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The Agency Costs of Sustainable Capitalism

Anna L. Christie

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THE AGENCY COSTS OF SUSTAINABLE CAPITALISM

ANNA CHRISTIE[*]

ABSTRACT

The passive index investing revolution and the demand for bespoke environmental, social, and governance ("ESG") investment products are the most monumental changes to shape the investor landscape for many years. These developments have been accompanied by an unprecedented concentration of power among BlackRock, Vanguard, and State Street (the "Big Three" asset managers), who are now the biggest shareholders and common owners of the vast majority of globally significant companies. Inevitably, the Big Three are among the most powerful shareholders of the companies that have been identified as major contributors to the climate crisis. Due to the failure of governments to take effective action in the global effort to combat climate change, there has been intense pressure directed at the Big Three to provide investor-driven solutions. The Big Three therefore increasingly purport to assume what I call the role of "sustainable capitalists".

In this Article, I build upon Gilson and Gordon's "agency capitalism" framework to put forward a new agency-costs theory of sustainable capitalism. In this "sustainable capitalism" framework, I show that the Big Three still exhibit some form of "rational reticence", especially with regard to firm-specific sustainability activism. I theorize that they may also be inflicted with a second agency problem that I call "rational hypocrisy". This concept is similar to corporate greenwashing as the Big Three are incentivized to claim that they have a stronger commitment to sustainability than is actually reflected in their voting and engagement records in reality. The combination of "rational reticence" and "rational hypocrisy" results in a dual-monitoring shortfall–the "agency costs of sustainable capitalism".

In the agency capitalism framework, the proposed solution was for specialist activist hedge funds to fill the monitoring shortfall by initiating firm-specific activism as "governance arbitrageurs". Analogously, in my sustainable capitalism framework, both ESG hedge funds (initiating firm-specific ESG activism) and other "responsible activists" (focusing on portfolio-wide ESG issues) can be thought of as potential candidates for the role of "ESG arbitrageurs". Successfully mitigating the problem of rational reticence depends on the complementarity of interests between the ESG arbitrageurs (as initiators) and the Big Three (as arbiters). When discussing appropriate strategies for responsible activists, I demonstrate that important lessons can be learned from a close examination of the way activist hedge funds have adapted to fit the role of governance arbitrageurs. Mitigating the problem of rational hypocrisy, however, requires a different approach. Here, I argue that responsible activists may need to focus on, and target their activism at, the Big Three themselves.

[*] Assistant Professor of Banking, Corporate and Financial Law, University of Edinburgh Law School; Research Associate, University of Cambridge Centre for Business Research.

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INTRODUCTION

The passive index investing revolution and the surge in demand for environmental, social, and governance ("ESG") investment products are the most monumental changes to sweep across the investor landscape for many years. The genesis of this unprecedented transformation in investor behavior can be traced back to the demise of the archetypal "Berle-Means corporation".[1] Epitomized by the dichotomy between powerful managers and powerless, dispersed shareholders,[2] the decades-long reconcentration of institutional investor ownership largely displaced the traditional account of the corporation in Anglo-American corporate

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

[2] *See generally* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994) (describing the political economy of the separation of ownership from control in the U.S.).

governance.[3] Particularly in the aftermath of the global financial crisis, there has been an escalating shift from active to passive investment strategies.[4] This culminated in 2019 with assets under management in passive equity funds in the U.S. officially overtaking the corresponding holdings in active equity funds.[5]

Although the active fund industry remains relatively fragmented, the passive index fund industry is extremely concentrated.[6] Consequently, the change in investor ideology has been accompanied by a massive aggregation of power among the largest asset managers who offer passive index funds at the lowest cost. The "Big Three" asset managers–BlackRock, Vanguard and State Street–are now the largest investors in the vast majority of economically significant companies in the U.S.,[7] and to an increasing extent, worldwide.[8] A relatively small number of companies have been identified as the key perpetrators of global warming.[9] Largely due to their passive index fund offerings–that mechanically track stock market indices such as the S&P 500 in the U.S. or the FTSE 100 in the U.K.–the Big Three are often the biggest shareholders, and common owners, of these offending companies. This tremendous concentration of ownership means that the Big Three have the potential to wield considerable power over the primary perpetrators of climate change as they control a significant proportion of the shares and thus the votes at those companies. With great power comes great responsibility. Calls for asset managers to exercise greater social and environmental responsibility have led to the Big Three increasingly purporting to assume what I call the role of "sustainable capitalists".[10] Namely, because Governments have failed to take swift and effective action in the global effort to combat issues such as climate change,

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[3] *See generally* Bernard S. Black, *Shareholder Passivity Reexamined* 89 MICH. L. REV 520 (1990), Edward B Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism* 79 GEO. L.J. 445 (1991) and Bernard S. Black & John C. Coffee, *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997 (1994).

[4] *See generally* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index funds, re-concentration of corporate ownership, and new financial risk* 19 BUS. & POL. 298 (2017). Passive investing generally involves replicating the performance of a specific stock market index, whereas active investing involves actively trading stocks based on assessments of firm value. *See infra* Part I A.

[5] As of 31 August 2019, passive U.S. equity assets surpassed U.S. equity fund assets by about $25 billion. $4.27 trillion (50.15%) of equity assets (in open-end and exchange-traded funds ("ETFs")) were held in passive funds compared to $4.25 trillion (49.85%) held in active funds. Over the past 10 years, active U.S. equity funds have had $1.3 trillion in outflows and their passive counterparts nearly $1.4 trillion in inflows. *See* Morningstar Research U.S. Fund Flows Report (Aug 2019) https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Fund_Flows_August2019_Final.pdf?.

[6] *See generally* John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, 5 (Harvard Public Law Working Paper No. 19-07, Sept. 20, 2018) https://ssrn.com/abstract=3247337 (detailing the "Problem of Twelve", where control of most public companies will soon become concentrated in the hands of a dozen or fewer people).

[7] Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B. U. L. REV. 721, 732-737 (2019).

[8] Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 4, at 311.

[9] Paul Griffin, *The Carbon Majors Database: CDP Carbon Majors Report 2017*, 8, https://b8f65cb373b1b7b15feb-c70d8ead6ced550b4d987d7c03fcdd1d.ssl.cf3.rackcdn.com/cms/reports/documents/000/002/327/original/Carbon-Majors-Report-2017.pdf?1499691240.

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

there has been increased pressure not only on companies but also on institutional investors to provide market-driven solutions.[11]

The quintessential agency problem in the traditional Berle-Means corporation arose due to the divergence of interests between managers and shareholders.[12] Gilson and Gordon later developed an "agency capitalism" framework where they theorized a new agency problem that arose from the divergence of interests between institutional investors and ultimate beneficial owners.[13] In this Article I build upon Gilson and Gordon's agency capitalism framework to put forward a new agency-costs theory of sustainable capitalism that accounts for the major shift to passive index investing and ESG investing. In the new "sustainable capitalism" framework, the Big Three act on behalf of diversified index investors–who are largely thought of as a proxy for wider society–and they also represent investors who have explicitly chosen to prioritize social and environmental values by investing in ESG funds.

Potential divergence between the interests of the Big Three and the ultimate index investors or ESG investors gives rise to what I call "the agency costs of sustainable capitalism".[14] Gilson and Gordon described institutional investors in the agency capitalism framework as "rationally reticent", as they would only respond to the proposals of others, rather than being proactive themselves.[15] In my sustainable capitalism framework–where the Big Three act as agents for passive index investors and ESG investors–I identify a dual-monitoring shortfall. The Big Three will most probably remain rationally reticent, especially with regard to firm-specific intervention, as many of the problematic incentives in the agency capitalism framework still persist in the new passive investing and sustainability context. However, I also theorize a second agency problem that presents itself in the sustainable capitalism framework–the risk of the Big Three exhibiting what I call "rational hypocrisy". Similar to what is commonly seen in corporate greenwashing, the Big Three might act in a rationally hypocritical manner, as they have strong incentives to claim that they uphold a higher commitment to sustainability than is actually the case in reality.

One major difference between the sustainable capitalism framework and the agency capitalism framework is that intervention on climate issues concerns systematic, rather than idiosyncratic (firm-specific) risk.[16] Environmental issues represent a portfolio-wide or market-wide problem in contrast to the firm-specific risks that received attention in the agency capitalism framework. Mirroring some of the successful interventions by the Big Three in portfolio-wide governance issues

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[11] Prominent figures including Al Gore have criticised the Big Three and other institutional investors and activists have submitted shareholder proposals to the Big Three to induce them to take sustainability issues more seriously. *See infra* Part I and Part V.

[12] *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) and John Armour, Henry Hansmann, Reinier Kraakman & Mariana Pargendler, *What is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW, 2 (Reinier Kraakman et al. eds., 2017).

[13] *See generally* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights* 113 COLUM. L. REV. 863 (2013).

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

[15] Gilson & Gordon, *supra* note 13, at 889.

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

(such as board gender diversity),[17] there may be some promise for the Big Three in their assumed role as sustainable capitalists. There is certainly a significant volume of rhetoric emanating from the Big Three in relation to climate change. The crucial question, though, is whether this rhetoric is accompanied by action.

A parallel can be drawn between the sustainable capitalist framework and the agency capitalism framework, as a monitoring shortfall exists. This gap contributes to the agency costs of sustainable capitalism. The solution that was identified by Gilson and Gordon as the primary means of reducing the agency costs of agency capitalism was for activist hedge funds to fill the monitoring shortfall left by institutional investors. Such activists were described as playing the role of governance intermediaries or arbitrageurs.[18] Similarly, in the realm of sustainable capitalism, a vocal minority of activist hedge funds have already transitioned to focus on ESG activism.[19]

In the agency capitalism framework, the combination of activist shareholders as initiators and institutional investors as arbiters arguably proved to be a reasonably successful means of mitigating the agency costs of agency capitalism. This may have been due to a general complementarity of the interests and incentives of activist hedge funds and the institutional investors who are pivotal in supporting their campaigns. Put simply, if the activist hedge fund intervention were successful, both the activist's position and the institutional investor's position would increase in value. Both sets of shareholders ultimately sought to increase shareholder value, although there could be some level of conflict inherent in whether the appropriate focus was on short-term or long-term shareholder wealth maximization.[20] Over time, there is evidence that these conflicts in time horizons were resolved to some extent, as activist hedge funds adapted their strategies incorporate a longer-term perspective, presumably to appease the institutional investors who provided crucial support to their campaigns.[21]

In the sustainable capitalism framework, I argue that ESG hedge funds may fulfil a role that no other actor is well positioned to fill. As we have seen in the agency capitalism framework, activist hedge funds are specialists in *firm-specific* intervention. Although the Big Three should rationally be more concerned with *portfolio-wide* risk in the context of climate change,[22] they could still be expected to support firm-specific sustainability initiatives. Therefore, ESG hedge funds could mitigate the problem of rational reticence in respect of firm-specific sustainability activism.

However, there is a real risk that ESG hedge funds may actually exacerbate the problem of rational hypocrisy. Hedge fund activists will only have incentives to pursue ESG strategies that they believe will contribute to the "double bottom-line"; strategies that generate significant profit as well as being environmentally or socially beneficial. As a result, ESG hedge funds may also exhibit a form of rational

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[17] 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. (forthcoming 2020), 122-127, https://ssrn.com/abstract=3439516.

[18] Gilson & Gordon, *supra* note 13, at 896-902.

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

[20] BlackRock, Vanguard and State Street all issued statements supporting long-term investment and criticizing financial engineering that creates short-term profits at the expense of sustainable value. *See* Martin Lipton, *Some Thoughts for Boards of Directors in 2017*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 19, 2018) https://corpgov.law.harvard.edu/2016/12/08/some-thoughts-for-boards-of-directors-in-2017.

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

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

hypocrisy, as their funds may outwardly focus on environmental and social issues but will ultimately only intervene when there is also a clear opportunity to make a large profit. If those dual motives do not nicely align, intervention by the hedge fund would not be rational, and a monitoring shortfall would persist.

The question then arises whether there are other appropriate intermediaries who can mitigate the agency problems of sustainable capitalism. A number of different "responsible activists" already submit climate-related shareholder proposals to large corporations.[23] These organizations ordinarily have entirely different incentives to activist hedge funds, as their primary focus will usually be mitigating climate risk. However, such organizations may lack the reputation, clout, expertise,[24] and funding that the most formidable hedge funds have amassed in order effectively challenge some of the world's most economically significant corporations. Moreover, the strategies these organizations use may, in some instances, conflict and overlap with the preferred strategies of the Big Three. In terms of providing better complementarity with the arbiters of campaigns, I demonstrate that there may be valuable lessons that responsible activists can learn from activist hedge funds' successful campaigns. Analogies can be drawn with the innovative strategies that have proven useful to activist hedge funds in their role as governance arbitrageurs, in particular the appointment of activist directors. Analyzing how activist hedge funds have adapted their tactics to appeal to institutional investors can provide insights into how ESG intermediaries can craft similar proposals in the sustainable capitalism context in order to maximize the chances of support from the Big Three.

Finally, appealing to and appeasing the Big Three as the pivotal arbiters of campaigns will not necessarily fully address or mitigate the problem of rational hypocrisy. Here, I contend that responsible activists can fulfil a useful function by targeting the Big Three themselves. I conclude by briefly considering some of the actions that have been, and can be, taken to hold the Big Three accountable in order to reduce the problem of rational hypocrisy. Only then may the agency costs of sustainable capitalism be fully mitigated.

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

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

Part III tracks the evolution of the original governance arbitrageurs identified in Gilson and Gordon's agency capitalism framework–activist hedge funds. It highlights how such activists have adapted their strategies over time to appeal to the institutional investors who are the ultimate arbiters of their campaigns, including a consideration of hedge funds' most recent foray into ESG activism.

Part IV delves more deeply into the role of ESG hedge funds and other "responsible activists" as the new "ESG arbitrageurs" in the sustainable capitalism

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[23] *See infra* Part IV C (discussing ESG shareholder proposals).

[24] *See generally* C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The second wave of hedge fund activism: The importance of reputation, clout, and expertise*, 40 J. CORP. FIN. 296 (2016).

framework. It considers the different incentives of ESG hedge funds and responsible activists and how effective their strategies may be in mitigating the dual-problems of rational reticence and rational hypocrisy. This Part also discusses the future of responsible activism. In particular, it advances some lessons that responsible activists–as ESG arbitrageurs in the sustainable capitalism framework–can learn from activist hedge fund strategies in the agency capitalism framework. Nominating climate directors is discussed as a strategy with great potential.

Part V focuses on the problem of rational hypocrisy. It argues that overcoming rational hypocrisy may require activism targeted at the Big Three themselves.

I. SUSTAINABLE CAPITALISM AND THE BIG THREE

"It is the essence of revolutions of the more silent sort that they are unrecognized until they are far advanced"[25]

--Adolf Berle & Gardiner Means--

At the World Economic Forum in Davos in January 2020, Larry Fink–the chief executive of the world's largest asset manager, BlackRock Inc–wore a scarf themed around climate change data. The scarf was designed by the 2 Degrees Investing Initiative and featured the "warming stripes"[26] visual created by U.K. climate scientist Ed Hawkins, where the color of the stripes represents the annual average temperatures of planet earth from 1850 to 2019.[27] Fink was being interviewed about his 2020 letter to CEOs, which focused on climate risk and ESG investing.[28] In January 2020, BlackRock also signed up to join a Climate Action 100+,[29] a global investor-led initiative (with its members now managing over $52 trillion in assets) which aims to ensure that the world's largest corporate greenhouse gas emitters take necessary action on climate change.[30] These bold announcements followed a period of intense pressure directed at BlackRock and other large asset managers, which urged them to take responsibility for their role in the climate crisis. Only a few weeks earlier, a coalition of shareholders had filed resolutions at BlackRock and Vanguard calling for the asset managers to review their voting policies on climate change issues, given their consistent record for voting against climate-oriented proposals.[31] Other prominent figures, including former US vice president Al Gore, similarly criticized BlackRock and Vanguard, accusing them of financing "the

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[25] Berle & Means, *supra* note 1.

[26] *#ShowYourStripes image*, https://showyourstripes.info.

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

[28] Larry Fink's 2020 Letter to CEOs, *A Fundamental Reshaping of Finance*, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

[29] Climate Action 100+, https://www.climateaction100.org. BlackRock (and Vanguard) had voted against all of the U.S. shareholder proposals backed by Climate 100+ until September 2019. *See* Majority Action, *Climate in the Boardroom: How Asset Manager Voting Shaped Corporate Climate Action in 2019*, 4, https://www.majorityaction.us/asset-manager-report.

[30] Richard Henderson, *BlackRock joins climate action group after 'greenwash' criticism*, FIN. TIMES (Jan. 9, 2020) https://www.ft.com/content/16125442-32b4-11ea-a329-0bcf87a328f2.

[31] Mercy Investment Services (the investment program me of the Sisters of Mercy of the Americas, a group of Catholic nuns) filed the resolution ahead of BlackRock's annual meeting, stating that BlackRock only supported six of 52 climate-related resolutions in 2019. *See* Attracta Mooney, *Nuns take on BlackRock over climate change*, FIN. TIMES (Dec. 15, 2019) https://www.ft.com/content/9f84e865-31ad-4a13-9398-8781e2cb0581.

destruction of human civilization".[32] Even activist hedge fund managers were vocal in their criticism. In December 2019, Christopher Hohn of TCI accused the asset manager of being "full of greenwash".[33] Thus in early 2020, BlackRock strengthened its commitment to "sustainability and climate-integrated portfolios", vowing to use its significant power as the world's largest asset manager as a force for good.[34] This Part explains how the growth of passive investing and the concentration of power among large asset managers has led to pressure for the Big Three to provide investor-driven solutions to climate change risk.

A. *The Passive Index Investing Revolution*

How did asset managers such as BlackRock, Vanguard and State Street amass such power? Much of their dominance is a by-product of the passive index investing revolution. In 1975, John Bogle and the Vanguard Group created the first index mutual fund, named the First Index Investment Trust.[35] On inception, the index fund (nicknamed "Bogle's folly" after its creator) was denounced as "un-American" and "a sure path to mediocrity".[36] It took two full decades before index funds began to earn broad acceptance in the mid-1990s.[37]

Index funds are a type of investment fund that pools the assets of multiple investors to invest in a diversified portfolio of securities.[38] The funds replicate the performance of a specific benchmark stock market index (such as the S&P 500 index in the U.S. or the FTSE 100 index in the U.K.) or track a specially designed bespoke index.[39] This passive investment approach can be contrasted with the "stock picking" strategy utilized by actively managed investment funds, where shares are actively traded based upon fund managers' firm-specific analysis which aims to uncover whether companies are undervalued or overvalued.[40] Passive index funds can take the form of traditional mutual funds, exchange traded funds

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[32] Leslie Hook, *Al Gore unloads on index funds*, FIN. TIMES (Dec. 11, 2019) https://www.ft.com/content/92c728e6-1ba3-11ea-97df-cc63de1d73f4.

[33] Leslie Hook & Gillian Tett, *Hedge Fund TCI vows to punish directors over climate change*, FIN. TIMES (Dec. 1, 2019) https://www.ft.com/content/dde5e4d4-140f-11ea-9ee4-11f260415385.

[34] Fink, *supra* note 28.

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

[36] Tanza Loudenback, *When Vanguard's founder first invented the index fund, it was ridiculed as 'un-American,' but 40 years later it's clear his critics were wrong*, BUS. INSIDER (Jan. 18, 2019) https://www.businessinsider.com/vanguard-jack-bogle-first-index-fund-criticism-2019-1?r=US&IR=T.

[37] Bogle, *supra* note 35, at 9.

[38] Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2043-2044 (2019); Jill Fisch, Assaf Hamdami & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 22 (2019).

[39] Jan Fichtner & Eelke M Heemskerk, *The New Permanent Universal Owners: Index funds, patient capital, and the distinction between feeble and forceful stewardship*, 49 ECON. & SOC'Y 493, 494 (2020); Fisch, Hamdani & Davidoff Solomon, *supra* note 38, at 21 (citing Adriana Z. Robertson, *Passive in Name Only: Delegated Management and Index Investing*, 36 YALE J. ON REG. 795 at 821 (2019) (explaining the nature of bespoke indices)).

[40] Bebchuk & Hirst, *supra* note 38, at 2043-2044.

("ETFs"),[41] or any other investment vehicle that algorithmically tracks a pre-defined index.[42] This can include bespoke ESG index funds.

The principle of indexation is grounded in Modern Portfolio Theory[43] and reflects the ideology that few investors can reliably and consistently "beat the market" with a more active, stock picking, strategy.[44] Empirical studies comparing the performance of active and passive funds reveal that the majority of active funds have not been able to generate higher returns compared with benchmark indices such as the S&P 500.[45] As a result, diversifying an investor's portfolio to hold virtually the entire stock market for the long-term is generally thought to earn the highest risk-adjusted return. This is particularly the case after the deduction of investment costs such as advisory fees, as indexation minimizes portfolio turnover and thus operating costs.[46] Index funds are advantageous to ultimate investors for a multitude of reasons, including reduced risk through diversification and very low, or even non-existent,[47] management fees.

The "momentous rise" of passive index funds has been described as a "pivotal shift" in capital migration from active to passive asset management.[48] In August 2019 it was reported that passive equity funds in the U.S. had officially overtaken active equity funds in terms of assets under management.[49] One newspaper report went so far as to proclaim that index funds are "eating the world".[50] This dramatic shift in investor behavior became particularly pronounced in the years following the 2008 financial crisis, when both individual and institutional investors "massively shifted capital from expensive, actively managed mutual funds to cheap, index mutual funds and exchange traded funds."[51] At the beginning of 2010, there was about $2.3 trillion in index funds whereas at the end of 2019, the global passive index investing market was worth $11.4 trillion.[52] The gravitation towards index funds has been driven by growing recognition of their low costs and tax benefits, together with increasing evidence that they outperform the majority of actively

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[41] Index funds are traded only once a day after markets have closed whereas ETFs can be bought and sold continuously during the entire trading day. *See* Benjamin Braun, *From Performance to Political Economy: Index Investing, ETFs and Asset Manager Capitalism* 21 New Pol. Econ. 257, 266 (2016).

[42] Bebchuk & Hirst, *supra* note 38, at 2044 (citing Lois Yurow, Timothy W. Levin, W. John McGuire & James M. Storey, MUTUAL FUNDS REGULATION AND COMPLIANCE HANDBOOK (2017) § 4:1 and William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problem of Mutual Funds* 33 DEL. J. CORP. L. 69, 76-86 (2008) (on the rules governing mutual funds and ETFs)).

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

[44] Coates, *supra* note 6.

[45] Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 101, 114 (2018).

[46] Bogle, *supra* note 35, at 9.

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

[48] Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 4, at 300.

[49] Morningstar, *supra* note 5.

[50] Jason Zweig, *Are Index Funds Eating the World?*, WALL ST. J. (Aug. 26, 2016) https://blogs.wsj.com/moneybeat/2016/08/26/are-index-funds-eating-the-world.

[51] Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 4, at 299.

[52] Robin Wigglesworth & Alex Janiaud, *Index funds break through $10tn-in-assets mark amid active exodus*, FIN. TIMES (Jan. 8, 2020) https://www.ft.com/content/a7e20d96-318c-11ea-9703-eea0cae3f0de (citing Morningstar data).

managed equity mutual funds.[53] For these reasons, index funds at least "seem to be a rare case of financial innovation that actually helps regular people" and have been described as "a populist victory, as finance goes".[54]

The transition from active to passive investing is likewise taking place in the U.K. and Europe, although the ascendancy of index investing is generally less pronounced than in the U.S., where the concept was pioneered. In the U.K., around 26% of assets are held in passive index funds.[55] In Europe, passive index funds make up around 20% of the assets under management, with individual European countries varying significantly (e.g. Switzerland 58.7%, Germany 11.1% and Italy 0.05%).[56] Although the rise of passive investing in Europe is less dramatic than the U.S., it has nevertheless experienced significant growth in the past decade.[57]

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

The fundamental shift in investor ideology described in Section A above has led to a significant aggregation of power among the largest asset managers who offer passive index funds at the lowest cost. Although the active fund management industry is relatively fragmented, the index fund industry is extremely concentrated. The "Big Three" asset managers are now the largest investors in the vast majority of economically significant companies. Collectively, they have global assets under management of over $18 trillion, with BlackRock's portfolio amounting to $7.81 trillion,[58] Vanguard's $7.1 trillion[59] and State Street's $3.1 trillion.[60] To put that into perspective, the GDP of the world's largest three economies is $21.43 trillion[61] for the U.S., $14.34 trillion for China[62] and $5.08 trillion for Japan.[63] The Big Three's concentration of power is also accelerating rapidly. From 2016 to 2020, their assets under management grew by over 125%.[64] There is unlikely to be a serious challenge to the market power of the Big Three, which led Bebchuk and Hirst to predict that "the Big Three will likely continue to grow into a "Giant Three"".[65] One of the main reasons for this continuing concentration of asset managers is that passive

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

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

[55] Steve Johnson, *Passive funds' share of European investment market jumps to 20%*, FIN. TIMES (Dec. 8, 2020) https://www.ft.com/content/0b5325da-585f-41ad-8267-0741e9693a7a.

[56] id.

[57] *See* Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV. 803, 811-812 (2018) (outlining that this growth is expected to continue given regulatory changes in EU financial markets).

[58] Global assets under management at 30 September 2020. *See* https://www.blackrock.com/sg/en/about-us.

[59] Chris Flood, *Vanguard's assets hit record $7tn*, Fin. Times (Jan. 13, 2021) https://www.ft.com/content/3b80cd1d-8913-4019-b6aa-b6f6ddb155a5..

[60] Global assets under management at 30 September 2020. *See* https://newsroom.statestreet.com/press-releases/press-release-details/2020/State-Street-and-Neuberger-Berman-Extend-Mutual-Fund-Servicing-Agreement/default.aspx.

[61] World Bank data, https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=US.

[62] World Bank data, https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=CN.

[63] World Bank data, https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=JP0.

[64] *See* Bebchuk, Cohen & Hirst, *supra* note 53 at 94 (noting that BlackRock, Vanguard and State Street Global Advisors had assets under management of $3.1 trillion, $2.5 trillion and $1.9 trillion, respectively in 2016).

[65] Bebchuk & Hirst, *supra* note 7, at 723.

index investing is a business of scale[66] and the Big Three have the benefit of first-mover advantage. They now dominate the market, managing over 90% of all assets under management in passive equity funds.[67] Therefore, they occupy a "quasi-monopolistic"[68] position and form an "oligopoly".[69] It would be extremely difficult for new entrants or even large pre-existing asset managers to make meaningful inroads into that level of market power.

Due to their passive index fund holdings, the Big Three are now permanent shareholders in the majority of companies globally. In the U.S., they control more than 20% of the shares of the average S&P 500 company, which translates into more than 25% of shares voted in such companies.[70] After the U.S., the U.K. is the jurisdiction with the next most significant blockholdings held by the Big Three, amounting to more than 10% of the shares of the average FTSE 100 company.[71] Therefore, unlike the traditional Berle-Means corporation which was characterized by "strong managers and weak owners",[72] the Big Three are in principle extremely strong shareholders of the member firms of the major U.S. and U.K. stock market indices. Even before the exponential rise of passive index investing as an investment strategy, Gilson and Kraakman opined that "we lack a normative model for how shareholders who invest "in the market" should behave towards the companies in which they invest."[73] In the current climate crisis, this is particularly important, as discussed in Section C below.

C. *Who Fuels the Fossil Fuel Industry?*

Since 1988[74] it is estimated that over half of global emissions have been caused by only 25 corporate and state entities (a list that includes U.S. companies

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[66] *See generally* Patrick Jahnke, *Ownership concentration and institutional investors' governance through voice and exit*, BUS. & POL. 327 (2019).

[67] Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 4, at 304.

[68] Jan Fichtner, Eelke Heemskerk & Javier Garcia-Bernardo, *These three firms own corporate America*, THE CONVERSATION (May 10, 2017) https://theconversation.com/these-three-firms-own-corporate-america-77072.

[69] Julie Segal, *There's an Oligopoly in Asset Management. This Researcher Says It Should be Broken Up*, INSTITUTIONAL INVESTOR (Nov. 24, 2020) https://www.institutionalinvestor.com/article/b1pcwthdczlycw/There-s-an-Oligopoly-in-Asset-Management-This-Researcher-Says-It-Should-Be-Broken-Up.

[70] Bebchuk & Hirst, *supra* note 7, at 724 (stressing that because the Big Three generally vote all of their shares, whereas not all of the non-Big Three shareholders do so, the shares held by the Big Three translate into even greater voting power). *See also* José Azar, Miguel Duro, Igor Kadach & Gaizka Ormazabal, *The Big Three and Corporate Carbon Emissions Around the World*, 20 (ECGI Finance Working Paper No. 715/2000, Dec. 2020) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3553258 (noting that this measure of Big Three ownership is a lower bound estimate of the total amount of claims owned directly or indirectly by these institutions).

[71] Fichtner & Heemskerk, *supra* note 39, at 502. *See also* Suren Gomtsian, *Shareholder Engagement by Large Institutional Investors*, 45 J. CORP. L. (forthcoming 2020), 11, https://ssrn.com/abstract=3412886 (noting that in 2017 BlackRock and Vanguard were among the top 10 shareholders in 90% of FTSE 100 companies with average shareholdings of 6.49% and 2.09%, respectively and noting that BlackRock was the largest shareholder in almost half of those companies, sometimes with shareholdings above 10%).

[72] Roe, *supra* note 2.

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

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

ExxonMobil, Chevron and ConocoPhillips and U.K. companies Shell and BP).[75] Therefore, a relatively small number of companies have been identified as the key corporate perpetrators of global warming. Each of the U.S. and U.K. companies identified on the list of the key 25 perpetrators is either a constituent of the U.S. S&P 500 index or the U.K. FTSE 100 index.

The implications of the massive shift to passive investing need to be understood in the context of the risk posed by climate change. In recent years, pressure on university endowments, pension funds and other institutions to divest from fossil fuel companies has intensified. Divestment campaigns and protests are increasingly successful and large numbers of funds continue to actively divest (or commit to divest) from fossil fuels.[76] Given the continuing mass exodus of actively managed portfolios from fossil fuel investments, and the continued rise of passive index funds that track the major stock market indices, the biggest shareholders of the prominent fossil fuel companies are now passive index funds. In terms of fossil fuel investments, index funds are becoming "the holders of last resort".[77] To illustrate, Table 1 shows that the Big Three collectively manage more than 20% of the stock of all eight oil and gas exploration and production companies in the S&P 500.

TABLE 1: PERCENTAGE OF STOCK IN EIGHT LARGEST U.S. OIL AND GAS EXPLORATION AND PRODUCTION COMPANIES HELD BY THE BIG THREE[78]

Corporation (by market value)	*Percentage of Stock Held*			
	BlackRock	*Vanguard*	*State Street*	*Big Three collectively*
ExxonMobil Corp	6.71%	8.43%	5.17%	20.31%
Chevron Corp	6.98%	8.50%	6.35%	21.83%
ConocoPhillips	8.05%	8.41%	5.12%	21.58%
Marathon Petroleum Corp	11.27%	9.95%	5.77%	26.99%
Occidental Petroleum Corp	5.97%	9.97%	5.46%	21.22%
Hess Corp	6.77%	10.02%	5.10%	21.89%
Devon Energy Corp	6.69%	9.86%	6.30%	22.85%
Apache Corp	6.08%	8.90%	5.72%	20.70%

These holdings are largely comprised of passive index funds. It was reported in 2019 that 98.2% of Vanguard's fossil fuel investments are held in passive funds, with the corresponding figures for BlackRock and State Street being 88.7% and 99%, respectively.[79]

[75] Griffin, *supra* note 9.

[76] To date, gofossilfree.org estimates that $14.5 trillion and over 1300 institutions have either divested or committed to divest from fossil fuels. *See* https://gofossilfree.org/divestment/commitments/.

[77] *See generally* Patrick Jahnke, *Holders of Last Resort: The Role of Index Funds and Index Providers in Divestment and Climate Change* (Working Paper, Mar. 9, 2019) https://ssrn.com/abstract=3314906.

[78] Ownership data at 30 September 2020, extracted from Fidelity Stock Research Center, https://eresearch.fidelity.com/eresearch/landing.jhtml.

[79] Patrick Greenfield, *World's top three asset managers oversee $300 bn fossil fuel investments: Data reveals crucial role of BlackRock, State Street and Vanguard in climate crisis*, THE GUARDIAN (Oct. 12, 2019) https://www.theguardian.com/environment/2019/oct/12/top-three-asset-managers-fossil-fuel-investments.

Climate Action 100+ also keeps an up-to-date list of "focus companies" that are key to driving the global net-zero emissions transition. At present, they have selected 167 focus companies for engagement, which account for over 80% of corporate industrial greenhouse gas emissions.[80] Of the nine U.K. companies on this list, eight are in the FTSE 100 index and one is in the FTSE 250 index. Of the 42 U.S. companies on the list, 40 are in the S&P 500 index. All of these "focus companies" will have a high percentage of shares owned by the Big Three in passive index funds. This underscores the role of the Big Three as the primary agents who are most invested in the major companies fueling the climate crisis.

D. *The Big Three as Sustainable Capitalists?*

Due to increased scrutiny of the Big Three's role in the climate crisis, they have begun to assume what I call the role of "sustainable capitalists". The concept of "sustainable capitalism" was advanced in a manifesto by Al Gore and David Blood in 2011 as "a framework that seeks to maximize long-term economic value by reforming markets to address real needs while integrating environmental, social and governance (ESG) metrics".[81] In particular, Gore and Blood stressed that "businesses cannot be asked to do the job of governments, but companies and investors will ultimately mobilize most of the capital needed to overcome the unprecedented challenges we now face."[82] In the last few years, the Big Three have begun to release public statements echoing these sentiments. Larry Fink's 2020 letter to CEOs advocated "achieving a more sustainable and inclusive capitalism", noting that "while government must lead the way in this transition, companies and investors also have a meaningful role to play".[83] Moreover, State Street outlined the "important role" institutional investors have to play in sustainable capitalism, stating that "capitalism works best when there is a healthy balance of power across the state, the market and civil society."[84]

The global problem of the climate crisis should, most appropriately, be addressed by democratically elected national governments and international cooperation, by way of environmental regulation and international treaties. It has also long been recognized by corporate law scholars that "the most efficacious legal mechanisms for protecting the interests of non-shareholder constituencies…lie outside of corporate law…for the public at large, it includes environmental law and the law of nuisance and mass torts."[85] As noted by Armour and Gordon, "the consensus view is that the appropriate techniques for controlling externalities are themselves *external* to firms: that is they do not involve any modification to internal corporate governance commitments."[86] However, as Davies highlights, "faith in both these extra-corporate legal mechanisms seems to have waned over the past

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[80] Climate Action 100+ Focus List of Companies, https://www.climateaction100.org/whos-involved/companies/.

[81] Al Gore & David Blood, *A Manifesto for Sustainable Capitalism: How businesses can embrace environmental, social and governance metrics*, Wall St. J. (Dec. 14, 2011) https://www.wsj.com/articles/SB10001424052970203430404577092682864215896.

[82] id.

[83] Fink, *supra* note 28.

[84] State Street Global Advisors, *Milken Institute 2020 Global Conference, The Future of Capitalism: A Panel Discussion with Ron O'Hanley*, https://www.statestreet.com/ideas/articles/ohanley-future-of-capitalism-milken.html.

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

[86] Armour & Gordon, *supra* note 16, at 44.

decade."[87] Much like "the ability of external mechanisms to impound social costs in systematically important financial firms' profit functions", regulation dealing with the problem of climate change has similarly turned out to be "highly incomplete".[88] The climate campaigner Greta Thunberg has pointed out that "political leaders have wasted decades through denial and inaction"[89] and even in 2020–a time when the urgency of the climate crisis is much more universally accepted and is increasingly visible through extreme weather patterns and the resulting devastation–government action still remains woefully inadequate. This may justify a mandate for investor intervention. In this vein, Hart and Zingales argue that "if political change is hard to achieve, action at the corporate level is a reasonable substitute".[90] Similarly, Azar, Duro, Kadach and Ormazaball stress that "since a full-scale regulatory solution to the emissions externality problem faces severe coordination frictions across countries, corporate governance is regarded as an alternative way of addressing climate change."[91]

The Big Three themselves, together with other investors, have criticized the failure of governments to adequately address the climate crisis. In 2018, Larry Fink stated that "we see many governments failing to prepare for the future", so it falls to the private sector to "respond to broader societal challenges".[92] He also reiterated a similar message in 2019, noting that due to the "failure of government to provide lasting solutions, society is increasingly looking to companies, both public and private, to address pressing social and economic issues."[93] Further, Christopher Hohn of the activist hedge fund TCI argued in December 2019 that "investors don't need to wait on regulators who are asleep at the switch and unwilling or unable to regulate emissions properly…they can use their voting power to force change on companies who refuse to take their environmental emissions seriously. Investors have the power, and they have to use it."[94]

There are various reasons why the Big Three may voluntarily assume the role of sustainable capitalists or "surrogate regulators"[95] engaging in "private environmental governance".[96] Firstly, it could reflect the rise in consumer demand for ESG funds and a desire on the part of the Big Three to attract and retain (millennial) investors who care about issues such as climate change.[97] Secondly, it could be a response to backlash from environmental activists who have targeted the Big Three for their poor record on climate voting.[98] Thirdly, and relatedly, it

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

[88] id.

[89] Jennifer Rankin, *Greta Thunberg tells EU: your climate target needs doubling*, THE GUARDIAN (Feb. 21, 2019) https://www.theguardian.com/environment/2019/feb/21/greta-thunberg-tells-eu-your-greenhouse-gas-targets-are-too-low.

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

[91] Azar, Duro, Kadach & Ormazabal, *supra* note 70, at 6.

[92] Larry Fink's 2018 Letter to CEOs, *A Sense of Purpose,* HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 17, 2018) https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/.

[93] Larry Fink's 2019 Letter to CEOs, *Profit and Purpose*, https://www.blackrock.com/americas-offshore/en/2019-larry-fink-ceo-letter.

[94] Hook & Tett, *supra* note 33.

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

[96] *See* Condon, *supra* note 95, at 72 (citing Michael P. Vandenbergh, *Private Environmental Governance*, 99 CORNELL L. REV. 129, 174 (2013))).

[97] *See generally* Barzuza, Curtis & Webber, *supra* note 17.

[98] *See* references at note 31.

could be due to pressure from other investors the Big Three interacts with, such as pension funds. Fourthly, it could be a precaution to avoid bad publicity and pre-empt regulation that might restrict the Big Three's power.[99] Finally, it could be based on "diversified investor self-interest" to mitigate the negative impact that climate change risk could have on a fully diversified index investment portfolio.[100]

As a final point, one advantage of efforts to mitigate climate change at the company and investor level is that large asset managers such as the Big Three invest in portfolio companies worldwide. Their engagement and activism can transcend national borders and operate on a global scale. By contrast, governmental and regulatory efforts on climate change will either be limited to the national level or face signification coordination, collective action, and free rider problems on an international level. That said, it has also been noted by Condon that institutional investors' "economic incentive to mitigate the harms climate change impose on their portfolios…is not aligned with the *socially* optimal level of emissions reduction. Many of the most extreme costs of climate change will be borne by those that do not participate in the global economy, and certainly not the economy that is reflected in asset valuation."[101] Consequently, "investor action to combat climate change will most certainly not be "enough" from the perspective of the global population."[102] It is clear, therefore, that any action by the Big Three to adopt the role of sustainable capitalists–where they utilize their significant investor power to mitigate the effects of the climate crisis at the corporate level–can never be a complete solution. To be sure, Big Three intervention, or ESG investing, cannot be a substitute for a strong regulatory framework.[103] Moreover, the fact that the Big Three have the power to act as quasi-regulators also raises "important questions regarding democratic accountability and the potential to displace the role of "traditional government"",[104] as "the power to "self-regulate" is the power to play a government-like role without the government's accountability to a democratic electorate".[105] BlackRock has already been called "the fourth branch of government"[106] and "the de-facto government based on Wall Street"[107] due to its immense power. However, given the urgency of the situation, and the relative

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

[100] Condon, *supra* note 95, at 73.

[101] Condon, *supra* note 95, at 67-68. *See also* Partnoy, *supra* note 59 (noting that "only about half of Americans own any stocks at all"); and *generally,* Sanna Markkanen & Annela Anger-Kraavi, *Social impacts of climate change mitigation policies and their implications for inequality*, 19 CLIMATE POLICY 827 (2019) (citing literature for the proposition that the poorest and marginalized populations (who are least responsible for past greenhouse gas emissions) are most vulnerable to climate change).

[102] Condon, *supra* note 95, at 68.

[103] Ann Lipton, *ESG Investing, or, If You Can't Beat 'Em, Join 'Em*, *in* RESEARCH HANDBOOK ON CORPORATE PURPOSE AND PERSONHOOD, (Elizbeth Pollman & Robert B. Thompson eds. forthcoming 2021), 17 https://ssrn.com/abstract=3715935.

[104] Condon, *supra* note 95, at 65.

[105] Condon, *supra* note 95, at 72.

[106] Annie Massa & Caleb Melby, *In Fink We Trust: BlackRock Is Now 'Fourth Branch of Government'*, BLOOMBERG BUSINESSWEEK (May 21, 2020) https://www.bloombergquint.com/businessweek/how-larry-fink-s-blackrock-is-helping-the-fed-with-bond-buying.

[107] Bill McKibben, *Can Wall Street's Heaviest Hitter Step Up to the Plate on Climate Change?*, NEW YORKER (Dec. 24, 2020).

inertia of governments to properly address the global climate crisis in a meaningful and urgent way, any progress that investors can make to mitigate corporate climate change damage would in itself be a valuable contribution to society.

II. THE AGENCY COSTS OF SUSTAINABLE CAPITALISM

"The large passive managers have a real difficult decision to make. Do they want to continue to finance the destruction of human civilization, or not?"[108]

--former U.S. Vice President, Al Gore--

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

A. *Rational Reticence*

In the archetypal Berle-Means corporation, shareholders were described as "rationally apathetic", due to collective action problems and coordination costs that inhibit widely dispersed shareholders from engaging in monitoring or activism.[109] As a result of the reconcentration of ownership among institutional investors,[110] Gilson and Gordon recharacterized institutional investors as "rationally reticent".[111] Rational reticence describes a scenario where institutional investor intermediaries

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[108] Hook, *supra* note 32.

[109] *See* ROBERT C. CLARK, CORPORATE LAW 390-396 (1986) (noting that coordination costs for dispersed shareholders lead to rational apathy); Black, *supra* note 3, at 527 (noting that "the cost and futility of becoming informed leads shareholders to choose rational apathy").

[110] By the 1990s in the U.S., the "Berle-Means Corporation" was an oversimplification of the reality of the majority of U.S. public companies. *See* Black, *supra* note 3, at 574 (noting that "the model of public companies as owned by thousands of anonymous shareholders simply isn't true. There are a limited number of large shareholders, and they know each other." *See also* John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1291 (1991) (noting that "institutional ownership is disproportionately heavy at the upper end of corporate America"). In the intervening years, institutional ownership became even more pronounced. *See also* Brian R. Cheffins & John Armour, *The Past, Present and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 87 (2011) (noting that the proportion of shares of U.S. public companies held by domestic institutional investors rose from 14% in 1965 to 45% in 1985 and to 65% by 2002). *See also* Charles McGrath, *80% of equity market cap held by institutions*, PENSIONS & INVESTMENTS, Apr. 25, 2017 (noting that by 2017, institutional investors owned approximately 78% of the market value of U.S. companies and 80% of the S&P 500 index). *See also* Jennifer G. Hill, *The Trajectory of American Corporate Governance: Shareholder Empowerment and Private Ordering Combat*, 2019(2) U. ILL. L. REV. 507, 512 (2019) (noting that individual investors in the U.K. now hold only around 10% of listed U.K. equities).

[111] Gilson & Gordon, *supra* note 13, at 867, 886-889 and 895.

"have business models that limit their incentives and capacity to monitor the business choices of their portfolio companies", leading them to rationally prefer to exit a stock rather than exercise governance rights.[112] The underlying explanation for this reticence can be explained by reference to the competitive pressures that these funds are subject to. In essence, the portfolio managers of key investment intermediaries such as actively managed mutual funds and pension funds are incentivized to focus on relative performance at the lowest cost.[113] Even if it might be in the ultimate interests of the beneficiaries for the fund managers to engage in activism to improve the absolute performance of the fund, fund managers only capture a small fraction of the benefits from activism while bearing the full costs.[114] As the benefits will be enjoyed by all shareholders, other funds could free-ride on the activists' efforts without bearing any of the costs. Therefore, the incentive for any individual fund manager to engage in costly monitoring of portfolio companies, or to initiate firm-specific activism, is extremely limited.

This divergence in incentives results in institutional investors assigning "a low value to governance rights since their proactive exercise will not improve the relative performance on which the institutional investor's profitability and ability to attract assets depends."[115] Consequently, Gilson and Gordon theorized that such institutions would only "respond to proposals but are unlikely themselves to create them"[116] and that, at most, they "might engage in "governance activism" not "performance activism"".[117] This gap between the interests of institutional investors and beneficial owners is described by Gilson and Gordon as "the agency costs of agency capitalism".

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

When developing the concept of rational reticence, Gilson and Gordon highlighted three characteristics of (actively managed) mutual funds, with respect to power, reticence and responsiveness.[118] Firstly, in theory mutual funds are incredibly powerful due to the significant levels of ownership concentration among institutional investors in recent decades. Secondly, in contrast, mutual funds are not proactive at all in terms of shareholder proposals. Thirdly, mutual funds are not entirely passive shareholders as they frequently oppose management on corporate governance issues such as poison pills and staggered boards.[119] Ultimately, Gilson and Gordon characterized such funds as "stubbornly responsive but not proactive".[120]

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[112] Gilson & Gordon, *supra* note 13, at 865.
[113] Gilson & Gordon, *supra* note 13, at 889-895.
[114] Gilson and Gordon, *supra* note 13, at 889-890; Bebchuk, Cohen & Hirst, *supra* note 64, at 96-97.
[115] Gilson & Gordon, *supra* note 13, at 895.
[116] Gilson & Gordon, *supra* note 13, at 867.
[117] Gilson & Gordon, *supra* note 13, at 889.
[118] Gilson & Gordon, *supra* note 13, at 886.
[119] Gilson & Gordon, *supra* note 13, at 886-887.
[120] Gilson & Gordon *supra* note 13, at 888.

The general characteristics that Gilson and Gordon use to describe of actively managed funds in terms of power, reticence and responsiveness also seem to hold true for passively managed funds generally and the Big Three asset managers specifically. Firstly, such funds potentially have immense power, especially given the increasing concentration of ownership among the Big Three. In fact, the Big Three's power and influence far exceeds that of smaller, actively managed mutual funds because the Big Three are now the largest shareholders in most economically significant corporations. Secondly, the Big Three are similarly not proactive in terms of putting forward shareholder proposals. In an empirical study, Lucian Bebchuk and Scott Hirst noted that from 2007 to 2018, the Big Three have never submitted a single shareholder proposal.[121] Thirdly, the Big Three have demonstrated the potential to be more active in terms of portfolio-wide issues. The most prominent example of this is board gender diversity.[122]

More specifically, however, the Big Three–predominantly managing passive index funds–may have some different incentives to active fund managers. There has been a lively academic debate regarding the incentives of passive index fund managers outside of the context of sustainability[123] and there is also some scholarship on the incentives of passive index fund managers in the ESG context.[124] As a general principle, passive index funds cannot exit a stock that is a constituent of an index that the fund tracks. As noted by Vanguard's CEO, "our index funds cannot choose the shares in which they invest. We are essentially permanent capital and cannot turn the S&P 500 into the S&P 499".[125] The "exit" or "Wall Street Walk" option from Albert Hirschman's treatise on "exit, voice, and loyalty"[126] is not open to passive index funds. Pursuant to Hirschman's theory, "exit was shown to drive out voice…and it began to look as though voice is likely to play an important role in organizations only on condition that exit is virtually ruled out."[127] This point was

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[121] Bebchuk & Hirst, *supra* note 38, at 2104. *See also* Attracta Mooney, *BlackRock takes on proxy advisers in dispute over investor rights*, Fin. Times (Nov. 24, 2018) https://www.ft.com/content/44110919-84d9-30d5-a346-e9ac30eef204 (noting that BlackRock has never filed a shareholder resolution); and Paul Rissman & Diana Kearney, *Rise of the Shadow ESG Regulators: Investment Advisers, Sustainability Accounting, and Their Effects on Corporate Social Responsibility*, 49 ENVTL. L. REP. 10155, 10173 (noting that "universal owners rarely, if ever, file shareholder resolutions, even for governance issues").

[122] *See* Barzuza, Curtis & Webber, *supra* note 17, at 122-127 and *generally* Todd A. Gormley, Vishal K. Gupta, David A. Matsa, Sandra Mortal & Lukai Yang, *The Big Three and Board Gender Diversity: The Effectiveness of Shareholder Voice* (ECGI Finance Working Paper 714/2020) https://ssrn.com/abstract=3724653.

[123] *See generally* Bebchuk & Hirst, *supra* note 38; Bebchuk & Hirst, *supra* note 7; Coates, *supra* note 6; Fichtner, Heemskerk and Garcia-Bernardo, *supra* note 4; Fichtner & Heemskerk, *supra* note 39; Fisch, Hamdani & Davidoff Solomon, *supra* note 38; Lund, *supra* note 45; John D. Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407 (2019); Kahan & Rock, *supra* note 99.

[124] *See generally* Barzuza, Curtis & Webber, *supra* note 17; Condon, *supra* note 95; Caleb N. Griffin, *Environmental and Social Voting at Index Funds*" (Working Paper, Feb. 14, 2020) https://ssrn.com/abstract=3542081; and Giovanni Strampelli, *Can BlackRock Save the Planet? The Institutional Investors' role in Stakeholder Capitalism*, 11 HARV. BUS. L. REV. (forthcoming) https://ssrn.com/abstract=3718255.

[125] Cyrus Taraporavala, *Index funds must be activists to serve investors*, FIN. TIMES (July 24, 2018) https://www.ft.com/content/4e4c119a-8c25-11e8-affd-da9960227309.

[126] *See generally* ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINES IN FIRMS, ORGANIZATIONS AND STATES (1970). *See also* Stuart Gillan & Laura Starks, *The Evolution of Shareholder Activism in the United States* 91 J. APPLIED CORP. FIN. 55, 56 (2007).

[127] Hirschman, *supra* note 126, at 76. *See also* Coffee, *supra* note 110, at 1288 (noting that "if "exit" is blocked, the members will become more interested in exercising a "voice" in governance decisions").

also made vividly by a principal at Vanguard, who noted "We're riding in a car we can't get out of, governance is the seat belt and air bag."[128] At first sight, therefore, it may seem as if passive investors would be *more* likely to utilize voice, given the unavailability of exit. Crucially, though, passive index funds do not compete on performance, as they offer what is essentially a commoditized product to investors.

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

(i) *Portfolio-wide ESG Initiatives*

The Big Three differ from the actors examined in the agency capitalism framework as they are common owners, and they increasingly manage ESG funds. These factors could prompt the Big Three to engage in more active monitoring, at least on portfolio-wide ESG issues. A key principle of Modern Portfolio Theory is that investors can mitigate idiosyncratic (firm-specific) risk by diversifying their portfolios.[129] This is one of the major benefits of passive index funds, as investors are diversified across a huge range of companies. The Capital Asset Pricing Model also teaches us that investment involves two types of risk: systematic risk and unsystematic risk (or specific risk).[130] Diversification does not solve the problem of systematic risk, as even a portfolio holding all of the shares in the stock market cannot eliminate systematic risk. Climate change has been described both as a systematic risk[131] and a systemic risk.[132] It "cannot be eliminated through diversification because its effects are felt economy-wide".[133] The climate crisis–if it continues unabated–will inevitably impose devastating losses on society, both in economic, and other, terms. Similar to the losses imposed by a financial crisis, the losses caused by climate change are likely to be "characteristically widely diffused, indirect and in aggregate very large".[134] As Armour and Gordon have noted, "the firm's majoritarian diversified shareholders", cannot eliminate systemic risk and thus "would prefer that the managers did not impose systemic externalities".[135] Therefore, it is clear that the interests of different types of shareholders–especially

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[128] Sarah Krouse, David Benoit & Tom McGinty, *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 25, 2016) https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101.

[129] Markowitz, *supra* note 43. *See also* Armour & Gordon, *supra* note 15.

[130] WILLIAM SHARPE, PORTFOLIO THEORY AND CAPITAL MARKETS (1970).

[131] John C. Coffee, *The Future of Disclosure: ESG, Common Ownership, and Systemic Risk,* 13, (ECGI Law Working Paper No. 541/2020) https://ssrn.com/abstract=3678197 ("climate change may present the clearest example of systematic risk").

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

[133] Condon, *supra* note 95, at 17 (citing Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193, 200 (2008) ("To the extent systemic risk affects markets, however, it is positively correlated with the markets and cannot be diversified away.")).

[134] Armour & Gordon, *supra* note 13, at 40 (describing the losses caused by the global financial crisis).

[135] Armour & Gordon, *supra* note 13, at 39.

with regard to portfolio-wide risk–are not homogenous.[136] The interests of fully diversified passive index investors can differ markedly from the interests of more concentrated shareholders who may be primarily concerned with increasing firm-specific value, due to their active, stock-picking, investment strategies.

Hart and Zingales noted that shareholders with diversified portfolios are "interested in total market return rather than the value of a particular firm."[137] In a similar vein, Gilson and Kraakman argued that the "surest way to increase the value of an indexed stock portfolio is to increase the value of all of the companies in the portfolio."[138] They hypothesized that the "only plausible" way to do this is by "improving the corporate governance *system* rather than by attempting to improve the management of particular companies."[139] Beginning in the 1990s, institutional investors such as public pension funds protected the "system" by securing portfolio-wide governance improvements, including dismantling takeover defenses.[140] Similarly, portfolio-wide benefits can be pursued in relation to climate change risk.

The climate crisis–as well as being the most severe threat to life on earth–poses the most significant risk to the economy. Estimating the magnitude of the damage that climate change will inflict upon investment portfolios is a very challenging task, given that estimating the effect of climate change on the economy more broadly is also extremely difficult.[141] However, the expected damage to the Big Three's investment portfolios is likely to be vast.[142] As outlined above, this damage is not something investors can avoid by diversifying their portfolios, and in fact it is the most diversified investors–who broadly represent the economy and society–who should logically be the most concerned about such climate change risk.

As a result, Condon's conclusion that "institutional investors–contrary to the traditional assumptions of investor passivity–have both the incentive and the capacity to serve as monitors of corporate behavior, so long as returns are justified at the portfolio level" seems theoretically sound.[143] In particular, the effect of common ownership among index investors should rationally translate into a willingness to internalize negative externalities–specifically to minimize the risks associated with climate change, given its detrimental effect at the portfolio level.[144] Put simply by Condon, "as "universal owners" it is in their financial self-interest to take action to reduce global emissions, including those generated by the publicly traded fossil fuel companies in which they invest."[145] Coffee similarly notes that "with high common ownership across a broad portfolio, it becomes rational and

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

[137] Hart & Zingales, *supra* note 90, at 251.

[138] Gilson & Kraakman, *supra* note 73, at 867.

[139] id.

[140] Gilson & Kraakman, *supra* note 73, at 867-871. *See also* Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 877 (noting that in the early 2000s, four types of precatory resolutions did obtain support: (i) proposals to repeal classified boards (average 62% of votes); proposals calling for the elimination of supermajority provisions (average 60% of votes); proposals calling for rescission of poison pills (average 59%); and proposals for shareholder approval of future golden parachutes (average 53%)).

[141] Condon, *supra* note 95, at 43-48.

[142] id.

[143] Condon, *supra* note 95, at 10.

[144] Condon, *supra* note 95, at 12.

[145] Condon, *supra* note 95, at 6.

predictable that these institutional investors will make both investment and voting decisions on a portfolio-wide basis (rather than simply trying to maximize the value of individual stocks)".[146] It is rational for the Big Three to take action to try to reduce the risk of climate change on a portfolio-wide basis, even if such action causes losses to some companies in their portfolio.[147]

Therefore, if the Big Three properly account for the expected damage to portfolio-wide returns in the future due to the impact of climate change, they should be incentivized to mitigate climate risk at the portfolio level. Other commentators have likewise argued that "passive investors have meaningful monitoring incentives when it comes to cross-cutting issues such as sustainability", where large investors such as the Big Three can exploit economies of scale to make a meaningful impact.[148] The theoretical impact of this cannot be overstated. Coffee argues that "the advent of portfolio-wide decision-making (both as to investments and voting) may represent the most important contemporary change in institutional investor behavior,"[149] solving a "problem that has frustrated legal scholars for decades" and finding "a strategy to make public corporations behave more virtuously."[150]

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

(ii) *Firm-specific ESG Activism*

Compared to an actively managed fund that could, theoretically, improve its relative performance by overweighting a specific stock then investing in activism or engagement,[151] a passive index fund manager has minimal incentives to engage in firm-specific monitoring and activism, as there is no real way for passive funds to compete on the basis of performance with other index funds that mechanically track the same index. The business model of passive index investing is simply to replicate the performance of specific stock market indices and to minimize the costs for end investors. Unlike actively managed funds, index funds are "essentially commodities"[152] that compete on cost rather than relative performance. Davies has noted that "the incentives for managers of index funds to engage at a deep level appears to be very low, even non-existent, despite the fact that such funds are locked in long term to the relevant index".[153] Despite the inability to exit, passive index fund managers may be much less likely than active fund managers to engage in firm-specific performance activism. Therefore, when considering firm-specific monitoring and activism, the rise of passive investing and common ownership would, logically, appear to exacerbate the problem of rational reticence.

[146] Coffee, *supra* note 131, at 5.
[147] Coffee, *supra* note 131, at 13.
[148] Azar, Duro, Kadach & Ormazabal, *supra* note 70, at 6 (citing Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Passive investors, not passive owners*, 121 J. FIN. ECON. 111 and Gormley, Gupta, Matsa, Mortal & Yang, *supra* note 122.
[149] Coffee, *supra* note 131, at 37.
[150] Coffee, *supra* note 131, at 38.
[151] Lund, *supra* note 45, at 501.
[152] Kahan and Rock, *supra* note 99, at 1783.
[153] Davies, *supra* note 87, at 77.

Condon does argue that institutions such as the Big Three have incentives to pursue firm-specific engagement in order to protect portfolio-wide returns.[154] This would appear to make sense, up to a point. Low-cost firm-specific intervention by the Big Three might be rational. However, free-rider problems loom large when it comes to higher cost firm-specific activism. There are ways to mitigate collective action and free rider problems. For example, institutional investors can form investor coalitions to coordinate action.[155] Coalitions such as Climate Action 100+ explicitly foster asset manager coordination.[156] Therefore, some minimal levels of firm-specific or coordinated sustainability activism may be rational on the part of the Big Three. However, this is very unlikely to stretch to firm-specific strategic or operational activism involving, for example, detailed and tailored energy transition plans at target companies. Predominantly, rational reticence with respect to firm-specific sustainability activism can be expected to prevail.

B. *Rational Hypocrisy*

The second problem that could afflict the Big Three specifically in the sustainable capitalism framework is what I call "rational hypocrisy". Hypocrisy is typically described as claiming to have higher standards or more noble beliefs than is actually the case in practice.[157] The concept of "corporate hypocrisy" is defined as "a firm that claims to be something that it is not".[158] In essence, a company will be perceived as insincere if it behaves in a manner that is inconsistent or that falls short of its self-proclaimed standards of social responsibility or if the company "says and does two different things".[159] In a similar vein, this Article introduces the concept of "rational hypocrisy" as a potential agency cost arising from the Big Three's assumed role as sustainable capitalists. In the media, BlackRock (in particular) has been regularly accused by various environmental activists as being hypocritical due to discrepancies between its public statements on climate risk and its actions in practice. To cite some examples, in 2016 BlackRock and Vanguard were labelled "hypocritical" after they failed to support a shareholder resolution at ExxonMobil which put them at odds with their commitments as signatories of the Principles of Responsible Investment.[160] Similarly, BlackRock was accused of "climate change hypocrisy" after it refused to support two landmark environmental shareholder resolutions at Australian oil companies Woodside Energy and Santos

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[154] Condon, *supra* note 95, at 61.

[155] id.

[156] Condon, *supra* note 95, at 64.

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

[158] The concept of "corporate hypocrisy" was first introduced in the marketing literature in 2009 but has also been examined in other disciplines such as management and organizational science, business ethics and social psychology. *See* Tillmann Wagner, Richard J. Lutz and Barton A. Weitz, *Corporate Hypocrisy: Overcoming the Threat of Inconsistent Corporate Social Responsibility Perceptions* 73 J. MKTING 77, 79 (2009) and Tillmann Wagner, Daniel Korschun and Cord-Christian Troebs, *Deconstructing corporate hypocrisy: A delineation of its behavioral, moral and attributional facets*, 114 J. BUS. RES. 385 (2020).

[159] Wagner, Lutz and Weitz, *supra* note 158, at 90.

[160] Laurie Havelock, *BlackRock, Vanguard among "hypocritical" investors ditching PRI agreement over Exxon vote, says AODP* RESPONSIBLE INVESTOR, Sept. 8, 2016 https://www.responsible-investor.com/articles/blackrock-vanguard-among-hypocritical-investors-ditching-pri-agreement-over.

that received high levels of support from other investors.[161] This led Majority Action to proclaim that "BlackRock joined Climate Action 100+ and enjoyed celebrity as a result of having done so, but has then made a mockery of its own commitment by voting to undermine its objectives."[162]

There are various reasons why the Big Three might be incentivized to engage in rational hypocrisy. In particular, being *perceived* as environmentally or socially conscious could bring greater or equal benefit to the Big Three than actually going through the costly process of substantively challenging managers on tough issues in a meaningful way. The former approach could help the Big Three to attract investors' money. Being perceived to be a responsible steward could also mitigate consumer and employee backlash against the Big Three. On the other hand, actually challenging corporate management on issues that may strike at the core of a company's business could be risky and controversial. As Choudhury and Petrin note, "environmental issues pose a unique challenge to business in that environmental protection may be fundamentally at odds with a specific corporation's core functions."[163] Therefore, an aggressive stance on these issues could jeopardize other business that the Big Three receive from the companies they invest in. Moreover, both politically and in the common ownership literature, the Big Three's escalating power is increasingly scrutinized. Intervening on firm-specific issues could heighten the risk of regulation curbing their power.

C. *Rational Reticence and Rational Hypocrisy in Practice*

Sections A and B above considered the theoretical basis for the agency problems of rational reticence and rational hypocrisy. Whether the Big Three epitomize these agency problems in practice is likely to be contested. As will be highlighted below, scholarship conflicts regarding the effectiveness of the Big Three's ESG stewardship in practice, and the associated incentives underpinning the actions of the Big Three.

Barzuza, Curtis and Webber argue that index funds have demonstrated effective stewardship when it comes to ESG issues, including challenging managers, voting against directors and demonstrating thought leadership that is backed up by concrete action.[164] The primary case study cited in support of this thesis is the progress made by the Big Three on gender diversity on corporate boards.[165] Indeed, there is a panoply of evidence to support the contention that the Big Three have been key activists in this portfolio-wide effort in U.S. companies. Undoubtedly the most high-profile, viral, marketing initiative on board gender diversity was State Street's "Fearless Girl" campaign which was launched on International Women's

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[161] Attracta Mooney, *BlackRock accused of climate change hypocrisy,* FIN. TIMES (May 17, 2020) https://www.ft.com/content/0e489444-2783-4f6e-a006-aa8126d2ff46.

[162] John Greenwood, *BlackRock "undermining objectives of climate coalition it just joined" – Majority Action,* CORP. ADVISOR (Dec. 14, 2020) https://corporate-adviser.com/blackrock-undermining-objectives-of-climate-coalition-it-just-joined-majority-action/. *See* Majority Action, *Climate in the Boardroom: How Asset Manager Voting Shaped Corporate Climate Action in 2020*, https://www.majorityaction.us/asset-manager-report-2020 (noting that BlackRock voted against 10 of the 12 shareholder proposals flagged by Climate Action 100+ in 2020).

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

[164] Barzuza, Curtis & Webber, *supra* note 17, at 105 (arguing that "when it comes to ESG (environmental, social and governance) issues, index funds…boldly challenge managers, vote out directors, and demonstrate vocal leadership in thought and deed – activities that are sharply at odds with the conventional account of index fund passivity.").

[165] Barzuza, Curtis & Webber, *supra* note 17, at 121-127.

Day in 2017. The Big Three asset manager commissioned the bronze statute to be installed opposite the Wall Street Charging Bull to advertise its new bespoke ESG index fund (denoted by the ticker symbol "SHE") that is dedicated to investing in companies with gender-diverse boards.[166] Barzuza, Curtis and Webber argue that this campaign should not be dismissed as a marketing gimmick, as it was followed up by concrete action on the part of State Street. The Big Three asset manager pledged to vote against the chair of the nominating committee of boards that lacked any female board representation and failed to improve their record on gender diversity.[167] Ultimately, in 2017, State Street proceeded to vote against directors at 400 of the 476 companies in its portfolio that had no female directors.[168] BlackRock responded in 2018 by going one step further, announcing that it would vote against the entire nominating committee if companies did not show sufficient progress on gender diversity. It also stated that it expected firms to have at least two female directors on the board.[169] This seems to be compelling evidence of the Big Three committing to, and competing on the basis of, ESG platforms.[170]

This evidence also appears to illustrate the Big Three overcoming rational reticence when it comes to portfolio-wide governance changes. The rationale that Barzuza, Curtis and Webber advance to explain this atypical behavior on the part of the Big Three is that "index funds are locked in a fierce contest to win the soon-to-accumulate assets of the millennial generation, who place a significant premium on social issues in their economic lives."[171] They posit that "signaling a commitment to social issues is one of the few dimensions on which index funds can differentiate themselves and avoid commoditization."[172] Bebchuk and Hirst similarly note that index fund managers will have an incentive to avoid being perceived as inferior stewards by their current and potential customers, and therefore will emphasize their commitment to stewardship in their public communications. They also note that this could "lead index fund managers to take positions on subjects that they expect to appeal to investors, such as gender diversity on boards and climate change disclosure."[173] Relatedly, the Big Three might have incentives to compete in this arena due to the dramatic rise in ESG investment products in recent years. Throughout 2019 and 2020, record sums have been invested in socially responsible

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166 Anna L. Christie, *A COVID-19 Index Fund – The New Fearless Girl? in* COVID-19 AND BUSINESS LAW, 33 (Horst Eidenmüller, Luca Enriques, Genevieve Helleringer & Kristen van Zwietan eds. 2020) (citing Jenny Rooney, *'Fearless Girl': State Street Global Advisors' CMO On The Rationale, The Controversy And What's Next*, Forbes (Apr 21, 2017) https://www.forbes.com/sites/jenniferrooney/2017/04/21/fearless-girl-state-street-global-advisors-cmo-on-the-rationale-the-controversy-and-whats-next/).

167 Barzuza, Curtis & Webber, *supra* note 17, at 124 (citing Joann S. Lublin & Sarah Krouse, *State Street to Start Voting Against Companies That Don't Have Women Directors*, WALL ST. J. (Mar. 7, 2017) https://www.wsj.com/articles/state-street-says-it-will-start-voting-against-companies-that-dont-have-women-directors-1488862863).

168 Barzuza, Curtis & Webber, *supra* note 17, at 124 (citing Justin Baer, *State Street Votes Against 400 Companies Citing Gender Diversity*, WALL ST. J. (July 25, 2017) https://www.wsj.com/articles/state-street-votes-against-400-companies-citing-gender-diversity-1501029490).

169 Barzuza, Curtis & Webber, *supra* note 17, at 125 (citing Sarah Krouse, *BlackRock: Companies Should Have at Least Two Female Directors*, WALL ST. J. (Feb. 2, 2018) https://www.wsj.com/articles/blackrock-companies-should-have-at-least-two-female-directors-1517598407).

170 Barzuza, Curtis & Webber, *supra* note 17, at 125-127.

171 Barzuza, Curtis & Webber, *supra* note 17, at 102.

172 id.

173 Bebchuk & Hirst, *supra* note 38, at 2072-2073.

index funds.[174] The market share of ESG funds is still small relative to the $41 trillion held by investment funds worldwide, but it has grown exponentially in the last two years.[175] Assets under management in ESG funds exceeded the $1 trillion mark by mid-2020.[176] In Europe–which is the leading market for such funds–ESG funds are predicted to outnumber traditional funds as soon as 2025.[177]

When presenting the evidence relating to the Big Three's board gender diversity activism, the Big Three have often been hailed as the initiators of these campaigns. This might lead to a conclusion that the Big Three are capable of overcoming the problems of rational reticence and rational hypocrisy without any outside influence. However, this conclusion would be premature. Indeed, a closer examination of the circumstances surrounding State Street's Fearless Girl campaign reveals that the campaign followed activism by the New York City Comptroller's Boardroom Accountability Project which targeted firms with poor diversity.[178] Other actions of the Big Three have closely followed pressure from pension funds, which illustrates their importance as responsible activists, as discussed in Part V below.

Despite the clear incentives to signal commitment to a range of environmental and social issues, the crucial question remains whether the public statements by the Big Three will be followed up with meaningful action in practice. Here, the evidence is unconvincing to date. This is particularly the case with regard to the Big Three's voting records. In that context, allegations of hypocrisy are easy to make. Even with respect to the issue of gender diversity on corporate boards–where the Big Three have celebrated the most success–the voting record of State Street's SHE Gender Diversity ETF surprised observers. During its first three years of operation, the SHE fund supported 12 gender-related resolutions, voted against 34 and abstained on 17.[179] Overall, as a firm, State Street voted in support of only 19% of gender-related resolutions from 2016-2018, despite benefitting from a wealth of good publicity from the Fearless Girl.[180]

Similar observations of hypocrisy can be made with respect to the Big Three's voting record on climate change. Consistent with the rational hypocrisy thesis advanced in this Article, a study by Caleb Griffin demonstrates that the major motivation of the Big Three may be to "be *perceived by potential customers* as taking positive action on environmental and social issues".[181] This hypothesis is supported by four findings from analysing the Big Three's voting records in the 2018-2019 proxy season, namely: (i) environmental and social initiatives at Big Three index funds are highly-publicized; (ii) the Big Three's voting guidelines do not commit funds to any particular course of action on environmental and social matters; (iii) actual environmental and social voting differs significantly from depictions of environmental and social values in public statements and marketing materials,

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[174] Christie, *supra* note 166, at 33.

[175] Siobhan Riding, *ESG funds attract record inflows during crisis*, FIN. TIMES (Aug. 10, 2020) https://www.ft.com/content/27025f35-283f-4956-b6a0-0adbfd4c7a0e.

[176] id.

[177] id.

[178] Although the "Boardroom Accountability Project – Version 2.0" was not launched until Sept. 8, 2017 (which post-dates State Street's Fearless Girl earlier in the year), the Comptroller had focused on firms with poor diversity as early as 2014. *See* Michal Barzuza, *Proxy Access for Board Diversity* 99 B. U. L. REV. 1279, 1283 (2019).

[179] Madison Sargis, *Gender-Diversity Funds: How Strong Are Their Intentions?* Morningstar (Apr 1, 2019) https://www.morningstar.com/insights/2019/04/01/gender-intentional.

[180] id.

[181] Griffin, *supra* note 124, at 3.

almost always in a pro-management direction; and (iv) the Big Three favor non-transparent methods of influence, such as "engagements", to avoid accountability to either side.[182] One particularly striking finding from Griffin's study is the Big Three's *ESG funds* often do not even vote in favor of environmental and social shareholder proposals.[183] Data from the 2018-2019 proxy season revealed that Vanguard's ESG funds supported such proposals 2.2% of the time with State Street's and BlackRock's ESG funds supporting 20.7% and 24.5% of proposals, respectively.[184] Notably, both Vanguard and State Street voted their funds universally (with the ESG funds voting in an identical manner to the general funds).[185] On the other hand, at BlackRock the ESG funds frequently voted differently from their traditional counterparts–with the ESG funds supporting almost three times as many environmental and social proposals than traditional funds.[186] The practice of following universal voting policies means the Big Three's voting is unlikely to match the preferences of ultimate investors in ESG funds. The Big Three tend to vote funds as a block, with their centralized stewardship teams determining the voting direction.

It seems clear that the Big Three's voting records on climate change do not live up to their marketing promises. Other studies have analyzed the voting records of asset managers such as BlackRock and Vanguard. A 2019 study identified 41 climate-critical resolutions submitted to corporations and highlighted that BlackRock only voted in favor of five and Vanguard only voted in favor of four.[187] In 2020, BlackRock was further criticized for its voting record which revealed that it had supported fewer climate resolutions than in previous years, despite Larry Fink's heavily publicized commitment to such initiatives at the beginning of the year.[188] Although Big Three support for environmental proposals has incrementally increased over the last few years, there is still a wide gulf between the commitments made and corresponding action in practice.

Overall, an examination of the Big Three's voting records–and particularly the voting records of ESG funds–supports the view that the Big Three do not sufficiently represent the interests of their ultimate investors, the economy, or society. Despite the Big Three assuming the role of sustainable capitalists, it seems clear that a monitoring shortfall persists. There is, however, an important caveat to this conclusion. A focus on voting records alone would be misconceived, as the Big Three favor engaging with companies over voting against management. It was reported in 2018 that "certain asset managers, including BlackRock, refuse to vote in favor of shareholder proposals if the companies concerned are engaging with the asset manager."[189] Despite the Big Three's failure to provide significant voting support to shareholder proposals related to climate change, there is some evidence

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[182] id.

[183] Griffin, *supra* note 124, at 26-28.

[184] Griffin, *supra* note 124, at 27-28.

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

[186] Griffin, *supra* note 124, at 26.

[187] Majority Action, *supra* note 29.

[188] Attracta Mooney, *BlackRock criticized over drop in climate votes*, FIN. TIMES (Oct. 4, 2020) https://www.ft.com/content/7a80f33b-a0ed-4dea-b2d3-ce56381f4084 (noting that BlackRock supported just 6% of environmental proposals filed by shareholders globally in the 12 months to June, down from 8% in the previous year).

[189] Kimberly Gladman, 50/50 Climate Project, *Asset Manager Climate Scorecard 2018*, https://5050climate.org/wp-content/uploads/2018/09/FINAL-2018-Climate-Scorecard-1.pdf, 1.

that their more informal "engagement" with portfolio companies may be associated with lower greenhouse gas emissions. An empirical study by Azar, Duro, Kadach and Ormazabal finds that firms with higher CO_2 emissions are more likely to be the target of Big Three engagements and that engagements are followed by a reduction in CO_2 emissions. Perhaps most importantly, the study finds that the association appears to only be significant in the most recent years of the sample period, which correlates with the Big Three's more recent commitments to address environmental issues.[190] The study also notes that the negative association between Big Three ownership and CO_2 emissions is driven by BlackRock and State Street, as opposed to Vanguard, which is the last of the Big Three to publicly commit to environmental issues.[191] This study provides preliminary evidence that the "engagement" efforts of the Big Three's stewardship teams may be associated with some positive climate action on the part of the worst corporate climate change offenders. Despite some evidence of progress, it seems justified to argue that the Big Three still exhibit rational reticence and are also inflicted with rational hypocrisy.

III. THE ORIGINAL GOVERNANCE ARBITRAGEUR: ACTIVIST HEDGE FUNDS

"Successful hedge funds will be entrepreneurial; it is the essence of the craft."[192]
--Paul Singer, founder of Elliott Management--

Part II identified and theorized a dual agency problem arising from the Big Three's assumed role as sustainable capitalists–rational reticence and rational hypocrisy. Parallels can therefore be drawn between the sustainable capitalism framework and the agency capitalism framework, as a monitoring shortfall similarly exists. In the agency capitalism framework, the solution that was identified by Gilson and Gordon was for activist hedge funds to fill the monitoring shortfall left by institutional investors.[193] Such activists played the role of governance intermediaries or arbitrageurs. Specifically, they were specialists in initiating firm-specific activist campaigns at companies where institutional investors were rationally reticent. In the realm of sustainable capitalism, a vocal minority of activist hedge funds have already transitioned to focus on firm-specific ESG activism. In this respect, it is useful to track the evolution of activist hedge fund strategies to highlight how hedge funds adapted their strategies to fill the monitoring shortfall left by institutional investors and how their campaigns evolved to effectively complement the incentives of those who ultimately decide upon the success or failure of their campaigns.

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[190] Azar, Duro, Kadach & Ormazabal, *supra* note 70, at 3-4, 6.

[191] Azar, Duro, Kadach & Ormazabal, *supra* note 70, at 22.

[192] Joseph A. Giannone, *Hedge fund tip-toe toward an uncertain future*, REUTERS (Dec. 10, 2009) https://mobile.reuters.com/article/amp/idUSLNE5B902B20091210?edition-redirect=in.

[193] It is important to acknowledge that Gilson & Gordon's agency capitalism framework "provides a generally optimistic assessment of the potential role of institutional investors in contemporary corporate governance" whereas other commentators, such as Martin Lipton, have criticized institutional investor voting power as being "harnessed by a gaggle of activist hedge funds". *See* Hill, *supra* note 110, at 513 and 537 (citing Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 26, 2013) https://corpgov.law.harvard.edu/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/).

A. *Activism 1.0–Financial Engineering*

Armour and Cheffins draw a distinction between "offensive" and "defensive" shareholder activism, with hedge funds representing the archetypal offensive shareholder activist.[194] Activist hedge funds identify target firms and purposefully invest in them to pursue an activist agenda, whereas other institutional investors tend to be reactionary and will usually only engage in activism to protect existing holdings.[195] Whether activist hedge funds represent a positive or negative force is a polarizing topic.[196] Most commonly, activist hedge funds are criticized for having a "bias toward near-term gain, regardless of…the interests of long-term investors, and the productivity of the wider economy".[197] Here, the most commonly criticized form of hedge fund activism is labelled *Activism 1.0*. *Activism 1.0* is defined as activism involving financial engineering or balance sheet activism. These are the types of demands that politicians and the media most commonly (and most negatively) associate with hedge fund activism.[198] It generally involves a direct intervention on financial matters, such as pressuring the target company to increase leverage or return cash to shareholders via dividends or share buybacks.

In 2007, Bratton noted that hedge fund demands "likely include one or more actions assuring a quick return on investment".[199] This was illustrated through an empirical study of activist hedge fund interventions from 2002 to 2006.[200] In the early 2000s, there was some evidence that activists may have "grabbed low-hanging fruit" and targeted cash rich companies to redistribute cash to shareholders.[201] Such financially-oriented strategies are consistent with the business model of activist hedge funds as they seek to quickly generate abnormal returns in order to increase the value of their funds. Hedge funds pursue absolute returns, often over short time periods. An easy target for an activist hedge fund would therefore be a cash-rich firm. Other tactics that can generate short-term gains for hedge funds include seeking to change the capital structure of the company by repurchasing shares or expanding leverage, or demanding companies dispose of assets or initiate cost-cutting measures.[202]

B. *Activism 2.0–Activist Directors*

However, *Activism 1.0* is a simplistic and outdated view of modern-day hedge fund activism. Hedge fund activism has adapted to appeal to the interests of long-term investors. Activist hedge fund tactics constantly evolve.[203] In the preceding decade, activist hedge funds have increasingly sought to secure minority

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[194] Cheffins & Armour, *supra* note 110, at 56.

[195] Anna L. Christie, *The New Hedge Fund Activism: Activist Directors and the Market for Corporate Quasi-Control*, 19 J. CORP. L. STUD. 1, 7 (2019).

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

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

[198] See Christie, *supra* note 195, at 1-2.

[199] Bratton, *supra* note 197, at 1379.

[200] Bratton, *supra* note 197, at 1385-1387.

[201] Bratton, *supra* note 197, at 1394-1395.

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

[203] Christie, *supra* note 195, at 37.

representation on the boards of target companies, with this now being the most common form of hedge fund activism.[204] An empirical study by the author shows that from 2010 to 2019, one hundred S&P 500 companies in the U.S. have been the target of campaigns seeking activist board representation.[205] Activist board representation campaigns are increasingly successful, which reflects the support that traditional institutional investors often lend to these campaigns. Of the one hundred S&P 500 companies that have been the target of board representation campaigns, 87 of these campaigns resulted in the activists securing board representation.[206]

Activist board representation is a specific type of intervention that may appeal to long-term institutional investors. In addition to holding shares for longer periods, activist hedge funds seeking board representation regularly submit extremely detailed business plans and proposals for long-term strategic and operational improvements at target companies.[207] Both of these developments can signal a longer-term commitment on the part of hedge fund activists to the target company, and thus mitigate some of the traditional concerns associated with the short-term "hit-and-run" motives of hedge funds.[208] Given that hedge funds need the support of long-term investors such as the Big Three to succeed in their campaigns,[209] the growth of activist board representation campaigns could be a reflection of activist hedge funds evolving and adapting to effectively mirror the incentives of institutional investors such as the Big Three.

This evolution in activist hedge fund tactics provides support for the view that activist hedge funds have sought to adapt their strategies in a manner that closely complements the interests of the institutional investor arbiters. This is particularly the case as activist hedge funds are unique in pursuing a form of firm-specific activism that other investors neither have the capacity nor the incentives to initiate. No other type of activist specializes in the appointment of activist directors who focus on strategy, operations and turnaround. These new strategies have cemented activist hedge funds' position as the governance arbitrageurs in the corporate governance ecosystem.

The Big Three (similar to other institutional investors) do not nominate directors to the boards of their portfolio companies. In an empirical study, Bebchuk and Hirst noted that from 2007 to 2018, the Big Three did not submit a single director nomination nor did they make any suggestions for particular directors to be added or removed through their engagement activities.[210] In the early 1990s, Gilson and Kraakman had proposed an agenda for institutional investors, envisaging that they could collectively nominate professional outside directors who would actively monitor public corporations in the shareholders interest.[211] These aspirations did not materialize, and instead activist hedge funds adapted to fulfil this role.

Activist hedge funds combine minority board representation with detailed operational and strategic turnarounds. Again, this is something that institutional

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[204] Christie, *supra* note 195, at 9.

[205] Hand collected dataset analyzing hedge fund activist board representations campaigns at S&P 500 companies from 2010-2019, on file with author.

[206] id.

[207] Christie, *supra* note 195, at 27.

[208] Christie, *supra* note 195, at 12.

[209] Institutional investors have been described as the "corporate equivalent of swing voters in politics". *See* Hill, *supra* note 110, at 539-540.

[210] Bebchuk & Hirst, *supra* note 38, at 2098.

[211] Gilson & Kraakman, *supra* note 73, at 883.

investors, such as the Big Three, would lack the incentives and resources to do themselves. The Big Three are not in the business of analyzing portfolio companies' strategies and operations in depth and formulating alternative, complex, business plans. Jahnke has noted that "while the asset management industry demands good corporate governance and transparency, most investors stop short of demanding changes to companies' business strategy."[212] On the other hand, the Big Three may be appropriately placed to act as an arbiter when presented with conflicting plans from the incumbent management and the activists. Davies argues that while index investors do not appear to be reliable initiators, they may be as well placed as anyone else to evaluate the impact of an activist hedge fund proposal.[213]

Therefore, it is clear that activist hedge funds, to some extent at least, fill the gap left by a lack of intensive, firm-specific monitoring by more traditional institutional investors. The form of monitoring pursued in *Activism 2.0* still fits with activist hedge funds' business model. Although they hold minority stakes in target companies, they are undiversified investors who hold concentrated positions in a small number of portfolio companies. As a result, they are willing to engage in "firm-specific agitation to a degree unheard of among traditional institutional investors."[214]

C. *Activism 3.0–ESG Activism?*

Traditionally, activist hedge funds have not promoted sustainability goals, nor have they launched activist campaigns with any environmental or social component. In a study conducted by the author of all activist hedge fund campaigns at S&P 500 companies in the past decade, there were only three activist campaigns that were publicized as involving any "ESG" element.[215] Each of those campaigns took place in 2018, which coincided with activist hedge funds launching specialist ESG-focused funds. In fact, some companies may have hesitated to promote renewable energy or focus on long-term sustainability projects for fear of being an easy target for an activist hedge fund attack. One prominent example of this eventuality materializing is Elliott Management's campaign at NRG Energy in 2017. NRG Energy, the biggest American independent power producer, was targeted after its share price declined by 60% when it became a "champion of renewable energy".[216] Activists Elliott Management and Bluescape Energy Partners were successful in appointing two directors to NRG's board. This led to conflicts with other shareholders, such as the New York City Pension Fund, as one of the nominees

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[212] Jahnke, *supra* note 77, at 7.

[213] Paul Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, *in* FESTSCHRIFT FÜR KLAUS J. HOPT ZUM 80. GEBURTSTAG AM 24. AUGUST 2020, 137-138 (Stefan Grundmann, Hanno Merkt and Peter O. Mülbert eds. 2020).

[214] Gilson & Gordon, *supra* note 13, at 896.

[215] Data on file with author. The campaigns were: (1) ValueAct's January 2018 campaign at international power producer AES Corporation; (2) Jana's January 2018 campaign at Apple; and (3) Trian's October 2018 campaign at paint company PPG. ValueAct's campaign at AES coincided with the launch of its new ValueAct Spring Fund and Jana's campaign at Apple coincided with the launch of Jana Impact Capital. Trian's "ESG" campaign goals at PPG appeared to be entirely focused on governance, rather than any environmental or social factors. *See* Trian Partners, *PPG: More Than a Fresh Coat of Paint* (Oct. 2018) https://www.10xebitda.com/wp-content/uploads/2020/03/Trian-PPG-Presentation-October-2018.pdf.

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

was a known climate-change denier who had repeatedly said global warming was not caused by carbon emissions and who labelled climate change a "hoax".[217] NRG ultimately announced a plan to divest its $4 billion renewable energy business, which caused a daily share price rise of around 25%[218] (increasing the value of Elliott's stake by approximately $58 million in one day).[219] Following the intervention, the company's shares were the best performing stock in the S&P 500 in 2017.[220] Elliott received similar criticism for its campaign at S&P 500 company Sempra energy, which partly focused on the firm divesting renewable energy assets.[221] Therefore, based on anecdotal evidence from various campaigns, activist hedge funds may not seem to be the most likely candidates to pursue environmental or social goals.

There is, however, some evidence of even formidable activists such as Elliott focusing on ESG issues. In 2018, Elliott created a new role of head of investment stewardship and reached an agreement with another S&P 500 power supplier, Evergy Inc, to execute a five-year operational "sustainability transformation plan" aimed at speeding up the company's transition to clean energy, which lagged behind peers. In keeping with the tactics used in *Activism 2.0*, Elliott appointed two representatives to Evergy's board. In a turnaround from the types of activities that were berated in *Activism 1.0*, Elliott even urged Evergy to suspend share buybacks.[222]

In the last few years, activist hedge funds have begun to launch bespoke ESG funds and initiate campaigns where ESG issues are the primary focus. One of the first forays by activist hedge funds into the ESG investing space was witnessed in January 2018 when hedge fund Jana Partners announced the launch of Jana Impact Capital. In a highly publicized endeavor, Jana enlisted the help of social activists, rock star Sting, and a former fund manager of BlackRock for its new impact fund, which was described in the press as "a convergence of Wall Street's roughest fighters and its do-gooders".[223] The fund's first headline activist campaign was conducted in partnership with the pension fund California Teachers' Retirement System (CalSTRS) and targeted the world's most valuable publicly traded company, Apple. This campaign raised concerns regarding the psychological damage to children and teenagers of too much "screen time".[224] In a public letter to Apple, the

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[217] Ed Crooks, *Activists clash over direction for NRG Energy,* FIN. TIMES (Apr. 9, 2017) https://www.ft.com/content/89417ba2-1d3e-11e7-a454-ab04428977f9.

[218] Tom DiChristopher, *Hedge fund titan Paul Singer scores big win after NRG Energy surges 25% in single day*, CNBC (July 12, 2017) https://www.cnbc.com/2017/07/12/hedge-fund-titan-paul-singer-scored-a-big-win-with-this-energy-bet.html.

[219] Tina Davis, *Paul Singer Made $57.6 Million in One Day On This Bet*, BLOOMBERG (July 12, 2017) https://www.bloomberg.com/news/articles/2017-07-12/singer-s-elliott-made-57-6-million-on-one-bet-in-one-day-chart.

[220] Ed Crooks & Lindsay Fortado, *Elliott builds stake and demands shake-up at Sempra Energy*, FIN. TIMES (June 12, 2018) https://www.ft.com/content/d00fc274-6d82-11e8-852d-d8b934ff5ffa.

[221] Tom DiChristopher, *Activist investor Paul Singer just chose Sempra Energy as his next turnaround project*, CNBC (June 11, 2018) https://www.cnbc.com/2018/06/11/elliott-management-launches-bid-to-overhaul-sempra-energy.html.

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

[223] David Benoit, *Wall Street Fighters, Do-Gooders – And Sting – Converge in New Jana Fund*, WALL ST. J. (Jan. 7, 2018) https://www.wsj.com/articles/wall-street-fighters-do-goodersand-stingconverge-in-new-jana-fund-1515358929.

[224] Attract Mooney, *Activists don sustainability cloak to whip up support*, FIN. TIMES (May 14, 2018) https://www.ft.com/content/b74d2adc-2b8e-11e8-97ec-4bd3494d5f14.

activists demanded stronger parental controls on devices such as the iPhone.[225] Despite being a laudable campaign, this demand was something that was relatively easy for Apple to respond to and address, and the company quickly and duly did so by unveiling a new "screen time" feature on its devices less than six months later.[226]

The other ESG campaign launched by a hedge fund activist around the same time as Jana's campaign was ValueAct Capital Partners' campaign at international power producer AES Corporation. ValueAct's newly launched Spring Fund initiated its first campaign in January 2018 which involved ValueAct founder Jeffrey Ubben joining the board of AES in order to provide support to the company to increase its focus on renewable energy and sell its legacy coal assets.[227] Ubben noted that the Spring Fund was built on the premise "that there is not just a societal good to be done, but excess return to be captured in identifying and investing in businesses that are emphasizing and addressing environmental and societal problems."[228] In June 2020, Jeffrey Ubben announced that he would leave ValueAct to launch Inclusive Capital Partners, a new environmentally- and socially-focused hedge fund.[229] This firm is expected to grow well beyond the Spring Fund in terms of assets under management. Prior to the shift, ValueAct Capital Partners had assets under management of around $16 billion, with the Spring Fund making up $1 billion.[230] Despite this significant commitment, ESG investing currently remains a niche part of most activist hedge funds' business, and accounts for a small percentage of assets under management. Even when ESG strategies are pursued by activist hedge funds, they always have an explicit profit motive in addition to attempting to advance environmental or social goals.

The U.K. activist hedge fund TCI has also increasingly marketed itself as an ESG leader, with founder Christopher Hohn positioning himself as one of the most outspoken and vocal activists in terms of the climate crisis. TCI has always had a philanthropic leaning, as the fund was originally launched (in 2004) together with an affiliated charity, The Children's Investment Fund Foundation.[231] Last year Hohn and his foundation donated £200,000 to Extinction Rebellion.[232] Hohn and

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

[226] Sarah Perez, *Apple unveils new screen time controls for children*, TECHCRUNCH (June 4, 2018) https://techcrunch.com/2018/06/04/apple-unveils-new-screen-time-controls-for-children/.

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

[228] David Faber, *Jeff Ubben's ValueAct launching fund with social goals, following similar moves by Jana, BlackRock*, CNBC (Jan. 19, 2018) https://www.cnbc.com/2018/01/19/jeff-ubbens-valueact-launching-fund-with-social-goal.html (citing a letter from Ubben to ValueAct's limited partners).

[229] Billy Nauman, *Jeff Ubben quits ValueAct for social investing*, FIN. TIMES (June 23, 2020) https://www.ft.com/content/eaa28471-e295-44a9-a138-dda047db6d1c.

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

[231] Edward Robinson & Nishant Kumar, *The World's Most-Profitable Hedge Fund is Now a Climate Radical*, BLOOMBERG GREEN (Jan. 22, 2020) https://www.bloomberg.com/news/articles/2020-01-22/the-world-s-most-profitable-hedge-fund-is-now-a-climate-radical.

[232] id.

TCI have also led a number of campaigns where they have filed shareholder resolutions to push companies to give shareholders "say on climate" votes.[233]

In December 2020 a new impact hedge fund, Engine No. 1, was launched. It initially launched with $250 million in capital and announced that it would "invest in companies that make money while also investing in jobs, workers, communities and the environment".[234] The founding members of the firm include a former executives from the activist hedge fund Jana Impact Capital and a former executive from BlackRock.[235] The fund's first activist campaign is a particularly ambitious move to nominate four independent director candidates to the board of directors of the world's largest listed oil company, ExxonMobil, at the 2021 annual meeting of shareholders.[236] The director nominees are energy industry veterans, mainly with backgrounds in renewable energy.[237] Engine No. 1's substantive campaign mainly focuses on capital allocation, with the fund urging Exxon to cut investment on projects based on unrealistic oil and gas prices and to focus on growth areas such as renewable energy. The campaign is not limited to operational ESG matters, however, with Engine No. 1 stating that its proposals are designed to help the company secure its dividend for shareholders.[238] Large institutional shareholders, such as the California State Teachers' Retirement System (CalSTRS) and the Church of England have already backed Engine No. 1's proposal.[239]

The outcome of Engine No. 1's campaign will be influenced heavily by the support (or lack of support) from the Big Three, who own over 20% of the stock in Exxon.[240] Similar to the targets of more traditional activist board representation campaigns, Exxon's shares have fallen by 40% in the last five years, but rose on the news of the activist campaign.[241] In *Activism 2.0* campaigns, where board representation is pursued at S&P 500 companies, the average stake taken by activist hedge funds is generally more than 6%.[242] Engine No. 1's stake in Exxon is

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[233] *See infra* Part IV D(ii) (discussing "say on climate" votes).

[234] Svea Herbst-Bayliss, *Hedge fund veteran launches impact firm with former Jana, BlackRock executives*, REUTERS (Dec. 1, 2020) https://uk.reuters.com/article/us-investment-funds-james/hedge-fund-veteran-launches-impact-firm-with-former-jana-blackrock-executives-idUSKBN28B6AO.

[235] id.

[236] Svea Herbst-Bayliss & Gary McWilliams, *Exxon faces proxy fight launched by new activist firm Engine No. 1*, REUTERS (Dec. 7, 2020) https://uk.reuters.com/article/exxon-shareholders-engine-no-1/exxon-faces-proxy-fight-launched-by-new-activist-firm-engine-no-1-idUKKBN28H1IO.

[237] id. (the nominees are: Gregory Goff (former CEO of San Antonio-based refiner Andeavor); Kaisa Hietala (former leader of the renewables business of Finnish refiner Neste Oyj); Alexander Karsner (former senior strategist of Alphabet's innovation lab who served in the Energy Department under President George W Bush); and Anders Runevad (former CEO of Danish wind turbine manufacturer Vestas).

[238] Ortenca Aliaj, Derek Brower & Myles McCormick, *ExxonMobil under pressure as Church of England joins investor campaign*, FIN. TIMES (Dec. 10, 2020) https://www.ft.com/content/c0639fb0-d81f-4ee9-8d58-d8e8da05c454.

[239] Svea Herbst-Bayliss & Jennifer Hiller, *Tiny activist investor's arguments against Exxon draw crowd to its side*, REUTERS (Dec. 11, 2020) https://uk.reuters.com/article/exxon-activist/tiny-activist-investors-arguments-against-exxon-draw-crowd-to-its-side-idUKKBN28L27G.

[240] *See* Table 1 in Part I C above.

[241] *See also* Liam Denning, *Exxon's Suddenly Trouncing Chevron. Coincidence?*, Bloomberg Opinion (Dec 17, 2020) https://www.bloomberg.com/opinion/articles/2020-12-17/exxon-stock-tops-chevron-amid-engine-no-1-activist-campaign (noting that "Exxon's relative outperformance versus Chevron since activist shareholder Engine No. 1 LLC showed up is actually the sharpest in the past decade").

[242] Hand collected dataset analyzing hedge fund activist board representations campaigns at S&P 500 companies from 2010-2019, on file with author.

considerably less, at 0.02%, due to the fund's small size.[243] Therefore, the Big Three's shareholdings are more than 1,000 times the activist's stake, and will undoubtedly be a significant determining factor of the success or failure of the campaign. The campaign has already drawn the attention of other activists. In February 2021, it was reported that Exxon was considering adding Jeffrey Ubben of Inclusive Capital Partners to its board, amid intensifying pressure on climate change.[244]

In summary, this Part has tracked the evolution of activist hedge fund campaigns from financial activism to longer-term operational and strategic activism (achieved through activist board representation) to the recent emergence of ESG campaigns. Part IV below more fully analyses these new ESG campaigns to determine whether they have the potential to mitigate the agency costs of sustainable capitalism.

IV. ESG ARBITRAGEURS: RESPONSIBLE ACTIVISTS

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

This Part discusses the incentives and strategies of ESG hedge funds and other "responsible activists" to determine which are best positioned to fill the role of ESG arbitrageurs and mitigate the problems of rational reticence and rational hypocrisy in the sustainable capitalism framework. It also discusses what responsible activists can learn from historical portfolio-wide activism and the activist hedge funds.

A. *Activist Hedge Funds as ESG Arbitrageurs*

When describing the agency capitalism framework, Gilson and Gordon outlined that a "happy complementarity"[246] could be achieved where "responsibility to beneficial owners for maximizing performance is split between specialists: Activist investors specialize in monitoring portfolio company strategy and formulating alternatives when appropriate for presentation to the institutional investors; in turn, institutional investors specialize in portfolio management and in evaluating proposals presented by activist investors."[247] This complementarity arose as activist hedge funds could "identify strategic and governance shortfalls with significant

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[243] Engine No. 1 was originally launched with a $250 million fund. *See* Herbst-Bayliss & Hiller, *supra* note 239.

[244] Scott Deveau, Ed Hammond & Kevin Crowley, *Exxon Board Mulls Adding Climate-Conscious Hedge Fund Mogul*, Bloomberg Green (Feb. 4, 2021) https://www.bloomberg.com/news/articles/2021-02-04/exxon-mobil-is-said-to-consider-adding-jeff-ubben-to-board.

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

[246] Gilson & Gordon, *supra* note 13, at 898 (noting that the "happy complementarity" requires an adequate supply of shareholder activists and thus a high enough return to activists to warrant their efforts).

[247] Gilson & Gordon, *supra* note 13, at 897. *But see* Coffee, Jackson, Mitts & Bishop, *supra* note 249, at 387-388 (outlining that a more skeptical view of activism may be necessary because the governance by referendum process does not actually work as simply as described, given the rarity of votes and the prevalence of settlements with activists).

valuation consequences" and "present reticent institutions with their value proposition: a specified change in the portfolio company's strategy or structure".[248]

In the agency capitalism framework, activist hedge funds proved to be the "key intermediary".[249] In *Activism 2.0*, they focused on activist board representation, together with detailed, firm-specific, strategic and operational changes. Through these campaign strategies, activist hedge funds became increasingly successful in carving out a governance arbitrageur niche where they filled a monitoring gap that no other actor had the capacity or incentives to fill. The symbiotic relationship between activist hedge funds (as initiators) and institutional investors (as arbiters) that resulted is arguably successful in mitigating rational reticence.

Hedge fund activists and big institutional investors were able to co-exist in relative harmony because activist hedge funds adapted their campaigns to align their goals with those of the institutional investors. Simplistically, both activist hedge funds and active mutual funds and pension funds were generally aligned to seek increases in shareholder value. Thus, activist hedge funds could act as governance arbitrageurs to pursue outcomes that were beneficial both for themselves and for shareholders more broadly. However, some conflicts in these campaigns arose with the growth of the Big Three. For example, in 2016, the Big Three complained that hedge fund settlements with companies disenfranchised them and prioritized short-term gains over long-term value.[250] However, *Activism 2.0* focused on activist hedge funds adapting their campaigns to pursue strategies that would enable them to secure the critical support of the institution. The result of this evolution in campaign strategies was largely that the institutional investors' long-term orientation balanced out some of the traditional criticisms of hedge fund activism, such as short-termism.[251]

As *Activism 3.0* campaigns are very much in their infancy, it is more difficult to predict how the relationship between ESG hedge funds and pivotal asset managers such as the Big Three will evolve. Activist hedge funds' transition to ESG has emulated some of the public statements made by the Big Three. Following BlackRock's letters highlighting the importance of ESG, many activist hedge funds released similar statements on their websites regarding their own approach to ESG.[252] Therefore, preliminary evidence would seem to suggest that activist hedge

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[248] Gilson & Gordon, *supra* note 13, at 896.

[249] John C. Coffee Jr., Robert J. Jackson Jr., Joshua R. Mitts & Robert E. Bishop, *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board*, 1004 CORNELL L. REV. 381, 385 (2019) (citing Gilson & Gordon, *supra* note 13, at 863).

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

[251] Christie, *supra* note 195, at 12.

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

funds are again attempting to adapt their strategies in order to capitalize on the new wave of Big Three interest in sustainable capitalism and thus align their activism with the priorities of their pivotal voters.

Continuation of the successful strategies pursued in *Activism 2.0* is also evident in the current campaign by Engine No. 1's at Exxon. An ESG proxy contest of this nature is completely unprecedented by an activist hedge fund. It draws clear parallels with the activist director campaigns that have become increasingly prevalent, and increasingly successful, at S&P 500 companies in the past decade. Here, the hedge fund is filling an ESG monitoring shortfall that arises from the most pronounced form of rational reticence, namely the Big Three's lack of incentives to initiate firm-specific ESG initiatives. It is unheard of for the Big Three to seek to appoint new independent directors to the board who have renewable energy or climate transition expertise or for them to intervene with detailed business plans for the strategy and operations of such a major S&P 500 oil and gas company. Firm-specific activism of this nature would clearly fulfil an ESG arbitrageur role in a sustainable capitalism framework by mitigating the most pronounced form of rational reticence. Similarly, Elliott Management's campaign at S&P 500 power supplier Evergy fills a similar gap as it involved activist board representation and a detailed strategic and operational five-year plan intended to catalyze Evergy's transition to clean energy.[253] These anecdotal examples show that in the sustainable capitalism framework, activist hedge funds focusing on ESG activism could evolve to play a similar role as ESG arbitrageurs as the role they played as governance arbitrageurs in the agency capitalism framework.

However, there are at least two problems that may arise with activist hedge funds acting as ESG intermediaries that did not arise in the agency capitalism framework. Firstly, although ESG hedge funds could mitigate the problem of rational reticence by presenting ESG proposals to institutions in a similar manner to the role they played as governance arbitrageurs in traditional profit-oriented campaigns, there may be a more pronounced misalignment of incentives between hedge funds and the Big Three in the ESG context. Through their ESG activism, hedge funds will undoubtedly pursue a profit motive. In order to initiate a campaign, they will need to be convinced that they will be able to achieve a large enough increase in the value of the target company to justify the cost of intervention. The profit motive will thus be balanced with the environmental and social motive. On the other hand, the Big Three (as agents of diversified shareholders and thus society at large) should be less concerned with idiosyncratic, firm-specific returns and more concerned with portfolio-wide risk and returns. It may be that these different incentives are not in conflict. Assuming that the activist hedge fund's campaign will not only increase the value of the target company itself but will also promote sustainability generally and thus provide portfolio-wide gains and reduction of risk for the Big Three, these divergent incentives could play out in a similar way to the long-term and short-term conflict we saw in *Activism 2.0*. The Big Three's portfolio-wide focus could induce ESG hedge funds to adapt their campaigns to directly appeal to the Big Three's motivations in order to secure their crucial support. If the firm-specific activism also generates portfolio-wide benefits, ESG hedge funds could prove successful in acting as the missing link to promote sustainable capitalism.

The second, and more problematic, issue arises in relation to rational hypocrisy. Due to their focus on the double bottom line, and due to the fact that ESG hedge

[253] Sattiraju, *supra* note 222.

funds will not invest unless they can make a profit that renders the intervention worthwhile, ESG hedge funds could potentially exacerbate the agency cost of rational hypocrisy. If the Big Three care primarily about *appearing* to be responsible stewards, ESG hedge funds could set up easy marketing wins for the Big Three by instigating campaigns that outwardly appear to have an environmental or social focus, but ultimately are mainly concerned with generating profit for shareholders. Thus, the problem of rational hypocrisy could be compounded by two actors who have incentives to behave in rationally hypocritical ways. In this respect, ESG hedge funds may not generate beneficial outcomes and the agency cost of rational hypocrisy could be exacerbated.

B. *Responsible Activists as ESG Arbitrageurs*

The role of activist hedge funds as governance arbitrageurs in the agency capitalism framework relied upon the activists identifying strategic or governance shortfalls and presenting reticent institutions with a value proposition to address those corporate failures.[254] Similarly, the role of ESG hedge funds as ESG arbitrageurs in the sustainable capitalism framework is premised upon the activists presenting reticent asset managers with firm-specific sustainability proposals. The monitoring shortfall identified by these activists, and thus the role they play, focuses on firm-specific issues. Other responsible activists, however, have mainly addressed a different monitoring shortfall: portfolio-wide ESG issues. There are a variety of strategies that responsible activists can use to agitate for positive change in terms of the climate crisis but overwhelmingly the most common mechanism utilized to date is fairly standardized shareholder proposals. As explained earlier, the Big Three have not, to date, submitted a single shareholder proposal,[255] even if such proposals may be beneficial for their diversified end-investors and their portfolios overall. This could potentially represent a monitoring shortfall or governance gap that responsible activists could suitably fill.

The Big Three certainly can, and sometimes do, lend their voting support to shareholder proposals submitted by responsible activists. Therefore, such proposals could mitigate the problem of rational reticence on portfolio-wide sustainability issues. However, one difference with respect to this monitoring shortfall, and this arbitrageur strategy, is that rational reticence in the portfolio-wide context is not as strong as it is in the firm-specific context. The Big Three sometimes seek to bring about similar changes to those sought by responsible activists in shareholder proposals in their private "engagements" with corporate managers. To some extent there might be a conflict if the Big Three prefer to engage with companies behind the scenes rather than lend voting support to a public shareholder proposal. Indeed, there are many examples of the Big Three refusing to support shareholder proposals specifically because they are engaging in a dialogue with the company on similar issues. Perhaps in the future this conflict will be less pronounced, particularly since the Big Three have now outwardly committed to supporting more proposals. BlackRock explicitly did so in their 2021 Stewardship Expectations report where

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[254] Gilson & Gordon, *supra* note 13, at 867.
[255] *See* Bebchuk & Hirst *supra* note 121.

they stressed that "we see voting on shareholder proposals playing an increasingly important role in our stewardship efforts around sustainability".[256]

However, compared to the strategies pursued by activist hedge funds, shareholder proposals have sometimes been considered a relatively weak disciplinary tool. Although mutual funds always vote their shares–so the Big Three are compelled to vote on each shareholder proposal submitted by responsible activists–the majority of proposals seek relatively standardized commitments. These could include greenhouse gas reduction targets, reports on climate-transition plans and strategies, or disclosure of climate lobbying. Therefore, they address the less pronounced portfolio-wide rational reticence problem as opposed to the more pronounced firm-specific rational reticence problem. Sustainability activism has also proven to be a much more laborious process than profit-oriented hedge fund activism, as proposals are often filed multiple years in a row before gaining any traction or securing a commitment from target companies. Given the urgency of the climate crisis, there may be lessons that can be learned from the more impatient governance arbitrageurs, activist hedge funds, as detailed in Section D below.

Responsible activists may, however, be better placed than ESG hedge funds to mitigate the problem of rational hypocrisy. The incentives of responsible activists–acting as ESG arbitrageurs through the submission of shareholder proposals–are ordinarily very different to the incentives of activist hedge funds. The business model of activist hedge funds is to generate a significant increase in shareholder value as a result of the intervention, whereas responsible activists most often seek to secure meaningful reduction in greenhouse gas emissions or increased disclosure and transparency in respect of corporate climate damage. Responsible activists may have financial interests, especially if they are a major shareholder (such as a pension fund) seeking to protect their portfolio against climate risk, but this is often subordinate to a genuine desire to mitigate the effects of climate change. Therefore, it may be that responsible activists provide better complementarity to the interests of the Big Three in terms of the problem of rational hypocrisy. While ESG hedge funds could potentially add an additional layer of rational hypocrisy with a potentially exaggerated commitment to ESG issues, responsible activists genuinely care about sustainability issues.

C. *Lessons from Portfolio-Wide Activists*

Neither the process of submitting shareholder proposals to companies nor the use of such proposals in an environmental or social context are recent innovations. There is a long history of individual investors using the shareholder proposal mechanism for governance interventions at large companies. David Larcker and Brian Tayan explain that the roots of individual shareholder activism in the U.S. go back to the 1930s when the Gilbert Brothers proposed a multitude of shareholder resolutions to try to improve governance standards and accountability across American corporations.[257] These "corporate gadflies" still persistently target

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[256] BlackRock, *Our 2021 Stewardship Expectations: Global Principles and Market-level Voting Guidelines*, 4, https://www.blackrock.com/corporate/literature/publication/our-2021-stewardship-expectations.pdf.

[257] David F. Larcker & Brian Tayan, *Gadflies at the Gate: Why Do Individual Investors Sponsor Shareholder Resolutions*, ROCK CENTER FOR CORPORATE GOVERNANCE STANFORD CLOSER LOOK SERIES NO. CGRP59 (Aug. 11, 2016) https://ssrn.com/abstract=2821755. *See also* Harwell Wells, *Shareholder power in America, 1800-2000: a short history*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, 22 (Jennifer G. Hill and Randall S. Thomas eds. 2015) (noting that "So

companies with shareholder proposals.[258] Some individuals are so ubiquitous that Yaron Nili and Kobi Kastiel outline that "in 2018 five individuals accounted for close to 40% of all shareholder proposals submitted to S&P 1500 companies."[259] Essentially, corporate gadflies fill a monitoring gap by initiating shareholder proposals that large institutional investors are willing to lend their voting support to, despite lacking strong incentives to submit the actual proposal themselves. These gadflies act as a form of governance arbitrageur, so this method of activism functions in parallel to the role played by activist hedge funds in the agency capitalism framework.[260] Gadflies tend to focus on standardized governance proposals. As the large institutional investors (such as the Big Three) have already "expressed formulaic views on these governance matters in their voting guidelines", the gadflies can "tailor their proposals to the voting guidelines of proxy advisors and large institutional investors".[261]

Environmental and social proposals are similarly not a modern invention. Historically, shareholder proposals have been crucial in raising public awareness on environmental and social issues. In the 1950s, the U.S. Securities and Exchange Commission permitted companies to reject shareholder proposals "of a general political, social, or economic nature".[262] However, a 1970 U.S. federal court decision reversed this policy by allowing a shareholder proposal to forbid the sale of napalm by Dow Chemical, and thereafter a flurry of social responsibility proposals were allowed to proceed.[263] Cheffins has highlighted that such proposals were particularly common during the 1970s, where campaigns on issues such as the Vietnam War, pollution and apartheid South Africa grew in prominence.[264] By the 1980s, there were more than 100 socially responsible shareholder proposals a year in U.S. corporations.[265] More recently, similar momentum can be seen in relation to the climate crisis, as a wave of environmentally focused shareholder proposals are submitted to corporations around the world.

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

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were born the shareholder "gadflies," the best-known being the Gilbert Brothers, Wilma Soss, and Evelyn Davis, who from the 1940s to the 1990s submitted literally hundreds of proposals to a range of companies.

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

[259] Nili & Kastiel, *supra* note 259, at 2.

[260] Nili & Kastiel, *supra* note 259, at 32.

[261] Nili & Kastiel, *supra* note 259, at 30-31.

[262] Wells, *supra* note 257, at 22 (citing JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (2003).

[263] Gillan & Starks, *supra* note 126, at 56 (citing HENRY G. MANNE & HENRY C. WALLICH, THE MODERN CORPORATION AND SOCIAL RESPONSIBILITY (1972)).

[264] BRIAN R. CHEFFINS, THE PUBLIC COMPANY TRANSFORMED, 124 (2018) (citing Donald E. Schwartz & Elliott J. Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L.J. 643-644 (1977) (documenting the shareholder proposals submitted by church groups in the 1970s to influence the activities of U.S. corporations doing business in South Africa). *See also*, John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts* 79 MICH L. REV. 72 (1980).

[265] Wells, *supra* note 257, at 22 (citing LAUREN TALNER, THE ORIGINS OF SHAREHOLDER ACTIVISM (1983)).

continental Europe. Compared to the U.S., shareholder proposals remain relatively infrequent in continental Europe.[266]

In the U.S., the Securities and Exchange Commission adopted the so-called "town hall" rule–what is now Rule 14a-8–in 1942. This required a corporation to include, in its proxy and at its expense, proposals put forward by shareholders, together with a short supporting statement to be voted on at the annual meeting."[267] Until recently,[268] any shareholder holding more than $2,000 in stock or a 1% ownership stake in the company for at least one year had the right to submit a shareholder proposal. Unless the S.E.C. gives permission for the company to exclude the item from consideration,[269] the company must add the shareholder proposal to the agenda for voting at the next annual or special meeting of shareholders."[270] If a proposal gains majority support (50% or more of the shareholder votes), it will pass, although any such proposal will still only be advisory. The first shareholder proposal filed by an institutional investor to be voted on was in 1986.[271] In the late 1980s and through the 1990s, it was common for public pension funds and other coordinated investor groups to file governance proposals (focusing on issues such as anti-takeover defenses).[272] Initially, very few of these proposals passed, although they were effective in publicizing issues and pressuring the board.[273] Governance proposals continued to increase in momentum and became much more successful over the years.

In the U.S., as well as in other jurisdictions around the world, it is now increasingly common for responsible activists to submit shareholder proposals to public companies in order to agitate for change on environmental or social issues. In 2020, 429 shareholder proposals on environmental, social and sustainable governance issues were filed at U.S. public companies, with 93 of those proposals being environmental ones.[274] Various types of responsible activists now submit

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

[267] Wells, *supra* note 257, at 22 (noting that "As a means of forcing the corporation to do anything, it wasn't much; shareholders during this era almost always voted with management… and even if a proposal had won a majority vote it was merely precatory; management was not required to follow it."). *See* Rule 14a-8, 17 C.F.R. 240. 14a-8.

[268] *See* text to *infra* notes 291 to 294.

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

[270] Griffin, *supra* note 124, at 9.

[271] ROBERT A. G. MONKS & NELL MINOW, CORPORATE GOVERNANCE, 177 (2011) (noting that in 1986, the proposal by the Teachers Insurance and Annuity Association-College Retirement Equities Funds (TIAA-CREF) to put International Paper's poison pill to a shareholder vote was the first such proposal by an institutional investor to be voted on).

[272] Stuart L. Gillan & Laura T. Starks, *Corporate governance proposals and shareholder activism: the role of institutional investors*, J. FIN. ECON. 275, 278 (2000); Gillan & Starks, *supra* note 126, at 57.

[273] Gillan & Starks, *supra* note 217, at 303; Wells, *supra* note 257, at 25 (noting that in 1994 "corporate governance proposals sponsored by institutions received on average almost 30 percent of votes cast").

[274] Heidi Welsh & Michael Passoff, *Proxy Preview: Helping Shareholders Vote Their Values*, 5, https://www.ussif.org/files/Proxy_Preview_2020_FIN6.pdf. *See also* Hirst, *supra* note 185, at 223 (noting that the most common social responsibility resolutions in 2014 related to political

shareholder proposals to major companies. Non-profit non-governmental organizations, public pension funds, labor unions and religious organizations feature especially prominently. In the past five years, the four U.S. companies listed in the Carbon Majors top 25 corporate and state global emitters (ExxonMobil, Chevron, ConocoPhillips, Shell, and BP) [275] have been targeted by non-profit organizations such as As You Sow and Follow This; public pension funds such as the New York State Common Retirement Fund; sustainable investment funds such as Arjuna Capital; labor unions such as the United Steelworkers of America; and various religious organizations.[276] In recent years some large asset managers have also begun filing or co-filing proposals, which illustrates the overlapping motives of responsible activists and large asset managers. For example, in 2019, Legal and General Investment Management–the U.K.'s biggest asset manager, with assets under management of £1.2 trillion[277]–co-filed their first ever shareholder resolution, calling on BP to explain how its strategy was consistent with the Paris Agreement on climate change.[278] Similarly, in 2020 and 2021, BNP Paribas Asset Management (who previously supported and voted in favor of similar resolutions) submitted shareholder proposals to Exxon Mobil and Chevron concerning climate lobbying.[279] The Big Three have not, to date, followed suit.

As noted above, shareholder proposals focusing on governance issues have been increasingly successful in recent decades. From 2006 to 2015, 85% of governance proposals to declassify the board received majority shareholder support.[280] One of the reasons these proposals often succeed is that the voting guidelines of institutional investors are largely uniform on such governance matters. Therefore, it is relatively easy for the filers of such proposals to tailor them so as to secure maximum votes from the institutions who will ultimately determine the proposal's success or failure. By contrast, during the same time period, 0% of environmental proposals received majority shareholder support.[281] Responsible activists initiating environmental and social proposals may face additional barriers, as the voting guidelines of the Big Three and other institutions in relation to these issues are often much less straightforward. In particular, voting guidelines often explain that environmental and social resolutions will be voted on a "case-by-case" basis.[282]

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contributions and lobbying disclosure, greenhouse gas emissions, climate change and sustainability).

[275] Griffin, *supra* note 9.

[276] Data extracted from the Ceres Engagement Tracker database of shareholder proposals (from 2016-present). *See* https://engagements.ceres.org.

[277] Legal & General Investment Management, *Our Business*, https://www.lgim.com/uk/ad/about-us/our-business/ (at 30 June 2020).

[278] Legal & General Investment Management, *Encouraging companies to act responsibly: LGIM Active Ownership report*, (June 2020) https://brand.legalandgeneral.com/investing-for-good/encouraging-companies-to-act-responsibly-lgim-active-ownership-report/.

[279] Data extracted from Ceres, *supra* note 276.

[280] Larcker & Tayan, *supra* note 257, at 9 (sample included all shareholder resolutions proposed by individual investors at Fortune 500 companies, 2006-2015).

[281] id.

[282] Nili & Kastiel, *supra* note 259, at 31 (noting that "institutional investors have more diverse views on environmental and social matters, and many voting guidelines provide asset managers more discretion on proposals relating to such matters. For example, the voting guidelines of Vanguard state that its funds "*will vote* for proposals to declassify an existing board"…whereas any proposal regarding environmental and social disclosures will be voted on "case-by-case…[and] evaluated on its merits." and citing The Vanguard Group, Inc, *Proxy Voting Guidelines for U.S. Portfolio Companies*, 10, 16 (Apr. 1, 2019) https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf).

Nevertheless, support for environmental and social resolutions is increasing. Although environmental proposals used to garner little support from shareholders, in the last few years they have attracted a much greater percentage of votes in their favor. The Big Three are undoubtedly some of the most significant arbiters of shareholder proposals, given their substantial voting power in economically significant companies. Before 2017, no climate change related shareholder proposal had ever received majority support at a U.S. company.[283] The first climate change shareholder proposal that secured majority voting support was a proposal submitted to Occidental Petroleum in 2017.[284] The proposal requested that Occidental issue an annual report assessing the impact of climate change on its business. This was also the first time that BlackRock voted in favor of an environmental shareholder proposal that management opposed.[285] This vote followed a shareholder resolution that was filed by socially responsible investors at BlackRock regarding its record on climate change. Crucially, the BlackRock resolution had the support of influential pension funds such as the Seattle City Employees' Retirement System which had $339 million invested in a BlackRock index fund and joined as a co-filer.[286] Following discussions with the filers, "BlackRock promised to improve its focus on ESG when engaging with companies, and the resolution was withdrawn."[287] Very shortly thereafter, BlackRock also supported an environmental proposal at ExxonMobil (after previously voting against certain Exxon directors in 2016).[288] The proposal at Exxon gained support from over 62% of shareholders, including each of the Big Three.[289] In 2020, 16 shareholder proposals concerning social or environmental issues gained more than 50% of the votes at U.S. companies.[290]

Despite the increasing prevalence and success of climate-oriented shareholder proposals in the U.S., the S.E.C. introduced controversial reforms to the rules on shareholder proposals, which will make it more difficult for responsible activists to submit environmental (or social) proposals. Under the new rules, which were introduced in September 2020 and take effect for proposals for meetings from 2022 onwards, shareholders may only submit a proposal if they have held $2,000 of company stock for at least *three* years (the previous requirement being *one* year), or higher amounts for shorter periods of time.[291] Aggregation of holdings for the

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283 Glass Lewis, *2020 Proxy Season Review*, 21, https://www.glasslewis.com/wp-content/uploads/2020/09/2020-Proxy-Season-Review-Shareholder-Proposals.pdf.

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

285 id.

286 Rissman & Kearney, *supra* note 121, at 10174.

287 Rissman & Kearney, *supra* note 121, at 10175.

288 Ross Kerber, *BlackRock withheld support from two key Exxon directors: filings*, Reuters (Aug. 29, 2016) https://www.reuters.com/article/us-exxon-directors-blackrock-idUSKCN11417F.

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

290 Patrick Temple-West, *Record year for environmental, social investor petitions*, FIN. TIMES (June 9, 2020) https://www.ft.com/content/6dceb82a-1084-40bf-91cb-7cb6100f3992.

291 U.S. Securities & Exchange Commission, *SEC Adopts Amendments to Modernize Shareholder Proposal Rule* (Sept. 23, 2020) https://www.sec.gov/news/press-release/2020-220 (Rule 14a-8(b) is amended so that a stockholder with at least $2,000 of stock will need to have held the stock for at least three years, a stockholder with at least $15,000 of stock will need to have held the stock for at

purposes of satisfying the amended ownership thresholds is now also prohibited.[292] Crucially for environmental and social resolutions, the reforms also revise the levels of shareholder support a proposal must receive to be eligible for resubmission at future shareholder meetings from 3%, 6% and 10% for matters previously voted on once, twice or three or more times in the last five years to 5%, 15% and 25%, respectively.[293] When deliberating the reforms, the S.E.C. specifically noted that the proposed amendments to Rule 14a-8(i)(12) could have a greater adverse impact on shareholder proposals relating to environmental and social issues compared to shareholder proposals on governance issues. This is because shareholder proposals on environmental and social issues tend to receive lower voting support than those on governance issues, and proposals on environmental and social issues are more likely to be resubmitted compared to proposals on governance issues.[294] These rules will to some extent impede the progress of environmental shareholder resolutions, especially resolutions that have repeatedly been submitted to companies. In many cases, resolutions are only successful in generating corporate change after multiple years of submission and activism, therefore this valuable route for responsible activists may encounter some more obstacles in future.

D. *Lessons from Firm-Specific Activists*

As noted in Part III, activist hedge funds use methods other than shareholder proposals to pressurize the companies they invest in. Regardless of one's views of whether hedge fund activists are heroes or villains, hedge fund activists have indisputably been incredibly successful in generating outsized influence at the companies they target and they have succeeded in gaining institutional investor support for their role as governance arbitrageurs. This poses the question: what can responsible activists, the ESG intermediaries in the sustainable capitalism framework, learn from hedge fund activists, the original governance intermediary in the agency capitalism framework? Here, a proposal is made regarding the appointment of climate directors, as an analogy to the activist directors who feature prominently in activist hedge fund campaigns in the agency capitalism framework. Some other key aspects common to activist hedge fund campaigns are also briefly mentioned, in order to inspire further dialogue of analogous strategies that might prove fruitful in the sustainable capitalism context.

(i) Climate Directors

As we have seen in the agency capitalism framework, hedge fund activism evolved to the point where the most common strategy of activist hedge funds is now the nomination of minority directors to the board. Institutional investors are often willing to lend their support to campaigns to nominate minority board directors, especially when the nominees are non-affiliated industry experts or turnaround specialists. Institutional investors even, on occasion, request that hedge

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least two years, and a stockholder with at least $25,000 of stock will only need to have held the stock for at least one year).

[292] id. (Rule 14a-8(b) amendments).

[293] id. (Rule 14a-8(12) amendments).

[294] *See* U.S. Securities & Exchange Commission, *Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8*, Release No. 34-87458 (Nov. 5, 2019), 132, https://www.sec.gov/rules/proposed/2019/34-87458.pdf.

funds pursue board appointments.[295] It is argued in this Section that it would be especially valuable for responsible activists to emulate this unique feature of hedge fund activism in the sustainable capitalism context. A fruitful course of action would be for activists to nominate climate-focused or specialist energy transition directors to corporate boards. This solution would be targeted at mitigating firm-specific rational reticence. It is reminiscent of the proposal made by Gilson and Kraakman in the early 1990s, which envisaged that institutional investors could nominate professional outside directors.[296] However, an important question arises regarding which type of responsible activist would have the necessary incentives, power and funding to facilitate the appointment of climate directors.

Apart from the few settlements negotiated by the new ESG-hedge funds to add representatives to boards, the only publicized case of a successful ESG campaign by institutional investors to nominate a climate expert director to a company board appears to be the case of the Italian energy company Enel, in summer 2020. In this case, the Dutch asset manager Robeco successfully appointed a climate transition expert, Samuel Leupold (the former CEO of Wind Power at Ørsted), to the board of Enel.[297] This campaign was made possible by what Belcredi and Enriques describe as a "peculiar feature of current Italian corporate governance regulation", where minority shareholders can submit a slate of candidates to Italian companies and have the right to have at least one candidate appointed, even where another slate gains a higher number of votes.[298] In this particular instance, Robeco joined the Executive Committee of the representative association of the Italian investment industry, Assogestioni, which coordinates the nominations from minority shareholders.[299]

Responsible activist organizations have followed an alternative route to try and focus boards on climate issues. They have submitted shareholder proposals requesting that companies add climate experts to the board. These proposals might be thought of as a lower-cost alternative to an actual proxy fight. As detailed in Section C above, ESG shareholder proposals are not new. Strategies of this nature can be traced back to the 1970s when shareholder activists campaigned to add directors to boards in order to further social and environmental causes. Of particular interest in the context of modern ESG activism is "Campaign GM", an activist campaign highlighted by Cheffins as "the most publicized instance of public

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[295] Christie, *supra* note 195, at 12-13 (citing OWEN WALKER, BARBARIANS IN THE BOARDROOM: ACTIVIST INVESTORS AND THE BATTLE FOR CONTROL OF THE WORLD'S MOST POWERFUL COMPANIES, 12-13 (2016)).

[296] *See* text to *supra* note 211.

[297] Sophie Robinson-Tillett, *Board senseless? The investor fight against climate incompetence*, Responsible Investor (June 11, 2020) https://www.responsible-investor.com/articles/board-senseless-the-investor-fight-against-climate-incompetence (noting that "Samuel Leupold was CEO of Wind Power at DONG Energy, which stood for Danish Oil and Natural Gas, during its transformation into one of the world's largest pureplay offshore wind developers, now named Ørsted" and quoting the Head of Active Ownership at Robeco, who explained that the Italian system lends itself to this kind of campaign but that these moves may be difficult to achieve at a large scale because not all jurisdictions make it possible).

[298] Massimo Belcredi and Luca Enriques, *Institutional investor activism in a context of concentrated ownership and high private benefits of control: the case of Italy*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, 386 & 393-395 (Jennifer G. Hill and Randall S. Thomas eds. 2015).

[299] Robinson-Tillet, *supra* note 297.

interest lobbying by shareholders".[300] In that case, shareholders targeted General Motors and submitted shareholder proposals on topics such as "vehicle emissions, automobile safety, pollution from manufacturing plants and ownership of car dealerships by minority groups."[301] Campaign GM was a very early example of shareholders attempting to add three diverse and environmentally-oriented directors to GM's all-male, all-white board. The shareholder resolution specifically proposed electing three types of individuals–"an environmentalist, an Afro-American, and a female consumer advocate"–to the board.[302] Although the proposal was (like many other proposals of its era) "voted down by an overwhelming majority", GM's 1970 annual meeting was characterized as "the decisive event in the politicization of the corporation".[303] Although Campaign GM was unsuccessful, within three years the company had in fact added "a black community leader, a female bank executive, and an eminent scientist" to the board.[304]

In more recent times, proposals of a similar nature have been filed at fossil fuel companies such as ExxonMobil and Chevron.[305] In 2015 and 2016, a shareholder proposal was submitted to Exxon, calling for a climate expert to be elected to the board. Although the resolution itself did not achieve majority support (instead it won support from investors with 20.9% of the shares), the following year Exxon capitulated and appointed a climate expert to its board.[306] However, such proposals are relatively rare. Of 93 environmental proposals submitted to U.S. companies in 2020, only 4 requested board member climate expertise.[307]

Campaigns to nominate climate directors are precisely the types of campaigns that may be supported by the Big Three, thus serving to mitigate the problem of firm-specific rational reticence. Support might be anticipated from the Big Three since they have made a number of statements regarding the need for board directors to be better educated on climate issues. In 2019, Vanguard stated that companies need to "better educate their boards on climate-risk-related topics".[308] Similarly, State Street noted in 2017 that companies should "ensure that directors have some knowledge, expertise or training on material sustainability or climate risks facing the company."[309] As was evident in the case of activist directors, the Big Three are extremely unlikely to nominate climate directors to companies themselves. The Big

[300] Cheffins, *supra* note 264, at 124 (citing *Campaign GM,* THE CORPORATION IN A DEMOCRATIC SOCIETY, 89, 89 (1975).

[301] Cheffins, *supra* note 264, at 125

[302] id.

[303] id.

[304] id.

[305] From 2015 to 2017, the Province of St. Joseph, Capuchin Order filed proposals for Exxon to nominate an environmental expert to their board. From 2011 to 2018, the New York State Comptroller filed proposals for Chevron to nominate an environmental expert to their board. Data extracted from Ceres, *supra* note 276.

[306] Ed Crooks, *ExxonMobil appoints climate scientist to board*, FIN. TIMES (Jan. 26, 2017) https://www.ft.com/content/d87ce444-e388-11e6-8405-9e5580d6e5fb (noting that Exxon had appointed Susan Avery, a respected scientist who has worked extensively on climate change, to the board).

[307] Welsh & Passoff, *supra* note 274, at 10.

[308] Vanguard, *Vanguard Investment Stewardship 2019 Annual Report*, 22, https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

[309] State Street Global Advisors, *SSGA's Perspectives on Effective Climate Change Disclosure*, 2, https://www.ssga.com/investment-topics/environmental-social-governance/2017/perspectives-on-effective-climate-change-disclosure.pdf.

Three do, however, care about board-related issues. There is a prominent precedent of the Big Three pushing major ESG board-related agendas on the issue of board gender diversity[310] and there are early signs that the Big Three will similarly push for racial board diversity in the near future.[311] Logically, therefore, the Big Three should be willing to support campaigns for the nomination of climate experts to boards.

One drawback of the shareholder proposal route is that these campaigns may not go far enough to foster the firm-specific, strategic, and operational change that is achieved when activist hedge funds appoint directors to boards. It can take a long time to secure climate expert board representation by way of the shareholder proposal mechanism. For example, in the case of Chevron, the New York State Comptroller filed shareholder proposals each year from 2011 to 2018 asking the company to nominate an environmental expert to the board.[312] There is also the problem of critical mass; one director with knowledge of, or expertise in, climate change, may not be enough to have a meaningful impact or generate lasting change at a fossil fuel company.[313] Commentary has highlighted that "It's worth remembering that there has been a climate scientist on the board of ExxonMobil since 2017…She was appointed by Exxon in response to shareholder concerns over climate, but clearly hasn't satisfied those concerns. It just goes to show, one person isn't enough to change the board."[314] Other responsible activists have taken more informal action to pressure companies to have a director responsible for climate change. Again, it is not clear how effective this is at changing corporate strategy with respect to climate issues. At present, 34 of the 42 U.S. companies on the Climate Change 100+ focus list, and all 9 U.K. companies on the same list, now have a board member or board committee responsible for climate change.[315] What may be much more effective, were they to succeed, are campaigns such as the one initiated by ESG hedge fund Engine No. 1, which seeks to nominate four independent directors with extensive expertise in renewable energy and climate transition to the board.

The main impediment to responsible activists nominating climate directors in an analogous manner to activist hedge funds, however, is cost. Submitting shareholder proposals works well for responsible activists as often these actors are non-profit organizations with comparatively limited funding and resources. Filing a shareholder proposal is relatively inexpensive,[316] especially compared to the costs involved in nominating a director to the board. Running a proxy contest for board

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[310] *See* Barzuza, Curtis & Webber, *supra* note 17; Gormley, Gupta, Matsa, Mortal & Yang *supra* note 122; and Part II B above.

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

[312] Data extracted from Ceres, *supra* note 276.

[313] *See generally* Mark Granovetter, *Threshold Models of Collective Behavior*, 83 AM. J. SOC. 1420 (1978), ROSABETH MOSS KANTER, MEN AND WOMEN OF THE CORPORATION (1977), Rosabeth Moss Kanter, *Some Effects of Proportions on Group Life*, 82 AM. J. SOC. 965 (1977) and Rosabeth Moss Kanter, *Men and Women of the Corporation Revisited*, 76 MGMT. REV. 14 (1987).

[314] Robinson-Tillett, *supra* note 297.

[315] Hand collected data extracted from the Transition Pathways Initiative, as of October 2020, https://www.transitionpathwayinitiative.org/sectors and the Climate Action 100+ Focus List, *supra* note 80.

[316] Bebchuk, *supra* note 140, at 876.

representation can, on the other hand, prove incredibly costly. As an extreme example, the most expensive proxy contest in history reportedly cost activist hedge fund Trian Partners $25 million,[317] and the average cost of a proxy fight in the U.S. is in excess of $10 million.[318] Although the vast majority of activist board representation campaigns now result in settlement, this is unlikely to be the case for responsible activists who would not have the reputational clout or the resources to back up a campaign for a climate director with a credible threat of a proxy contest.[319] Prohibitive cost may ultimately prove to be a barrier to the types of appointments proposed in the Engine No. 1 campaign.

The board of directors is and always has been a key focus for the Big Three. Another strategy increasingly favored by the Big Three is the opposite side of the coin–voting against directors who fail to make meaningful progress on climate change. Voting against directors requires considerably less effort than nominating a new director. BlackRock has consistently reiterated its commitment to vote against directors where the company is not dealing with environmental and social concerns appropriately. Its 2021 voting guidelines state "where we believe companies are not moving with sufficient speed and urgency, our most frequent course of action will be to hold directors accountable by voting against their re-election."[320] In September 2020, BlackRock disclosed that it had voted against 55 directors at 49 companies for failing to make progress on climate change. The list of those it voted against was focused mainly on energy companies, including S&P 500 constituents ExxonMobil and Chevron.[321] In its 2021 Stewardship Expectations report, BlackRock outlined that in some instances where it had voted against climate risk shareholder proposals for being too prescriptive, it still voted against directors for insufficient disclosure on climate issues.[322] Therefore, there is some evidence that the Big Three may be more willing to vote against directors than they are to vote in favor of shareholder proposals.

However, even in this arena, the Big Three are not leaders. Many other–largely U.K. and European–asset managers have been much more active in voting against directors who fail to take sufficient action on climate change. At present, these votes may act more as a signal to directors and companies to change their behavior, rather than operating as a real threat of removal. Indeed, in the same year, it was noted that at ExxonMobil, Chevron, BP, Shell and Total, directors were appointed with an average 97% support from shareholders, with a parallel being drawn to the lead-up to the financial crisis, where directors at banks were routinely reappointed with

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[317] Christie, *supra* note 195, at 27 (citing Adam Hartung, *The Case for Trian's Nelson Peltz Joining P&G's Board*, FORBES (Sept. 7, 2017) https://www.forbes.com/sites/adamhartung/2017/09/07/the-case-for-trians-peltz-joining-the-pg-board/#7954396639bb.

[318] Nickolay Gantchev, *The costs of shareholder activism" Evidence from a sequential decision model*, 107 J. FIN. ECON. 610. 611 (2013) (noting that "a campaign ending in a proxy fight has average costs of $10.71 million"). However, it should be acknowledged that most activist hedge fund board representation campaigns – at least with the major activist hedge funds targeting S&P 500 companies – are settled and do not result in a proxy contest or shareholder vote.

[319] *See generally* Krishnan, Partnoy & Thomas, *supra* note 24 (noting that the top hedge funds succeed because they acquire a reputation for what the authors label "clout and expertise").

[320] BlackRock, *supra* note 329, at 7.

[321] Joanna Partridge, *BlackRock votes against 49 companies for lack of climate crisis progress*, THE GUARDIAN (Sept. 17, 2020) https://www.theguardian.com/business/2020/sep/17/blackrock-votes-against-49-companies-for-lack-of-climate-crisis-progress.

[322] BlackRock, *supra* note 309, at 22-23.

more than 95% support despite overseeing strategies that led to dangerous levels of risk.[323]

To conclude, the appointment of climate experts to boards is an area with a lot of potential for ESG arbitrageurs. It has already been demonstrated how successful the strategy of appointing activist directors has been in the traditional governance arbitrageur scenario. Nominating climate directors could have a meaningful impact on firm-specific corporate sustainability strategies and thus could serve to genuinely promote sustainable capitalism. This is an area where responsible activists could generate support from the Big Three, in a similar manner to activist hedge funds. However, the problem may remain one of reputation, power, and financing. Assuming the Big Three and other asset managers are not willing to personally take on this role–due to the problems of rational reticence and rational hypocrisy–ESG hedge funds may be the only actors that could realistically afford to pursue such a strategy. There are lower cost routes that responsible activists have taken, but these are correspondingly less impactful. Nevertheless, appointment of climate directors is a niche in the ESG activism ecosystem that is waiting to be exploited, if any actor has sufficient incentives to do so. There is one early example with Engine No. 1's campaign at Exxon, but Engine No. 1 is a new entrant to the hedge fund market. Therefore, it does not have sufficient kudos in terms of the reputational clout and expertise that hedge funds benefit from when executing campaigns and reaching settlements with target companies. In any event, it will be interesting to discover whether the Big Three and other asset managers support this campaign, which is the first ESG campaign to bear a striking resemblance to more traditional hedge fund activist board representation campaigns.

(ii) Other Strategies

There are some other analogies that can be drawn between the activities of hedge funds as governance arbitrageurs and the activities of responsible activists as ESG arbitrageurs. Hedge fund activism frequently involves "wolf packs". This is the targeting of a company by more than one activist hedge fund, or a loose network of activist investors acting in a collective or parallel manner.[324] In a study of activist interventions across 23 countries from 2000-2010, Becht, Franks, Grant and Wagner show that "wolf packs are associated with almost one quarter of all engagements" and "it is the most profitable type of engagement, reflecting the high probability of achieving successful outcomes".[325] Responsible activists similarly try to maximize their chances of success and impact by joining forces. Various investor and non-profit organizations such as Climate Action 100+ and ShareAction often assume the role of coordinating the activities of investors. Institutional investors increasingly work collectively with these non-governmental organizations to submit shareholder proposals. One example from January 2021 is a resolution submitted to HSBC that was coordinated by the U.K. responsible investment non-profit ShareAction. The resolution requests that HSBC, as Europe's second largest financier of fossil fuels, publish a strategy and targets to reduce its exposure to fossil

[323] Natasha Landell-Mills, *Asset managers must use their votes to tackle climate change*, FIN. TIMES (Oct. 14, 2019) https://www.ft.com/content/da38652c-eb75-11e9-aefb-a946d2463e4b.

[324] Christie, *supra* note 195, at 19 (citing John C. Coffee and Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, J. CORP. L. 545, 562 (2016)).

[325] Marco Becht, Julian Franks, Jeremy Grant & Hannes F. Wagner, *Returns to Hedge Fund Activism: An International Study*, 30 REV. FIN. STUD. 2933, 2934 & 2936 (2017).

fuel assets on a timeline consistent with the Paris climate goals. It was filed by fifteen institutional investors with a combined $2.4 trillion in assets under management, including Europe's largest asset manager Amundi, the world's largest publicly traded hedge fund group, Man Group, and Trinity College, Cambridge, alongside 117 individual shareholders.[326] Earlier in 2020, ShareAction coordinated a similar resolution to be filed at Barclays, Europe's largest financier of fossil fuel companies. This was the first climate change resolution filed at a European bank.[327] Again, the resolution was filed by a group of 11 pension and investment funds managing over £130bn worth of assets.[328] This resolution achieved close to 24% support at Barclay's annual general meeting,[329] which is a significant level of support, but not close to the 75% of shareholder votes that is required for a resolution to pass at a U.K. company. BlackRock voted against the resolution and was criticized for potentially facing "conflicts of interest as it has been selected by Barclays to advise the bank on its climate change strategy".[330] Barclays' own resolution on its net-zero ambition–which was "filed in response to intensive investor engagement triggered by ShareAction's resolution" received 99.93% shareholder support.[331] While it may be very difficult for a single responsible activist to achieve the necessary support for a shareholder proposal to pass, when a group of responsible activists co-file or support the proposal, it puts much more pressure on companies. Similarly, pension fund clients of the Big Three play a crucial role in pressuring them to act on sustainability issues. As noted earlier, it was the actions of pension funds that caused BlackRock to vote in favor of a climate resolution for the first time. At present, pension fund clients are also publicly urging BlackRock to vote in favor of the HSBC resolution[332]

A second innovation in hedge fund activist strategies that may have a relevant analogy in the sustainable capitalism context is golden leash compensation structures. These compensation mechanisms involved director nominees who were not affiliated with the activist hedge fund being offered compensation in exchange for achieving specific (usually financial) targets at the company once elected to the board.[333] Although these compensation structures were extremely controversial in the hedge fund activism context, the important point to note is that such compensation acts as a commitment device.[334] Given that climate experts on the boards of companies (for example at Exxon) have not been particularly successful in catalyzing meaningful change, it may be useful to tie their compensation, and the compensation of other directors and executives, to specific climate targets. Armour

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[326] ShareAction, *USD 2.4 trillion investor group files climate resolution at HSBC*, (Jan. 11, 2021) https://shareaction.org/usd-2-4-trillion-investor-group-files-climate-resolution-at-hsbc/.

[327] ShareAction, *Shareholder resolution at Barclays puts climate crisis centre stage for European banking sector in 2020*, (Jan. 8, 2020) https://shareaction.org/shareholder-resolution-at-barclays-puts-climate-crisis-centre-stage-for-european-banking-sector-in-2020/.

[328] id. The European asset manager Amundi, who was not a co-filer of the Barclays resolution but who supported the resolution filed at Barclays and voted in favor of it, later co-filed the resolution at HSBC.

[329] ShareAction, *24% of shareholders voice dissent at Barclays' current fossil fuel support*, (May 7, 2020) https://shareaction.org/24-of-shareholders-voice-dissent-at-barclays-current-fossil-fuel-support/.

[330] id.

[331] id.

[332] Attracta Mooney, *BlackRock urged to take tough line with HSBC over climate change*, FIN. TIMES (Feb. 6, 2021) https://www.ft.com/content/a5d2969b-d198-4357-a061-095fcd7c932e.

[333] Christie, *supra* note 195, at 30.

[334] Gregory H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 64 UCLA L. REV. 1246, 1249 (2017).

has noted that "so long as stock-based pay is *de rigeur* for corporate executives…managers will face intense pressure to focus on the stock price of their firm….if diversified shareholders are able to coordinate over voting, they could in principle also use their say on pay votes to encourage the use of new metrics designed to combat externalities".[335] Indeed, linking carbon emissions targets to executive pay is becoming more common. As an example, in 2018, following investor pressure from asset manager Robeco and the Church of England, Shell announced that it would tie executive pay to cuts in carbon emissions.[336] In the U.K., there have also been calls for companies to give shareholders a vote, or "say-on-climate". In January 2021, it was reported that "The Investor Forum, an influential group whose members account for a third of the U.K.'s FTSE all-share market capitalization, called on the government to consult on rolling out so-called "say on climate" votes–a concept popularized by hedge fund billionaire Christopher Hohn."[337] The proposal is akin to the concept of "say on pay" votes, which are already a vital part of shareholder meetings. It followed a campaign in 2020 where Aena, the Spanish airport group, became the first company in the world to agree to "say on climate" shareholder votes, following a campaign by Christopher Hohn. Unilever subsequently also pledged to give shareholders a recurrent "say on climate".[338] As a result, one fruitful area for responsible activists is seeking to align executive compensation with climate commitments and pushing for "say on climate" votes for shareholders. These are also proposals which the Big Three might logically be expected to support, in line with their incentives of promoting portfolio-wide climate improvements.

V. RATIONAL HYPOCRISY AND BIG THREE ACCOUNTABILITY

"Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[339]

--former U.S. Supreme Court Justice, Louis Brandeis--

Part II above highlighted that while rational reticence may persist in the index investing context, a second problem–rational hypocrisy–also emerges. There does not seem to be a solution where ESG arbitrageurs can simultaneously address rational hypocrisy as well as effectively mitigating rational reticence. Hedge fund activists actively court, and aim to work collaboratively with, the Big Three to generate support for their campaigns and may succeed in overcoming the problem of firm-specific rational reticence. Responsible activists may similarly attempt to drum up Big Three voting support for their shareholder proposals and thus mitigate

[335] John Armour, *Shareholder Rights*, 36 OXFORD REV. ECON. POL'Y 314, 334 (2020).

[336] *See* Anjli Ravel, Leslie Hook and Attracta Mooney, *Shell yields to investors by setting target on carbon footprint*, FIN. TIMES (Dec. 3, 2018) https://www.ft.com/content/de658f94-f616-11e8-af46-2022a0b02a6c and Andrew Ward, *Shell faces shareholder push on climate change goals*, FIN. TIMES (Mar. 25, 2018) https://www.ft.com/content/fae8e478-2eba-11e8-9b4b-bc4b9f08f381.

[337] Attracta Mooney, *UK urged to introduce mandatory climate votes at AGMs*, FIN. TIMES (Jan. 12, 2021) https://www.ft.com/content/c0e039ae-b6c0-482a-af06-c8902e3ab989.

[338] id. *See also* Attracta Mooney, *Billionaire Chris Hohn forces first annual investor vote on climate policy*, FIN. TIMES (Oct. 22, 2020) https://www.ft.com/content/07e4aa70-a99e-40ea-9b66-2eac47ade0d6 and Judith Evans and Attracta Mooney, *Unilever to put its plan to fight climate change to shareholder votes*, FIN. TIMES (Dec. 14, 2020) https://www.ft.com/content/a0814dc8-c662-4412-a554-0a7d61c65ce8.

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

the problem of portfolio-wide rational reticence. However, focusing on the Big Three in their role as arbiters and pivotal voters may not do much to mitigate the problem of rational hypocrisy. Rather, responsible activists and interest groups may need to target their activism *at* the Big Three themselves, rather than at the target companies. Drawing attention to the mismatch between Big Three rhetoric and action may be crucial to mitigating the agency problem of rational hypocrisy.

A. *Engagement, Voting and Disclosure*

Since 2003, U.S. based mutual funds are required to publicly disclose their voting policies and to publicly disclose how the fund voted on each resolution voted on at companies.[340] This means that the Big Three's voting records are reported in a publicly available repository.[341] However, this information is not particularly useful to investors, as it is reported in an inaccessible format and there would be considerable time, effort and costs involved in collating and analyzing the data. Conditions may, therefore, be ripe for rational hypocrisy to thrive. As outlined by Scott Hirst, "investors in mainstream mutual funds are likely to be unaware of the way their funds vote, and that those votes may not be consistent with their own preferences."[342] There is a "collective action problem of voting information gathering" and the result is that the end-investors do not have a clear picture of the manner in which their mutual fund votes. This lack of transparency can contribute to the problem of rational hypocrisy, as the Big Three may be more concerned with marketing themselves as good stewards or responsible investors, rather than committing more time and resources into ensuring they vote responsibly and robustly engage on key issues.

The engagement activities of the Big Three have historically been lacking in transparency. For many years, the Big Three have issued "Investment Stewardship Reports"[343] which elaborate on the Big Three's behind-the-scenes engagement with companies. The Big Three's stewardship reports contain anecdotal evidence, with selective disclosure of engagements that the Big Three explicitly choose to draw attention to.[344] These stewardship reports mostly operate as a marketing exercise, rather than serving as a comprehensive and honest review of success and failure.

On a voluntary basis, the Big Three have promised to be more transparent with their stewardship activities and voting. BlackRock's Investment Stewardship

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[340] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564 (Feb. 7, 2003) (codified at 17 C.FF.R. §§ 239, 249, 270, 274). This must be reported in an S.E.C. filing on Form N-PX. *See* Investment Company Act of 1940 17 C.F.R. 270.30b1-4 and Hirst, *supra* note 185, at 222.

[341] N-PX filings are available on the S.E.C.'s Edgar database, https://www.sec.gov/edgar/searchedgar/n-px.htm.

[342] Hirst, *supra* note 185, at 235 (noting that although mutual funds disclose their voting policies, and although funds are required to disclose their actual votes, these policies and voting records are difficult to compare and interpret and thus comparing the approaches of multiple funds would require considerable effort).

[343] *See, for example*, BlackRock, *Investment Stewardship Annual Report* (Sept. 2020) https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2020.pdf, Vanguard, *Investment Stewardship 2020 Annual Report* (Sept. 2020) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2020_investment_stewardship_annual_report.pdf and State Street, *Stewardship Report 2018-19*, https://www.ssga.com/library-content/products/esg/annual-asset-stewardship-report-2018-19.pdf.

[344] Griffin, *supra* note 124, at 14.

Group[345] are increasingly publishing voting bulletins on high profile votes. In 2020, their Stewardship Report notes that they published 45 vote bulletins to August 2020, which was four and a half times as many as they have issued in the past three years combined.[346] To cite an example from October 2020, BlackRock issued a press release explaining its rationale for voting in favor of a shareholder proposal at P&G requiring reporting on its effort to eliminate deforestation.[347] While this is a positive development, as more information is being disclosed, the information reported is still selective.

The U.K. now goes much further than the U.S. in terms of asset manager disclosure. The Big Three are all Tier 1 signatures to the U.K. Stewardship Code.[348] In the 2020 Stewardship Code, there is a new emphasis on disclosure and reporting, with each Principle of the Code being followed by "Reporting Expectations". As noted by Katelouzou and Klettner, disclosure through stewardship codes can increase transparency and accountability across the investment chain.[349] Signatories to the U.K. Stewardship Code must disclose "the outcomes of engagement that is ongoing or has concluded in the preceding 12 months".[350] This reporting obligation has the potential to mitigate the problem of rational hypocrisy, as it applies to all engagements. Davies argues that "since the ESG obligations for signatories to the SC are essentially disclosure obligations, their impact on behavior is likely to be driven by the reputational consequences of reporting."[351]

B. *Name and Shame Campaigns*

Due to the historical lack of transparency with regard to the Big Three's voting policies and engagements, responsible activists have targeted the Big Three directly in this regard. As previously highlighted, coalitions of shareholders submitted shareholder proposals to BlackRock and Vanguard.[352] Moreover, there are organizations that focus specifically on improving asset manager accountability. These responsible activists essentially act as "information intermediaries",

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[345] BlackRock advertises that it has the largest global stewardship team in the industry with 50+ people across 8 offices. *See* BlackRock, https://www.blackrock.com/corporate/about-us/investment-stewardship#engagement-priorities. However, given the vast number of portfolio companies in BlackRock's portfolio, commentators insist that BlackRock underinvests in stewardship. *See* Bebchuk & Hirst, *supra* note 38, at 2076-2080.

[346] BlackRock, *Investment Stewardship Annual Report* (Sept. 2020) https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2020.pdf.

[347] BlackRock, *Voting Bulletin: The Proctor & Gamble Company* (Oct 13, 2020) https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-procter-and-gamble-oct-2020.pdf.

[348] Financial Reporting Counsel, *Asset Managers*, https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements/asset-managers (listing the asset managers who have published a statement of commitment to the Stewardship Code). Tier 1 signatories "provide a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary".

[349] Dionysia Katelouzou & Alice Klettner, *Sustainable Finance and Stewardship: Unlocking Stewardship's Sustainability Potential*, *in* GLOBAL SHAREHOLDER STEWARDSHIP: COMPLEXITIES, CHALLENGES AND POSSIBILITIES (forthcoming, Dionysia Katelouzou & Dan W. Puchniak eds.) (EGCI Law Working Paper No. 521/2020) 23, https://ssrn.com/abstract=3578447.

[350] Davies, *supra* note 213, at 144.

[351] Davies, *supra* note 213, at 147.

[352] *See* Mooney, *supra* note 31.

enforcing a system of reputational deterrence.[353] One such organization, Majority Action, runs a campaign to hold asset managers accountable on climate votes.[354] Majority Action has produced a number of reports which detail the voting records of the Big Three and other asset managers in an accessible format. This data is much more user-friendly for investors than the official data that asset managers are obliged to disclose regarding their voting. It therefore serves to increase transparency around the Big Three's voting in practice and thus hold the Big Three accountable.

In recent years, organizations such as Majority Action, ShareAction and Morningstar have published reports, rankings, and research on asset manager voting.[355] For example, ShareAction ranks the 75 most influential asset managers worldwide on responsible investment governance, climate change, biodiversity, and human rights.[356] European asset managers consistently top the list, with Robeco, BNP Paribas Asset Management, and Legal and General Investment Management taking the top three spots. Those asset managers are ranked "A–Leaders" which is defined as "strong management of risks and opportunities, as well as impacts across multiple responsible investment themes". BlackRock ranks 47th, Vanguard ranks 69th and State Street ranks 39th.[357] BlackRock and State Street are both ranked "D–Business as usual" which is defined as "little evidence of suggest adequate management of material responsible investment risks and opportunities". Vanguard is ranked "E–Laggards" which is defined as "evidence suggests poor management of material responsible investment risks and opportunities". These rankings can serve as good marketing for asset managers who genuinely have strong records of on sustainability issues. They can also cause reputational damage to asset managers who outwardly purport to prioritize these issues but have poor rankings in practice. Similarly, Majority Action has published blog posts outlining which key climate-related shareholder resolutions would have passed with BlackRock and Vanguard support. In 2019, they publicized that "BlackRock and Vanguard were among the asset managers least likely to support these critical climate-related resolutions", outlining that at least 16 critical climate votes would have received majority support if both of these asset managers had voted in favor of them."[358]

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

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

[354] Majority Action, *Our Campaigns: Holding Asset Managers Accountable On Climate Votes*, https://www.majorityaction.us/asset-manager.

[355] *See* Majority Action, *supra* notes 29, 162 and 189; Jackie Cook, Morningstar, *How Fund Families Support ESG-Related Shareholder Proposals* (Feb. 13, 2020) https://www.morningstar.com/insights/2020/02/12/proxy-votes.

[356] *See* ShareAction, *Point of No Returns: A ranking of 75 of the world's asset managers approaches to responsible investment*, https://shareaction.org/research-resources/point-of-no-returns/.

[357] id.

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

play a key role in mitigating rational hypocrisy and reducing the agency problems of sustainable capitalism.

Other corporate campaign groups have targeted their activism at BlackRock and other asset managers. For example, "BlackRock's Big Problem" is "a global network of NGO's and social movements that are pressuring asset managers like BlackRock to align their business practices with a climate-safe world".[359] Their website–which likens BlackRock to Goldman Sachs as the "New Vampire Squid", a "global financial giant with its tentacles in major asset classes all over the world"[360]–features a number of articles, reports and campaign strategies highlighting BlackRock's poor record with respect to the climate crisis and other issues.

Despite their massive power, the Big Three nevertheless operate in a delicate equilibrium. On the one hand, they are conscious to mitigate the risk of being subjected to greater regulation if they overreach their power. There are already vocal calls for increased regulation, or break up, of the Big Three due to antitrust issues uncovered in the common ownership literature.[361] Coffee therefore argues that "the threat of political retaliation will incline many institutional investors toward no more than reticent participation in attempts to curb externalities through collective action."[362] On the other hand, the Big Three may be anxious to avoid aggravating investors and society more generally by being perceived as failing to act as responsible stewards. As a result, they care about, and carefully cultivate, their reputation with investors, other institutional shareholders, and the general public. Hill has scrutinized changing attitudes to shareholder power over recent decades, noting that "around the time of the global financial crisis…attitudes to shareholder power became increasingly ambiguous and polarized.[363] Institutional investors were heavily criticized for failing to use their power effectively to mitigate the effects of the global financial crisis.[364] Similar polarization might be evident in the context of climate change and other ESG issues. As highlighted in Part I above, the Big Three face significant pressure to use their power responsibly to mitigate the effects of the global climate crisis. They risk losing their social mandate if they are perceived as abusing their power. Barzuza, Curtis and Webber have likewise argued that "each index fund faces pressure to make sure it is not perceived as less committed to social values than its competitors".[365] Name and shame campaigns on the part of responsible activists draw attention to this delicate balance. Therefore, such activism could prove to be particularly effective in closing the gap between the Big

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[359] BlackRock's Big Problem, https://www.blackrocksbigproblem.com/about (noting that the initiative partners with other organizations such as Friends of the Earth U.S., Amazon Watch and Sierra Club)

[360] id. (citing Ellen Brown, *Meet BlackRock, the New Great Vampire Squid*, COMMON DREAMS (June 22, 2020). https://www.commondreams.org/views/2020/06/22/meet-blackrock-new-great-vampire-squid

[361] *See generally* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016); Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors* 81 ANTITRUST L. J. 669 (2017); José Azar, Martin Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018).

[362] Coffee, *supra* note 131, at 36.

[363] Jennifer G. Hill, *Images of the shareholder – shareholder power and shareholder powerlessness*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER AND ACTIVISM, 56 (Jennifer G. Hill and Randall S. Thomas eds. 2015).

[364] id.

[365] Barzuza, Curtis & Webber, *supra* note 17, at 158.

Three's rhetoric and their actions in practice. This has promise for mitigating the problem of rational hypocrisy and thus the agency costs of sustainable capitalism.

CONCLUSION

In 2020, BlackRock CEO Larry Fink argued that the climate crisis would trigger a "fundamental reshaping of finance".[366] By that stage, a fundamental reshaping of the investor landscape–featuring the incredible rise to power of the Big Three–had already passed the point of no return. In the absence of regulation to break up the Big Three, their future dominance is largely assured. The urgent global problem of the risk caused by the climate crisis is similarly going nowhere. The Big Three's assumed role as sustainable capitalists therefore becomes increasingly important not only for economic reasons, but also for the future of humanity. This Article sought to map the potential and perils involved in the Big Three assuming this role. It identified and analyzed the dual agency problem that arises in the context of the Big Three's sustainable capitalism–rational reticence and rational hypocrisy. Rational reticence has long been recognized as afflicting institutional investors. The passive index investing revolution does not solve this problem, and indeed may exacerbate it. A monitoring shortfall therefore persists. Examining the wide gulf between the Big Three's rhetoric and their corresponding actions also revealed a new problem: rational hypocrisy. These dual problems give rise to what I have called the agency costs of sustainable capitalism. There is a divergence between the Big Three's actions in the climate context and the rational preferences of diversified index investors who represent society as a whole.

The Article then turned to the potential solutions to these problems by investigating the role different forms of ESG arbitrageurs could play in mitigating these agency costs. Through examining the evolving role of activist hedge funds as governance arbitrageurs in the agency capitalism framework, the Article discussed whether an analogous solution presents itself in the sustainable capitalism framework. Activist hedge funds focusing on ESG campaigns and organizations I call responsible activists emerge as potential candidates to fill the new monitoring shortfall. The Article suggests that because of the dual problem, neither group is well positioned to eliminate the agency costs of sustainable capitalism entirely. ESG hedge funds may successfully mitigate firm-specific rational reticence but could exacerbate rational hypocrisy. Responsible activists may mitigate portfolio-wide rational reticence but generally lack the financing to take on target companies to the same extent that wealthy and formidable activist hedge funds do. Ultimately, a key role that responsible activists can play is to target the Big Three themselves, by exposing the discrepancies between their words and actions in order to ensure that hypocrisy does not remain rational in future.

[366] Fink, *supra* note 28.