tailored investment portfolios, the managers may not insist that all beneficiaries forego return in order to serve social goals. Depending on the type of institution, to prioritize social goals over the financial interests of beneficiaries, or even to take them into account, would constitute a breach of fiduciary duty.[9] The financial value argument is, accordingly, cheap talk that conveys no information other than that the institution wants the SEC to require the disclosures.

There are good reasons to believe that these institutions' purpose is in part to pursue public policy goals outside the normal political process. This is a particular concern with respect to large public pension plans, the trustees of which are subject to weak market discipline but strong political forces.[10] The herding behavior of private fund managers, such as BlackRock, State Street, and Vanguard, toward ESG activism[11] is puzzling if they are interested only in

[7] For a similar institutional authority and competence argument regarding the Federal Reserve, *see* Christina Parajon Skinner, *Central Banks and Climate Change*, 75 VAND. L. REV. (forthcoming 2021) (manuscript at 64–71), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3703142 [https://perma.cc/E6L6-V64S] (on file with the Columbia Business Law Review).
[8] Letter from Cyrus Taraporevala, President & CEO, State St. Glob. Advisors, to Bd. Members, CEO's Letter on our 2020 Proxy Voting Agenda (Jan. 28, 2020), https://www.ssga.com/us/en/institutional/ic/insights/informing-better-decisions-with-esg [https://perma.cc/9L4M-U88D] (on file with the Columbia Business Law Review) ("We believe that addressing material ESG issues is good business practice and essential to a company's long-term financial performance – *a matter of value, not values*.").
[9] *See* Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 385–86 (2020) (concluding that a trustee of pensions, charities, and personal trusts can consider ESG factors in making investment decisions without violating his or her fiduciary duty only if: "(1) the trustee reasonably concludes that the ESG investment program will benefit the beneficiary directly by improving the risk-adjusted return; and (2) the trustee's exclusive motive for adopting the ESG investment program is to obtain this direct benefit").
[10] *See infra* notes 71–76 and accompanying text.
[11] *See* Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401, 1405–06 (2020) (describing these funds as "[c]hief supporters" of ESG activism).

uncovering as-yet unpriced risks. Money managers who believe they have found an over- or undervalued asset do not generally broadcast that fact to the world and invite others to share in the investment opportunity. Political activism, by contrast, relies heavily on bandwagon effects.

If we are correct that institutional investors' enthusiasm for ESG investing is not just a question of risk and return, then mandated ESG disclosures are not merely outside the core concerns of the SEC, but in active conflict with them. ESG disclosures will exacerbate conflicts of interest between the managers of mutual funds and pension plans and their shareholders and beneficiaries. Protecting investors against such conflicts is one of the SEC's primary functions.[12]

Mandated ESG disclosures may also conflict with the SEC's goal of protecting retail investors in another, more subtle way. Disclosure requirements that come bundled with substantial political and litigation risk can discourage companies from going (or staying) public. The result will be to reduce the investible assets available to Main Street investors—although not to high net-worth investors who can participate in private equity vehicles.

Our assessment of the future of securities regulation, then, begins with the proposition that the SEC stands at a fork in the road. It may continue to pursue its longstanding mission of investor protection, with a particular emphasis on protecting unsophisticated investors from fraud and agency costs.[13] Alternatively, it may cast its lot with the institutional investors and political activists who wish to further public policy objectives without subjecting them to the transparency and compromises inherent in the normal substantive policy making process. Fairly or not, the latter path may lead investors and the broader public to conclude that the SEC caters to Wall Street rather than Main Street.

The Article proceeds as follows. Part II argues that ESG disclosures, despite claims to the contrary, will facilitate the pursuit of social goals at the possible expense of investor returns. Part III describes the separation of ownership and control inherent in mutual and pension funds and explains why it manifests in institutional investors' ESG activism. Part IV explores the policy implications of our analysis. Part V concludes.

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[12] The Investment Company Act of 1940, 15 U.S.C. §§ 80a-1–80-64 (2018) and the Investment Advisers Act of 1940, *id.* §§ 80b-1–80b-21 are the primary vehicles through which the SEC regulates money managers. The former reflects a Congressional purpose to ensure that investment companies are managed in the interests of their shareholders rather than their sponsors or managers. *Id.* § 80a-1(b)(2). The latter was intended to impose fiduciary duties on investment advisers as a matter of federal law. *See* Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979).

[13] *See* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048–50 (1995). *See also* Elizabeth Pollman, *Private Company Lies*, 109 GEO. L. REV. 353, 361–63 (2020).

II. Securities Law, Disclosure, and ESG Investment

Securities law's core consists of mandatory disclosure and prohibitions on fraud.[14] Mandatory disclosure is designed to protect investors who cannot "fend for themselves," in the Supreme Court's phrase,[15] or "Main Street investors," in the words of the SEC's website.[16]

Proponents of ESG disclosure mandates insist that they fit within the traditional disclosure paradigm, which focuses on material financial risk. The Sustainability Accounting Standards Board (SASB), for example, states that its "[s]tandards identify the subset of ESG issues reasonably likely to materially impact the financial performance" of a company in a given industry.[17] ESG investing, therefore, is an attempt to correct and profit from the mispricing of risk.

Commentators have noted the logical and empirical hurdles standing in the way of a conclusion that ESG investment strategies can generate excess returns above costs.[18] We will focus primarily on two issues that we think deserve more attention than they have received to date. The first is the lack of a clearly identified (financial) market failure that ESG disclosures could address and that the current system of materiality-based disclosure cannot. The second is the misalignment of incentives between institutional money managers and their beneficiaries.

A. The Absence of Market Failure

Regulatory mandates require a market failure justification.[19] For example, mandatory disclosure of management compensation may be justified by the fact that corporate managers

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[14] *See* Kevin S. Haeberle, *Marginal Benefits of the Core Securities Laws* 2 (March 19, 2021) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3667963 [https://perma.cc/MBQ9-RRC6] (on file with the Columbia Business Law Review).
[15] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).
[16] *What We Do*, *supra* note 6.
[17] SUSTAINABILITY ACCT. STANDARDS BD., SASB IMPLEMENTATION SUPPLEMENT: GREENHOUSE GAS EMISSIONS AND SASB STANDARDS 1 (2020), https://www.sasb.org/standards/download/ (click "Greenhouse Gas Emissions") (on file with the Columbia Business Law Review).
[18] *See* Schanzenbach & Sitkoff, *supra* note 9, at 425–48; Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *How Investors Can (and Can't) Create Social Value*, 44 J. CORP. L. 205, 227 (2018) ("The argument [that ESG ratings are directly related to returns], while superficially attractive, is implausible. Information concerning stranded assets is publicly available, and proponents offer no explanation for why this risk is not already reflected in existing stock prices[.]"); Gerhard Halbritter & Gregor Dorfleitner, *The Wages of Social Responsibility—Where Are They? A Critical Review of ESG Investing*, 26 REV. FIN. ECON. 25, 35 (2015) ("[T]his study strongly questions whether there is actually a relationship between ESG ratings and returns which is exploitable with a trading strategy[.]").
[19] Economists generally trace the market failure justification for regulation to Pigou. *See, e.g.,* Andrei Shleifer, *Efficient Regulation*, *in* REGULATION VS. LITIGATION, PERSPECTIVES FROM ECONOMICS AND LAW 27, 27–28 (Daniel

have a direct personal interest in concealing the size of their compensation from shareholders. In general, there are plausible market failure arguments with respect to some governance issues—the "G" in ESG. The interests of managers and investors sometimes conflict when it comes to governance matters. Accordingly, there are theoretical and empirical results tying firm value to governance policies that reduce traditional managerial agency costs.[20] Part of the impetus for including governance in ESG was to "rebrand" socially responsible investing as *financially* responsible investing.[21]

Even when shareholders' and managers' interests conflict, the likelihood of a mispricing is reduced if mandated and voluntary disclosures sufficiently allow shareholders to distinguish "good" from "bad" companies. For example, as investors became aware of the empirical results tying certain governance practices to higher valuation, the association between those practices and valuation largely disappeared.[22] With that in mind, would "E" and "S" disclosures address market failures more effectively than the current materiality-based system? We consider two salient examples.

The Nasdaq exchange recently sought SEC approval for a rule that imposes a comply-or-explain mandate on listed companies with respect to board diversity and that requires "statistical information . . . related to a director's self-identified gender, race, and self-identification as LGBTQ+[.]"[23] Nasdaq justified the proposed rule on the grounds that companies with diverse boards outperform those without.[24] It did not, however, identify an externality or other problem

P. Kessler ed. 2011); *see also* A.C. PIGOU, THE ECONOMICS OF WELFARE, at xviii (4th ed. 1938) (discussing "the general merits of public intervention in industry … as a remedy for the failures of private enterprise").

[20] *See, e.g., generally* Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003).

[21] Schanzenbach & Sitkoff, *supra* note 9, at 396.

[22] *See* Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, *Learning and the Disappearing Association Between Governance and Returns*, 108 J. FIN. ECON. 323, 345–47 (2013) (finding that governance remains important to performance but that the market has learned to price this value).

[23] Notice of Filing of Proposed Rule Change to Adopt Listing Rules Related to Board Diversity, 85 Fed. Reg. 80,472, 80,472 (proposed Dec. 4, 2020).

[24] *Id.* at 80,475–77. Nasdaq also suggested further justifications, including public support. *Id.* at 80,474.

interfering with companies acting in their best interests.[25] It instead emphasized "the inherent value of board diversity"—a social value argument.[26]

We also consider environmental risks. Under current rules, particularly the risk factor and management's discussion and analysis requirements of Regulation S-K, a company must generally identify known operational and financial risks.[27] Potential losses associated with weather events that may occur with sufficient probability fit squarely within the existing framework.[28] So do the costs of complying with existing or probable regulatory mandates.[29]

The market failure claim with respect to these risks turns on disclosure standardization. No individual company has an incentive to develop a standardized set of ESG disclosures, but investors would benefit from it.[30] Companies use different metrics to assess the risk of climate-based harm and of the effects of possible future regulations on their operations.[31] Different nongovernmental organizations give different climate "scores" to the same company.[32]

Disagreement about the future, however, is not a market failure. At a conceptual level, commentators and standard setters agree that a changing climate will generate physical risks—risks associated with adverse weather events, sea level changes, and so on—and transition risks—the costs firms will incur in complying with future climate policies.[33] Not surprisingly, there is no universally-accepted measure of what these future changes will be and how they will affect individual companies.

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[25] There is a potential market failure if diverse boards are more likely to hold CEOs accountable and CEOs therefore try to avoid them. *See* Michal Barzuza and Gideon Parchomovsky, Diversity Across the Board (working paper 2021). For there to be a systematic mispricing, however, there must also be some reason why companies with diverse boards will not publicize that fact, allowing shareholders to draw an adverse inference against those who do not.

[26] Notice of Filing of Proposed Rule Change to Adopt Listing Rules Related to Board Diversity, 85 Fed. Reg. at 80,474 (emphasis omitted).

[27] *See* 17 C.F.R. § 229.105 (2020) (requiring disclosure of "the most significant factors that make an investment in the registrant or offering speculative or risky"); *id.* § 229.303(a) instruction 3 (requiring disclosure of "material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition").

[28] EVA SU & NICOLE VANATKO, CONG. RESEARCH. SERV., IF11307, CLIMATE-RELATED RISK DISCLOSURE UNDER U.S. SECURITIES LAWS 1 (2019).

[29] *Id.*

[30] *See* MICHAEL CLEMENTS ET AL., U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-20-530, PUBLIC COMPANIES: DISCLOSURE OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS AND OPTIONS TO ENHANCE THEM 32 (2020) ("We identified inconsistencies in how companies disclosed on some of our . . . ESG topics, which may limit investors' ability to compare these disclosures across companies.").

[31] *See id.* at 17–18 (explaining the processes companies use to choose metrics).

[32] *See* Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921, 1998 (2020).

[33] *See* SU & VANATKO, *supra* note 28.

Financial markets, however, are clearly attentive to these risks. Over the past decade, for example, ExxonMobil's price/earnings ratio has averaged about fifteen, while First Solar's is currently around forty-five.[34] In early 2021, Tesla had a market capitalization more than seven times that of General Motors.[35] This is not evidence of the market's inability to value ESG factors without mandatory, standardized disclosures.

Indeed, it appears that ESG investors may object to the status quo partly because market valuations also reflect the political barriers to dramatic policy changes. A common argument is that markets are not correctly valuing companies responsible for substantial greenhouse gas emissions.[36] That is undoubtedly true if our baseline for "correct" valuation is a theoretical, optimal global policy response to climate change. It is likely not true if our baseline is current policy and reasonable extrapolations from it. There is substantial reason to doubt whether the United States will (as opposed to should) achieve a net-zero emission economy in the future,[37] which blunts the usefulness of any disclosure regime premised on a net-zero 2050 or on other assumptions not yet reflected in law. Indeed, if the impact of policies that may not be adopted are material risks, so is the impact of a possible public backlash and reversal of those policies should they prove economically painful.

Disclosures about how a company would respond to an assumed future physical and policy environment, then, are essentially stress tests. In the wake of the global financial crisis, Congress mandated periodic stress tests for certain financial institutions that measure their resiliency to hypothetical adverse economic conditions.[38] Stress tests are not part of the SEC's standard toolkit because they are not investor protection measures. They are designed to help regulators measure and respond to risks that affect the entire financial system, economy, or

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[34] *Exxon PE Ratio 2006-2020*, MACROTRENDS, https://www.macrotrends.net/stocks/charts/XOM/exxon/pe-ratio [https://perma.cc/PRA4-3L38] (last visited Feb. 22, 2020); *First Solar PE Ratio 2007-2020*, MACROTRENDS, https://www.macrotrends.net/stocks/charts/FSLR/first-solar/pe-ratio [https://perma.cc/6TXE-9N9L] (last visited Feb. 22, 2020).

[35] *See General Motors Co.*, WALL ST. J.: MKTS., https://www.wsj.com/market-data/quotes/GM [https://perma.cc/N8YH-G2Q9] (last visited Mar. 6, 2021) (giving a market capitalization of $77.45 billion for GM); *Tesla Inc.*, WALL ST. J.: MKTS., https://www.wsj.com/market-data/quotes/TSLA [https://perma.cc/7K6J-Z67T] (last visited Mar. 6, 2021) (giving a market capitalization of $573.94 billion for Tesla).

[36] *See, e.g.*, Daniel C. Esty & Quentin Karpilow, *Harnessing Investor Interest in Sustainability: The Next Frontier in Environmental Information Regulation*, 36 YALE J. ON REG. 625, 690 (2019) (arguing that the market would direct more capital toward "sustainability leaders" with fuller disclosures).

[37] *See* CARY FUNK & BRIAN KENNEDY, PEW RES. CENTER, THE POLITICS OF CLIMATEat 30 (2016) (describing polarization of views about climate mitigation strategies).

[38] *See* 12 U.S.C. § 5365(i).

society. Measuring the societal impact of climate change is an important task, but not within the SEC's purview.

B. The Goals of ESG Advocates

Why, then, are institutional investors and political activists pressing for the SEC to require an expanded and standardized set of ESG disclosures,[39] given that its rules already require companies to disclose known risks that are material to their future operations and financial position?[40] For political activists, the answer is straightforward—they want to use the information to prod companies to change policies in socially-motivated directions.[41] Standardized disclosures that facilitate the production of an ESG "score" are particularly valuable to political activists. Such disclosures facilitate an ordinal ranking of companies that can serve as a focal point to organize boycotts, demonstrations, and social media campaigns against "brown" companies.[42]

The SEC should consider the possibility that this is also an important goal of institutional investors who argue for ESG disclosures. As market prices have adjusted to environmental risks, making it more difficult to earn excess returns by selling "brown" and buying "green" companies, institutional investors have emphasized the social value of their sustainable investment strategies. Larry Fink, the CEO of investment management firm BlackRock and the most prominent Wall Street voice on climate change, outlined the social benefits of attaining a net-zero economy by 2050 and urged the CEOs of BlackRock's portfolio companies to cooperate with governments to make the goal a reality.[43] State Street Global Advisors website claims that it "proactively us[es] our voice and our vote to make a measurable difference around the globe."[44]

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[39] *See supra* note 8 and accompanying text.
[40] *See supra* notes 27–28 and accompanying text.
[41] *See, e.g.*, *The Climate Accountability Scorecard*, UNION OF CONCERNED SCIENTISTS (Oct. 23, 2018), https://www.ucsusa.org/resources/climate-accountability-scorecard-0 [https://perma.cc/8U2K-269T] (recommending that fossil fuel companies should "renounce disinformation on climate science and policy" and "plan for a world free from carbon pollution" among others).
[42] *Cf.* Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. ON REG. 499, 513–17 (2020) (describing conditions that facilitate "shaming campaigns" against companies).
[43] *See* Letter from Larry Fink, Chairman & CEO, BlackRock, to CEOs, 2021 Letter to CEOs, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [https://perma.cc/3PVR-MGDQ] (last visited Mar. 2, 2021) ("[A] successful transition—one that is just, equitable, and protects people's livelihoods—will require both technological innovation and planning over decades. And it can only be accomplished with leadership, coordination, and support at every level of government, working in partnership with the private sector[.]").
[44] *See Asset Stewardship*, STATE ST. GLOB. ADVISORS, https://www.ssga.com/us/en/institutional/ic/capabilities/esg/asset-stewardship [https://perma.cc/945W-TMMQ] (last visited Apr. 1, 2021).

BlackRock's former chief investment officer for sustainable investing recently stated that institutional investors do not believe they can use ESG metrics to generate excess returns, but wish to have them to pursue social goals.[45]

These investors have indicated that they intend to use their shareholder voting rights to move companies in a greener direction. In January 2020, the CEO of State Street Global Advisors apprised portfolio companies that it was using SASB information to generate "ESG scores" for publicly traded companies and "will take appropriate voting action against board members at companies . . . that are laggards."[46] Around the same time, Larry Fink's letter to CEOs of Blackrock's portfolio companies similarly warned that "[w]here we feel companies and boards are not producing effective sustainability disclosures or implementing frameworks for managing these issues, we will hold board members accountable."[47] As we discuss further below, various public pension funds have announced plans to divest from particular industries based on ESG factors.

This prodding should be unnecessary if it is aimed only at getting each company to protect itself against known risks to which it is subject. If these risks threaten financial harm to a company, its managers have a strong incentive to address them. It is not in the shareholders' interests, however, to address social harms that do not impose financial losses on the company or, more generally, to pursue projects in which the company gains only a small benefit while incurring large costs. Free riding on others' efforts to solve environmental problems will often be the *financially* correct strategy, which is why substantive environmental regulations exist.

One might argue that this analysis misses a critical point: diversified institutional investors internalize more of the economy-wide costs and benefits of good or bad environmental and social outcomes than does any individual portfolio company.[48] For example, if a fund owns shares in electric utilities along with shares in companies that operate Florida coastal resorts, climate-friendly policies that harm the former companies while benefiting the latter may make

[45] *See* Lisa Fu, ESG Cannot Combat Climate Change: Ex-BlackRock Sustainable CIO, FundFire (March 18, 2021) ("People were interested in ESG, not because they thought … it would help to generate alpha [but] because there was a growing societal anger around the lack of action on social issues."), https://www.fundfire.com/c/3105474/391684/cannot_combat_climate_change_blackrock_sustainable
[46] *See* Taraporevala, *supra* note 8 (emphasis omitted).
[47] *See* Letter from Larry Fink, Chairman & CEO, BlackRock, to CEOs, A Fundamental Reshaping of Finance, https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceo-letter [https://perma.cc/6H39-6K3J] (last visited Feb. 22, 2020).
[48] *See* John C. Coffee, Jr., *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk*, 2021 COLUM. BUS. L. REV. (forthcoming) (manuscript at 16–17) (on file with the Columbia Business Law Review).

the fund as a whole better off. Because these managers "own the market," they benefit from market-wide policy implementation and their activism is accordingly financially justified.

While it is true that diversified institutional shareholders internalize more of these social costs and benefits than any one company, the difference is not sufficient to explain their enthusiasm for ESG-related disclosures. Take greenhouse gas emissions as an example. CDP, a nonprofit created to measure environmental impact, concluded that twenty-five private and government-controlled organizations were responsible for approximately half of global greenhouse gas emissions from 1988 to 2015.[49] Only five of them are U.S. publicly traded companies and only one (ExxonMobil, number five) ranks in the top ten. By 2015, the importance of U.S. companies was reduced further; three of the top twenty-five were incorporated in the U.S. and ExxonMobil had fallen to number nine.[50]

A company incorporated in Country A may, of course, manufacture goods in Country B for sale and consumption in Country C. The figures above accordingly do not parcel out moral blame for emissions among countries. They do, however, indicate how little influence the U.S. securities regulatory system can have on global emissions. With minor exceptions, companies incorporated outside the United States are exempt from the U.S. proxy voting system.[51] Outside that system, State Street's or BlackRock's ability to influence managerial decisions depends on foreign law. They have no influence at all over the world's largest emitters, which are government-controlled entities.[52]

Just as most of the activity that generates greenhouse gasses takes place outside the S&P 500, most of the benefit (that is, the reduction in future harm) of climate-friendly policies would accrue to people and assets outside a U.S. fund manager's investment portfolio. A large portion of the coastal lands most threatened by rising sea levels, for example, are outside the United

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[49] *See* PAUL GRIFFIN, CDP, 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 [https://perma.cc/XY9L-BXB3].
[50] *Id*. at 15.
[51] *See* 17 C.F.R. § 240.3b-4(c) (defining "foreign private issuer" as a company organized under the laws of a foreign country unless U.S. residents own more than 50% of the voting securities *and* either a majority of executive officers are U.S. citizens or residents, more than 50% of the assets are located in the U.S., or the business is administered principally in the U.S.; *id.* § 240.3a12-3(b) (securities of foreign private issuers exempt from proxy rules).
[52] The eight largest emitters in 2015 were all government-controlled entities: Saudi Aramco, Gazprom, National Iranian Oil Co., Coal India, Shenhua Group, Rosneft, CNPC, and Abu Dhabi National Oil Co. *See* Griffin, *supra* note 48, at 15.

States.[53] When it comes to carbon production and use and climate-sensitive assets, an S&P 500 index fund does not own the market—far from it.

In short, climate change is a collective action problem requiring a coordinated, global governmental response. From a strictly financial perspective, it is not individually rational for a fund manager to try to solve it.

We accordingly see ESG activism (that is, divestment, shareholder voting, or other engagement) as an attempt to use beneficiary resources to impose a private price on socially detrimental activity in substitution for a government-imposed price. We will take greenhouse gas emissions as an example, but a similar analysis would apply to other "E" and "S" issues. Greenhouse gas emissions impose a classic externality: the emitter does not suffer the full social costs of its activity. One straightforward solution to the externality is to impose a price on greenhouse gas emissions through a tax, a regime of tradeable permits, or other means. That has not, to date, proved politically possible at the national level.

Rather than wait for federal government action, we hypothesize that institutional investors seek to impose a capital cost on greenhouse gases. Through capital reallocation, shareholder votes, and coordination with social activists, institutions can make it costly for companies to act in their self-interest with respect to emission-generating activities.[54] The capital cost will prod companies to operate in ways more closely aligned with the investors' view of social welfare.

The obvious question is why institutional investors would do this. Why take actions that generate private costs and social benefits? One possible answer lies in the divergent interests of those institutions' decisionmakers and their beneficiaries. Institutions invest other people's money. As such, they are subject to agency costs, a topic to which we now turn.

III. The "New" Separation of Ownership and Control: Money Managers Versus Beneficiaries

In *The Modern Corporation and Private Property*, Adolph Berle and Gardiner Means described the separation of ownership and control between corporate shareholders and managers

[53] *See* Ciara Nugent, *The 10 Countries Most Vulnerable to Climate Change Will Experience Population Booms in the Coming Decades*, TIME (July 11, 2019), https://time.com/5621885/climate-change-population-growth/ [https://perma.cc/ZQ4C-V3T3] ("Climate scientists have long warned that the impacts of climate change will hit less developed regions in the global south harder and earlier" than others).
[54] *See* Brest, Gilson & Wolfson, *supra* note 18, at 223–24.

as the central problem for corporate law. The book was written at a time when most shares of corporate stock were owned by individuals. It documents the rise of middle-class investors and the consequent dispersion of stock ownership.[55] Consistent with this picture, households continued to own a majority of publicly traded shares for decades.[56]

A. The Rise of Institutional Ownership

Today, the landscape of corporate ownership is different.[57] While a majority of households have stakes in public companies, those stakes are now largely intermediated through institutional investors, including employer-sponsored pension plans, mutual funds, investment advisers, bank trust accounts, and others.[58]

On the one hand, this development can reduce agency problems between a corporation's managers and the households that have a financial interest in the corporation. In comparison to retail investors, institutions can more effectively hold corporate managers accountable.[59] An institutional investor may hold a large enough investment in a company to make monitoring economically feasible and worthwhile.[60] While the task of monitoring hundreds of portfolio companies may seem daunting, the market has provided a solution in the form of proxy advisory

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[55] *See* BERLE & MEANS, *supra* note 1, at 47–68.

[56] *See* 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, 874 (2013).

[57] A precise measure of household and institutional ownership depends on one's definitions and categorizations. *Compare* KATIE KOLCHIN, SEC. INDUS. & FIN. MKTS. ASS'N, Q: WHO OWNS STOCKS IN AMERICA? A: INDIVIDUAL INVESTORS 14 (2019), https://www.sifma.org/wp-content/uploads/2019/10/SIFMA-Insights-Who-Owns-Stocks-in-America.pdf [https://perma.cc/S4RW-W5K2] (finding that households own thirty-eight percent of U.S. equities), *with* Ralph S.J. Koijen & Motohiro Yogo, *A Demand System Approach to Asset Pricing*, 127 J. POL. ECON. 1475, 1477 (2019) (finding that institutions own sixty-eight percent of U.S. equities).

[58] The latest Federal Reserve Board Survey of Consumer Finances shows fifty-three percent of families owning stock directly or indirectly, while only fifteen percent own directly. *See* Neil Bhutta et al., *Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances*, FED. RESERVE BULL., Sept. 2020, at 1, 18 box 5, 19. The data are accessible at *Survey of Consumer Finances (SCF)*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., https://www.federalreserve.gov/econres/scfindex.htm [https://perma.cc/HJ3P-S7ST] (last updated Nov. 17, 2020).

[59] *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 813 (1992).

[60] Institutional investors, however, are subject to free rider problems. *See* Anat R. Admati, Paul Pfleiderer & Josef Zechner, *Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium*, 102 J. POL. ECON. 1097, 1099–1100 (1994) (modeling the free rider problem confronting large shareholders). Prodding companies to make value-enhancing governance changes will sometimes, but not always, be individually rational.

firms that specialize in advising institutions on how to vote their shares.[61] Institutional investors have both the incentive and the means to affect the policies of public companies.

The heavy intermediation of household investment through institutions, however, creates its own agency problems.[62] The beneficiaries of institutional accounts—directly or indirectly—are households with small amounts at stake. These households cannot monitor fund managers any better than they can monitor corporate managers. The Berle and Means logic, therefore, holds that the managers of institutions will tend to further their own interests at the expense of fund beneficiaries.[63]

We are far from the first to analyze this new separation of ownership and control and its potential consequences.[64] An important strand of scholarship focuses on the problem of managerial passivity. It argues that fund managers do not use their control rights aggressively to further beneficiary interests.[65] Instead, they focus on beating their benchmarks in the short run and selling positions rather than engaging managers in long-run projects to improve corporate performance.[66] Index funds, which attempt to match rather than beat a benchmark, have even less incentive to be activist.

A separate strand of the literature focuses on managers' use of proxy voting and informal engagement to further interests other than maximizing beneficiary returns. For example, critics observe that fund managers may choose to vote with corporate management so as not to damage other business relationships with the company.[67]

[61] *See* Chong Shu, The Proxy Advisory Industry: Influencing and Being Influenced 1 (Dec. 22, 2020) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3614314 (on file with the Columbia Business Law Review).
[62] *See* Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 881 (2010) ("The intermediary's separation of ownership from control creates a second layer of agency costs.") (footnote omitted); Gilson & Gordon, *supra* note 56, at 876 (describing rise of "agency capitalism").
[63] *See* BERLE & MEANS, *supra* note 1, at 123–25. We will refer to institutional investors as "funds" for ease of exposition regardless of the type of institution. We will also use the terms "money manager," "fund manager" or "investment adviser" loosely to refer to the firms or individuals making investment decisions.
[64] For a useful summary, see generally Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89 (2017).
[65] *See, e.g.*, John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1281 (1991) ("[T]he agents controlling institutional investors have considerable reason to remain 'rationally apathetic' about corporate governance and little reason to become active participants."); Gilson & Gordon, *supra* note 55, at 876 ("In their own way, U.S. institutions . . . are themselves passive with respect to much of corporate governance[.]").
[66] *See, e.g.*, Coffee, *supra* note 65, at 1361–62 (suggesting "that institutional investors who rely on 'exit' will participate in corporate governance" only in extreme cases and "on a short-term basis").
[67] *See* Bebchuk, Cohen & Hirst, *supra* note 64, at 90.

Fund managers may also have private incentives to vote in favor of ESG-related shareholder proposals. Institutional investors have voted in favor of such proposals at a steadily increasing rate over the past twenty years.[68] As already noted, they have also allocated capital away from companies with low ESG scores and toward companies with high ones.[69]

Some funds invest in green companies because their beneficiaries wish to use their investment dollars to further social goals. Fund sponsors accordingly offer sustainability- or ESG-focused funds. Explicitly ESG-focused funds do not raise conflicts of interest because well-informed beneficiaries who invest their own money can trade off social value and fuller diversification to maximize their own welfare, all things considered.[70] This Article, by contrast, is concerned with the conflicting interests of fund managers and their beneficiaries in the many funds whose stated objective is to maximize risk-adjusted returns.

B. Agency Problems in Public Pension Funds

Public pension fund trustees are subject to particularly strong incentives to take social goals into account. As Roberta Romano pointed out nearly 30 years ago, when pension fund activism was thought to be a solution to manager-shareholder conflicts, their trustees are subject to unique political pressures.[71] Typically, some are elected or appointed officials who cannot afford to anger their constituents by pursuing local policy preferences with insufficient zeal.[72]

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68 *See* Kosmas Papadopoulos, *The Long View: US Proxy Voting Trends on E&S Issues from 2000 to 2018*, HARV. L. SCH. F. ON CORP. GOVERNANCE, https://corpgov.law.harvard.edu/2019/01/31/the-long-view-us-proxy-voting-trends-on-es-issues-from-2000-to-2018/ [https://perma.cc/F3AY-JY6K].

69 *See supra* notes 34–35 and accompanying text.

70 *See* Samuel M. Hartzmark & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, 74 J. FIN. 2789, 2792–93 (2019) (finding that mutual funds ranked high (low) on sustainability measures experience large inflows (outflows) of investor funds despite no evidence that the former outperform the latter—evidence of non-pecuniary motivations). We express no view on the effectiveness of ESG-focused funds in achieving their stated objectives. Critics have argued that, in practice, ESG funds are tech-focused funds. *See* Akani Otani, *Big Technology Stocks Dominate ESG Funds*, WALL ST. J. (Feb. 11, 2020, 11:45 AM), https://www.wsj.com/articles/big-technology-stocks-dominate-esg-funds-11581330601 (on file with the Columbia Business Law Review). Because the largest tech companies earn revenue primarily through advertising that encourages consumers to purchase manufactured products and have them shipped to the consumer's door, whether tech companies on balance help or hurt the environment is an interesting question. *See, e.g.*, *Is Google Advertising Revenue 70%, 80% or 90% of Alphabet's Total Revenue?*, FORBES (Dec. 24, 2019), https://www.forbes.com/sites/greatspeculations/2019/12/24/is-google-advertising-revenue-70-80-or-90-of-alphabets-total-revenue/?sh=356d5ce44a01 [https://perma.cc/G74E-FAKB].

71 *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (1993) ("Public fund managers must navigate carefully around the shoals of considerable political pressure to temper investment policies with local considerations . . . which are not aimed at maximizing the value of their portfolios' assets.").

72 *See, e.g.*, *Board Elections*, CALPERS, https://www.calpers.ca.gov/page/about/board/board-elections [https://perma.cc/5TQ5-FS56] (last updated Oct. 4, 2014) ("The Cal[ifornia] [Public Employees' Retirement

Moreover, the pension plans they oversee are largely defined-benefit plans in which the employee's entitlement is not a function of investment returns.[73] In some instances, these entitlements have a legally protected status that would make it difficult, short of government insolvency, for the state government not to make up shortfalls out of general tax revenues.[74] Even when not given legal priority, these entitlements may have political priority because of the importance of public employee unions as political constituents.[75] The beneficiaries, meanwhile, are a captive audience that cannot easily move their retirement savings. In short, market discipline operates only weakly on these trustees. Political discipline, by contrast, operates strongly.

The California Public Employee Retirement System, or CalPERS, provides an example. It has developed divestment and proxy voting policies that align with local policy preferences. Initially, elected officials on its board conceded that the purpose was social and not financial. As CalPERS embarked on a program of divestment from tobacco companies, the state's treasurer, an ex officio trustee, stated that the goal was to "mobilize the power of the capital markets for public purpose."[76]

The use of beneficiary funds to pursue public policy goals generated criticism.[77] The *New York Times* reported concerns that the CalPERS board was "so activist, so eager to promote social change through investing, that its . . . ability to provide for the 1.3 million public employees whose pensions it guarantees [was] in question."[78]

System] Board of Administration consists of 13 members who are elected, appointed, or hold office ex officio for four-year terms.").

[73] According to Fed data, at the end of the third quarter of 2020, defined benefit liabilities of state and local governments totaled $9 trillion, while assets in state and local government defined contribution plans totaled $0.5 trillion. *See* BD. OF GOVERNORS OF THE FED. RES. SYSTEM, STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT FUNDS DEFINED BENEFIT PLANS, Dec. 10, 2020, https://www.federalreserve.gov/releases/z1/20201210/html/l120b.htm [https://perma.cc/QGC8-9Y3M]. *See also* BD. OF GOVERNORS OF THE FED. RES. SYSTEM, STATE AND LOCAL GOVERNMENT EMPLOYEE RETIREMENT FUNDS DEFINED CONTRIBUTION PLANS, Dec. 10, 2020, https://www.federalreserve.gov/releases/z1/20201210/html/l120c.htm [https://perma.cc/RSX9-WSSJ].

[74] *See, e.g.*, N.Y. CONST., art. V, § 7(a) (guaranteeing that pension benefits "shall not be diminished or impaired"); ILL. CONST., art XIII, § 5 (same).

[75] *See, e.g.*, Bruce Schreiner, *Retired Teachers Voice Opposition to Pension Overhaul*, THE ASSOCIATED PRESS (Feb. 28, 2018), https://apnews.com/article/0be8b596dd1f46c39cc567c4583acdb3 [https://perma.cc/8PWX-BR2S] (describing Kentucky teachers' opposition to pension changes).

[76] Mary Williams Walsh, *Calpers Wears a Party, or Union, Label*, N.Y. TIMES, Oct. 13, 2002, at B1 (internal quotation marks omitted).

[77] *See* Schanzenbach & Sitkoff, *supra* note 9, at 397.

[78] *See* Walsh, *supra* note 76.

More recently, a free-market-oriented think tank argued that CalPERS was sacrificing returns for political reasons.[79] In response, CalPERS rejected the claim that its divestments and engagements were politically motivated and argued that they reflected a "sound" analysis of risk and return.[80] Its beneficiaries, however, were not fully persuaded. Six of the thirteen members of the CalPERS board are elected by various constituencies, including current state employees.[81] In 2018, the state employee representative, who was the board's chair and a strong proponent of ESG investing, was unseated in an election. The employee who ran against her argued that CalPERS had been "used more as a political-action committee than a retirement fund."[82] This is a stark indicator of trustee-beneficiary conflicts over socially motivated investing.

New York's state pension fund recently announced it would divest many of its fossil fuel stocks over a five-year period.[83] The state's comptroller stated that the decision would maximize long-run returns.[84] The comptroller, however, was between a rock and a hard place. He had previously resisted divestment on the grounds that it would make it harder to achieve the required long-term returns needed to pay pension benefits, but relented under pressure from state legislators and activists.[85] As a trustee, he had no choice but to state that the decision was made in the beneficiaries' best interests.[86] By any reasonable standard, however, the decision was motivated by public policy rather than risk and return.

As these examples illustrate, public pension boards tend to pursue public policy goals not just through shareholder voting and engagement, but through divestment. In addition to fossil fuel and tobacco companies, various pension funds have divested from or declared they will divest from firearms manufacturers, operators of private prisons, and companies from countries

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[79] *See* TIM DOYLE, AM. COUNCIL FOR CAP. FORMATION, POINT OF NO RETURNS: TAXPAYERS ON THE HOOK FOR $1 TRILLION AS PUBLIC PENSIONS CHOOSE POLITICS OVER PERFORMANCE 26 (2017).
[80] *See Slanted 'Study' on the Role of ESG Falls Completely Apart*, CALPERS, https://www.calpers.ca.gov/page/newsroom/for-the-record/2017/slanted-study-esg-falls-apart [https://perma.cc/XTF6-QQ5Z] (last updated Dec. 13, 2017).
[81] *See Board Members*, CalPERS, https://www.calpers.ca.gov/page/about/board/board-members [https://perma.cc/4333-6A4M] (last updated Oct. 21, 2020).
[82] *See* Paul S. Atkins, Opinion, *California Public Employees Vote Against Pension-Fund Activism*, WALL ST. J. (Oct. 18, 2018), https://www.wsj.com/articles/california-public-employees-vote-against-pension-fund-activism-1539904066 (on file with Columbia Business Law Review) (internal quotation marks omitted).
[83] *See* Anne Barnard, *Pension Fund of New York Divests of Oil*, N.Y. TIMES, Dec. 10, 2020, at B1.
[84] *See* Elizabeth Bauer, *Fossil Fuel Divestment Comes for New York Pension Funds—Is That Constitutional?*, FORBES (Dec. 20, 2020, 11:46 AM), https://www.forbes.com/sites/ebauer/2020/12/20/fossil-fuel-divestment-comes-for-new-york-pension-fundsis-that-constitutional/?sh=22f1cdd9aff6 [https://perma.cc/M5TG-MPXS].
[85] *See id.*
[86] *See id.* (noting that the New York Constitution "prohibits actions that would cause [covered] pensions to be inadequately funded" (emphasis omitted)).

that do not meet specified labor standards, among others.[87] The phenomenon is not ideologically homogeneous. A group of Idaho lawmakers and its lieutenant governor recently requested that the state's pension system divest its holdings of social media companies that they argued were engaged in censorship.[88]

The straightforward result of divestment mandates is that policy-inclined public pension funds will hold equity portfolios that are less diversified than a broad market index. For example, funds that divest from companies that emit greenhouse gasses will be more heavily weighted in technology and financial companies that don't manufacture things than the market as a whole. During some periods, such a portfolio will outperform the broader market; in others, it will underperform. In the event, CalPERS's divestment from tobacco companies was disastrously timed from a financial perspective.[89]

The CalPERS tobacco divestment illustrates a broader point. Because a portfolio that omits stocks in politically disfavored companies is imperfectly diversified, the fund voluntarily assumes idiosyncratic—and therefore uncompensated—risks. It also incurs costs associated with monitoring portfolio companies for undesired traits and trading based on them.[90] Again, logic strongly suggests that these decisions are less than optimal from a risk-return perspective and instead reflect public policy preferences.[91]

The empirical results are consistent with the anecdotal evidence of public pension fund investment decisions made for political rather than risk-return reasons.[92] There is evidence that

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[87] *See, e.g.*, The Associated Press, *Rhode Island To Divest from Private Prisons, Gun Makers*, ABC NEWS (Jan. 22, 2020, 4:15 PM), https://abcnews.go.com/US/wireStory/rhode-island-divest-private-prisons-gun-makers-68452646 [https://perma.cc/XM5B-H58C]; Steven Malanga, *The Pension Fund that Ate California*, CITY J., https://www.city-journal.org/html/pension-fund-ate-california-13528.html#:~:text=Unlike%20most%20government%20pension%20funds,California%20state%20and%20local%20budgets. [https://perma.cc/SS6A-GBZ2] (last visited Mar. 6, 2021).

[88] *See PERSI Responds to Letter Encouraging State to Divest from Big Tech Stocks*, IDAHO NEWS 6 (Jan. 25, 2021, 5:10 PM), https://www.kivitv.com/news/political/inside-the-statehouse/idaho-legislators-ask-persi-to-divest-of-big-tech-stock [https://perma.cc/R7KG-EEAJ].

[89] *See* Brad M. Barber, *Monitoring the Monitor: Evaluating CalPERS' Activism*, J. INVESTING, Winter 2007, at 66, 77. More generally, in any given period, a small number of stocks may account for nearly all of the market risk premium, *see* Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?*, 129 J. FIN. ECON. 440 (2018). Less than optimal diversification can accordingly be extremely costly.

[90] *See* Hendrik Bessembinder, Frictional Costs of Fossil Fuel Divestment 2–3 (June 3, 2016) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2789878 (on file with the Columbia Busines Law Review).

[91] *See* Barber, *supra* note 89, at 77 ("[T]he [CalPERS tobacco divestment] decision was almost certainly motivated by moral, rather than investment, considerations.").

[92] *See* Aleksandar Andonov, Yael V. Hochberg & Joshua D. Rauh, *Political Representation and Governance: Evidence from the Investment Decisions of Public Pension Funds*, 73 J. FIN. 2041, 2043–45 (2018).

the presence of state officials on pension fund boards is associated with lower returns.[93] That result appears to be driven in part by politically motivated decisions to invest in particular industries or to use particular private managers.[94]

C. Agency Problems in Private Funds

There is also evidence that private fund managers' public policy preferences influence their shareholder votes. Patrick Bolton and co-authors find evidence that institutional investors' proxy votes can be placed on a left-right continuum similar to that of the well-known Poole and Rosenthal congressional voting continuum.[95] The result is consistent with ideological voting in the sense that institutional investors' choices on particular issues are predictable despite their differential impact across a portfolio. Individual money managers predictably vote in favor of, or against, shareholder proposals dealing with specific social and environmental issues.[96]

A plausible explanation for this voting pattern is that it is driven by the personal views of fund managers. Ideological voting, however, is self-interested, regardless of the sincerity of the fund managers' beliefs that environmental and social issues are among society's most pressing problems.

Some private fund managers may also wish to avoid unpleasant conflicts and confrontations. Money managers face pressure from social peers, individual politicians, and activists to show that they are on the "right side" of current political issues.[97] As Barzuza, Curtis, and Webber point out, fund managers also face pressure from their own employees to incorporate ESG principles into investment decisions.[98] These pressures are intended to, and may, lead fund managers who value the quiet life to fall in line with ESG principles even if they are not persuaded they are in the beneficiaries' interests. In doing so, the fund manager acts on the basis of personal interest.

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[93] *See id*. at 2043 (finding that increases in the fraction of board members who are state officials reduce the internal rate of return on private equity investments).
[94] *See id.* at 2043–45 (finding also that elected officials lack financial expertise but that this cannot explain the underperformance of more qualified appointees).
[95] *See* Patrick Bolton et al., *Investor Ideology*, 137 J. FIN. ECON. 320, 320–22 (2020).
[96] *See id.* at 321–22.
[97] *Cf., e.g.*, 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 (2020) (describing pressures applied by social activists and investors).
[98] *See id.* at 1251. It is important to distinguish selection from self-interest. Individuals who work in a fiduciary capacity may choose to work only for beneficiaries who share their values. They may not choose to ignore beneficiary interests that conflict with their personal values. For example, lawyers may choose not to represent particular categories of criminals; they may not represent them and intentionally lose their cases.

D. Does the Urgency of the Problem Justify Activism Regardless of its Effects on Beneficiaries?

One might acknowledge that fund managers are motivated in part by their own or their employees' and peers' policy preferences but nevertheless argue that they are acting in society's best interests. Under this view, a fund CEO who believes that climate change is the greatest threat the country faces and that political actors haven't done enough to address it is justified in demanding that portfolio companies prepare for a zero-carbon economy.

This is a corporate social responsibility argument once removed. Corporate social responsibility, or stakeholder capitalism, refers to the idea that corporations should take actions to benefit constituencies other than shareholders, sometimes at the expense of shareholder returns.[99] By extension, institutional investors should use their voting rights to encourage corporate managers to act in socially responsible ways even at some cost to their beneficiaries.

Indeed, some money managers hedge the claim that ESG practices are "good for business" with a corporate social responsibility argument. For example, BlackRock and other asset management firms signed the 2019 Business Roundtable statement on corporate purpose stating that corporate managers owe duties to stakeholders including employees, customers, suppliers, and local communities.[100]

The argument against delegating the solution to social problems to corporate and fund managers turns on issues of competence, legitimacy, and conflicts of interest. These issues do not go away simply because the social problems are serious.

Milton Friedman famously argued that the social responsibility of a business is "to increase its profits so long as it stays within the rules of the game."[101] Many commentators focus on the first part of that quotation and take it as a "greed is good" manifesto.[102] Read as a whole, however, Friedman's focus was on the division of labor in a market-oriented democratic society.[103] Law and regulation impose constraints on businesses that permit corporate managers

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[99] *See* Leonardo Becchetti, Rocco Ciciretti, and Iftekhar Hasan, *Corporate Social Responsibility, Stakeholder Risk, and Idiosyncratic Volatility*, 35 J. CORP. FIN. 297, 298 (2015).
[100] *Statement on the Purpose of a Corporation*, BUS. ROUNDTABLE, https://system.businessroundtable.org/app/uploads/sites/5/2021/02/BRT-Statement-on-the-Purpose-of-a-Corporation-Feburary-2021-compressed.pdf [https://perma.cc/9LKS-5JAN] (last updated Feb. 2021).
[101] FRIEDMAN, CAPITALISM AND FREEDOM, *supra* note 1, at 133.
[102] *See, e.g., generally Greed Is Good. Except When It's Bad*, *supra* note 1.
[103] *See* Friedman, *A Friedman Doctrine*, *supra* note 1 ("On the level of political principle, the imposition of taxes and the expenditure of tax proceeds are governmental functions. . . . We have a system of checks and balances to separate the legislative function of imposing taxes and enacting expenditures from the executive function of collecting taxes and administering expenditure programs and from the judicial function of mediating disputes and

to act—within the constraints—as faithful agents for their principals while still serving society's interests as mediated through the political process.

In a system of shareholder primacy, boards of directors select managers based on their competence as managers rather than as political theorists or policy analysts. The board delegates substantial discretion to the managers because their skills and authority are well-aligned with their assigned tasks. The severe agency problems that would otherwise accompany this delegation are mitigated by the single and measurable obligation to maximize profit.[104] Externalities and other social problems that the single-minded pursuit of profit might create are mitigated through law and policy, which set constraints within which corporate managers must operate.

Like operating companies, asset management firms select managers based on their ability to maximize beneficiary returns, making them an insular group. The CEOs of the five largest U.S. asset management firms—BlackRock, Vanguard, Fidelity, State Street, and J.P. Morgan[105]—all have MBAs, four of them from Harvard.[106] All have extensive industry experience. While well-qualified to manage beneficiary funds, they are hardly representative of the population at large. Nor do they have the political legitimacy that comes from election to office. Their role in managing tradeoffs among social goals is self-appointed.

In addition to questions of competence and legitimacy, one should also be skeptical of corporate or fund managers taking the role of social problem solvers because it risks exacerbating managerial agency problems. A manager accountable to multiple constituencies, by definition, has more discretion than one accountable to a single constituency. By declaring an

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interpreting the law. Here the businessman—self-selected or appointed directly or indirectly by stockholders—is to be simultaneously legislator, executive and jurist.").

[104] *See id*. (noting that in deploying corporate assets to solve social problems, corporate fiduciaries are "guided only by general exhortations from on high to restrain inflation, improve the environment, and so on and on."). *See also* Brian Cheffins, *Stop Blaming Milton Friedman* 37 (ECGI, Working Paper No. 523/2020, 2020) (noting that "Friedman was alive" to the logic that "managerial discipline is fortified if profits are the top priority because executive performance can be assessed in accordance with a single, comprehensible metric").

[105] *See* ADV RATINGS, AMERICA'S TOP 50 ASSET MANAGERS BY AUM, https://www.advratings.com/top-us-asset-managers [https://perma.cc/4HDA-XNTN] (last visited Apr. 2, 2021).

[106] *See Larry Fink*, BLACKROCK, https://www.blackrock.com/corporate/about-us/leadership/larry-fink [https://perma.cc/WF8B-M2TX] (last visited Apr. 7, 2021); *Our Leaders*, VANGUARD, https://about.vanguard.com/who-we-are/our-leaders/ [https://perma.cc/3UQA-NQ6R] (last visited Apr. 7, 2021); *Abby Johnson*, LINKEDIN, https://www.linkedin.com/in/abbyjohnson/ (on file with the Columbia Business Law Review) (last visited Apr. 7, 2021); *Ronald O'Hanley*, LINKEDIN, https://www.linkedin.com/in/ronald-o-hanley-444aa693/ (on file with the Columbia Business Law Review) (last visited Apr. 7, 2021); *Jamie Dimon*, LINKEDIN, https://www.linkedin.com/in/jamie-dimon-65634172/ (on file with the Columbia Business Law Review) (last visited Apr. 7, 2021).

intention to serve multiple constituencies, managers assign themselves the discretionary task of deciding which constituency to favor in any given decision. Managers can use that expanded discretion to pursue personal ends. By contrast, holding corporate or fund managers to a single metric makes it easier for their shareholders or beneficiaries to measure and monitor their performance, thereby reducing agency costs.

Critics of stakeholder capitalism note that in the past it has served as a smokescreen for managers to pursue self-interested policies.[107] In the 1980s, corporate managers lobbied for statutes permitting them to take account of the interests of non-shareholder constituencies to give them another tool to fight hostile tender offers.[108]

The self-interest underlying ESG activism is more subtle. It is a means to pursue the preferred public policies of the fund's managers and employees outside the formal political process. Like Friedman, however, we take the view that differences of opinion over questions of public policy should be resolved through votes at the political ballot box rather than on the corporate proxy card.

Interestingly, the Business Roundtable's CEO has argued that its statement on corporate purpose is broadly consistent with democratic governance and shareholder primacy:

> We agree that business shouldn't usurp government's proper role. Companies can, however, do their part by investing in their employees, customers, suppliers and communities. Far from undermining shareholders or capitalism, the many actions major corporations are taking to support all stakeholders will pay dividends, especially as the American economy battles to grow again.[109]

This letter's critics, by contrast, construe it as a manifesto for managers to balance the interests of multiple constituencies rather than pursue shareholder interests.[110] It is too early to know which view will prove correct in practice.

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[107] *See* Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 165 (2020).

[108] *See* Mark J. Roe, Takeover Politics, in The Deal Decade: What Takeovers and Leveraged Buyouts Mean for Corporate Governance 321, 338 (Margaret M. Blair, ed. 1993).

[109] Joshua Bolten, Opinion, *A Good Year for Stakeholder Capitalism*, WALL ST. J., Aug. 19, 2020, at A15.

[110] *See, e.g.*, Bebchuk & Tallarita, *supra* note 106, at 124–29 (arguing that the statement was "mostly for show" but identifying language that lent itself to bolder interpretations); Martin Lipton & William Savitt, *Stakeholder Governance—Issues and Answers*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 25, 2019), https://corpgov.law.harvard.edu/2019/10/25/stakeholder-governance-issues-and-answers/ [https://perma.cc/7EPT-Q6ET] (describing the statement as an "important [one] rejecting shareholder primacy and embracing stakeholder governance").

IV. Policy Responses

The SEC cannot assume that more ESG disclosures will be either beneficial or, at worst, harmless. That might be true were the interests of fund managers and their beneficiaries perfectly aligned when it comes to ESG activism. As we have argued, that is likely not the case. The easier the SEC makes it for funds to pursue their insiders' public policy goals, the more the SEC will disserve its primary constituency, the retail investor. How, then, should the SEC proceed in response to calls for ESG disclosures and any other disclosures that serve public policy goals? We identify the proper short-term responses and then provide more speculative thoughts about long-term responses.

A. Short-term Responses

We propose that the SEC analyze current ESG disclosure proposals using the following metric: what is the financial benefit to households whose retirement, college, and other savings are invested through pension plans, mutual funds, and other investment vehicles? This will require taking careful account of the conflicts of interest between fund managers' desires to be seen as solvers of challenging societal problems and their beneficiaries' needs to build wealth and achieve financial security.

The most likely outcome of that analysis is that the SEC should do nothing at present. Non-governmental organizations such as SASB are busy developing ESG metrics that they claim will help institutional asset managers produce superior risk-adjusted returns.[111] Those claims may or may not prove true. If not, the private asset managers who use them will underperform over time and suffer outflows of investor money.

The SEC should also consider an explicit statement that its mission is investor protection, efficiency, competition, and capital formation, not social welfare writ large. The statement might include a reminder that the support of professional money managers for ESG disclosures is evidence of investor benefit, but not conclusive evidence. The strength of the case depends on the extent of the divergence of interests between money managers and their clients over ESG activism. Finally, the SEC might reiterate that companies must disclose material risks, including known events and uncertainties.

[111] *See, e.g.*, SUSTAINABILITY ACCT. STANDARDS BD., *supra* note 17, at 1–2.

Adopting a comprehensive, one-size-fits-all set of ESG disclosures could harm the retail investors who should be the SEC's primary concern and potentially harm the agency itself. We have already addressed the possibility that these disclosures will make it easier for fund managers to pursue their own ideological or other interests at the expense of beneficiary returns. They may also harm retail investors by reducing the set of investments available to them.

The SEC's use of disclosure policies to become a covert environmental and social regulator may decrease further the number of public companies to the detriment of small investors. Unlike a carbon tax that could be broadly imposed across the economy, the SEC's periodic disclosure rules apply to publicly traded companies only. At the margin, increasing the disclosure burden discourages companies from going public, a point that Congress recognized in the JOBS Act.[112]

This may be particularly true for ESG disclosures, which will generate risks apart from normal compliance costs. It is challenging for a company to describe how it will look in 2035 or 2050 without making substantial mistakes, which may generate litigation well before those years arrive. Disclosures that come in the form of a climate "score" or a carbon "cost" will necessarily put some publicly traded companies in the crosshairs of politicians and activists.

The result will be to reduce the incentive for current public companies to remain public and for privately held businesses to go public. Driving carbon-intensive assets into private or non-U.S. ownership will not provide the desired climate benefits but will reduce the assets available for investment by U.S. retail investors.

Discouraging IPOs would have the same bad effects by reducing opportunities for retail investors to invest in early-stage companies. Because those companies may also be relatively fast-growing, keeping them out of the public markets may make it harder for average households to build wealth. Wealthier investors who can invest in private equity vehicles and the asset managers who sponsor those vehicles will be less affected. But reducing investment opportunities for Main Street investors may increase wealth inequality, contrary to the social objectives of ESG advocates.[113]

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[112] The JOBS Act sought to "improv[e] access to the public capital markets for emerging growth companies," Pub. L. No. 112-106, 126 Stat. 306, 306 (2012) by, inter alia, reducing those companies' disclosure obligations. *See, e.g.*, *id.* sec. 102(b), §§ 7(a), 13(a), 126 Stat. at 309–10.

[113] *See, e.g.*, Economic Inequality: Putting the S into ESG (2017), https://www.unpri.org/academic-research/economic-inequality-putting-the-s-into-esg/547.article

ESG disclosure requirements would not be the first example of a symbolic regulatory mandate adopted for reasons unrelated to an agency's normal mission that manages to harm some of its intended beneficiaries. Conflict minerals disclosure provides a useful cautionary tale. Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to promulgate regulations requiring disclosure of a company's use of certain minerals originating in the Democratic Republic of the Congo (DRC).[114] Congress's stated purpose in adopting the provision was to alleviate an "emergency humanitarian situation" in the DRC.[115]

The provision did not aim to help investors make investment decisions. It was designed to shame companies into reshaping their supply chains to avoid possibly introducing conflict minerals into their operations. Given the difficulty of tracing minerals back to their original sources, the statute had the predictable if unintended consequence of inducing companies to avoid sourcing any products from Congolese manufacturers, with "devastating" consequences for its intended beneficiaries.[116]

More recently, a staff report by the Federal Reserve Bank of New York analyzed whether and how the central bank could use interest rate policies to alleviate racial inequality as President Biden suggested during his 2020 campaign.[117] The staff economists found that lower interest rates may reduce the racial income gap but exacerbate the wealth gap. The report therefore concluded that accommodative monetary policy "may well accentuate inequalities for extended periods."[118] Because mandates adopted to signal that an agency is "doing something" about a public policy problem may take the agency into territory where it has neither expertise nor experience, they may be unusually likely to backfire.

ESG regulation also presents risks to the SEC itself. The agency's claim to a degree of policy autonomy and judicial deference is based on the idea that it is a technocratic, expert body insulated from day-to-day political pressures. Wading into controversial areas of public policy under the guise that they can be shoehorned into the SEC's disclosure mandate is good neither

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[114] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 1502(b), § 13, 124 Stat. 1376, 2213–15 (2010) (codified at 15 U.S.C. § 78m(p) (2018)).
[115] *See id.* sec. 1502(a), 124 Stat. at 2213.
[116] *See* John Berlau & Seth Carter, *Dodd-Frank Undermines the Fight Against Covid*, WALL ST. J. (Oct. 27, 2020, 7:07 PM), https://www.wsj.com/articles/dodd-frank-undermines-the-fight-against-covid-11603840074 (on file with the Columbia Business Law Review).
[117] *See* ALINA BARTSCHER ET AL., FED. RESERVE BANK OF N.Y., STAFF REP. NO. 959, MONETARY POLICY AND RACIAL INEQUALITY 1, 12–15 (2021).
[118] *Id*. at 2.

for policy nor for the agency. For that reason, former SEC Chair Arthur Levitt, a Democrat appointed by President Clinton, recently urged the SEC not to approve Nasdaq's rule proposal regarding board diversity.[119] His message was simple: "the SEC shouldn't be drawn into politics."[120]

We suspect that the SEC's Commissioners and staff agree with that message in the abstract. Many, however, would disagree that adopting ESG disclosure mandates draws the SEC into politics. The supporters of ESG disclosure mandates within the agency have argued consistently that they are responding to investor demand for more ESG-related information.[121]

It should, however, be a concern that the investors demanding more ESG disclosures are not investing their own money.[122] The CalPERS election described above indicates that beneficiaries may not agree with fund managers that ESG activism improves returns. Fairly or not, many individual investors, voters, and politicians will conclude that the SEC is taking sides in policy debates that divide along ideological and party lines.[123] Doing so would threaten the bipartisan support the SEC has traditionally enjoyed. It would also leave the SEC open to future calls by either party's presidents to use the agency's powers to support their policy agendas.[124]

B. Long-Run Responses

The apparent willingness of some institutional investors to prioritize policy goals over beneficiary returns should lead the SEC and other policy makers to consider longer-run solutions to the new separation of ownership and control. Here we offer a tentative and incomplete set of potential policy changes.

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[119] For a summary of the rule, see *supra* text accompanying notes 23–26.
[120] Arthur Levitt Jr., Opinion, *If Corporate Diversity Works, Show Me the Money*, WALL ST. J., Jan. 21, 2021, at A17.
[121] *See* Allison Herren Lee, Acting Chair, U.S. Sec. & Exch. Comm'n, A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC (March 15, 2021), https://www.sec.gov/news/speech/lee-climate-change [https://perma.cc/PN2U-PXCR].
[122] *See id.* at n. 3 (identifying BlackRock, Bank of America Merrill Lynch, and State Street Global Advisors as examples of investors that seek to use ESG disclosures).
[123] *See, e.g.*, *Important Issues in the 2020 Election*, PEW RSCH. CTR. (August 13, 2020), https://www.pewresearch.org/politics/2020/08/13/important-issues-in-the-2020-election/ [https://perma.cc/XSG4-TRAC] (reporting that 68% of Biden supporters and 11% of Trump supporters view climate change as an issue "very important" to their vote).
[124] *Cf.* Stephen M. Bainbridge, *Corporate Purpose in a Populist Era*, 98 NEB. L. REV. 543, 568 (2020) (explaining how "corporate social responsibility" initiatives could be used as tools for promoting conservative goals including "protection of American jobs from the forces of globalization" and the "defense of traditional cultural and social mores").

The SEC might consider requiring mutual funds to pass through voting rights to their shareholders.[125] This suggestion has been criticized on the grounds that individual investors lack the expertise and time to make sensible use of voting rights in hundreds of companies.[126] If proxy votes for publicly traded companies increasingly become referenda on public policy issues, however, individual investors will presumably wish to express their views. The market may even respond with proxy advice aimed at individual investors and tailored to political preferences.

A more fundamental change would be to repeal Regulation 14A[127] and replace it with simple anti-fraud and disclosure rules, thus returning the detailed regulation of proxy voting to the states. A state that wished to encourage companies to make their annual meetings a forum to vote on shareholder proposals designed to advance public policy goals could do so, while other states might choose to be more restrictive. The market would then decide which approach maximizes shareholder welfare.[128]

Conflicts of interest between public pension funds and their beneficiaries pose a trickier problem. Formally, state constitutions or statutes often require trustees to consider only the interests of beneficiaries when making investment and voting decisions.[129] As the California and New York pension funds have demonstrated, however, trustees can treat these as check-the-box compliance issues that constrain what trustees may say but not what they may do.[130]

We accordingly agree with Romano that "there are no practical solutions to the problem of political influence on public pension funds short of a substantial restructuring of the funds toward defined contribution plans."[131] That is a policy change outside the scope of securities

[125] *See* CALEB GRIFFIN, REFORMING INDEX FUND VOTING 5 (2020), https://www.mercatus.org/system/files/griffin_-_policy_brief_-_we_three_kings_disintermediating_voting_at_the_index_fund_giants_-_v1.pdf [https://perma.cc/42VZ-MJKS].
[126] JOHN GULLIVER ET AL., COMM. ON CAP. MKTS. REG., REFORMING U.S. CAPITAL MARKETS TO PROMOTE ECONOMIC GROWTH 130–31 (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3619023 (on file with the Columbia Business Law Review).
[127] 17 C.F.R. §§ 14a-1 to -104, 14b-1 to -2 (2020).
[128] *See* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 290–92 (1977) (discussing the benefits of state competition).
[129] *See, e.g.,* CAL. CONST., art. XVI, § 17(b).
[130] *See supra* notes 76–86 and accompanying text.
[131] Romano, *supra* note 71, at 799.

regulation, but one that state governments may adopt for their own reasons as pension costs rise.[132]

In the longer run, Congress should consider whether having an important and influential class of public company shareholders whose voting decisions are politically influenced is healthy for the economy. An easy answer is that public pension funds are not majority shareholders of the firms in which they invest and so do not raise the traditional concerns of government as controlling shareholder. Government pension funds at all levels own approximately 6% of U.S. equities[133] and, as diversified investors, do not own controlling stakes in portfolio firms.

That easy answer is a bit too easy. Public pension funds exercise influence over corporate policies out of proportion to their ownership precisely because they are not as constrained by market forces as other investors. The sheer size of the largest public pension funds also gives them influence over other money managers. CalPERS, for example, requires the external private money managers to whom it outsources part of the management of its funds to vote proxies in accordance with CalPERS' investment principles.[134]

Moreover, the negative effects of government ownership do not kick in only when a government entity takes control of a private business. The announcement of a government entity's acquisition of a non-controlling stake in a publicly traded firm can produce a negative stock price reaction as well.[135] Interestingly, the effect is positive if the acquirer is expected to be financially motivated and negative if it is expected to be politically motivated.[136]

During the fortunately brief window of widespread Treasury investment in the banking system, commentators debated mechanisms the government could use to minimize its influence over corporate policy, including the use of options or non-voting preferred shares.[137] If public

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[132] *See* PEW CHARITABLE TRS., THE STATE PENSION FUNDING GAP: 2017, at 6 fig.2 (2019) (showing that from late 1990s to 2017, the difference between the value of state pension fund assets and actuarial liabilities fell from a surplus of about 5% of GDP to a deficit of more than 8% of GDP).

[133] See KOLCHIN, *supra* note 57, at 14.

[134] *See* CALPERS, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM TOTAL FUND INVESTMENT POLICY 57 (2020), https://www.calpers.ca.gov/docs/total-fund-investment-policy.pdf [https://perma.cc/LYS4-C4FH].

[135] *See* Kateryna Holland, *Government Investment in Publicly Traded Firms*, 56 J. CORP. FIN. 319, 320 (2019) (finding this reaction particularly for "government investors that are most likely to have political motivations").

[136] *See id.* at 328, 329 tbl.4.

[137] *See, e.g.*, Matthew R. Shahabian, *The Government as Shareholder and Political Risk: Procedural Protections in the Bailout*, 86 N.Y.U. L. REV. 351, 379–84 (2011) (suggesting that administrative law can constrain the federal government's use of shareholder powers); J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 347–49 (2010) (arguing in favor of the government taking options rather than equity).

pension funds continue to act as policy-making bodies for out-of-state businesses, the same issues will resurface. Congress could simply choose to deny voting rights in public companies to government entities or their agents.

V. Conclusion

The Dodd-Frank Act included several new disclosure mandates designed to further public policy goals unrelated to the SEC's traditional concerns of investor protection and market quality, including conflict mineral use,[138] mine safety,[139] and CEO pay ratio.[140] Any hope that this was an anomaly resulting from Congress's rushed reaction to a financial crisis has been dashed as pressure mounts on the SEC to adopt ESG disclosure mandates. These mandates, no matter how they are justified, would be designed to facilitate pressure on companies to comply with desired but not-yet-enacted environmental and social policies.

The future of securities regulation, then, depends on how the SEC responds. It could, and we think should, continue to insist that companies disclose material risks and give their managers room to determine and describe those risks, while leaving the social costs of climate change and other issues for Congress and non-financial agencies to address. Such an approach would enable the SEC to avoid the multiple dangers of lack of legitimacy, unintended consequences, and giving the impression that it is willing to take sides on sensitive political issues.

On a broader note, a central feature distinguishing poorly-functioning financial markets from well-functioning ones is the association between firm valuation and political risk.[141] A government that plays favorites among companies is a potent source of political risk. In our current political climate, the SEC, the Federal Reserve, and other agencies may face pressures to raise costs for companies that are out of step with the governing party's priorities. Should that practice become accepted, the cost of capital for a given company may rise and fall with each change of administration. The SEC, of all arms of government, should understand that robust

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[138] *See supra* notes 113–15 and accompanying text.
[139] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1503, 124 Stat. 1376, 2218–20 (2010) (codified at 15 U.S.C. § 78m-2 (2018)).
[140] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 953(b), 124 Stat. at 1904.
[141] See Robin L. Diamonte, John M. Liew & Ross L. Stevens, *Political Risk in Emerging and Developed Markets*, FIN. ANALYSTS J., May/June 1996, at 71, 71 ("Political risk represents a more important determinant of stock returns in emerging than in developed markets.").

financial markets cannot be taken for granted. It should decline to become a transmission mechanism for political risk in the U.S. markets.