Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk

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This Article presents the case for risk-related activism—the exercise of shareholder power to promote firm management, mitigation, and disclosure of risk, including nonfinancial environmental, social, and governance (ESG) risks. Drawing on a substantial empirical literature largely overlooked in current corporate governance debates, it presents evidence that accounting for both financial and nonfinancial risk can drive firm and portfolio performance, while advancing market transparency and stability. Risk-related activism therefore represents a realignment of investor interests with long-term firm value and core regulatory goals. This Article also counters common objections to institutional investor monitoring by showing that risk-related activists have both the tools and the incentives to engage portfolio firms. This evidence urges greater attention to ESG risks by corporate boards and stronger regulatory and policy support for risk-related activism as a path toward greater corporate accountability.

I. INTRODUCTION 649

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II. SHAREHOLDER ACTIVISM AND RISK 654
A. Understanding Risk 654
1. Firm-Specific Risk 655
2. Portfolio Risk 656
3. Systemic Risk 656
4. ESG Risk 657
B. The Activist Toolkit 658
III. THE RATIONALES FOR RISK-RELATED ACTIVISM 662
A. Risk Management as Good Governance 663
B. Fundamental Financial Performance 664
C. The Financial & Nonfinancial Risk Link 666
D. Information Asymmetry 668
E. The Risk-Return Link 671
F. A Word About Short-Termism & Risk 673
III. BEYOND PASSIVITY: THE MEANS OF RISK-RELATED ACTIVISM 675
A. The Passivity Challenge 676
B. Activist Arbitrageurs 677
1. Activism Without Blockholders 678
2. The "Other Arbitrageurs" 681
3. Blurring the Lines 682
C. Beyond Activism: ESG Integration 683
1. Understanding ESG Integration 683
2. Breaking Down Structural Barriers 684
IV. ASSESSING IMPACT 686
A. The Metrics of Activism 686
1. The Limits of Financial Metrics 687
2. Evidence From Returns 688
3. Evidence From Withdrawn Shareholder Proposals 688
4. Evidence from Corporate Practice 690
B. Anticipated Objections 690
1. The Agency Cost Challenge 691
2. Special Interests and Investor Heterogeneity 693
3. Beyond the Bottom Line 694
V. THE FUTURE OF FIDUCIARY CAPITALISM 694
A. Reorienting Corporate Boards 695

B. Reorienting Investors 697
VI. CONCLUSION 700
APPENDIX: ESG METRICS 701

I. INTRODUCTION

In 2014, New York City's public pension funds kicked off a "Boardroom Accountability" campaign targeting 75 major public companies and seeking shareholder

approval for proxy access—corporate bylaw changes that would open certain board seats to candidates nominated directly by shareholders.[1] In 2015, over 70% of these proposals were approved by at least a majority vote, creating new momentum for proxy access among leading firms.[2] As an example of shareholder activism, the campaign represents the results of over a decade of market and regulatory shifts that have increased the ownership concentration of public corporations and put greater voting power and influence into the hands of fewer investors.[3] These changes have revived expectations that institutional investors, like mutual funds and public pension funds, which now hold most of the publicly traded equity in the United States,[4] will play an active monitoring role for public corporations.

At the same time, the pension fund campaign challenges much of the received wisdom about how shareholders actually behave. The campaign's stated objective—to "ensure that companies are managed for the long-term" for the benefit of diversified investors—is quite conventional.[5] Yet the campaign is backed by Ceres, a coalition of investors who advocate sustainable business practice, and its supporters see proxy access and board accountability to shareholders—corporate governance reform—as a way to make boards more responsive to investors' views on board diversity, executive compensation and climate change, all topics generally considered to be "social" goals of niche investors. Taking the campaign's goals at face value therefore raises interesting questions about how nonfinancial issues can drive long-term value for target firms and their shareholders and how shareholders should use their power.

As it happens, part of the answer has to do with risk. Of course, risk matters to all investors because firm profitability and investment returns depend on the associated risk.[6] However, the board accountability campaign has targeted firms because of broader risk concerns, specifically, the perceived "risks associated with climate change, board diversity, and excessive CEO pay."[7] In fact, the pension funds are engaging in "risk-related activism"—the exercise of shareholder governance rights to motivate firms to effectively monitor, manage, and disclose risk, including nonfinancial environmental, social, and governance (ESG) risks. The term "ESG" is now widely used by institutional investors and investment professionals to refer not only to sustainability measures or to environmental, social, or governance practices specifically, but to all nonfinancial fundamentals that can impact firms' financial performance, such as corporate governance, labor and employment

1. Press Release, N.Y.C. Comptroller, NYC Pension Funds Launch National Campaign to Give Shareowners a True Voice in How Corporate Boards are Elected (Nov. 6, 2014), http://comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-pension-funds-launch-national-campaign-to-give-shareowners-a-true-voice-in-how-corporate-boards-are-elected/.

2. During the 2015 proxy season, over 80 proxy access proposals went to a vote, and over 70% received majority voting support. PWC, PROXY PULSE: 2015 PROXY SEASON WRAP-UP 2, 6 (3d ed. 2015), http://media.broadridge.com/documents/ProxyPulse-Third-Edition-2015.pdf [hereinafter PROXY PULSE].

3. *See, e.g.*, Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55, 57 fig. 1 (2007) (discussing these trends).

4. For information on the changes in ownership patterns, see generally MATTEO TONELLO & STEPHEN RABIMOV, 2010 INSTITUTIONAL INVESTMENT REPORT 22 tbl.10 (2010), http://www.shareholderforum.com/e-mtg/Library/20101111_ConferenceBoard.pdf.

5. *Boardroom Accountability Project*, N.Y.C. COMPTROLLER, http://comptroller.nyc.gov/boardroom-accountability/ (last visited Feb. 15, 2016).

6. *See generally infra* Part II (discussing various forms of risk).

7. *See* N.Y.C. Comptroller, *supra* note 1 (quoting Comptroller Stringer).

standards, human resource management, and environmental practices.[8] Consistent with emerging international standards discussed below, this Article defines risk-related activism to include investor engagement with portfolio firms that (1) urges companies to adopt sound governance practices, including effective risk management; (2) encourages corporate boards to effectively identify and manage both financial and nonfinancial, or ESG, risks; or (3) seeks to improve the quality of financial reporting and voluntary disclosures related to risk. Activism to achieve goals that *increase* the target firm's risk exposure or undercut prudent risk management are not included.

Risk-related activism is not a new concept. Indeed, in the wake of the financial crisis, many policymakers and other advocates of shareholder power saw better alignment between corporate boards and shareholders as a way to constrain excessive managerial risk-taking and prevent future corporate governance failures by public companies.[9] It is therefore no accident that the reforms expanding shareholder voice in corporate governance were adopted in tandem with regulatory mandates for public corporations that focused on firm risk management and oversight.[10]

The potential impact of broader risk factors on investment risk and return also drive many of the emerging regimes that seek to promote investor monitoring of portfolio firms. For example, the United Nations' Principles for Responsible Investment (UNPRI), whose signatories now account for over half of all publicly traded equities globally,[11] commit institutional investor signatories to engage portfolio firms around ESG performance and to encourage investment intermediaries to do the same.[12] The complementarity between shareholder governance rights and the primary responsibilities of corporate boards and managers to monitor and manage risk also informs international corporate governance codes, such as the International Corporate Governance Network's (ICGN) Global Governance Principles and its 2013 Statement of Principles for Institutional Investor Responsibilities,[13] the Organization for Economic Co-Operation and Development's (OECD) Principles of Corporate Governance,[14] and responsible investment or investor stewardship codes adopted by governments around the world since 2011, including the

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8. *See, e.g.*, *The Six Principles*, PRI, http://www.unpri.org/about-pri/the-six-principles/ (last visited Feb. 15, 2016) (discussing ESG factors)*; see also* Dinah A. Koehler & Eric J. Hespenheide, *Finding the Value in Environmental, Social, and Governance Performance*, 12 DELOITTE REV. 99, 101 (2013) (defining ESG risks to include product, supply-chain, and operational risks).

9. *See* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 850 (2005) (discussing greater shareholder involvement with corporate managers); Mary L. Schapiro, *Testimony Concerning the State of the Financial Crisis: Testimony Before the Financial Crisis Inquiry Commission*, SEC (Jan. 14, 2010), https://www.sec.gov/news/testimony/2010/ts011410mls.htm (advocating stronger accountability to shareholders for these reasons).

10. *See* Ellul & Yerramilli, *infra* note 88, at 1761 (discussing proxy disclosure rules on board risk oversight and executive compensation). These rules apply to all public companies, in addition to the more comprehensive reforms targeting the banking sector, many of which focused on the dangers posed by systemic risk.

11. PRI, THE SILENT REVOLUTION: THE POWER BEHIND THE PRINCIPLES 3 (2014), http://www.unpri.org/wp-content/uploads/PRI-Nasdaq_Silent-Revolution1.pdf.

12. *About the PRI Initiative*, PRI, http://www.unpri.org/about-pri/about-pri/ (last visited Feb. 15, 2016).

13. ICGN, STATEMENT OF PRINCIPLES FOR INSTITUTIONAL INVESTOR RESPONSIBILITIES (2013), https://www.icgn.org/policy/responsible-investment-codes.

14. OECD, OECD PRINCIPLES OF CORPORATE GOVERNANCE (2004), http://www.oecd.org/daf/ca/corporategovernanceprinciples/31557724.pdf; *see also* OECD, THE ROLE OF INSTITUTIONAL INVESTORS IN PROMOTING GOOD CORPORATE GOVERNANCE (2011), http://www.oecd.org/daf/ca/49081553.pdf [hereinafter OECD (2011)] (promoting investor monitoring).

United Kingdom, Canada, Australia, Japan, and the European Union.[15] Recognizing the power investors wield in modern capital markets, these codes direct institutional investors to promote better firm governance and risk management through the exercise of voting and other governance rights and through investor influence over asset managers. They also seek to hold institutional investors accountable for how they use their power.

Critics have cautioned, however, that these measures simply will not work because institutional investors lack the incentives and the ability to play a monitoring role.[16] Although the New York board accountability campaign claims to push systemic market reform, from this perspective it is exceptional, since most public pension funds prefer passive investment strategies.[17] Looking to shareholders as a source of corporate accountability may also be misguided because shareholders are perhaps as much to blame as corporate boards for the excessive risk-taking that fueled the financial crisis.[18] The controversy over shareholder empowerment has deepened with the rise of hedge fund activism, which has sparked debate over whether those most likely to use their power are short-term investors whose strategies will cause firms to take on more risk and jeopardize long-term firm value.[19] What is undisputed is that investors have diverse preferences, that investors' goals do not always align with effective risk management or maximizing long-term firm value, and that most institutional investors do not actively monitor portfolio firms.

The New York pension fund campaign therefore points to two of the central challenges raised by shareholder power. The first is how to motivate more shareholders to use their power to play a monitoring role, and the second is how to ensure that those who engage in activism do so in a manner that is transparent and promotes long-term firm value and prudent risk-taking. Whether risk-related activism like the board accountability campaign suggests a useful response to the first challenge or demonstrates the urgency of the second depends largely on its economic justifications.

This Article presents the business case for risk-related activism. It argues that risk-related activism represents a re-alignment of investor power with the core regulatory goals that motivated shareholder empowerment in the first place and that it has the potential to advance market transparency and stability. However, broader shareholder and board

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15. *See, e.g.*, FIN. REPORTING COUNCIL, THE U.K. STEWARDSHIP CODE (Sept. 2012), https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf (introducing investor stewardship guidelines). For a list of responsible investment codes and related links, see *Responsible Investment Codes*, ICGN, https://www.icgn.org/policy/responsible-investment-codes (last visited Feb. 15, 2016) (noting that these codes do not apply to retail investors and other beneficial owners).

16. 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, 868–89 (2013).

17. *See id.* at 865, 889–96 (discussing the sources of investor passivity).

18. *See* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 659 (2010) (pointing to shareholder short-termism as a major cause of the financial crisis); Lynne L. Dallas, *Short-Termism, The Financial Crisis & Corporate Governance*, 37 J. CORP. L. 265, 267 (2012) (linking the financial crisis to short-termism by financial institutions).

19. *See generally* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008) (advocating fiduciary duties for minority shareholder activists); April Klein & Emanuel Zur, *The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders*, REV. FIN. STUD. 1735 (2011) (analyzing the impact of hedge fund activism on the default risk of firms targeted between 1994 and 2006). Lucian Bebchuk and others have argued, in contrast, that hedge fund activism contributes to long-term firm value. *See generally* Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015) (analyzing activist interventions between 1994 and 2007).

support for risk-related activism and consideration of new models to promote accountability for activists themselves have been impeded by outdated understandings of the goals and tools of risk-related activism as incompatible with shareholders' economic interests. Drawing on a substantial literature largely overlooked in current corporate governance debates, this Article challenges these conceptual barriers by presenting the economic rationales for risk-related activism. It demonstrates that activism directed toward these goals can generate long-term firm value that benefits shareholders as a class and satisfies the fiduciary duties that institutional investors owe to the individuals who are their ultimate beneficiaries and clients.

This Article also presents evidence that risk-related activists have the ability to serve as active monitors of portfolio firms using the standard tools provided by corporate law and federal proxy regulation, primarily through direct dialogue with firms, backed by shareholder-sponsored proposals. This Article shows further that these efforts can drive changes in firm practice and help refocus firm management on drivers of long-term risk and return. Importantly, the argument here does not assume that all investors actively monitor portfolio firms, that financial goals motivate all risk activism, or that any particular activist campaign will in fact be value-enhancing if implemented by the target firm. Whether and how activists' goals are realized are matters that corporate law leaves ultimately to corporate boards.

Part of the explanation here for *how* risk-related activism actually works parallels prior accounts of hedge fund activism by Ron Gilson and Jeff Gordon.[20] They observe that institutional investors are not in fact passive, but "rationally reticent"—that is, most are unlikely to initiate activism, but will vote on proposals initiated by hedge fund activists.[21] Similarly, evidence from shareholder proposals and the broader literature on shareholder engagement shows that by initiating engagement with target firms and then presenting proposals to a shareholder vote, a relative few shareholder activists can facilitate voting by other shareholders on matters related to firm governance, risk management, and disclosure, as well as direct changes in corporate conduct.[22] In addition, the rationales for risk-related activism presented here support equally the incorporation of nonfinancial ESG indicators into passive and automated investment strategies. Expanding the use of tools for ESG integration in investment analysis and practice may help overcome many of the structural barriers to institutional investor monitoring—such as financial intermediation and short-term trading practices—that have been previously identified in the literature.

Of course, many activists are not explicit about how their specific goals relate to risk mitigation, risk management, or firm value. However, viewing activism that directly or indirectly aims to encourage appropriate risk-taking as "risk-related" offers new insights into the incentives for institutional investor monitoring more broadly. It also fills a gap in the current corporate governance literature, where debates have focused heavily on how shareholder activism affects investor risk-adjusted returns, with less explicit attention to risk itself.

Part II begins by introducing core definitions and measures of risk from the perspective of firms and diversified investors. Part III then presents the economic rationales for risk-related activism, while Parts IV and V show how risk-related activism occurs and

20. *See generally* Gilson & Gordon, *supra* note 16.

21. *Id.*

22. *See infra* Part IV (analyzing the "means of risk-related activism").

present evidence of its impact on the financial performance and behavior of target firms. The initial conclusion, and one with broad ramifications for investors, firms, and their legal advisors, is that any effort to realign shareholder interests with long-term firm value will require greater attention to nonfinancial risks by corporate boards and by shareholders themselves. A further conclusion is that if institutional investors have both the tools and the incentives to actively monitor portfolio firms, then policy reforms encouraging greater transparency by activist investors around their exercise of governance rights, perhaps modeled on international corporate governance standards or the recent transparency mandates for investment advisers and proxy advisory firms,[23] could encourage value-enhancing monitoring and also strengthen the accountability of investment fiduciaries to their clients and beneficiaries.

II. SHAREHOLDER ACTIVISM AND RISK

A foundational premise of the New York pension funds' campaign, as well as the UNPRI and international corporate governance codes, is that institutional investors have economic incentives to engage in activism that derive both from the prospect of reduced risk and the potential for higher returns. The U.K.'s Stewardship Code, for example, combines both of these elements: it defines the core goal of stewardship or active ownership as "*enhancing and protecting* . . . value for the ultimate beneficiary or client."[24] Similarly, signatories of the UNPRI commit to be "active owners" who take into account "the relevance to the investor of [ESG] factors, and the long-term health and stability of the market as a whole . . . . in order to allocate capital in a manner that is aligned with the short and long-term interests of their clients and beneficiaries."[25]

To understand why diversified investors might engage in activism around firm risk management and mitigation and whether they can, in fact, do so effectively requires a brief introduction to shareholder activism and risk concepts. Section A explains the types of risk that matter to investors and to firms. Although somewhat technical, these concepts are important to understanding the relationship between nonfinancial risk and standard measures of financial and investment risk, and where firm and investor interests in risk management align. Section B then explains the basic forms of shareholder activism, particularly as they relate to activism around risk.

A. Understanding Risk

At its most basic, risk can be defined as uncertainty about outcomes or events, and in financial terms, it reflects the volatility or variation in expected financial outcomes.[26] The term "risk" therefore has both positive and negative dimensions, whether it refers to the uncertainty of future events or of financial outcomes. Shareholders stand to benefit when

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23. *See infra* Section VI.B (discussing these recommendations).

24. The two are synonymous under the U.K. Stewardship Code. FIN. REPORTING COUNCIL, *supra* note 15, at 6 (emphasis added).

25. *Introducing Responsible Investment*, UNPRI, http://www.unpri.org/introducing-responsible-investment/ (last visited Feb. 15, 2016). Principle 2 of the UNPRI commits signatories "to be active owners," consistent with fiduciary duties. *The Six Principles*, UNPRI, http://www.unpri.org/about-pri/the-six-principles/ (last visited Feb. 15, 2016).

26. Marc Orlitzky & John D. Benjamin, *Corporate Social Performance and Firm Risk: A Meta-Analytic Review*, 40 BUS. & SOC'Y 369, 370 (2001) (citations omitted).

management accepts an appropriate, but not excessive, level of risk associated with business opportunities, innovation, investment, and other strategic choices that promise a net positive return.[27] Because distinguishing the two requires careful judgment, corporate law charges corporate boards with oversight of the firm's risk management function. However, understanding why shareholders might engage in risk-related activism directed at particular target firms is further complicated by the different measures of risk that are relevant to investors and firm managers.

1. Firm-Specific Risk

From the firm's standpoint, high financial return and low financial risk are the twin indicators of economic performance.[28] For nonfinancial firms, much of the focus of the risk management function is directed at reducing or hedging firm-specific or idiosyncratic risk,[29] which is the variability or volatility in various dimensions of the firm's financial performance over time. Idiosyncratic risk can be quantified using market measures of risk—such as the volatility of the firm's stock price—or measures of accounting risk, namely, the variability of internal accounting returns, such as the standard deviation of return on assets (ROA) or the standard deviation of return on equity (ROE).[30] Higher idiosyncratic risk affects the firm's financial performance, since greater unpredictability can impair long-term planning and the firm's ability to weather crisis.[31]

Idiosyncratic risk includes both financial and nonfinancial risks. Financial risks are external events that have the potential to affect a financial outcome, such as the ability to collect debts owed to the firm (credit risk), to exchange assets for cash quickly (liquidity risk), or to sell assets at a desired rate of return (market risk). These risks can typically be hedged with financial instruments.[32] All other risks are nonfinancial risks. These include operational or business risk, resulting from the failure of internal processes or systems, or from external events, as well as reputational risk and strategic risk.[33] Like other nonfinancial risk, operational risks—including key compliance or legal risks—are inherent in any business and cannot be hedged or completely eliminated, and as discussed below, they can also affect financial risk. Moreover, firms can experience uncertainty about the likelihood and magnitude of negative risk events, such as future liability, as well as uncertainty about the future return associated with new investment opportunities. Although both positive and negative events can impact the firm's idiosyncratic risk, a firm will generally wish to lower its exposure to material negative risk events, which can reduce long-term value, but should take on appropriate risk in order to achieve growth and higher expected returns on its own investments.

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27. This formulation is a slightly simplified version of the net present value test for capital investment.

28. Orlitzky & Benjamin, *supra* note 26, at 370–71 (citations omitted).

29. Daniel A. Rogers, *Managing Financial Risk and Its Interaction with Enterprise Risk Management*, *in* ENTERPRISE RISK MANAGEMENT 321, 322–31 (John Fraser & Betty J. Simkins eds., 2010).

30. *See* Orlitzky & Benjamin, *supra* note 26, at 379 (discussing these standard measures).

31. *See id.* (reviewing the literature).

32. *See generally* Rogers, *supra* note 29.

33. Diana Del Bel Belluz, *Operational Risk Management*, *in* ENTERPRISE RISK MANAGEMENT, 279, 279–80 (John Fraser & Betty J. Simkins eds., 2010).

2. Portfolio Risk

The standard capital asset pricing model (CAPM) predicts that investors with a higher risk appetite are compensated with higher returns for bearing that risk. However, idiosyncratic or firm-specific risk is of less interest to shareholders. According to portfolio theory, investors cannot earn a higher return by bearing idiosyncratic risk, because it is diversifiable. Instead, their return is based only on the market or systematic risk of their portfolio, which is a function of the market risk of each stock in the portfolio.[34] Market or systematic risk is the degree to which a given stock (or portfolio) fluctuates in response to changes in the market as a whole and is measured by the beta coefficient of the stock (or portfolio). Riskier investments will be more volatile than less risky ones, and on balance, market risk is higher for firms with higher leverage or higher costs and also for smaller or higher-growth firms than for larger or more stable firms.[35] Total market risk, which is typically measured using the standard deviation of the company's stock returns, includes both systematic (i.e., undiversifiable) risk and idiosyncratic (i.e., diversifiable) risk.[36]

Under CAPM, the market price of the firm's stock is a measure of the expected future cash flows of the firm. The discount rate applied to those cash flows is the cost of equity capital and reflects the market risk, not the idiosyncratic risk, of those cash flows.[37] If CAPM holds, there is a direct, positive relationship between risk and return: the higher the risk, the higher the discount rate and the lower the present value of the stock, implying a higher return to investors. A less risky (i.e., volatile) portfolio should offer a lower expected return. Because additional factors beyond the CAPM parameters have been found to contribute to portfolio risk, multi-factor models for measuring market risk have also been developed and are widely used in the literature referenced below.[38] In addition, value-at-risk (VaR) is another tool that has emerged since the development of CAPM to measure market risk and is widely used by financial institutions, asset managers, and regulators, as well as in enterprise risk management (ERM).[39] However, because VaR has been applied less extensively to test the effect of nonfinancial factors on portfolio risk, the studies referenced in this Article generally rely on CAPM and related multi-factor risk measures.

3. Systemic Risk

Beyond systematic risk, which measures how much a firm's stock—or an investor's portfolio—responds to market movements, all investors are also exposed to systemic risks (i.e., the "risk of failure in the financial system").[40] These risks are important, since

34. STEPHEN A. ROSS ET AL., CORPORATE FINANCE 353–54 (10th ed. 2013).

35. *Id.* at 360–67.

36. Orlitzky & Benjamin, *supra* note 26, at 379.

37. *Id.* at 363–67.

38. Many of the studies referenced *infra* Part III use one of these standard alternatives, such as the Fama-French three-factor model or the Fama-French-Carhart four-factor model, instead of CAPM to more precisely identify abnormal returns. *See generally* Eugene F. Fama & K. R. French, *Common Risk Factors in the Returns on Stocks & Bonds*, 33 J. FIN. ECON. 3 (1993); Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57 (1997).

39. As a method of measuring portfolio risk, VaR measures the maximum expected investment loss over a certain time period at a given confidence level, based on historical distributions; however, the accuracy of its predictions weakens over longer time horizons. PHILIPPE JORION, VALUE AT RISK: THE NEW BENCHMARK FOR MANAGING FINANCIAL RISK viii–ix (3d ed. 2006).

40. PAUL SWEETING, FINANCIAL ENTERPRISE RISK MANAGEMENT 97–99 (2011). The volatility of the

diversified investors' returns are driven largely by the underlying volatility of the market itself, which as we have seen, can be significantly affected by weaknesses in the financial system.[41] Leverage, scale, lack of transparency, the degree of integration or networking within the financial system, and information asymmetry are all sources of systemic risk, and all have been linked to the most recent financial crisis.[42] The use of hedging and insurance strategies are essential to reducing and managing financial risk, but their use may itself become a source of systemic risk. Examples from the financial crisis include mortgage-backed securities, credit default swaps, and other complex instruments whose risks now appear to have been poorly understood.[43] New sources of systemic risk are continually emerging, such as climate change, resource scarcity, bioterrorism, cybersecurity, and technological integration that may have significant effects on global capital markets.[44] Unless firms identify and quantify new risks, investors and regulators may be unable to gauge their magnitude.[45]

4. ESG Risk

Like the term "risk," the term "ESG" is itself neutral and can refer to ESG practices generally. Corporate governance and other ESG practices may also be viewed positively because of their potential contribution to firm profitability.[46] Similarly, the term "ESG risk" can refer to uncertainty about both the positive and negative outcomes of firm behavior, but it is used here to emphasize the negative effect of poor ESG practices. As the preceding discussion shows, many ESG risks are nonfinancial firm-specific risks, such as risks arising from future environmental liability, reputational harm, changes in the firm's asset base, or the agency costs of poor corporate governance. ESG risks may also increase market risk, which can be managed by firms but not eliminated through diversification.[47] Still other ESG risks, such as climate change risk (environmental) or unforeseen risks in standard hedging practices (governance), represent systemic risks that can affect an entire industry or economy with broader consequences for the market and for investors.

Table 1 of the Appendix provides examples of ESG measures that have been used by institutional investors or developed by standard-setting bodies for use in financial analysis and reporting. As these examples show, many ESG measures are forward-looking or leading indicators of value and risk over medium- to long-term time horizons. In general, the governance measures used by institutional investors are standard metrics used to assess board alignment with shareholders, board independence and entrenchment, and the degree of managerial control. Many of the "E" and "S" factors are related to the corporate social

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market itself is captured in CAPM by the equity risk premium, which is the difference between a market return and the risk-free rate of return. Systematic risk then measures how volatile the portfolio is relative to this baseline.

41. *See generally* Ioannis Oikonomou et al., *The Impact of Corporate Social Performance on Financial Risk and Utility: A Longitudinal Analysis*, 41 FIN. MGMT. 483 (2012) (finding that capital market volatility enhances the strength of the relationship between various ESG indicators and systematic risk).

42. IOSCO, MITIGATING SYSTEMIC RISK: A ROLE FOR SECURITIES REGULATORS 16–21 (Feb. 2011), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD347.pdf (discussion paper).

43. *Id.*

44. Ian Goldin & Tiffany Vogel, *Global Governance and Systemic Risk in the 21st Century: Lessons from the Financial Crisis*, 1 GLOB. POL. 4, 12 (Jan. 2010).

45. *See* IOSCO, *supra* note 42, at 39–40 (acknowledging this challenge and proposing responses).

46. *See infra* Section III.B (surveying the literature).

47. *See infra* Section III.C (discussing evidence of this relationship).

performance (CSP) or sustainability of portfolio firms and to the company's impact on its key stakeholders. Conceptually, responsible business practices should translate into lower ESG risks, while irresponsible business practices should increase ESG risks.[48]

B. The Activist Toolkit

Risk-related activism utilizes the basic toolkit that state corporate law and federal securities law give all investors to monitor and influence the firm's board of directors, and through them, its management: the ability to elect directors, veto fundamental transactions approved by the board, adopt bylaws, enforce director and officer fiduciary duties through derivative litigation, and initiate or support proposals for board action. Of these, shareholders' primary tools to effect corporate change are the right to initiate shareholder proposals and bylaw changes, and the power to directly engage with corporate management to achieve their goals. Although simply exercising voting rights can itself be considered a form of activism, this Article follows the literature by referring to shareholder activists as investors who use more direct forms of influence, such as *initiating* shareholder proposals, direct engagement with firm executives and directors, or proxy contests for director seats.

Of course, most shareholders who are disappointed with the performance of a particular stock or a company's management can (and do) simply exit by selling their shares.[49] However, investor exit might not be a viable option for all investors, since a position that is large enough to cause a noticeable drop in the share price when liquidated may be difficult for the investor to sell without a loss.[50] For investors who want to change corporate behavior, exit may also be less attractive since, like consumer boycotts, it will have little impact on the firm unless the investor directly communicates its reasons to firm management.

The most direct, and perhaps expensive, way to challenge firm management is through shareholder litigation. Legal action may challenge inadequate or misleading disclosures under the securities laws, or raise fiduciary duty claims against a transaction that has been approved by the corporation's board of directors.[51] Pension funds, in particular, are frequently approached by other investors to serve as the lead plaintiff in shareholder litigation.[52]

The most obvious tool to promote greater attention to risk management is a derivative action challenging board *inaction* for failure to exercise risk oversight as a breach of fiduciary duty, but these claims are no longer viable in the vast majority of cases.[53] Absent

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48. These correlations are supported by numerous studies discussed *infra* Part III.

49. *But see* John Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1288 (1991) (observing even in the early 1990s the decline of exit and the rise of activism).

50. *See* Miguel Rojas et al., *Bringing About Changes to Corporate Social Policy through Shareholder Activism: Filers, Issues, Targets, and Success*, 114 BUS. & SOC'Y REV. 217, 220 (2009) (surveying prior studies confirming the limited effect of divestment).

51. Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 318 (2008).

52. *See id.* at 319–20 (observing pension fund participation in litigation); Michael Perino, *Have Institutional Fiduciaries Improved Securities Class Actions? A Review of the Empirical Literature on the PSLRA's Lead Plaintiff Provisions*, *in* CAMBRIDGE HANDBOOK OF INSTITUTIONAL INVESTMENT AND FIDUCIARY DUTY 146 (James P. Hawley et al. eds., 2014).

53. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) ("[Breach of oversight duty] is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.").

willful disregard of fiduciary duties, such as a complete failure to implement a compliance system or a failure to respond to "red flags" as they arise, the business judgment rule ensures substantial deference to boards in implementing a compliance system, and in monitoring and responding to risk events.[54] Moreover, the Delaware Court of Chancery has held that the scope of oversight duty only encompasses legal or compliance risks, not business risk.[55] The high standard of liability for an alleged breach of oversight duty, as well as the procedural hurdles presented by derivative suits, prevent the threat of litigation from affecting firm risk-taking incentives in any substantial way.

In contrast, regulatory reforms over the past decade have dramatically increased the direct and indirect influence of shareholder voting. Historically, the right to elect corporate directors was of limited utility because candidates could be nominated only by the current board and its nominating committee. Shareholders opposing these nominees had only the right to vote against the nominee, or to engage in a proxy contest at their own expense to seek support for their own nominee. However, election of the board's nominees was difficult to challenge. Because Delaware law previously mandated that directors be elected by only a plurality of the votes, and any withheld votes were not counted, abstentions were essentially a vote in favor of management's nominees.[56]

A number of reforms have changed the landscape dramatically. In 2006, Delaware authorized corporate charters to adopt majority, rather than plurality voting for directors. In addition, with the passage of Delaware's proxy access rule in 2009, corporate bylaws can now permit the nominees of shareholders meeting certain criteria to be voted on alongside the board's own nominees at the firm's expense, as the New York pension fund campaign illustrates.[57] Regulatory guidance has also clarified that the fiduciary duties of mutual funds, Employee Retirement and Income Security Act of 1974 (ERISA)-governed pension funds, and other institutional investors require them to vote corporate proxies.[58] Finally, in 2010, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank) eliminated undirected broker voting for director elections, executive compensation, and other "significant matters." [59] As a result, withheld votes no longer count in favor of management. Federal rules under Dodd–Frank also mandated advisory shareholder votes on executive compensation (say-on-pay) and on the frequency of such votes (say-when-on-pay) that have given investors greater leverage with corporate boards.[60]

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54. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

55. *See generally In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009).

56. *See generally* Bebchuk, *supra* note 9 (discussing the limits of shareholder voting prior to the Dodd–Frank reforms).

57. *See* DEL. CODE tit. 8, §§ 112–13 (2009) (implementing proxy access). This statute codified the ruling of the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008), which upheld bylaws facilitating shareholder nominations.

58. *See* Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 29 C.F.R. § 2509.08–2 (Oct. 17, 2008), *superseding* 59 Fed. Reg. 32,607 (June 23, 1994) (defining fiduciary duty under ERISA to generally include voting corporate proxies); Final Rule: Proxy Voting by Investment Advisers, Exchange Act Release No. 1A-2106, 17 C.F.R. § 275 (Jan. 31, 2003), www.sec.gov/rules/final/ia-2106.htm (defining fiduciary duty for defined contribution plans, mutual funds, and other investment fiduciaries to include voting in the best interests of clients).

59. The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 957, 124 Stat. 1376 (2010) [hereinafter Dodd–Frank].

60. *See id.* § 951 (mandating "say-on-pay" and "say-when-on-pay"). Dodd–Frank also mandated recently

With these reforms, "just vote no" and "withhold the vote" campaigns have proven to be a low-cost and successful means of activism. In a "just vote no" campaign, activists lobby fellow investors to convince them to vote against or to withhold votes on a director candidate in order to voice disapproval of the company's governance or management.[61] These campaigns are typically initiated by institutional investors, primarily pension funds, and tend to target large, underperforming firms.[62] In 2015, approximately 6% of directors failed to receive at least 70% of the shareholder vote.[63] Boards only rarely ignore majority withhold votes, even in uncontested elections. More importantly, withheld votes typically prompt corporate changes that respond to shareholders concerns as well as observable performance improvements.[64] They can also induce the unsupported nominee to resign or can force a management change, such as disciplinary turnover of the CEO.[65]

The prospect of withheld votes, a majority "no" vote on say-on-pay, direct opposition to the board's nominees, a proxy contest, or an outright takeover bid has created a context where direct engagement between investors and boards is now one of the most important avenues for shareholder activism. The process of engagement depends to some extent on the activist and their goals, and the most visible activist campaigns in recent years have been led by activist hedge funds. According to a recent study by Gantchev, hedge fund activism typically involves "a sequence of escalating decision steps, in which an activist chooses a more hostile tactic [such as requesting a board seat or ultimately waging a proxy contest] only after less confrontational approaches have failed."[66] However, unless the activist becomes dissatisfied with the outcome of private communications and decides to adopt a public engagement strategy,[67] the process of engagement is often not publicly disclosed, and engagement outcomes are not systematically reported.

Shareholder proposals under Rule 14a-8 of the Securities Exchange Act of 1934 have historically been the most widely used and least expensive means of shareholder activism, and are typically part of a multifaceted campaign of sustained engagement between an activist and the board or corporate management. Under Rule 14a-8, investors holding stock worth at least $2000 in market value or 1% of the outstanding voting shares of the company for at least one year may submit a proposal to the company for inclusion in the agenda of the annual meeting of the shareholders.[68] If the proposal seeks to adopt or amend corporate bylaws, which is a statutory right of the shareholders, or any other action reserved to the

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enacted rules on pay ratio between the CEO and other employees. *Id.* § 953(b); Pay Ratio Disclosure, Release No. 34-75610, 80 Fed. Reg. 56,103 (Aug. 18, 2015).

61. *See generally* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993); Diane Del Guercio et al., *Do Boards Pay Attention When Institutional Investor Activists "Just Vote No"?*, 90 J. FIN. ECON. 84 (2008).

62. *See* Del Guercio et al., *supra* note 61, at 84–85 (examining publicly announced campaigns between 1990 and 2003). In this study, hedge funds initiated relatively few campaigns, compared to public pension funds, which initiated or co-sponsored over 70% of the campaigns in the study. *Id.* at 86.

63. PROXY PULSE, *supra* note 2, at 5. Firms receiving less than a 70% favorable vote on their executive compensation plan are likely to face tighter scrutiny from proxy advisory firms. MATTEO TONELLO & MELISSA AGUILAR, PROXY VOTING ANALYTICS (2010–2014) 13–14 (2015) [hereinafter PROXY ANALYTICS].

64. Del Guercio et al., *supra* note 61, at 89–91.

65. *Id.*

66. *See* Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 611 (2013) (examining data from 1164 activist campaigns between 2000 and 2007).

67. Rob Bauer et al., *Who Withdraws Shareholder Proposals and Does It Matter? An Analysis of Sponsor Identity and Pay Practices*, 23 CORP. GOV.: INT'L REV. 472, 474–75 (2015).

68. 17 C.F.R. § 240.14a-8(b) (2011).

shareholders under the corporate charter, a majority vote is binding on the board. All other shareholder proposals are advisory in nature—a proposal that receives a majority vote of the shareholders need not be implemented by the board of directors.[69]

Shareholder proposals offer a unique window into shareholder activism and the impact of direct engagement.[70] Shareholders may submit proposals to a firm either to signal their interest in starting a conversation on the issue with management, or as a last resort when earlier negotiations fail.[71] On receipt of a shareholder proposal, management may negotiate with the proponent and seek their withdrawal of the proposal, or management may agree to submit the matter to a shareholder vote at the next annual meeting with a statement of opposition. [72] Alternatively, the company may opt to resist the proposal by seeking a "no-action" letter from the United States Securities and Exchange Commission (SEC). A no-action letter represents the view of the SEC staff that the proposal may be properly kept from going to a shareholder vote on grounds permitted by Rule 14a-8.[73] Grounds for exclusion include proposals that are vague, materially false, misleading, or fail to comply with the rule's procedural requirements. Rule 14a-8 also gives companies the ability to exclude the proposal if has already been substantially implemented, or if it conflicts with a management proposal to be submitted at the same meeting.[74] In addition, the proposal may be excluded on substantive grounds if it concerns a matter "relating to the company's ordinary business operations," unless the matter is a "sufficiently significant social policy issu[e]" and the proposal does not seek to "micro-manage" the day-to-day business of the company.[75] Of relevance to risk-related activism, the ordinary business exception is grounded on the separation of ownership and control,

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69. *See id.* § 240.14a-8(i)(1) (permitting exclusion of proposals that purport to mandate board action and would therefore be improper under state law).

70. *See generally* MARC GOLDSTEIN, INVESTOR RESPONSIBILITY RESEARCH CENTER INSTITUTE REPORT, DEFINING ENGAGEMENT: AN UPDATE ON THE EVOLVING RELATIONSHIP BETWEEN SHAREHOLDERS, DIRECTORS, AND EXECUTIVES (2014), http://irrcinstitute.org/pdf/engagement-between-corporations-and-investors-at-all-time-high.pdf (surveying 82 institutional investors and 133 large-cap companies listed in the United States and incorporating findings from 45 interviews).

71. *See generally* Rojas et al., *supra* note 50 (analyzing shareholder proposals on social policy issues from 1997 to 2004); *see also* Bauer et al., *supra* note 67, at 474–76 (describing these two processes).

72. *See* Bauer et al., *supra* note 67, at 475 (noting that firms generally engage in private negotiation when management is eager to avoid a vote on the issue).

73. No-action letters represent the views of the SEC staff and are neither precedential nor binding. Amalgamated Clothing & Textile Workers Union v. SEC, 15 F.3d 254, 257 (2d Cir. 1994). Parties may seek a declaratory judgment from the court on the excludability of a proposal in addition to or in lieu of seeking no-action relief.

74. *See* 17 C.F.R. § 240.14a-8(i) (providing grounds for exclusion).

75. *Id.* § 240.14a-8(i)(7); Exchange Act Release No. 34-40018 (May 21, 1998), *as interpreted by* Apache Corp. v. NYC Employees' Ret. Sys., 621 F. Supp. 2d 444, 449–51 (S.D. Tex. 2008). Of those proposals that have been resisted during the no-action process in recent years, the SEC has typically permitted companies to exclude around 20% of all submitted proposals, most frequently on procedural grounds. PROXY ANALYTICS, *supra* note 63, at 37, chart 14; *see also* Rojas et al., *supra* note 50, at 240 (finding that on average 19% of all challenged proposals are excluded during no-action review). In 2014, 14% were excluded as pertaining to the ordinary business operations of the company, 12% because the company had already substantially implemented the proposal, and 11% because the proposal conflicted with a proposal already submitted to a vote by the company at the same meeting. Amy L. Goodman & John Olson, *Shareholder Proposal Developments During the 2014 Proxy Season*, HARV. L. S. CORP. GOV. (July 2, 2014), http://corpgov.law.harvard.edu/2014/07/02/shareholder-proposal-developments-during-the-2014-proxy-season/ (relying on data from Institutional Shareholder Services (ISS)).

and recognizes that managers and other corporate insiders enjoy an informational advantage over shareholders regarding risk exposure and risk management.[76]

At any time during the engagement process, the shareholder proponent may elect to withdraw the proposal. Although results vary widely, withdrawn proposals often signal a successful outcome, such as dialogue, compromise, or a positive response by the firm to the proponent's concerns.[77] In fact, because many activists approach management directly as a first step, the fact that a proposal is not withdrawn and is submitted to a vote should be interpreted as an *unsuccessful* engagement confirming management's resistance.[78]

III. THE RATIONALES FOR RISK-RELATED ACTIVISM

Whether institutional investors will use their power to urge companies toward appropriate risk-taking and better risk management depends in part on the validity of the link between ESG issues and financial risk and return. Shareholders must have adequate incentives to spend scarce resources on influencing firms, and they must attract support from other shareholders, and ultimately from firm management, in order to achieve their goals.[79] If corporate boards and their counsel see risk-related activism as enhancing firm value, they will be more receptive to governance reforms, sustainability practices, or information disclosures sought by investors. Given the strength of the shareholder wealth maximization norm within the U.S. business community, any policy proposal to encourage responsible investment, investor stewardship, or active investor monitoring of ESG risks must also be justified on the basis of shareholder value to succeed.

Understanding the economic rationales for risk-related activism is particularly important from the perspective of fiduciary duties. The prudent investor standard, which is the core fiduciary duty standard under ERISA and comparable state laws that apply to public pension funds, requires fiduciaries to act solely in the interests of the fund's beneficiaries and to maintain adequate diversification.[80] Current regulatory guidance from the Department of Labor, which enforces ERISA, indicates that shareholder activism is only consistent with institutional investor fiduciary duties if it is justified by the expected economic benefit to fund beneficiaries.[81] Accordingly, voting of corporate proxies and the

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76. *See* Bratton & Wachter, *supra* note 18, at 655–56, 696–704 (arguing that information asymmetry limits shareholder activism as a means of reducing excessive risk-taking).

77. *See, e.g.*, Paula Tkac, *One Proxy at a Time: Pursuing Social Change Through Shareholder Proposals*, 91 ECON. REV.: FED. RES. BANK OF ATLANTA, Aug. 2006, at 13 ("[W]ithdrawal can be viewed as indicating some level of success."); Bauer et al., *supra* note 67, at 474 ("[I]f negotiations are successful, the proposal is withdrawn"). *Cf.* Rojas et al., *supra* note 50, at 222–25 (expressing more skepticism about this interpretation). Due to the confidential nature of private engagement, the number of withdrawals that represent a successful outcome cannot be determined precisely.

78. N. K. Chidambaran & Tracy Woidtke, The Role of Negotiations in Corporate Governance: Evidence from Withdrawn Shareholder-Initiated Proposals 7 (1999) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=209808.

79. *See infra* Part IV (discussing the impact of shareholder activism).

80. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 (2001) (defining the prudent investor standard for trustees); ERISA, 88 Stat. 829 Pub. L. 93-406, Sec. 404(a) (1974) (defining the prudent man standard of care). Public pension funds are governed under similar state and local requirements, as ERISA governs only certain private employee benefit plans. *See* JUN PENG, STATE AND LOCAL PENSION FUND MANAGEMENT 86–88 (2009) (surveying these standards).

81. *See* Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments, 29 C.F.R. § 2509.15-01 (Oct. 26, 2015) ("ERISA [does] not permit fiduciaries to sacrifice

requirements of any investment policies and guidelines for investment managers may only consider nonfinancial ESG factors if they "have a direct relationship to the economic value of the plan's investment" or help differentiate between investments that are otherwise equivalent in terms of risk and return.[82]

An interdisciplinary literature spanning finance, accounting, and management has established that effective monitoring and management of financial and nonfinancial risk can drive firm and portfolio performance. Unfortunately, advocates of risk-related activism and responsible investment often conflate their economic rationales in a way that prevents a thoughtful consideration of the claims by a more critical audience. This Part considers the empirical evidence supporting these rationales at both the firm and portfolio levels, as well as the possibility that financial incentives might motivate private arbitrage rather than activism.

A. Risk Management as Good Governance

One of the primary justifications for risk-related activism is that investor demand for better information about potential firm-level risks or governance matters potentially affecting the firm's risk management and its oversight can motivate more effective risk management and inform firm managers about the materiality of certain risks to investors. Risk management is the process of identifying, monitoring, reporting and responding to the range of financial, operational and strategic risks that firms face.[83] As this definition suggests, effective risk management is already widely recognized as requiring firms to take account of nonfinancial or ESG risks, including compliance, regulatory, environmental and other operational risks, as well as strategic risks.[84] It is therefore considered integral to firm strategy and a core governance function.

This broader approach to risk management is reflected in the adoption of ERM systems by the vast majority of publicly traded firms in the United States.[85] In 2004, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its ERM guidelines, urging firms to adopt a comprehensive understanding of risk that extends beyond a narrow focus on financial risk to include operational and strategic risk.[86] Under the COSO guidelines, risk management is also understood as an affirmative driver

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the economic interests of plan participants . . . in order to promote collateral [legislative, regulatory or public policy] goals.").

82. *Id.* at 4–5.

83. Marijn van Daelen, *Risk Management from a Business Law Perspective*, *in* RISK MANAGEMENT AND CORPORATE GOVERNANCE: INTERCONNECTIONS IN LAW, ACCOUNTING & TAX 56, 78–79 (Marjin van Daelen & Christoph Van der Elst eds., 2010).

84. *See generally* MATTEO TONELLO, THE CONFERENCE BOARD, EMERGING GOVERNANCE PRACTICES IN ENTERPRISE RISK MANAGEMENT: RESEARCH REPORT (2009), http://www.shareholderforum.com/e-mtg/Library/20101111_ConferenceBoard.pdf.

85. *See* MATTEO TONELLO, THE CONFERENCE BOARD, RISK IN THE BOARDROOM 5 (2013), https://www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V5N9-13.pdf&type=subsite (reporting that over 70% of all 359 surveyed public companies and over 85% of the largest firms (measured by assets and annual revenue) have adopted an ERM framework).

86. *See generally* COSO, ENTERPRISE RISK MANAGEMENT—INTEGRATED FRAMEWORK (2004), http://www.coso.org/documents/coso_erm_executivesummary.pdf [hereinafter COSO ERM FRAMEWORK]. In December 2014, a project began to update the 2004 COSO Framework. COSO, *Enterprise Risk Management—Integrated Framework Update*, http://www.coso.org/ermupdate.html [hereinafter COSO, *Enterprise Risk Management*] (last visited Feb. 15, 2016).

of long-term value because it enables firms to identify new business opportunities and to respond flexibly and quickly to changes in the business environment.[87]

Although effective risk management cannot eliminate all risk, it can help firms manage financial and operational risks. Risk management therefore contributes to future financial performance by reducing the cost of future liabilities due to enforcement actions, legal claims, and other negative risk events, as well as losses to investors when these events become known to the market. During the financial crisis, financial institutions with superior risk management practices were less exposed to downside risk and related losses,[88] and the expectation that good risk management can preserve value explains many of the reforms directed at financial institutions' risk management practices under Dodd–Frank.

Proxy disclosure rules introduced in 2009 also focus on risk management as a governance concern. They require corporate proxy statements to explain the role of the board in risk oversight and to disclose how compensation policy and practice affects risk management practices and risk-taking incentives if those policies are "reasonably likely to have a material adverse effect on the [company]."[89] Investors may see the degree of a firm's transparency around nonfinancial risks and risk management as an indication of the quality of its governance practices.[90]

Investment strategies and shareholder engagement directed at better management of ESG risks therefore reinforce firms' ERM practices and the oversight duties of corporate boards. They are also consistent with orthodox understandings of shareholders as specialized risk-bearers and the expectation that incentivizing appropriate levels of risk-taking by management can expand the size of the corporate pie for all the firm's constituencies.[91] However, investors rely on corporate boards to ensure that portfolio firms do not take on excessive risk and that they monitor and disclose material risks to investors.

B. Fundamental Financial Performance

A second justification for risk-related activism comes from empirical work examining the relationship between nonfinancial risk and firm financial performance. Whether ESG risks are material from a financial standpoint depends on their magnitude. Variation in empirical findings over time may therefore be due to the fact that certain risks may become material for companies as they become the subject of public concern or heightened regulatory attention.

The literature on the link between nonfinancial risk and financial performance complements a more prominent literature that examines the effect of nonfinancial indicators, such as corporate governance, employment standards, environmental practices, reputation and sustainability on firm financial performance. A minority of these studies

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87. COSO, *Enterprise Risk Management*, *supra* note 86; Dominic Elliott et al., *Governance, Control and Operational Risk: The Turnbull Effect*, 2 RISK MGMT. 47, 50–54 (2000).

88. *See generally* Andrew Ellul & Vijay Yerramilli, *Stronger Risk Controls, Lower Risk: Evidence from U.S. Bank Holding Companies*, 68 J. FIN. 1757 (2013); *see also infra* notes 100–02 and accompanying text (discussing the insurance effect of CSR).

89. Proxy Disclosure Enhancements, 74 Fed. Reg. 68334, 68334 (Dec. 23, 2009) (codified at 17 C.F.R. pts. 229, 239, 240, 249 & 274); 17 C.F.R. §§ 229.402(s), 229.407(h).

90. UNPRI, *infra* note 153, at 37.

91. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPLIED CORP. FIN. 8, 8–9, 11 (2001).

find a negative relationship between various ESG indicators and financial performance or find that firms who optimize CSP fare better financially than those with very low or very high levels of CSP.[92] However, the vast majority (by some estimates upwards of 80%) of empirical studies to date find that although not all firm sustainability efforts translate into higher returns for investors, positive social performance has a positive or neutral effect on risk-adjusted returns, profitability, and other standard measures of financial performance at the firm and portfolio level.[93]

One of the consistent findings on risk effects is that firms with strong monitoring and management of nonfinancial risks enjoy a lower cost of equity and cheaper debt financing, which are key determinants of the firm's financial health. Indeed, share prices should reflect the fact that discounting by a lower cost of capital increases the net present value of the firm's earnings. Empirical studies explaining this link find first that the implied cost of equity capital based on standard discounted cash flow models is significantly lower for firms with strong social performance, particularly in matters related to employee relations, environmental policy, and product strategy.[94] Some of these studies have also found that firm investments that reduce negative ESG risk (i.e., reduce negative CSP) have a stronger effect on the cost of capital than positive ESG indicators, perhaps because excessive positive investments that benefit stakeholders may reduce shareholder wealth and increase risk.[95] Because investors benefit from transparency, studies also identify a correlation between higher quality risk disclosures and a lower cost of equity capital.[96] Other studies show that good governance, measured by indicia of outside director and investor control, improves credit ratings by reducing agency costs, improving monitoring, and reducing

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92. These studies generally use aggregate CSP measures or indicators of positive investments in CSP—such as reputational measures—that are more likely to reflect a higher investment cost relative to the benefit measured during the time period of the study. *See, e.g.*, Stephen Brammer et al., *Corporate Social Performance and Stock Returns: UK Evidence from Disaggregate Measures*, 35 FIN. MGMT. 97 (2006) (finding a negative relationship between environmental performance and stock returns for of a sample of U.K.-listed firms over a one- to three-year period); Michael L. Barnett & Robert M. Salomon, *Beyond Dichotomy: The Curvilinear Relationship Between Social Responsibility and Financial Performance*, 25 STRATEGIC MGMT. J. 1101 (2006) (finding the strongest financial returns to low and high levels of sustainability based on an analysis of socially screened mutual funds).

93. *See generally* Gordon Clark et al., *From the Stakeholder to the Stockholder: How Sustainability Can Drive Financial Outperformance* (2015), http://www.arabesque.com/index.php?tt_down=51e2de00a30f888728 97824d3e211b11 (reporting that 88% of 51 studies surveyed show a positive relationship between sustainability and firm operational performance, and 80% of 41 studies show a positive relationship between sustainability and financial performance); *see also* Joshua Margolis et al., Does it Pay to Be Good . . . And Does it Matter? A Meta-Analysis of the Relationship between Corporate Social and Financial Performance, (Mar. 1, 2009) (unpublished manuscript), http://papers.ssrn.com/so13/papers.cfm?abstract_id=1866317 (surveying 251 studies from 1972 through 2007); Marc Orlitzky et al., *Corporate Social and Financial Performance: A Meta-Analysis*, 24 ORG. STUD. 403 (2003) (surveying 52 studies from 1970 to 2003).

94. *See generally* Mark Sharfman & Chitru S. Fernando, *Environmental Risk Management and the Cost of Capital*, 29 STRATEGIC MGMT. J. 569 (2008) (finding that environmental risk management reduces the cost of equity and debt capital); Sadok El Ghoul et al., *Does Corporate Social Responsibility Affect the Cost of Capital?*, 35 J. BANKING & FIN. 2388 (2011).

95. *See generally* Allen Goss & Gordon S. Roberts, *The Impact of Corporate Social Responsibility on the Cost of Bank Loans*, 35 J. BANKING & FIN. 1794 (2011). The studies referenced in this Article generally distinguish positive CSP measures and negative CSP or nonfinancial risk indicators in order to measure distinct performance dimensions.

96. *See generally* Dan. S. Dhaliwal et al., *Voluntary Nonfinancial Disclosure & the Cost of Equity Capital: The Initiation of Corporate Social Responsibility Reporting*, 86 ACCT. REV. 59 (2011).

information asymmetries between firms and lender.[97] Conversely, firms with higher ESG risk, or poor social performance, incur a higher cost of debt capital.[98]

The results of a widely cited meta-study on the connection between corporate social performance and risk by Orlitzky et al., show further that this relationship is bidirectional—firms with lower financial risk in an earlier period exhibit better social performance in a later period, and firms with strong social performance in an earlier period exhibit lower financial risk in a later period.[99] The literature therefore offers evidence of a virtuous cycle between operational risk management and the cost of capital.

Another key motivation for shareholder activism around firm-specific ESG risks is that greater managerial attention to reputational risk helps *maintain* firm value. A seminal study by Godfrey et al. finds that risk management strategies that emphasize positive contributions toward the firm's stakeholders provide an insurance-like effect when a firm experiences potential liability or enforcement action.[100] This may be because the firm's financial performance is less likely to be affected by negative events if it maintains the loyalty of its key stakeholders.[101] Accordingly, activism that motivates management to attend to nonfinancial risks both generates long-term value and *preserves* it.

C. The Financial & Nonfinancial Risk Link

Improved management and mitigation of nonfinancial risks may also benefit shareholders by reducing the financial risk of particular portfolio firms or other assets. For example, BlackRock, the world's largest investment management firm, has adopted investment and activism policies that recognize this link. According to its signatory disclosure under the *United Nations Principles for Responsible Investment*, BlackRock uses regional indices each quarter to identify laggards in managing ESG considerations in order to drive proactive engagement where there is a clear nexus between the ESG matter and financial risk.[102] An alternative view is that firm mitigation of environmental or other nonfinancial risks reduces firm profitability and increases financial risk, either because of

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97. *See generally* Sanjeev Bhojraj & Partha Sengupta, *Effect of Corporate Governance on Bond Ratings and Yields: The Role of Institutional Investors and Outside Directors*, 76 J. BUS. 455 (2003) (finding that institutional ownership and stronger control by outside directors resulted in lower bond yields and higher ratings on new bond issues, but finding that these effects were reversed in the presence of concentrated ownership).

98. *See generally* Goss & Roberts, *supra* note 95; *see also* Klaus-Michael Menz, *Corporate Social Responsibility: Is it Rewarded by the Corporate Bond Market? A Critical Note*, 96 J. BUS. ETHICS 117 (2010) (finding a weak positive effect of corporate social performance on the cost of debt capital); Najah Attig et al., *Corporate Social Responsibility & Credit Ratings*, 117 J. BUS. ETHICS 679, 679–80 (2013) (analyzing long-term issuer credit ratings for a sample of U.S. publicly held firms from 1991 to 2010). One limitation of this study is that CSR was measured by netting positive indicators and negative "concerns" from the widely used Kinder, Lydenberg & Domini (KLD) ratings, rather than separately analyzing the two. This method may introduce imprecision in the results. Chatterji et al., *How Well do Social Ratings Actually Measure Corporate Social Responsibility?*, 18 J. ECON. MGMT. STRATEGY 125, 164–65 (2009).

99. *See generally* Orlitzky & Benjamin, *supra* note 26.

100. *See generally* Ping-Sheng Koh et al., *Firm Litigation Risk and the Insurance Value of Corporate Social Performance*, 35 STRATEGIC MGMT. J. 1464 (2013) (finding a significant insurance effect of CSP against litigation risk using data from 3000 publicly listed firms from 1991 to 2007); Paul C. Godfrey et al., *The Relationship Between Corporate Social Responsibility and Shareholder Value: An Empirical Test of the Risk Management Hypothesis*, 30 STRATEGIC MGMT. J. 425 (2009).

101. *See generally* Koh et al., *supra* note 100; Godfrey et al., *supra* note 100.

102. RI TRANSPARENCY REPORT 2014/2015, BLACKROCK 31 (2015), http://www.unpri.org/viewer/?file=wp content/uploads/Merged_Public_Transparency_Report_BlackRock_2014.pdf.

the additional costs of mitigation or because it results in lost business opportunities. [103]

Refuting the risk-enhancing view, a deep empirical literature supports the conclusion that firms with strong positive social performance indicators—or alternatively, lower ESG risk—have lower volatility, as measured by market risk. These studies find that firms with poor social performance—that is, high ESG risk—have higher market risk, controlling for other related factors, while positive ESG performance is associated with lower market risk.[104] The strength of these effects varies for different ESG indicators, and the effect on risk is generally strongest for negative ESG indicators.[105] Importantly, most studies that focus on firm-level risk effects include controls for profitability and other measures of corporate financial performance, in addition to other standard controls, such as firm size, leverage, and sector. As a result, their findings show that reducing ESG risk does not sacrifice financial performance. Consistent with the insurance effect of positive CSP discussed in Section III.B above, event studies have shown that short-term stock returns fall sharply in response to news of ESG crises, such as environmental disasters, product claims, or corporate criminal or civil liability, and that these effects are weaker for firms with better ESG practices.[106]

Despite portfolio theory's prediction that firm-specific risk is irrelevant to diversified investors, studies now find that some idiosyncratic, or firm-specific, risk, is also currently priced in the market.[107] Idiosyncratic nonfinancial risks include negative environmental, social or governance practices that increase potential liability exposure (legal risk), reduce product demand (business risk), increase reputational risk, or increase the likelihood that costly regulatory changes will be imposed (regulatory risk).[108] These risks can increase cash flow and earnings volatility and increase the pressure on firms to engage in earnings management. In general, studies examining the relationship between ESG risk factors and

103. *See* Dieter Gramlich & Nicole Finster, *Corporate Sustainability and Risk*, 83 J. BUS. ECON. 631, 632 (2013) (discussing these competing views).

104. *See generally* Orlitzky & Benjamin, *supra* note 26 (conducting a metaregression analysis of the literature on the effect of corporate social performance on various measures of risk for studies from 1976 to 1997); *see also* Rui Albuquerque et al., *Corporate Social Responsibility and Firm Risk: Theory and Empirical Evidence* (Oct. 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1961971 (finding that corporate social responsibility decreases systematic risk and increases firm value when controlling for the effect of negative risk events); Aly Salama et al., *Does Community and Environmental Responsibility Affect Firm Risk? Evidence from U.K. Panel Data 1994-2006*, 20 BUS. ETHICS: EUR. REV. 192 (2011) (finding that firms with better social performance have slightly lower systematic risk); Oikonomou et al., *supra* note 41 (confirming a negative relationship between corporate responsibility and systematic risk and a positive relationship between corporate *irresponsibility* and systematic risk in a study of S&P 500 firm data from 1992 to 2009); Xueming Luo & C.B. Bhattacharya, *The Debate Over Doing Good: Corporate Social Performance, Strategic Marketing Levers, and Firm-Idiosyncratic Risk*, 73 J. MKTG. 198 (2009) (finding that socially responsible firms have both lower idiosyncratic and systematic risk).

105. *See, e.g.*, Kais Bouslah et al., *The Impact of Dimensions of Social Performance on Firm Risk*, 37 J. BANKING & FIN. 1258, 1259 (2013) (finding the strength of these relationships depends upon the particular indicators at issue); Hoje Jo & Haejung Na, *Does CSR Reduce Firm Risk? Evidence from Controversial Industry Sectors*, 110 J. BUS. ETHICS 441 (2012) (finding that firm "CSR engagement" reduces both total risk and systemic risk). Studies of this relationship tend to use standard multidimensional ESG rankings and to use either standard CAPM, Fama-French or Fama-French-Carhart betas to measure market (i.e., systematic) risk.

106. Koehler & Hespenheide, *supra* note 8, at 100–02 and sources cited therein.

107. This is independently tested by Burton G. Malkiel & Yexiao Xu, *Risk & Return Revsited*, 23 J. PORTFOLIO MGMT. 9 (1997) (finding that idiosyncratic risk affects equity prices and that investors demand a premium to hold higher risk portfolios).

108. These operational risks are not easily hedged by firms and cannot be eliminated by diversification.

total or idiosyncratic risk find that strong social performance lowers idiosyncratic risk and that weak social performance—alternatively, high ESG risk—increases idiosyncratic risk.[109] In other words, firms that produce negative impacts on stakeholders have higher levels of firm-specific risk.

The implications of these findings for portfolio returns are mixed. Some studies find, consistent with portfolio theory, that investors demand a risk premium for bearing higher firm-specific risk over and above the return associated with standard measures of market risk; therefore, holding stocks with lower ESG risk sacrifices some of this premium.[110] Other studies, however, find that portfolios with higher idiosyncratic risk offer *lower* returns, which implies that risk mitigation lowers portfolio risk while offering the same or higher return.[111]

D. Information Asymmetry

Beyond the direct effect of ESG risk management on portfolio firm financial performance and volatility over time, another key reason why diversified investors engage in risk-related activism is their demand for better information about material risks. Unless firms face regulatory requirements or external demand from investors or consumers for risk-related information, management can be expected to approach risk-related disclosures conservatively because disclosure is costly and may benefit competitors. In addition, the market price will only reflect ESG risks if ESG information is in fact publicly available. Without adequate transparency around risk, investors will be exposed to risks that they are not compensated for bearing. As some of the evidence surveyed in Part IV confirms, a significant percentage of risk-related shareholder proposals seek improved disclosure of particular ESG risks, such as greenhouse gas emissions or CEO succession planning.

One objection to this argument is that if markets efficiently reflect all public information about material (financial and nonfinancial) risks,[112] the market price should already give investors adequate information on which to vote their shares. Instead of engaging in activism to influence firms, investors should simply select investments that reflect their risk preferences. This argument has important corporate governance implications as well, since the standard justification for why corporate law gives shareholders and, with limited exceptions,[113] shareholders alone, voting and other

109. Many of the studies examining systematic risk, *supra* note 104, also test idiosyncratic risk or total risk. *See generally* Darren D. Lee & Robert W. Faff, *Corporate Sustainability Performance and Idiosyncratic Risk: A Global Perspective*, 44 FIN. REV. 213 (2009) (exploring the risk-return relationship by comparing portfolio performance of sustainability leaders and laggards to a market portfolio); Bouslah et al., *supra* note 105 (testing total and idiosyncratic risk effects); Michael Dobler et al., *Environmental Performance, Environmental Risk and Risk Management*, 23 BUS. STRATEGY & ENV. 1 (2014) (finding that firms with strong environmental performance in fact exhibit lower environmental risk, holding financial performance constant).

110. *See generally* Isabelle Girerd-Potin et al., *Which Dimensions of Social Responsibility Concern Financial Investors?*, 121 J. BUS. ETHICS 559 (2014) (analyzing data for 2003 to 2010).

111. *See* Andrew Ang et al., *The Cross-Section of Volatility and Expected Returns*, 61 J. FIN. 259, 260 (2006) (finding somewhat lower average monthly returns for portfolios with higher idiosyncratic risk); *see also* Luo & Bhattacharya, *supra* note 104 (finding the higher firm-specific risk effects largely equalized the higher financial performance they observed for firms with *poor* social performance).

112. *See* ROSS ET AL., *supra* note 34, at 428–66 (discussing the Efficient Capital Market Hypothesis). The strong form of market efficiency, which states that *all* information, public and private, is efficiently reflected in the market price, is not empirically supported. *Id.*

113. When a corporation is insolvent, its creditors have standing to exercise the enforcement rights of

governance rights is that shareholders are residual claimants of the firm's assets whose interests are most closely aligned with its long-term success.[114] Since a given shareholder typically sells their shares during the life of the firm, this justification only holds if the market price of the stock when sold reflects the value of that ultimate residual claim, discounted to reflect its risk.

Of course, federal securities regulation already requires publicly traded firms to identify and monitor risk by mandating that material risk-related information be disclosed to investors so that they can accurately evaluate the risks of their investments.[115] Initial disclosures and ongoing reporting obligations require a discussion of risk factors affecting the company's equity,[116] material legal or regulatory proceedings,[117] and management's discussion and analysis (MD&A) of future trends, events or uncertainties that are "reasonably likely" to have a material impact on the firm's financial condition or operating performance.[118] The 2009 proxy disclosure rules described above require the board to explain its risk oversight practices, and, in some cases, how executive compensation affects risk management.[119] As the SEC has recognized, material nonfinancial ESG risks, such as the operational or regulatory risks created by climate change, must also be disclosed under standard reporting requirements,[120] and specific nonfinancial disclosures regarding the use of conflict minerals and the disclosure of payments to certain foreign governments are now required as well. Internal controls and risk oversight systems are required by federal law, as well as by state corporate law.[121] In addition, mandatory nonfinancial reporting is now required for companies listed in European Union markets and other leading jurisdictions worldwide.[122] Beyond these mandatory disclosures, approximately 85% of the largest U.S. firms also produce voluntary sustainability reports.[123]

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shareholders through derivative litigation, but even then, creditors are owed no direct fiduciary duties. N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007).

114. Henry Hansmaan & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 449 (2001).

115. The standard for materiality was articulated in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). Information is material and must be disclosed if there "is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" or make an important investment decision, or, if the information would "alter the 'total mix' of information made available." *See* Basic v. Levinson, 485 U.S. 224, 231 (1988) (quoting and applying *TSC Industries*, 426 U.S. at 449).

116. Securities Act of 1933, Securities Exchange Act of 1934, Reg. S-K, *amended by* Item 101 17 C.F.R. § 229.101 (2011).

117. 17 C.F.R. § 229.103.

118. *Id.*

119. *See supra* note 89 and accompanying text (discussing these rules).

120. *See* Commission Guidance Regarding Disclosure Related to Climate Change, Exchange Act Release Nos. 33-9106; 34-61469; FR-82, 75 Fed. Reg. 6292 (Feb. 8, 2010) [hereinafter Commission Guidance] (detailing existing disclosure requirements potentially requiring disclosure of climate-change impacts on firms).

121. On corporate law requirements, see *supra* notes 53–54 and accompanying text. The Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78dd-1–dd-3 and disclosure rules introduced under Sarbanes-Oxley, as well as U.S. Generally Accepted Accounting Principles (GAAP), and International Financial Reporting Standards (IFRS) all require internal reporting systems to monitor compliance and other financial risks.

122. Commission Directive, 2014/95, 2014 O.J. (L 330) 1, http://ec.europa.eu/finance/accounting/nonfinancial_reporting/index_en.htm; *see also* SUSTAINABLE STOCK EXCHANGES (SSE), 2014 REPORT ON PROGRESS (2014), http://www.sseinitiative.org/wp-content/uploads/2012/03/SSE-2014-ROP.pdf (detailing the requirements across jurisdictions).

123. *See* KPMG, CURRENTS OF CHANGE: THE KPMG SURVEY OF CORPORATE RESPONSIBILITY REPORTING 2015 33 (Nov. 2015), http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/kpmg-

Despite this expansion of voluntary and mandatory reporting, the SEC has concluded that some material nonfinancial risk factors are not yet adequately disclosed under existing regulations.[124] Where they are disclosed, nonfinancial risks are often not reported in timely, consistent, and comparable ways that are useful to investment analysts. Uniform reporting and audit standards, such as IFRS, GAAP, and Generally Accepted Auditing Standards (GAAS), do not yet exist for nonfinancial reporting and basic materiality guidelines have not yet been widely adopted.[125] Most sustainability reports are not released for six to nine months from the end of the latest reporting period, and many are unaudited, weakening their reliability. Despite an increase in nonfinancial reporting mandates globally, most disclosure regimes are voluntary, and so available data is not readily comparable across firms and over time.[126] Despite steady progress toward quantitative ESG metrics,[127] forward-looking information about ESG risks that is disclosed is often qualitative in nature and unrelated to standard measures of financial risk.[128] This is perhaps because some risks are difficult to quantify, are measureable only in the medium- to long-term, or concern externalities of the firm's operations that are difficult for firms themselves to capture.

More critically, the very nature of standard discounted cash flow and net present value methodologies used to determine the present value of an asset, liability, or investment is such that any valuation done beyond a five- or ten-year horizon, even at fairly conservative discount rates, will result in a low discounted present value. As a result, the present value of potentially large, but remote, future losses, such as environmental liability from weak monitoring practices, is likely to be underestimated, while the present value of future gains to investment in research and development or conservation practices is likely to be undervalued. These limits help explain why market prices may not efficiently incorporate ESG factors or reflect the quality of the firm's risk management.

This lack of uniform, comparable information on firm-specific ESG risks may result in systemic distortions of market prices and inefficient capital allocation, which may be partially remedied by improved risk disclosure so that market prices accurately reflect investment risk. The challenge is to balance these benefits against the potential costs of increased disclosure, whether voluntary or mandatory. Focusing only on readily quantifiable metrics may create its own distortions. Nonetheless, one motivation for risk-related activism is the possibility that by motivating voluntary disclosure of nonfinancial risks, risk-related activism may contribute usefully toward broader market transparency and stability, and the emergence of new reporting norms. Because what gets disclosed gets measured, expanded investor focus on ESG risks may also motivate boards toward improved risk oversight and risk management.

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survey-of-corporate-responsibility-reporting-2015-O-201511.pdf [hereinafter KPMG SURVEY] (reporting on the basis of firm revenue).

124. *See generally* Commission Guidance, *supra* note 120.

125. Robert G. Eccles et al., *The Need for Sector-Specific Materiality and Sustainability Reporting Standards*, J. APP. CORP. FIN., Spring 2012, at 65.

126. *See* KPMG SURVEY, *supra* note 123, at 24–25, 30, 36 (finding that a majority of the largest firms globally produce audited sustainability reports but that quality concerns persist).

127. *See* Appendix, *infra* at tbl.1 (providing examples of ESG metrics).

128. *See, e.g.*, Philip M. Linsley & Philip J. Shrives, *Risk Reporting: A Study of Risk Disclosures in the Annual Reports of UK Companies,* 38 BRIT. ACCT. REV. 387, 400 (2006) (examining reporting by U.K.-based companies).

E. The Risk-Return Link

Finally, the key question is how risk-related activism helps investors achieve the highest risk-adjusted returns for their risk preferences. To the extent that better risk management lowers the cost of capital, markets should place a higher value on firm earnings by discounting them at a rate that reflects this lower risk. However, where standard understandings of market risk and return apply, reducing firms' cost of equity capital means that investors earn a lower expected return since they are bearing less risk. As one of the leading studies on the risk effects of strong ESG performance has observed, "the risk-return trade-off appears to be such that no clear utility gain or loss can be realized by investing in firms characterized by different levels of social and environmental performance."[129] Instead, investors should simply select a portfolio that compensates them for the level of risk they are willing to bear. This standard account is supported to some extent by studies comparing ESG indices with standard benchmarks or comparing high-sustainability and low-sustainability portfolios.[130]

An initial response to the argument that activism to reduce portfolio risk (volatility) is simply an expensive way to lower portfolio returns is that market returns do not always fully align with the risk-return predictions of CAPM.[131] As discussed above, the evidence for this position is mixed at present, since some studies examining how ESG risk mitigation affects idiosyncratic risk, rather than the systematic risk captured by CAPM, still find that investors demand a risk premium for portfolios with higher ESG risk,[132] while others find no significant differences in risk and return measures.[133] However, studies analyzing firm-level risk effects show that firms with strong ESG indicators have lower market risk without sacrificing return, and this conclusion is also supported by a number of studies testing these effects at the portfolio level.[134] Related analysis of the volatility of mutual funds incorporating ESG factors has found it to be lower than for traditional funds in the same risk class.[135]

Thus far, this evidence suggests that investors with more complete ESG information than what is reflected in the market may stand to gain from arbitrage. If strong ESG performance translates to lower market risk than CAPM would predict, they can earn above-market returns (i.e., *alpha*) by investing in firms with strong ESG risk

129. Oikonomou et al., *supra* note 41, at 512.

130. Examples of such studies include: Lee & Faff, *supra* note 109; Girerd-Potin, *supra* note 110.

131. *See* RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 195–203 (10th ed. 2011) (discussing empirical challenges to CAPM).

132. *See* Girerd-Potin et al., *supra* note 110 (analyzing data for 2003 to 2010). *But see* Ang et al., *supra* note 111 (reaching a contrary result).

133. *See* Gramlich & Finster, *supra* note 103 (finding no significant differences between firms included in multiple sustainability indices and those included in fewer ones in terms of risk-adjusted returns or firm-specific profitability and liquidity risk).

134. *See, e.g.*, Lee & Faff, *supra* note 109; Andreas Hoepner et al., Does Pension Funds' Fiduciary Duty Prohibit the Integration of Environmental Responsibility Criteria in Investment Processes? (2011) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1930189; *see also supra* note 104 and sources cited therein; Leonardo Beccheti et al., *Corporate Social Responsibility and Shareholder's Value*, 65 J. BUS. RES. 1628 (2012) (using data for firm exits from the Domini 400 social index between 1990 and 2004 and finding that the market reacted negatively to exit, implying a higher valuation for firms in the index).

135. *See* MORGAN STANLEY, SUSTAINABLE REALITY: UNDERSTANDING THE PERFORMANCE OF SUSTAINABLE INVESTMENT STRATEGIES 6 (2015), https://www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf (analyzing equity and fixed income funds from 2007 to 2014).

management.[136] This prospect has motivated many asset managers to develop and apply nonfinancial key risk indicators (KRIs) or other ESG metrics, even though obtaining ESG data can be more expensive than standard financial data.[137] But the opportunity for investors to beat the market by analyzing ESG factors will not persist in mature markets. For example, Gompers et al.'s early work on the effect of governance on market measures of firm financial performance found opportunity for above-market gains to good governance, but these now appear to have dissipated as a result of market adaptation and learning and more complete disclosure of governance metrics.[138] Still, the lack of mandatory ESG disclosure standards in the United States and the poor quality of ESG disclosures in many markets suggests that arbitrage opportunities for investors with access to ESG information should persist for some time.

The potential for ESG arbitrage gains does not yet explain risk-related activism. Although arbitrage opportunities are indeed a strong motivation for the renewed interest in ESG indicators and sustainability data, investors with the opportunity to earn abnormal (i.e., above-market) returns by trading on information about firms' ESG risks would be expected to do so rather than engaging in costly activism to improve the performance of weak portfolio firms.

The further argument for institutional investor activism is that because of diversification requirements and the cost effectiveness of passive investment strategies, most institutional investors are highly diversified "universal owners" whose holdings span the entire economy.[139] Universal owners have direct incentives to engage in activism to reduce negative ESG operational, compliance, or other nonfinancial risks of portfolio firms because they bear some degree of systemic and market risk for which they are not rewarded in the capital markets and which they have in fact internalized by virtue of the breadth of their portfolio. Even if individual firms can generate higher short-term returns to investors by shifting risk to other stakeholders or to future shareholders, these costs and risk are still internalized by universal owners through the impact on other portfolio firms.[140] Finally, not all institutional investors will be able to engage in arbitrage. Most are "locked into [their positions] on a long-term basis" because their holdings are large or dispersed enough that they cannot liquidate a position without affecting market prices.[141]

Universal owner theory also helps explain the New York pension funds' campaign and similar examples of institutional investor activism. Where highly diversified universal owners identify common issues of concern across an entire industry or asset class, they have stronger incentives to engage with portfolio firms around these issues because activism at leading firms can have positive spillover effects across a portfolio and can potentially reduce systemic risks affecting overall market volatility. This type of broad-

136. *See generally* Alex Edmans, *Does the Stock Market Fully Value Intangibles?*, 101 J. FIN. ECON. 621 (2011) (finding that firms with high employee satisfaction earned 3.5% abnormal returns between 1984 and 2009).

137. *See* UNPRI, *infra* note 153, at 6, 11.

138. *See* Paul Gompers et al., *infra* note 253 (associating abnormal returns with governance activism, controlling for risk and related factors). More recent findings show that governance factors are now efficiently priced. *See generally* Bebchuk et al., *Learning and the Disappearing Association Between Governance and Returns*, 108 J. FIN. ECON. 323 (2013) (finding no long-term benefits to investors from investors in firms with better governance practices).

139. *See* JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM 3–5, 98–99 (2000) (developing this concept).

140. *Id.*

141. *See* OECD (2011), *supra* note 14, at 10 (presenting findings on institutional investor practice).

reaching activism is not uncommon. For example, Vanguard recently notified hundreds of portfolio companies about its views on corporate governance matters and identified specific issues for engagement with about 350 of these firms.[142] These types of engagements have even greater value for investors who are both equity and debtholders in a given firm or invest in a number of firms in an industry.

Risk-related activism by institutional investors can serve another important systemic role by advancing the interests of other important universal owners, namely individual investors. Most individuals invest in passive index funds directly pegged to the market and are exposed to risk that affects its volatility, but they cannot play a monitoring role for the firms in which they invest. Activism that targets market and systemic risks may therefore carry out the fiduciary responsibilities of institutional investors, which require them to serve in the best interests of their clients and fund beneficiaries.

Beyond these economic incentives, some shareholder activists are motivated to initiate or support risk-related activism by ethical or other concerns traditionally associated with the socially responsible investment (SRI) (alternatively, the "sustainable, responsible, and impact-invested") movement. CAPM is premised on the assumption that investors value assets based on their expected return,[143] but some investors may value the positive social contribution of their portfolio firms as much or more than economic gains. Investors that do not view portfolio firms as strictly financial assets may be willing to bear the costs of risk-related activism. They may also be willing to accept a reduced return in exchange for the lower market risk associated with solid financial and nonfinancial risk management and improved social performance. The influence of these investors is growing as a percentage of the market: SRI investments now represents over 15% of all assets under management in the United States.[144]

F. A Word About Short-Termism & Risk

Considering the economic rationales for risk-related activism raises the question of how these incentives or the arguments themselves are affected by market or investor short-termism. A much-debated consequence of the shareholder empowerment movement is that investor pressure itself may be driving corporate managers to focus myopically on maximizing the market price for corporate stock without due attention to risk and long-term performance.[145] Short-termism has also been linked to fund manager incentive structures, rapid portfolio turnover, and the rise of automated and high-frequency trading, as well as the ease of making investment decisions on the single metric that quarterly

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142. Kobi Kastiel, *Board Structures & Directors' Duties: A Global Overview*, HARV. L. SCH. FORUM ON CORP. GOV. & FIN. REG. (Aug. 13, 2014), http://corpgov.law.harvard.edu/2014/08/13/board-structures-and-directors-duties-a-global-overview/.

143. *See generally* Eugene F. Fama & Kenneth R. French, *Disagreement, Taste, and Asset Prices*, 83 J. FIN. ECON. 667 (2007) (explaining how deviations from this assumption may alter CAPM's predictions).

144. USSIF, 2014 REPORT ON U.S. SUSTAINABLE, RESPONSIBLE, AND IMPACT INVESTING TRENDS IN THE UNITED STATES 12 (2014), http://www.ussif.org/Files/Publications/SIF_Trends_14.F.ES.pdf.

145. Bratton & Wachter, *supra* note 18, at 659; Dallas, *supra* note 18. *See generally* JOHN KAY, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING (July 2012), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf (describing a crisis of short-termism in the U.K.). *But see* Mark Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. L. 977 (2013) (challenging short-termism claims).

earnings provide.[146]

The previous discussion does not presume that all institutional investors are focused on long-term objectives, and this Article has attempted thus far to disentangle consideration of the effects of shareholder activism on managerial risk-taking from the broader debate on investor and market short-termism. This is not to diminish in any way the high stakes of the short-termism debate. If shareholder interests are no longer aligned with long-term firm value, then shareholders are unable or unwilling to play the role corporate law expects them to play. The outcome of the debate also has obvious ramifications for determining whether future policy reforms should support or constrain shareholder activism and how responsive boards should be to activist pressure. To the extent that institutional investor activism is directed at maximizing short-term gains, it raises serious concerns about investors' lack of accountability for the long-term interests of the individual investors and beneficiaries whose funds they manage.

A few observations about the effect of investment time horizons on activist incentives are therefore necessary. First, there is evidence that monitoring enhances long-term firm value and that long-term investors are more likely to serve a monitoring role.[147] Second, because of the long-term interests of their fund beneficiaries, public pension funds and labor union funds have long been considered those most likely to adopt long-term investment strategies and engage in active monitoring,[148] and institutional investor ownership has been shown to have a positive effect on research and development and other long-term investment, as well as innovation.[149] Because the payoff to activism increases relative to its costs over longer time horizons, institutional investors with longer investment horizons should be more likely to engage in activism. Investors must also hold their shares for at least one year in order to initiate shareholder proposals,[150] and their salience with management will also be greater if they are seen as "patient capital." Finally, as in the board accountability campaign, investors who engage in risk-related activism or are committed to responsible investment goals generally often frame their goals in terms of long-term investment horizons.

At the same time, institutional investors must make investment decisions across a range of time horizons, and they have often opted for governance terms that do not reflect a long-term perspective. For example, the vast majority of shareholders voting on the

146. *See* Roe, *supra* note 145, at 985–87 (summarizing the basic argument); KAY, *supra* note 145. Because executive compensation is tied to these same measures of financial performance, shareholder activism may target firms with poor short-term profits, exacerbating the problem. *Id.*

147. *See, e.g.*, Jarrad Harford et al., Do Long-Term Investors Improve Corporate Decision Making? 3 (Apr. 18, 2015) (unpublished manuscript), http://ssrn.com/abstract=2505261 (finding that longer investor horizons lead to greater shareholder value both by improving profitability and by lowering risk and that long-term investors improve monitoring and reduce managerial slack).

148. *See, e.g.*, Choi & Fisch, *supra* note 51 (discussing pension fund activism); *see also* SEC Commissioner Luis Aguilar, *Evaluating Pension Fund Investments Through the Lens of Good Corporate Governance*, HARV. L. SCH. FORUM ON CORP. GOV. & FIN. REG. (July 1, 2014), http://corpgov.law.harvard.edu/2014/07/01/evaluating-pension-fund-investments-through-the-lens-of-good-corporate-governance/ (urging greater activism by pension fund trustees and fund managers to help promote good corporate governance).

149. *See generally* Sunil Wahal & John J. McConnell, *Do Institutional Investors Exacerbate Managerial Myopia?*, 6 J. CORP. FIN. 307 (2000); *see also* Parthiban David et al., *The Influence of Activism by Institutional Investors on R&D,* 44 ACAD. MGMT. J. 144 (2001) (finding that pension funds are more active investors than investment managers and that pension fund activism contributes to higher levels of research and development among portfolio firms).

150. *Supra* note 68.

frequency of say-on-pay advisory votes have elected to do so on an annual rather than a biennial or triennial basis,[151] and shareholders have strongly supported board declassification proposals that result in more directors standing for reelection annually.[152] Even if these annual checks on performance improve director accountability to shareholders, it is less clear that they help directors attend to long-term risks and generating long-term value. This mixed evidence on investor willingness to engage in long-term monitoring is one of the challenges to which Part VI of this Article responds. For the moment, these observations reconfirm that institutional investors have the potential to engage in or support risk-related activism, but whether particular activist campaigns advance long-term value or promote appropriate risk management must be determined on a case-by-case basis.

While findings from the empirical studies referenced here vary to some extent due to differences in methodologies, data, and relevant market conditions, risk concepts offer direct rationales for investors to engage in activism. At the firm level, the key economic justifications are that effective management of financial and nonfinancial risk can generate higher returns to investors by driving or preserving profit, and by reducing risk, at times simultaneously.[153] Risk management is an important element of good governance, and activism can focus management attention on specific risks that might otherwise be overlooked or ignored. Activism around nonfinancial risk may also motivate decisions that reduce the cost of capital or the volatility of cash flow or earnings, all of which can improve profitability and fundamental firm financial performance. At the portfolio level, investor monitoring of both financial and nonfinancial risk can improve the informational content of market prices, and activism directed at both nonfinancial and financial risk may provide opportunities for active investors to either earn above-market returns or to reduce value-impairing risks. Even where markets offer investors a risk premium for holding high-risk assets, universal owners are likely to benefit from activism that mitigate risks that may negatively impact returns across an entire portfolio.

III. Beyond Passivity: The Means Of Risk-Related Activism

The push for greater shareholder power in the aftermath of the financial crisis and more recent efforts to harness shareholder power through investor stewardship reform assume that the institutional investors who dominate today's capital markets have the power, as well as the incentives, to improve risk management and long-term monitoring. Of course, the basic mechanisms of shareholder activism—shareholder proposals and direct engagement with target firms—have been widely used for decades. However, commentators to date have generally concluded that risk-related activism of this sort cannot succeed because most shareholders are rationally passive in the face of well-known

151. *See, e.g.*, Matteo Tonello, *Proxy Season 2012: The Year of Pay for Performance*, HARV. L. SCH. FORUM ON CORP. GOV. & FIN. REG. (May 17, 2012), http://corpgov.law.harvard.edu/2012/05/17/proxy-season-2012-the-year-of-pay-for-performance/ (reporting that in 2011, shareholders at more than 75% of companies opted for an annual say-on-pay vote).

152. PROXY ANALYTICS, *supra* note 63, at 17, 19.

153. A recent survey by the UNPRI finds that institutional investors who use ESG measures seek to differentiate risk and return effects to avoid double-counting. UNPRI, INTEGRATED ANALYSIS: HOW INVESTORS ARE ADDRESSING ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS IN FUNDAMENTAL EQUITY VALUATION 34 (Feb. 2013), http://www.unpri.org/wp-content/uploads/Integrated_Analysis_2013.pdf.

institutional barriers and the costs of activism.

This Part revises the standard account of institutional investor passivity. It argues that beyond the question of incentives explored above, *how* exactly highly diversified institutional investors might effect change among portfolio firms has been poorly understood. In fact, the same tools that allow a relative handful of activist hedge funds and other blockholders to catalyze support for their goals from the broader (passive) shareholder base also help non-blockholders engage portfolio firms around broader performance and risk issues. More importantly, institutional investor demand can encourage the integration of ESG metrics into standard financial analysis. Since new tools now allow ESG metrics to inform investment across different asset classes and time horizons, some of the structural obstacles to risk-related activism caused by financial intermediation and short-term trading practices are also less daunting than has previously been assumed.

A. The Passivity Challenge

Given the concentrated ownership patterns of publicly traded firms, an early explanation for shareholder passivity—the fragmentation of shareholding among widely dispersed shareholders—is less relevant today. However, other standard explanations for the rational passivity of shareholders remain, and although some public company investors already use the activist toolkit, most do not.[154]

The most obvious explanation is that the costs of activism, which are borne by the activist, may exceed the benefits, and these benefits are shared equally by other shareholders who can free-ride on the activist's efforts.[155] For direct forms of activism, such as proxy contests, these costs can be substantial.[156] The rise of proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis demonstrates that even the costs associated with informed voting across a large number of portfolio firms are too high to be feasible for many institutional investors.

The cost-benefit analysis makes sense largely for blockholders, such as hedge funds or private equity firms, who remain engaged with the target firm long enough to reap the benefits of their activism.[157] However, pension funds and mutual funds are subject to diversification requirements that prevent them from holding more than 10% of their assets in a single firm.[158] High portfolio turnover may also discourage some forms of activism,

154. *See, e.g.*, Choi & Fisch, *supra* note 51, at 317–19 (finding that, with some exceptions, most public pension funds do not engage in activism and that mutual funds are even more hesitant to do so); Jonathan M. Karpoff, The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings (2001) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=885365 (conducting a meta-analysis of 20 studies of shareholder activism based on data from the 1980s and 1990s).

155. Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 461 (1991); Gilson & Gordon, *supra* note 16, at 868–69.

156. A widely cited study by Nickolay Gantchev on the costs of hedge fund activism finds that a proxy contest costs an average of $10.71 million and that the costs of hedge fund monitoring effectively reduce their returns to activism by more than two-thirds. *See generally* Gantchev, *supra* note 66.

157. *See generally* Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986) (arguing that institutional investors hold sufficient voting power to benefit from active monitoring).

158. *See* Gilson & Gordon, *supra* note 16, at 889–95 (discussing this and other reasons for institutional investor passivity).

although average holding periods still exceed the tenure of most fund managers.[159] In a climate where nearly 85% of public pension funds may be facing unfunded obligations to beneficiaries, some forms of activism may simply prove too costly.[160]

Activism by diversified investors is also impeded by the intermediated nature of modern capital markets, which have witnessed a shift from direct stock ownership by individual investors to a market where an extended chain of investment intermediaries separates individuals, institutional investors, and the firms in which they invest.[161] This system strengthens the influence of institutional investors and other investment intermediaries, since the beneficiaries of public pension funds and privately funded employer plans cannot directly influence the practices of firms in which they invest.[162] Few individual investors exercise voting rights,[163] and even large institutional investors often delegate the voting rights associated with these funds to external investment managers, albeit under investment or voting guidelines required by the investor or the fund itself.[164] Financial intermediation therefore introduces new agency costs and reduces institutional investors' ability to monitor investment decisions and influence portfolio firms.

B. Activist Arbitrageurs

Ron Gilson and Jeff Gordon have responded to the passivity challenge by arguing that institutional investors are not in fact *passive*, but "rationally reticent," a conclusion that aligns with prior studies of institutional investor activism. That is, institutional investors are unlikely to initiate activism, but are willing to vote in support of a proposal or decision that has been presented to them by an activist investor.[165] As they explain, hedge fund activists have emerged as the quintessential "activist arbitrageurs," initiating and facilitating governance proposals for institutional investors to vote on. But since hedge fund activists typically own less than 10% of any given firm,[166] they cannot, short of an expensive takeover bid, achieve their goals alone. Instead, "both activist and institutional shareholders must agree for a proposal to go forward. While activist investors frame and seek to force governance or performance changes, they are successful only if they can attract broad support from institutional investors capable of assessing alternative strategies presented to them."[167]

Hedge funds are willing to bear the costs of activism on behalf of the broader class of shareholders because of the gains they stand to reap if they succeed, often in the form of

159. Roe, *supra* note 145, at 1000 (citations omitted).

160. *See* Aguilar, *supra* note 148 (providing statistics on expected unfunded obligations).

161. *See generally* Gilson & Gordon, *supra* note 16 (explaining this problem); Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 MINN. L. REV. 1822 (2011) (emphasizing the disconnect between record and beneficial owners).

162. *See generally* Anne Tucker, *The Outside Investor: Citizen Shareholders and Corporate Alienation*, 11 U. ST. THOMAS L.J. 99 (2013).

163. In the 2015 proxy season, retail investors voted only 28% of their shares. *See* PROXY PULSE, *supra* note 2, at 4 (reporting on results from shareholder meetings held between January 1, 2013 and May 15, 2015).

164. Around 50% of the public pension funds included in Choi & Fisch's survey delegated voting to external agents and an additional 40% did so subject to voting guidelines. Choi & Fisch, *supra* note 51, at 323 & tbl.1(b).

165. *See generally* Gilson & Gordon, *supra* note 16.

166. *See* Gantchev, *supra* note 66, at 621 (finding that hedge funds only hold positions averaging around 8% or 9% of the equity capital of the firm throughout the duration of a campaign).

167. Gilson & Gordon, *supra* note 16, at 897.

dividend payouts or a potential rise in the share price.[168] Gilson and Gordon argue that this division of labor between activists, who bear the initial costs of bringing an issue to the company and to a shareholder vote, and other investors, who simply vote their shares for or against, is an efficient specialization of roles in the capital markets since it lets institutional investors exercise their governance rights more cheaply. However, because they believe that institutional investors lack the incentives and ability to serve as "activist arbitrageurs," they conclude that institutional investors cannot use similar means to serve as long-term monitors of portfolio firms.[169]

While many of the limits Gilson and Gordon identify persist, their skepticism overlooks the reality of risk-related activism. In fact, as with hedge funds, a relative handful of activists can leverage the voting power of other shareholders to urge firms toward better risk management and greater transparency.

1. Activism Without Blockholders

The primary distinction between risk-related activists and hedge fund activists is that the individuals and institutional investors who initiate risk-related activism are not blockholders like hedge funds. They are therefore unlikely to pursue costly forms of activism, like proxy contests or outright takeover bids.[170] Expensive, confrontational tactics that have been used by hedge funds are also less useful in achieving better management and transparency around risk, since those outcomes will depend on management's own commitment. Instead, ESG activism occurs largely through private and public engagement and the shareholder proposal process.[171] But like activist hedge funds, ESG activists need the collective support of other investors for their proposals to attract the attention of management. Even where proposals do not reach a vote, the success of direct engagement may still depend on management's assessment of the proposal's potential economic impact and the level of support it may receive from investors.

Because the shareholder proposal mechanism can be used effectively and relatively cheaply by a small number of shareholder activists and because of the efficiencies of coordinated campaigns, the cost barriers to risk-related activism are in fact lower than has previously been assumed. The low ownership thresholds under Rule 14a-8[172] allow shareholders to bring issues to a shareholder vote at relatively low cost to the proponent. ESG activists also enjoy various forms of support that reduce some of the costs of bringing a proposal to management or a shareholder vote. Some of the coordination and communication costs associated with risk-related activism are in fact borne by consumer and business nonprofits, global nongovernmental organizations (NGOs), and research institutes whose interests in sustainable development, human rights, or environmental advocacy align them with shareholder activists. The UNPRI and various investor

168. *See generally* Gantchev, *supra* note 66.

169. Gilson & Gordon, *supra* note 16, at 868–69.

170. *See* Choi & Fisch, *supra* note 51, at 317 (finding that pension funds surveyed did not attempt to nominate their own directors and did not initiate proxy contests).

171. *See, e.g.*, Goldstein, *supra* note 70, at 31–38 (discussing survey and interview results on shareholder engagement).

172. 17 C.F.R. § 240.14a-8(b) (2013).

coalitions, such as Ceres, also facilitate coordinated engagement around ESG risks.[173] Since 1992, federal proxy regulations have allowed such coalitions to directly negotiate with firm management without falling afoul of the rules on proxy solicitation.[174] Finally, as in the case of the New York pension funds' board accountability campaign, identical proposals may be submitted at multiple firms, and targets are selected because of their visibility and influence in an entire industry, with expected spillover effects to other firms in the investors' portfolios.[175] The use of targeted campaigns explains how institutional investors with diversified portfolios containing hundreds of firms can reap a reward from urging firm managers or specific portfolio firms to change how they monitor and manage ESG risk.

Since 2009, the space for risk-related activism has also expanded, making shareholder proposals a more viable tool for engaging firms around ESG issues. Prior to 2009, the SEC had rejected any proposal that required the company to engage in an evaluation of risk, which it deemed to concern the "ordinary business operations" of the company and therefore not appropriate for a shareholder vote.[176] In 2008, this rationale was used, for example, to reject a proposal that Sunoco, Inc. create a board sustainability committee.[177] In Staff Legal Bulletin 14E, the SEC reversed this policy and adopted an approach that focused instead on the nature of the risk at issue rather than the demands the request would place on the company.[178] Governance proposals relating to risk management or urging the appointment of board risk or sustainability committees are now not excludable so long as the subject matter of the risks such committees oversee does not involve ordinary business matters.[179] In responding to recent no-action requests, the SEC has consistently viewed environmental issues, sustainability reporting, and executive compensation as not excludable from the corporate proxy, since these issues are deemed to relate to risk and to raise important policy issues that should be submitted to a vote.[180]

Changes in the legal and regulatory environment over the past decade that have stimulated the rise of shareholder activism generally have also contributed to the success of activism by non-blockholders. First, the current regulatory environment and decades of activist engagement mean that communicating with, and responding to, investors is institutionalized and largely *de rigeur* for publicly traded companies, as well as other mid-cap and large firms who have historically been the primary target of activist hedge funds.

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173. CERES, http://www.ceres.org/ (last visited Feb. 16, 2016).

174. *See* Choi & Fisch, *supra* note 51, at 319 (discussing the emergence of investor coalitions). *See* Regulation of Communications Among Shareholders, Exchange Act Release No. 34,31326 (Oct. 16, 1992) (interpreting the Securities Exchange Act of 1934, Rule 14a-2(b)(3)).

175. *See* Miguel Rojas et al., *Characteristics of Companies Targeted by Social Proxies: An Empirical Analysis in the Context of the United States*, 117 BUS. & SOC'Y REV. 515, 531 (2012) (stating that "[targeted firms] are larger, as well as less profitable and less socially performing" than comparable firms not targeted by social proposals); Rojas et al., *supra* note 50, at 227 (finding repeated filings targeting large firms).

176. 17 C.F.R. § 240.14a-8(i)(vii). *See* SEC Staff Legal Bulletin, No. 14E (CF) (Oct. 29, 2009), https://www.sec.gov/interps/legal/cfslb14e.htm (describing the prior approach).

177. Miller v. Sunoco, Inc., No. 07-1456, 2008 WL 623806 (E.D. Pa. Mar. 4, 2008).

178. SEC Staff Legal Bulletin, *supra* note 176.

179. There is considerable nuance in the SEC's approach to these proposals. *See, e.g.*, Western Union Co., SEC No-Action Letter, 2011 WL 916163 (Mar. 14, 2011) (regarding board committees).

180. *See, e.g.*, Kohl's Corp., SEC No-Action Letter, 2013 WL 6701965 (Jan. 28, 2014) (regarding Kohl's sustainability policy); SEC Staff Legal Bulletin, No. 14A, 2002 WL 32987526, at *1–2 (July 12, 2012) (regarding executive compensation).

Second, despite the precatory nature of shareholder proposals, boards who ignore proposals that achieve high levels of investor support are later subject to unfavorable say-on-pay votes and high withhold votes on director candidates.[181] Proxy advisory firms now recommend that shareholders consider opposing directors who have previously ignored advisory shareholder proposals that received majority support.[182] They also recommend investors to withhold or directly oppose directors, even in uncontested elections, in "extraordinary circumstances," where the company has experienced "failures of . . . risk oversight," including large regulatory fines or sanctions, significant legal judgments or other material governance failures.[183] Voting guidelines from proxy advisor Glass Lewis now provide specifically that it will recommend a vote against directors who fail to exercise appropriate oversight of ESG risk because it "views the identification, mitigation and management of [ESG] risks as integral components [of] a company's overall risk exposure."[184] Empirical evidence shows that even when shareholders are unable to obtain a majority vote supporting a shareholder-sponsored bylaw amendment or other proposal—or to oppose a director candidate or management proposal—a significant minority vote can prompt a board response.[185] Prior studies using earlier data may underestimate the impact of engagement and shareholder activism on firms in the current environment.

Responding to the emergence of risk-related activism, proxy advisor ISS now recommends support for many common ESG proposals. For example, in 2013, ISS also reversed its recommendation that investors vote against shareholder proposals to include nonfinancial performance metrics in executive compensation and now recommends a favorable vote.[186] As its current Sustainability Voting Guidelines state:[187]

> ISS recognizes the growing view among investment professionals that sustainability or [ESG] factors could present material risks to portfolio investments. Whereas investment managers have traditionally analyzed topics such as board accountability and executive compensation to mitigate risk, greater numbers are incorporating ESG performance into their investment making decisions in order to have a more comprehensive understanding of the overall risk profile of the companies in which they invest to ensure sustainable long-term profitability for their beneficiaries.[188]

Even though voting support for ESG proposals varies widely depending on the subject, the support of proxy advisory firms increases the likelihood that shareholders and firm management will take seriously proposals on ESG matters that they believe relate to

181. *See generally* Del Guercio, *supra* note 61.

182. *See* ISS, 2015 U.S. PROXY VOTING SUMMARY GUIDELINES 14 (Mar. 4, 2015), http://www.issgovernance.com/file/policy/2015-us-summary-voting-guidelines-updated.pdf (providing factors for investor consideration).

183. *Id.*

184. Glass Lewis, PROXY PAPER GUIDELINES 2016 PROXY SEASON (UNITED STATES) 15 (2016).

185. *See generally* David Yermack, *Shareholder Voting & Corporate Governance*, 2 ANN. REV. FIN. ECON. 103 (2010) (assessing the effect of shareholder voting on corporate boards); *see also* Rojas et al., *supra* note 50, at 245–47 (providing examples of management responses to weakly supported social proposals).

186. *See also* ISS, U.S. CORPORATE GOVERNANCE POLICY 2013 UPDATES 19 (Nov. 16, 2012), http://www.issgovernance.com/file/2013-policies/2013USPolicyUpdates.pdf (initially recommending a case-by-case approach).

187. ISS, 2015 U.S. SUSTAINABILITY PROXY VOTING GUIDELINES 8 (Feb. 5, 2015), http://www.issgovernance.com/file/policy/2015-sustainability-international-voting-guidelines.pdf.

188. *See* 2015 U.S. PROXY VOTING SUMMARY GUIDELINES, *supra* note 182, at 62.

material drivers of risk and return.

2. The "Other Arbitrageurs"

Which investors, then, can play the role of activist hedge funds in catalyzing the support of passive investors for risk-related activism and directly influencing corporate management? These "other arbitrageurs" are a diverse, and relatively small, class of investors who are the sponsors of nearly all shareholder proposals submitted to public companies across a range of issues.[189] Not surprisingly, public pension funds and labor union funds together are the most active institutional investor sponsors of shareholder proposals, accounting for 20–30% of all filed shareholder proposals.[190] They are also dominant players in the capital markets—together, public and private pension funds control over 25% of all public equity traded on U.S. markets, and mutual funds now account for around 7% of all publicly traded equities.[191]

Other leading sponsors include mutual funds and investment advisers specializing in responsible investment products, such as Calvert, Domini, and Pax, as well as religious institutions and other organizations, such as the Nathan Cummings Foundation.[192] Individuals typically sponsor another 30–40% of all filed proposals,[193] and in the first half of 2014, five individuals alone—the "corporate gadflies"—accounted for over 23% of all proposals.[194]

Not all of these activists are ESG–oriented investors or ground their activism on economic goals, but many do. This is reflected by the fact that many of the leading institutional sponsors of shareholder proposals are signatories of the UNPRI,[195] a list that also includes most of the leading asset managers in the United States.[196] A number of the dominant activist labor union and pension funds, including the AFL-CIO and two California state pension funds, CalPERS and CalSTRS, have also separately affirmed their commitment to promoting long-term value through engagement and the use of long-term metrics in evaluating investments.[197] However, as with hedge fund activism, the actual motive of the "arbitrageur" is in fact irrelevant to the question of *how* activism happens. Whether the motivations of the "arbitrageur" are in fact value-driven, self-interested, or policy-oriented may affect whether they achieve success, but all that is needed to overcome the collective action barriers to risk-related activism is the effort of a relatively small group

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189. *See* PROXY ANALYTICS, *supra* note 63, at 34–35, tbl.2 ("Most Frequent Sponsors"). Hedge funds file relatively few proposals, less than 3% of the total, based on recent proxy seasons. *Id.* at 23, chart 6.

190. *Id.* at 23, chart 6.

191. TONELLO & RABIMOV, *supra* note 4, at 25, tbl.12. The increases in mutual fund holdings is attributable to the growth of employer-sponsored retirement plans. *See* Gilson & Gordon, *supra* note 16, at 879–86.

192. *See* PROXY ANALYTICS, *supra* note 63, at 41–43 & tbl.2 ("Most Frequent Sponsors").

193. *Id.* at 23, chart 6.

194. *Id.* at 29, tbl.1. In the first half of 2014, corporate "gadfly" John Chevedden submitted 88 proposals, the most of any single proponent. *Id.*

195. This is supported by the overlap in the most frequent sponsors of shareholder proposals, see *id.* at 41–43, tbl.2, and the list of UNPRI signatories. PRI, *Signatories to the Principles for Responsible Investment*, www.unpri.org/signatories (last visited Feb. 16, 2016).

196. These include Goldman Sachs, J.P. Morgan, Janus Capital, Morgan Stanley, TIAA-CREF, T. Rowe Price, and Franklin Templeton Investments. PRI, *supra* note 195.

197. These funds are among the institutional investor subscribers to the Aspen Institute's "Aspen Principles." *See generally* THE ASPEN INSTITUTE, LONG-TERM VALUE CREATION: GUIDING PRINCIPLES FOR CORPORATIONS & INVESTORS (2010), www.aspeninstitute.org/sites/default/files/content/docs/bsp/FinalPrinciples.pdf.

of activists who are willing to engage management and seek broader investor support.

3. Blurring the Lines

The economic goals and current practice of risk-related activism demand another important revision to standard accounts of shareholder activism: because risk-related activism, along the lines of New York's board accountability campaign sees ESG issues as equally relevant to long-term firm value, it renders the conventional dichotomy between "governance" and "social" (i.e., non-governance) proposals flawed and misleading.[198] Under the conventional view, "governance" proposals may, for example, seek to separate the roles of the CEO and the board chairman. Those considered social proposals, in contrast, may relate to climate change, the firm's human rights impacts, or voluntary disclosure of corporate campaign contributions. This convention arose because non-governance proposals almost inevitably concern the "ordinary business" of the company, and in order for such proposals to go to a vote under Rule 14a-8, the proposal must raise "substantial policy" issues.[199] Using this standard approach, approximately 40% of all proposals in recent years have been social and environmental proposals, approximately 40% are governance proposals, and executive compensation and other matters make up the balance.[200] This traditional typology reinforces the view that governance proposals are inevitably more value-enhancing than social proposals, and that the two are clearly distinguishable. It has therefore contributed to the reticence of some investors and firms to support changes advocated by risk-related activists.

In reality, risk is a multi-dimensional concept, and risk-related proposals span the governance–social divide. For example, the proposal urging Sunoco's board to create a sustainability committee relates both to corporate governance and also to firm management of environmental risks.[201] Similarly, the New York City board accountability campaign focuses on board nominees, but its goals include both addressing climate change risk and better management alignment with long-term performance.[202] The SEC's guidance on proposals related to risk, issued in 2009, itself links corporate governance to the Rule 14a-8 language typically associated with social proposals; it notes that the board's oversight role with respect to risk management "is a significant policy matter regarding the governance of the corporation."[203] In recent years, the SEC staff has identified as "significant policy matters" key governance issues, such as CEO succession policy[204] and executive compensation,[205] as well as other "E/S" concerns that run the gamut from food

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198. The statistics referenced here are drawn from a Conference Board Report that uses a more nuanced approach. *See* PROXY ANALYTICS, *supra* note 63, at 31 (categorizing proposals as "governance," "social," "executive compensation," or "other").

199. 17 C.F.R. § 240.14a-8(i)(7) (2013). *See* Amendments to Rules on Shareholder Proposals, Release No. 40018, WL 254809 (May 28, 1998) (interpreting the ordinary business exception).

200. PROXY ANALYTICS, *supra* note 63, at 31.

201. Miller v. Sunoco, Inc., No. 07-1456, 2008 WL 623806, at *2 (E.D. Pa. Mar. 4, 2008)*; see also* Target Corporation, No-Action Petition, 2014 WL 556446 (Mar. 10, 2014) (reporting proponent's successful negotiation and withdrawal of proposal to ensure that a board committee oversee human rights risks).

202. *Supra* note 1 and accompanying text.

203. SEC Staff Legal Bulletin, No. 14E (CF), *supra* note 176, at *2.

204. *See, e.g.*, Whole Foods Mkt, Inc., SEC No-Action Letter, 2009 WL 3844590 (Nov. 10, 2009) (regarding a proposal that the board adopt a succession policy).

205. *See, e.g.*, JP Morgan Chase & Co., SEC No-Action Letter, 2010 WL 147284 (Feb. 25, 2010) (regarding recommended changes to the company's executive compensation plan).

sourcing practices[206] and human rights[207] to sustainability and the implementation of ESG principles in project finance.[208]

Two obvious results of this reality are that risk-related activists who are focused on economic objectives may draw support from more ideologically driven investors, but, by the same token, what appear to be policy issues may in fact reflect material risks. These observations point again to the need for firms to respond on a case-by-case basis to particular activist demands. They also require a reexamination of some of the common challenges to risk-related activism, discussed in Part V below.

C. Beyond Activism: ESG Integration

Beyond direct investor engagement with portfolio firm, one of the most powerful forms of risk-related activism—and one largely overlooked to date—is the market influence institutional investors have in driving the integration of broader risk indicators through the investment chain and across the capital markets. This can occur both indirectly, as a result of activists' demands for greater firm transparency around ESG risk, and directly, through the contractual mandates between asset owners and investment intermediaries. More widespread integration of ESG measures into standard investment analysis would address several important structural objections to risk-related activism: (i) that fund manager incentives are based on benchmarking strategies that do not reward activism and on short-term quarterly or annual performance targets; and (ii) that the goals of risk-related activism are incompatible with the dominance of passive investment products and automated trading practices in modern capital markets.

1. Understanding ESG Integration

Current approaches to ESG integration represent a transformation of the responsible investment landscape. Historically, "socially responsible" or ethical investors engaged in negative screening, excluding firms or sectors from the portfolio that did not fit the screening criteria of the investor. However, empirical studies finding that traditional screening strategies may lower investment returns or increase portfolio risk have raised concerns that screened investments were inconsistent with fund manager fiduciary duties.[209] Now, both traditional social investors and mainstream institutions are increasingly using multiple tools to measure nonfinancial ESG fundamentals in addition to, and not in lieu of, standard measures of financial risk and return.

ESG integration therefore encompasses a range of approaches. Bloomberg has made ESG data available on its terminals alongside standard financial analytics, and a number of other service providers offer proprietary ESG analytics. According to a recent case study analysis by the UNPRI, most institutional investors that incorporate ESG metrics into

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206. *See, e.g.*, Denny's Corp., SEC No-Action Letter, 2009 WL 772857 (Mar. 17, 2009) (regarding a proposal on adoption of a commitment to use 10% cage-free eggs).

207. *See, e.g.*, Yahoo! Inc., SEC No-Action Letter, 2011 WL 494129 (Apr. 5, 2011) (regarding a proposal on adoption of a specific human rights policy for business in China).

208. *See, e.g.*, Bank of Am. Corp., SEC No-Action Letter, 2008 WL 524166 (Feb. 22, 2008) (regarding a proposal urging preparation of an Equator Principles report); Kohl's Corp., SEC No-Action Letter, 2013 WL 6701965 (Jan. 28, 2014) (regarding a proposal that the board report on the cost-benefit analysis behind its sustainability policy).

209. *Supra* note 92 and sources cited therein.

financial analysis rely on ESG factors to inform fundamental analysis and to adjust standard financial forecasting and metrics, such as cash flow estimates or discount rates, rather than relying on overall sustainability ratings.[210] Although some investors still use screening strategies, many are inclusive rather than exclusive approaches that do not screen out firms, but rather select best in class firms for inclusion in the portfolio based on ESG standards and financial performance relative to industry peers.[211]

Leading securities exchanges, including the New York Stock Exchange and the NASDAQ, have also voluntarily committed to enhance the ESG disclosure and performance of listed firms and to promote sustainable capital markets under the Sustainable Stock Exchanges Initiative.[212] Nonetheless, in the United States, ESG integration is still largely driven by investor demand for responsible investment fund products, which are now offered by most major fund families such as Vanguard, TIAA-CREF, and Fidelity, and ESG integration has not yet been fully embraced in mainstream investment practice.

The limits of ESG metrics described earlier and uncertainty about their materiality remain key barriers to ESG integration. However, as the Appendix indicates, the challenge is not an absence of indicators but rather identifying comparable, quantitative indicators that are material for different firms and industries. To address this, important efforts are underway by the International Integrated Reporting Council (IIRC)[213] and the Sustainability Accountability Standards Board (SASB)[214] to develop materiality guidelines and uniform nonfinancial reporting standards with direct input from multiple industry sectors in order to facilitate the incorporation of material nonfinancial information into existing financial reporting.[215] With the continued maturation of ESG metrics and investment technologies, new tools for incorporating ESG risk analysis into standard financial analysis will improve transparency around material ESG risks and potentially move the use of ESG indicators beyond specialized products and further into mainstream investment practice.

2. Breaking Down Structural Barriers

ESG integration offers a potential tool to address some of the identified structural barriers to institutional investor monitoring of portfolio firms. In particular, ESG integration may give asset owners greater ability to realign the incentives of financial intermediaries and to harness short-term trading practices to improve how efficiently ESG information is communicated to the market.

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210. UNPRI, *supra* note 153, at 21, 34, 40.

211. *See generally* Koehler & Hespenheide, *supra* note 8 (surveying these trends).

212. *See Sustainability Reporting Policies—2012*, SUSTAINABLE STOCK EXCHANGES INITIATIVE (2013), http://www.sseinitiative.org/sustainability-reporting-policies/ (reporting on implementation through listing rules and other mandatory and voluntary disclosure requirements).

213. INTEGRATED REPORTING, http://integratedreporting.org/ (last visited Feb. 16, 2016).

214. SASB, http://www.sasb.org (last visited Feb. 16, 2016).

215. For a survey of these efforts, see generally *Integrated Financial & Sustainability Reporting in the United States*, IRRC INSTITUTE (Apr. 2013), http://irrcinstitute.org/pdf/FINAL_Integrated_Financial_Sustain_Reporting_April_2013.pdf. SASB's industry-specific sustainability standards may be accessed at http://www.sasb.org/standards/download/ (last visited Feb. 16, 2016)*; see also* KPMG SURVEY, *supra* note 123, at 36 (finding that over 50% of all surveyed firms globally include disclosures related to corporate responsibility in their annual report).

Financial intermediation remains a primary barrier to shareholder activism because fund managers lack incentives to facilitate activism and because monitoring costs rise as investment chains lengthen. One reason that activist investors engage directly with portfolio firms is that the typical compensation structures of fund managers do not cover the costs of engagement with portfolio firms. In addition, fund managers are rewarded for achieving higher returns relative to established benchmarks for a given asset class, not for achieving higher absolute returns.[216] Rather than actively mitigating firm or portfolio risk, investors' risk tolerance is reflected in the mix of assets they choose.

A related obstacle is that, by contributing to market short-termism, financial intermediation may undermine the cost-benefit analysis for risk-related activism where the materiality of any benefit to activism is expected over a longer time horizon. The key challenge is that even if some institutional investors serve as active monitors of portfolio firm performance and risk, the dominance of high-frequency traders and other investors "who focus on short-term stock price performance, and/or favor high-leverage and high-risk corporate strategies designed to produce high short-term returns"[217] has a systemic effect on markets that may undermine their monitoring role. Fund manager compensation and bonuses also depend on reaching short-term targets, working against appropriate risk oversight throughout the investment chain.

The integration of ESG factors into voting and investment guidelines may offer a way for asset owners to motivate investment intermediaries and the firms they invest in to focus on ESG risks and other indicators of long-term performance through the chain of agency relationships. Investors can do so most readily through separately-managed account arrangements or through side agreements with fund managers. Mandatory expectations can then be monitored and enforced contractually. Although investors may not always have the ability to require such terms from fund managers, as, for example, when investing in mutual funds, institutional investors can also "vote with their feet" by selecting funds whose managers evaluate ESG risk and use ESG criteria in making investment decisions.

The integration of ESG indicators into standard investment analysis may also enable investors in index funds and other passively managed asset classes, or fund managers who rely on automated trading strategies to appropriately price portfolios and firms based on lagging and leading ESG indicators. With ESG integration, portfolio performance can be assessed on the basis of a combination of standard and ESG benchmarks. Mainstreaming ESG metrics across all asset classes and into standard trading models could indirectly facilitate market-based measures that will better align money managers with the near- and longer-term goals of asset owners, and ultimately, with the best interests of the ultimate clients or beneficiaries.[218]

Even at present levels of ESG integration, institutional investors can already influence firm-level ESG commitments and risk management through investment in other funds that are themselves long-term blockholders. For example, private equity is an asset class that offers relatively high returns to public pension funds and other institutional investors, but

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216. *See* Gilson & Gordon, *supra* note 16, at 890–95 (discussing mutual fund fee structures and incentives).

217. THE ASPEN INSTITUTE, OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2 (Sept. 9, 2009), www.aspeninstitute.org/sites/default/files /content/docs/pubs/overcome_short_state0909_0.pdf.

218. The disconnect between the interests and time-horizons of money managers and individual investors has been widely observed. Leo E. Strine, Jr., *Can We Do Better By Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 458–60 (2014).

these funds are themselves active monitors of firm performance and already integrate many ESG considerations into pre-investment due diligence and ongoing monitoring of portfolio firms.[219] The integration of ESG risks into portfolio firm monitoring by private equity and venture capital funds is beyond the scope of this paper, and funds vary widely in their investment strategies and focus. Nonetheless, ESG integration across diverse asset classes portfolio diversification gives institutional investors tools beyond the proxy process to influence firm-level ESG commitments and directly or indirectly monitor portfolio firms.

IV. ASSESSING IMPACT

Answering the fundamental normative questions of whether regulatory policy should support or constrain risk-related activism, and whether corporate boards, management, and shareholders as a class should take the goals of risk-related activism depends on whether risk-related activism can drive positive changes in firm behavior and financial performance. Although measuring impact presents challenges, it is important to weigh the evidence of impact in light of the goals of risk-related activism. This Part presents this evidence and responds to anticipated concerns about the actual and potential impact of risk-related activism.

A. The Metrics of Activism

The real impact of risk-related activism has been overlooked in the corporate governance literature in part because prior studies have largely measured the wrong things. Popular and academic commentary on the impact of shareholder activism has generally measured success based on whether specific proposals garner a majority vote or on whether activist campaigns can be empirically linked to direct improvements in firm financial performance. Hedge fund proposals—though relatively infrequent—often garner majority support, and governance proposals on matters such as proxy access, majority voting, and staggered boards have enjoyed majority support in recent years; in contrast, majority support is rare for social or sustainability proposals.[220] Prior studies have also generally failed to find positive market reactions to high shareholder support for specific proposals.[221]

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219. Some private equity firms are now more explicitly linking their practices to ESG goals. *See, e.g.*, KKR, KKR 2013 ESG & CITIZENSHIP REPORT 50 (2013), www.kkresg.com/pdf/kkr_esg_2013.pdf; *see also* UNPRI, RESPONSIBLE INVESTMENT IN PRIVATE EQUITY: A GUIDE FOR LIMITED PARTNERS 4 (2d ed. June 2011), http://www.unpri.org/wp-content/uploads/PE_Guide_2.pdf (discussing the spread of ESG integration). Investment in fixed assets is another asset class that requires substantial due diligence and longer-term investment horizons.

220. PROXY ANALYTICS, *supra* note 63, at 46–47, charts 20–21.

221. Earlier empirical studies have generally found that shareholder proposals have little observed effect on firm value, although several studies identify limited effects on firm governance practices. *See generally* Karpoff, *supra* note 154 (surveying the empirical literature and concluding that activism has some effect on firm governance but minimal effect on firm financial performance); Yermack, *supra* note 185 (same); Jonathan M. Karpoff et al., *Corporate Governance and Shareholder Initiatives: Empirical Evidence*, 42 J. FIN. ECON. 365 (1996) (analyzing a sample of governance proposals from 1986–1990); Andrew Prevost & Ramesh P. Rao, *Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds?*, 73 J. BUS. 177 (2000) (finding negative price reactions to proposal filings by public pension funds); Sunil Wahal, *Pension Fund Activism and Firm Performance*, 31 J. FIN. QUANT. ANALYSIS 1 (1996) (finding no long-term wealth effects to activism in a sample of target firms from 1987–1993).

These standard approaches may discount the actual impact of risk-related activism. By focusing narrowly on *direct* share price effects over various time horizons and majority support for shareholder proposals, empirical studies as well as legal commentary have missed evidence of activists' success in shaping firm behavior. A better approach is to examine whether the activist effort achieved its intended goals, altered firm practice, or influenced broader changes across a sector.

1. The Limits of Financial Metrics

Financial metrics are fairly well-suited to capturing the impact of hedge fund activism, but methodologies that rely on immediate stock price effects or direct measures of financial performance may not capture the effects of risk-related activism. Hedge fund activism occurs primarily through direct engagement, and hedge funds account for only a small percentage of filed shareholder proposals—an average of 3% of the total in recent years.[222] These proposals tend to be used to advance the goals of a broader public or private campaign, and they often achieve relatively high levels of support, compared to those submitted by other investors.[223] However, in contrast to the shareholder proposals initiated by other activists, they are, with few exceptions,[224] generally matters for which a majority shareholder vote is binding on the board and therefore likely to trigger a measurable reaction in the financial markets. These include, for example, proposals on the election or removal of directors, the issuance of authorized dividends, bylaw changes related to a proxy contest, or proposed transactions.[225]

Although institutional investors and hedge fund activists may at times work together toward a common goal, comparisons between the success of hedge fund activists and risk-related activists in achieving their goals are also highly suspect because their objectives are quite different. Hedge fund activism can affect the target firm's investment risk, but it is rarely directed at risk management, firm-specific risk, or other drivers of operational efficiency. Instead, hedge funds tend to seek more efficient deployment of the firm's cash reserves and other assets, often using leveraged strategies that may increase the target firm's financial risk.[226] Consistent with prior trends, hedge funds sponsored *no* proposals related to corporate governance, environmental and social, or executive compensation in the 2014 proxy season.[227]

In contrast to specific transactions or the results of a proxy contest, the ultimate impact

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222. PROXY ANALYTICS, *supra* note 63, at 23, chart 6.

223. *See id.* at 46, chart 20 (reporting that in 2014, 75% of hedge fund proposals achieved majority support, compared to success rates for other proponent groups averaging less than 30%).

224. Common exceptions include proposals that the board divest assets, declare dividends or a share repurchase. *See id.* at 69 (describing the types of proposals most often filed by hedge funds).

225. *Id.* at 33 & chart 13. In 2014, hedge funds sponsored 5.2% of all shareholder proposals, most related to the election of a dissident director nominee, bylaw amendments, or other transactions. *Id.* at 33 & chart 13, 71–72.

226. *See generally* April Klein & Emmanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009) (discussing hedge fund goals and strategies); *cf.* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008) (finding some operational improvements among hedge fund targets). *But see* Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 331 (2008) (finding that targets of activist hedge funds had lower cash levels than firms owned by passive hedge funds).

227. *See* PROXY ANALYTICS, *supra* note 63, at 31, 34 (categorizing all hedge fund proposals as "other," i.e., as neither governance, social and environmental, nor executive compensation proposals).

of risk-related activism is also inherently more difficult to assess since it is harder to trace causality to an activist campaign. This is doubly so around issues of good governance or risk, which are by definition multi-faceted and require management to engage in a cost-benefit calculation around strategic choices. Such campaigns may extend over years and urge operational changes and reporting practices that take time to develop. Most importantly, the success or failure of risk-related activism may not have an observable effect on the market price for the firm's shares or even on firm behavior because, under state law, shareholder proposals are advisory and cannot dictate board action. Indeed, shareholders are *precluded* under Rule 14a-8 from using the proxy process to pursue highly specific, and therefore more readily measureable, goals by the ordinary business exception's prohibition on proposals that attempt to "micro-manage" the firm's operations.[228] For many institutional investors, dialogue itself is the goal of engagement rather than a specific decision by the company's board, and these broad goals may also be easier to achieve than specific reforms.[229] As a result, event study methodologies and other standard approaches to quantify the financial impact of risk-related activism are likely to be less useful.

2. Evidence From Returns

Despite these difficulties, some studies find positive financial benefits to risk-related engagement. For example, a recent study by Dimson et al. finds that engagements by institutional investors that resulted in changes to the firms' sustainability policies produced above-market returns.[230] With respect to volatility, a number of event studies show that better ESG practices help moderate the stock market's reaction to news of negative risk events.[231] The empirical studies that find a limited impact for non-hedge fund activists also rely largely on data predating the implementation of the Dodd–Frank reforms, which gave investors greater voice over executive and board composition.[232]

3. Evidence From Withdrawn Shareholder Proposals

In the past few years, new evidence has also emerged that investors are focusing more attention on engaging boards around specific risks and that these engagements are successful. Most critically, these engagements are not necessarily mediated by the board but may involve investors speaking directly with the CEO, CFO or other senior executives.[233] In these cases, investors are influencing the senior officers most directly responsible for risk management and key operational decisions.

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228. 17 C.F.R. § 240.14a-8 (2010). *See* Apache Corp. v. N.Y.C. Emps.' Ret. Sys., 621 F. Supp. 2d 444, 450 (S.D. Tex. 2008).

229. *See* GOLDSTEIN, *supra* note 70, at 38–42 (reporting that over 60% of investors and 90% of issuers viewed dialogue as a successful outcome).

230. *See generally* Elroy Dimson et al., *Active Ownership*, 28 REV. FIN. STUD. 3225 (2015).

231. Koehler & Hespenheide, *supra* note 8, at 100–02.

232. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 530–64 (1990) (highlighting legal obstacles to shareholder activism and reviewing the literature); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 717 (2007) (identifying limits to shareholder influence); Rock, *supra* note 155 (expressing skepticism about the monitoring potential of shareholder activism); Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. REG. 174, 176–82 (2001) (surveying the literature).

233. GOLDSTEIN, *supra* note 70, at 17–22.

Because they often signal a successful engagement, withdrawn proposals are one of the best indicators of activists' success.[234] Approximately 5–10% of submitted proposals are withdrawn each year, and the percentage is nearly 15% for proposals on social and environmental issues and executive compensation.[235] During the 2014 proxy season, investors filed 148 climate-related resolutions, a 50% increase over 2013. Half were withdrawn after companies responded to the activists' demands.[236] Again, one reason for the higher withdrawal rate is that activists often accept dialogue or adoption of an alternative approach to be a successful outcome, recognizing the need for firms to make their own evaluation of how to best address risk management issues.[237]

Studies find that shareholder proposals that successfully achieve either dialogue or the underlying objectives of the proposal are generally advanced by public pension funds, labor union funds, or mutual funds, rather than individuals or religious institutions.[238] Withdrawal rates are therefore also higher for proposals backed by institutional investors themselves than for individuals or other organizations.[239] These successes may be due to the fact that most large, publicly traded companies have embraced a commitment to corporate social responsibility that is aligned with the goals of risk-related activism.[240]

Because proposals that go to a vote often signal a failed engagement, it is perhaps not surprising that majority votes are rare, but if investor support is high enough, the vote may still prompt a response from the firm.[241] Here too, institutional investor activists enjoy higher average voting support for their proposals—nearly 40% for public pension and labor union funds.[242] Governance proposals have typically fared better than social and environmental proposals. In 2014, average support for governance proposals was 43%, compared to nearly 20% for social proposals and around 30% for executive compensation

234. *See* Bauer et al., *supra* note 67, at 484 (finding withdrawn proposal impact on executive compensation at least as effective as proposals that received high voting support ex-post). Other studies estimate that shareholder proposals were withdrawn because they prompted a change in corporate practice in around 10% of the cases, but in more than one-third of the cases, a withdrawal signaled an ongoing dialogue with the target firm. *See* Rojas et al., *supra* note 50, at 240 (coding "success" only as reported implementation of the shareholder request).

235. *See* Bauer et al., *supra* note 67, at 483–84 (analyzing withdrawn proposals at S&P 1500 firms between 1997 and 2009). On average, between 5–10% of all shareholder proposals are withdrawn. PROXY ANALYTICS, *supra* note 63, at 37, chart 14 (analyzing data from 2012–2014 for S&P 500 and Russell 3000 firms).

236. *See* Andrea Vittorio, *Investors Push Energy Companies on Climate Change*, BLOOMBERG BNA (July 16, 2014) (analyzing data from Ceres).

237. *See* GOLDSTEIN, *supra* note 70, at 38–40 (finding that 60% of issuer and investor survey respondents did not define success differently for different issues).

238. Stuart L. Gillan & Laura L. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 283 (2000); *see also* Rojas et al., *supra* note 50, at 241–43 (analyzing proponent identity as a factor in successful activism); *see also* PROXY ANALYTICS, *supra* note 63, at 46 & chart 20 (reporting the weakest support for proposals sponsored by individuals (65.9% opposition) and religious groups (70.6%); support for investment adviser proposals was also quite low in 2014 (73.3% opposition)).

239. Bauer et al., *supra* note 67, at 480–81; *see also* Rojas et al., *supra* note 50, at 241 (finding that mutual funds backed 13% of social proposals but over one-third of withdrawn proposals; pension funds accounted for a quarter of all withdrawn proposals).

240. *See* GOLDSTEIN, *supra* note 70, at 42 (reporting that 50% of surveyed investors considered their engagement with a target firm sometimes successful and 72% of responding issuers reported engagement was usually successful).

241. Del Guercio et al., *supra* note 61 and accompanying text.

242. PROXY ANALYTICS, *supra* note 63, at 46, chart 20.

proposals.[243] In recent years, average shareholder support for environmental and social proposals has risen relative to past trends.

4. Evidence from Corporate Practice

Finally, the strongest evidence of ESG activists' success is the shift in corporate practices that were initiated by shareholders. For example, majority, rather than plurality voting for director elections, board declassification, and the separation of the board chair and CEO roles have all been widely adopted by large-cap firms. Activism around many of these goals is now targeted at mid-cap or small-cap companies, suggesting a standardization of what were once novel governance practices.[244] Say-on-pay, too, was proposed by shareholders (largely labor union and public pension funds) before it became mandatory under Dodd–Frank. Survey data show that this mandate has driven higher levels of engagement between institutional investors and corporations.[245] Similarly, investors responded to the *Citizens United*[246] decision with shareholder proposals for voluntary political contribution disclosures.[247] After years of such proposals achieving high levels of support, or even majority support,[248] 80% of S&P 500 firms now make some form of political campaign disclosure, in some cases, in direct response to shareholder campaigns.[249] Sustainability reports, too, have become standard among large firms since investors joined NGOs in demanding greater transparency around ESG risks.[250] This evidence demonstrates not only the vitality of intermediated activism beyond the world of hedge funds, but that the issues that succeed in attracting broader investor support over time, even at lower than majority levels, do have an impact on firm policies and practices.

B. Anticipated Objections

The economic rationales for risk-related activism and related responsible investment strategies suggest that risk-related activism can have a positive effect on financial and operational performance. This undercuts a primary objection to the positive and normative claims presented here, namely, that activism directed at sustainability or other nonfinancial operational and strategic concerns inevitably impairs firm value and shareholder wealth and is therefore inconsistent with institutional investor fiduciary duties.[251] However,

243. *Id.* at 47.

244. *See generally* PROXY PULSE, HOW IS THE 2014 PROXY SEASON SHAPING UP THUS FAR? (2d ed. June 2014), https://www.pwc.com/us/en/corporate-governance/publications/assets/proxypulse-2nd-edition-june-2014.pdf (reporting that activism in these areas is "moving downstream" toward smaller firms).

245. GOLDSTEIN, *supra* note 70.

246. *See generally* Citizens United v. FEC, 130 S. Ct. 876 (2010) (expanding authorization for corporate campaign expenditures).

247. *See, e.g.*, Int'l Bus. Machs Corp., No-Action Letter, 2010 WL 5479675 (Jan. 13, 2011) (withdrawing a no-action challenge to a proposal requesting a review of the company's political campaign contributions policy).

248. *See* PROXY ANALYTICS, *supra* note 63, at 12, 71, chart 26 (reporting that political spending and lobbying proposals account for nearly 40% of all social and environmental proposals and are the most frequent single proposal topic across all types of proposals).

249. Emily Chasan, *More Companies Bow to Investors with a Social Cause*, WALL STREET J., Apr. 1, 2014, at B8.

250. *See* KPMG SURVEY, *supra* note 123 (gauging current levels of sustainability reporting). In 2014, support for proposals on sustainability reporting was around 20%. PROXY ANALYTICS, *supra* note 63, at 68, tbl.14.

251. *See* Henry G. Manne, *The 'Corporate Democracy' Oxymoron*, WALL STREET J., Jan. 2, 2007, at A23

before exploring the implications of these conclusions, three related objections to risk-related activism deserve a further response: the agency cost challenge; investor heterogeneity; and concerns that these economic incentives are still inadequate to motivate institutional investor monitoring.

1. The Agency Cost Challenge

The first challenge to risk-related activism comes from agency theory, which posits that tighter alignment of management with shareholder interests reduces managerial agency costs and generates wealth for shareholders.[252] Good governance is understood to mean a greater degree of monitoring and control by shareholders and outside directors,[253] which should cause management to give less weight to creditors and other stakeholders.[254] Although the term "ESG" has been widely adopted in the financial industry and among institutional investors themselves, the alignment of corporate governance (G) and environmental, social, or other nonfinancial (E/S) risks in the term "ESG" is therefore rather puzzling, since it presumes a direct relationship between good governance and superior environmental and social performance.

Of course, the basic notion that good governance is essential to strong financial performance and that corporate governance matters to investors is fairly uncontroversial. At a pragmatic level, then, the alignment of the three ESG factors may represent a strategic effort by ESG advocates to draw support from a broad range of investors who agree that good governance matters. However, tighter managerial alignment with shareholder interests (i.e., G factors) only promotes long-term firm value, with potential positive spillover effects on stakeholder (i.e., E/S) welfare, if investors are indeed focused on maximizing firm value. Otherwise, as Chief Justice of the Delaware Supreme Court, Leo Strine, Jr., has noted, shareholder empowerment may push firms toward short-termism or excessive risk-taking, which may externalize the cost of negative risk events to stakeholders.[255]

Another aspect of the standard agency cost challenge is that stakeholder-oriented decision-making may be a cover for managerial shirking and self-dealing. If this is so, strong social performance may be found in firms with *weak* corporate governance because of wealth transfers from shareholders to stakeholders.[256] Responsible business practice that requires higher investments or sacrifices profit, whether through investment in technologies that reduce environmental risk or through corporate philanthropy, also imposes direct costs that may be value-reducing, at least in the short run. Although corporate law generally permits directors to sacrifice profits in the best interests of the

(arguing that activism around "social causes" interferes with the contractual rights of other shareholders).

252. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

253. *See, e.g.*, Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107 (2003) (formulating their well-known governance index to measure the strength of shareholder rights).

254. *See generally* Edward Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PENN L. REV. 1907 (2013) (arguing that the conflict between shareholders and other stakeholders is in fact, the primary concern in the current shareholder-centric climate).

255. Leo Strine, *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. L. 1, 8 (Nov. 2010).

256. *See* MILTON FRIEDMAN, CAPITALISM & FREEDOM 133–36 (1962) (articulating this basic view).

firm,[257] choices that reduce cash flows can also increase financial risk.

An initial response is that the use of the term "ESG" by leading investors and investment professionals across the industry represents a shift in understandings of CSP since the days of Milton Friedman and throughout the 1990s, when CSP was understood primarily as profit-sacrificing. Today, in contrast, CSP, sustainability, or responsible business practice are embraced by most public companies as an integral part of corporate strategy, aligned with shareholders' economic interests, that creates "shared value" for the firm and corporate stakeholders.[258] The agency cost challenge has far less force when investors themselves see better management of nonfinancial E/S risks as integral to long-term value and therefore less distinct from core governance (G) issues.

The strong market pressures corporate boards now face to maximize profitability and shareholder power also largely alleviate worries about managerial agency costs. It is also important to note that the potential for ESG activism to impose net costs on the firm or transfer wealth from shareholders to stakeholders is stronger for investments in positive ESG practice (or CSP) and weak with regard to expenses intended to mitigate ESG risk or "negative CSP."[259] Recent empirical work distinguishing these dimensions finds that strong corporate governance causes companies to reduce *both* positive CSP (proactive stakeholder relationship management) and negative CSP (as measured by regulatory violations).[260]

Findings from recent work by Allen Ferrell et al. lend further support for the alignment of E/S and G factors. Based on a global panel dataset from 1999 to 2011, their study analyzes the link between corporate social performance (i.e., the E/S indicators) and good governance, using pay-for-performance and cash reserves as indicators of agency slack, and multiple ESG indicators to measure CSP.[261] It finds that positive CSP, such as strong environmental performance, is closely related to tighter cash and higher pay-for-performance sensitivity, which are key indicators of low managerial agency slack and, therefore, of good governance. Their study shows that strong social performance, and by extension, better management of ESG risk, is indeed associated with good governance and is also value-maximizing. This finding supports the broader literature finding a strong link between ESG risk management and ex-post measures of firm value. Further evidence for the alignment of governance and other nonfinancial measures, such as environmental or social performance, also comes from the empirical findings discussed in Part III on the correlations and causal links between corporate social and financial performance, and studies on the relationship between both governance and social performance dimensions and various measures of risk.

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257. Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 763–76 (2005).

258. *See generally* Michael E. Porter & Mark R. Kramer, *Creating Shared Value*, HARV. BUS. REV. (Jan.–Feb. 2011).

259. *Supra* notes 92–96 and accompanying text.

260. *See generally* Punit Arora & Ravi Dharwadkar, *Corporate Governance and Corporate Social Responsibility (CSR): The Moderating Roles of Attainment Discrepancy and Organizational Slack*, 19 CORP. GOV. INT'L REV. 136 (2011).

261. *See generally* Allan Ferrell et al., *Socially Responsible Firms* (ECGI, Working Paper No. 432, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=246456.

2. Special Interests and Investor Heterogeneity

The second challenge centers on an unavoidable consequence of shareholder power, which is that corporate boards must respond to the demands of activists with diverse interests. This raises two further objections to the case for risk-related activism. First, that the stated economic drivers of risk-related activism are simply a cover for the special interests of a minority of investors, and second, that directors will be forced to weigh competing stakeholder demands.[262]

The data on shareholder proposals and engagement discussed in Part IV weakens arguments that the financial goals asserted by ESG activists are just a false front or that risk-related activism is legitimate only if it is *solely* driven by financial goals. Indeed, a striking fact about ESG activism that emerges from the data is that those activists who enjoy the most success in terms of engagement results, withdrawn proposals, and voting support on governance and executive compensation issues—public pension funds and labor union funds—are also the primary backers of sustainability or social proposals.[263] It is hard to conceive of the same activists who are successfully backing governance reforms that promise reduced agency costs as "special interests" only when they advocate changes to executive compensation or better transparency around ESG risks.

Labor union pension funds are often cited as the quintessential social activist whose private interests will cause them to use their clout to push for labor-friendly policies rather than representing solely the economic interests of their beneficiaries. However, studies of say-on-pay proposals prior to the say-on-pay mandate under Dodd–Frank found that shareholders were discriminating voters and were generally less likely to support labor union-initiated proposals that targeted firms where CEO pay was not in fact excessive.[264] In addition, labor union pension funds, like public pension funds and, to a lesser extent, mutual funds, initiate and support activism across a range of governance and social issues, rather than focusing narrowly on campaigns that might win (unrelated) concessions for labor at a target firm.[265] Labor union campaigns also receive levels of support that are comparable to similar proposals initiated by other institutional investors, and their wins or

262. This challenge was raised in 2014 in the Chamber of Commerce's proposal to tighten eligibility requirements under Rule 14a-8. *See* U.S. Chamber of Commerce of the United States of America, Petition for Rulemaking Regarding Resubmission of Shareholder Proposals Failing to Elicit Meaningful Shareholder Support, (Apr. 9, 2014), http://fsroundtable.org/petition-and-exhibits-for-rulemaking-regarding-resubmission-of-shareholder-proposals-4-11-14/ [hereinafter Rulemaking Petition].

263. *See* PROXY ANALYTICS, *supra* note 63, at 34–35, tbl.2 ("Most Frequent Sponsors") (identifying the most frequent proposal sponsors by proposal subject). Of course, some proponents of social proposals limit their activism to these issues. *Id.*

264. *See generally* Jie Cai & Ralph A. Walkling, *Shareholders' Say on Pay: Does it Create Value?*, 46 J. FIN. & QUANT. ANAL. 299 (2011); *see also* Randall S. Thomas & Kenneth J. Martin, *Should Labor be Allowed to Make Shareholder Proposals?*, 73 WASH. L. REV. 41, 44 (1998) (reporting based on data from the 1994 proxy season that labor-sponsored shareholder proposals "obtained approximately the same percentage of votes as proposals sponsored by public institutions").

265. Labor union funds are among the most active proponents of corporate governance and executive compensation-related proposals. *See* PROXY ANALYTICS, *supra* note 63, at 34–35, tbl.2 ("Most Frequent Sponsors"); *see generally* Yonca Ertimur et al., *Shareholder Activism and CEO Pay*, 24 REV. FIN. STUD. 535 (2010) (concluding that union pension funds are not more likely to target unionized firms or firms with labor-related negotiations); Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1043–74, 1084–88 (1998) (presenting similar findings).

losses are not along observable ideological or issue-specific lines.[266]

The "special interests" objection to shareholder activism also ignores the fact that activism only succeeds with the broad support of other shareholders who see its connection to financial performance. The observed weaker voting support for non-governance proposals may indicate that shareholders as a class prefer to defer to the board's judgment on non-governance matters or do not yet see non-governance proposals as value-enhancing. At the same time, the high rate of withdrawn proposals and the fact that many governance proposals, and, increasingly, non-governance proposals, attract high voting support indicates that more shareholders see these proposals as advancing their economic interests.

Of course, as with all forms of activism, shareholder voice remains subject to the discretion of the corporation's board of directors, which is charged with determining firm strategy and risk appetite. The likelihood that the board's discretion will be overrun by special interests is also lessened by the precatory nature of most proposals, the prohibition on shareholder "micro-managing" under Rule 14a-8, and the procedural limitations of the rule. And in reality, all investors have "special" preferences in terms of risk tolerance, investment horizon, and commitment to activism. Hedge funds, widely viewed as operating from strictly economic objectives, have in fact come under fire for advancing their own goals, which may not be shared by other shareholders. Similarly, pension funds, SRI mutual funds, and other committed risk-related activists have different investment strategies for different asset classes, which may explain why many exhibit both short-term and long-term behavior. Ultimately, though, how firms respond to risk-related activism is subject to the board's control.

3. Beyond the Bottom Line

While the evidence presented here emphasizes the potential economic payoffs to risk-related activism and ESG integration, a final and somewhat contrary critique is that market incentives alone cannot prevent excessive risk-taking by fund managers and corporate executives. This is an important point, since responsible investment cannot replace the important roles of fiduciary duty, ethical obligations, and formal regulation in creating sustainable financial systems and economies. Moreover, risk-related activism will not contribute to a sustainable financial system if its goals are focused only on the portfolio, industry, or firm level without considering how the behavior of institutional investors and other financial intermediaries themselves contribute to systemic risk or may work against the best interests of individual investors and fund beneficiaries. Part V considers steps institutional investors and policymakers can take to address these concerns.

V. THE FUTURE OF FIDUCIARY CAPITALISM

The present era has been described as the age of fiduciary capitalism because of the

266. *See generally* Ertimur et al., *supra* note 265 (studying 134 vote-no campaigns and 1198 shareholder proposals on executive pay between 1997 and 2007, before the advent of mandatory say-on-pay voting). *But see* Ashwini Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting*, 25 REV. FIN. STUD. 187 (2012) (finding higher AFL-CIO objection to directors when their level of worker representation in target firms declined).

tremendous power institutional investors and other fiduciaries wield in today's global capital markets.[267] By engaging in risk-related activism, institutional investors can realign this power with the economic interests of their ultimate beneficiaries, while contributing to market transparency and stability. To the extent risk-related activism focuses investors and firms on long-term value, it also realigns investor power with the fundamental assumptions of state corporate law. Nonetheless, risk-related activism confronts a level of skepticism in the legal literature and from corporate boards and other shareholders that is no longer justified by the empirical evidence.

The findings presented here instead urge greater policy support for ESG integration and suggest that corporate boards and institutional investors, regardless of their time horizon or investment strategy, should take greater account of both financial and nonfinancial risks. Since possible approaches necessarily affect a broad range of firm and investor practices, a full consideration of their merits and limits is beyond the scope of this Article, but it is possible to at least highlight here immediate possibilities, some already underway, that could advance these goals. Critical to all of these reforms is a recognition of the shared economic goals that drive risk-related activism and responsible investment today, as well as the diversity of investor preferences and goals.

A. Reorienting Corporate Boards

The immediate implication of the findings presented here is that in engaging with risk-related activists, corporate boards and their advisors must recognize the possibility that ESG activists' goals are indeed aligned with shareholder and firm value. Firms should be open to engaging activists directly around ESG issues, as many already do, and see engagement as a potential source of external input into the firm's risk management and oversight processes. Legal counsel should be particularly aware that historically "social" or policy concerns may point to material operational or financial risks that deserve management's attention and must also be disclosed under public reporting obligations.

The important role of the shareholder proposal process in promoting incremental reforms and the alignment between advocacy around governance and "social" risks also suggest that limits on access to the shareholder proposal process should be viewed with caution. For example, in 2014, the U.S. Chamber of Commerce recommended that the SEC amend the rule to raise the ownership thresholds for filing shareholder proposals and the levels of voting support required for resubmitting proposals in order to reduce the cost burden of Rule 14a-8 proposals on firms.[268] However, many proposals that have ultimately been endorsed by regulators, such as say-on-pay or the voluntary disclosure of climate change risk, began as shareholder proposals that initially attracted limited support.[269] Although the full value to firms of investor engagement and external perspectives that Rule 14a-8 provides may be difficult to quantify, these benefits should not be ignored in weighing its costs.

267. *See generally* HAWLEY & WILLIAMS, *supra* note 139.

268. *See generally* Rulemaking Petition, *supra* note 262. This petition built upon remarks made by Delaware Supreme Court Chief Justice Leo E. Strine, Jr. Strine, *supra* note 218, at 489.

269. Although the rulemaking petition defers to the SEC on the choice of an appropriate threshold, Delaware Chief Justice Strine has proposed that corporations should be permitted to automatically exclude from the proxy proposals that previously achieved less than 20% support instead of the highest current threshold, which is 10%. Strine, *supra* note 218, at 499.

A further implication of the analysis here is that investor attention to a broader range of risks requires new capacities from corporate boards. While many nonfinancial firms have already formed sustainability committees, risk committees, or other specialized committees, in addition to the audit or executive compensation committees,[270] most still rely heavily on audit committees for oversight of financial and nonfinancial risk.[271] However, studies of audit committees find that few have confidence in their ability to effectively oversee firm management of operational and systemic risk, and many are overburdened.[272] Perhaps constrained by director independence requirements, many audit committees also report that they "need a better understanding of the company's strategy and risks,"[273] some of which can be more readily assessed by corporate insiders. Given the limited capacity of existing board committees to oversee nonfinancial risk, boards should ensure that they have access to risk management experts who can advise on nonfinancial risks and that the full board, as well as senior management, are familiar with these issues. Understanding the potential alignment between risk-related activism and firms' existing risk management practices might also help boards more readily identify common ground with risk-related activists. In order to adequately advise directors and management, legal counsel will also need to develop greater familiarity with ESG risks and their relationship to firm strategy, ERM practices, and existing compliance and reporting functions.

To the extent firms identify particular ESG risks as material, they may also benefit from integrating nonfinancial performance metrics and long-term benchmarks into executive compensation. Tying executive compensation more closely to long-term performance through the use of nonfinancial targets may also reduce incentives for excessive risk-taking, advancing the policy goals that motivated the post-financial crisis proxy disclosure rules on executive compensation and risk-taking incentives. Some firms have already adopted long-term financial and nonfinancial performance targets, tied in some cases to operational risk management,[274] but the primary metrics used in executive compensation plans for most firms still give little, if any, weight to nonfinancial indicators and remain skewed toward relatively short-term time horizons.[275] Continued dialogue between investors and firms might encourage firms to give greater weight to long-term measures and ESG indicators that have been shown to contribute materially to firm value without unduly increasing the complexity of executive compensation determinations and disclosure.

A more expansive step to promote board attention to ESG issues would be for the SEC or the stock exchanges to move toward some form of comprehensive nonfinancial reporting, either for all firms or as part of differentiated listing requirements, as some stock exchanges in other markets have done. At present, the New York Stock Exchange (NYSE)

270. Dodd–Frank, *supra* note 59, § 165(h); *see also* TONELLO, *supra* note 85, at 12 (stating that specialized risk committees are required for financial institutions under Dodd–Frank).

271. KPMG, 2015 GLOBAL AUDIT COMMITTEE SURVEY 4, 16 (2015), http://www.kpmg.com/BM/en/IssuesAndInsights/ArticlesPublications/Documents/Audit/2015-Documents/2015-global-audit-committee-survey.pdf.

272. *Id.* at 2, 16.

273. *Id.* at 5.

274. GARY HEWITT, GMI RATINGS, SUSTAINABILITY METRICS ON EXECUTIVE PAY: A SHORT TERM FOCUS ON A LONG-TERM ISSUE 5 (Apr. 30 2014), http://www.sustainalytics.com/sites/default/files/gmiratings_sustainabilityinexecpay_april_2014.pdf (finding that over 50% of S&P 500 firms incorporate a sustainability factor into compensation decisions, but with wide sectoral variation).

275. *Id.* at 2.

and NASDAQ-OMX have sustainability indices, but they offer no training or guidance on ESG reporting.[276] Both are, however, part of the sustainability working group of the Worldwide Federation of Exchanges that is working to build consensus around the measurement, use, and materiality of ESG data, which could lead to the adoption of ESG listing standards.[277]

Another starting point that is already galvanizing support from institutional investors is demand for new reporting requirements regarding climate change risk that build on the SEC's earlier materiality guidance.[278] Much can already be done through the efforts of SASB, investors and analysts, and issuers themselves to identify where other ESG risks are material and therefore necessary to disclose under current reporting rules. Even if more comprehensive ESG reporting requirements are not adopted by the SEC in the near term, U.S.-based firms and investors operating in global markets also need to familiarize themselves with these standards as they are adopted by more and more governments around the world.

These recommendations present a bit of a chicken and egg problem. The expansion of mandatory ESG reporting may be necessary for the use of ESG metrics to become standard within the financial industry, since quantitative financial analysis requires extensive comparable firm data. However, any effort to require integrating ESG issues into investment analysis, executive compensation, and standard financial reporting demands further progress to be made in developing, testing, and standardizing ESG metrics. These proposals also raise familiar questions about the potential costs of new forms of disclosure and expanded internal and external oversight. Still, the evidence here of the links between nonfinancial and financial risk supports the continued efforts of global regulators, stock exchanges, standard-setting organizations, and financial institutions to promote greater uniformity in non-financial reporting.

B. Reorienting Investors

The findings explored here also have important implications for investors. The rise of fiduciary capitalism means that institutional investors now have the ability to influence portfolio firms and investment intermediaries to an unprecedented degree. Not all are willing to play the monitoring role envisioned by advocates of shareholder power. As John Coffee noted nearly two decades ago, investors may be absent, ineffective, opportunistic, risk-preferring, or unaccountable.[279] However, given their potential influence on portfolio firm boards and management and throughout the investment chain, reorienting investors to play an effective monitoring role is now of first importance.

Regulatory policies to encourage greater transparency and accountability from shareholder activists are a starting point that could discourage activist short-termism and opportunism. Here, the focus is not on how to improve existing rules governing the

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276. SSE, *supra* note 122, at 13.

277. Press Release, WFE, WFE Introduces Sustainability Working Group (Mar. 26, 2014), http://www.world-exchanges.org/insight/reports/wfe-launches-sustainability-working-group.

278. *See* Open Letter to SEC Commissioner Mary Jo White (Apr. 15, 2015), http://www.osc.state.ny.us/press/releases/apr15/sec_letter0415.pdf (requesting that "the SEC consider enforcement and other actions to bring disclosures by companies in the fossil fuel industry into compliance with SEC requirements and guidance").

279. *See generally* Coffee, *supra* note 49.

transparency of proxy voting by mutual funds,[280] activists' blockholdings,[281] or evidence of ownership required for proponents of shareholder proposals under Rule 14a-8.[282] Instead, informal guidance or regulatory reform would focus on transparency regarding how activists use their influence and how it aligns with investor fiduciary duties.

Rules recently issued by the SEC for proxy advisory firms offer an example of a positive step in this direction. They require disclosure of potential conflicts of interest and promote greater transparency regarding the authority and oversight obligations of investment advisers over proxy advisory firms they retain.[283] These guidelines provide a template for similar guidance that might define the oversight obligations of asset owners to monitor investment intermediaries to ensure that their investment strategies are implemented throughout the investment chain in a manner that is consistent with the long-term interests of their beneficiaries and established voting and engagement guidelines. To the extent disclosure requirements encourage adoption and oversight of long-term investment strategies, they could also motivate voluntary adoption of responsible investment practices and ESG integration, consistent with applicable fiduciary duties.

The emergence of risk-related activism suggests that more institutional investors might be motivated to engage in or support active monitoring of portfolio firms and financial intermediaries if they understood the economic impact of ESG risk on portfolio value. The recently revised policy guidance from the Department of Labor acknowledging the relevance of non-financial considerations to financial risk and return removes a significant barrier to serious consideration of ESG issues by investment fiduciaries.[284] Industry leaders and standard-setting organizations, such as the CFA Institute, which confers financial analyst credentials, could also play a key role by endorsing the empirical evidence supporting ESG integration and advocating its use in financial analysis. These efforts could stimulate broad-based consideration of how mainstream institutional investors and other fiduciaries can promote appropriate risk-taking and attention to long-term objectives.

Policy guidelines modeled on the investor codes adopted by the United Kingdom and other governments offer the most direct approach to address the twin challenges of generally incentivizing active monitoring by institutional investors and improving the accountability of shareholder activists. These codes encourage or require institutional investors, whether as asset owners or asset managers, to disclose how their investment strategy contributes to the medium and long-term performance of the investor's assets.[285] Because they are focused on the economic interests of fund beneficiaries, these codes advance the goals of existing prudent investment rules and related disclosures that apply to investment fiduciaries under state and federal law. For example, reforms have been

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280. *See supra* note 58 (regarding fiduciary duty to vote proxies under ERISA); Report of Proxy Voting Record, 17 C.F.R. §§ 270.30(b)1–4 (2003).

281. The Williams Act requires anyone acquiring a beneficial ownership stake of greater than 5% of the registered equity of an issuer to disclose their interest within ten days by filing a report with the SEC. 15 U.S.C. § 78m(1)(d) (2015).

282. 17 C.F.R. § 240.14(a)–8(b) (2015).

283. *See generally Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, SEC (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm.

284. *See generally* Interpretive Bulletin, *supra* note 81.

285. *See supra* note 15 (discussing these codes).

introduced under the proposed changes to the European Union's Shareholder Rights Directive, which would require institutional investors and their asset managers to disclose how their investment strategy contributes to the long-term performance of the investor's assets and to develop polices to monitor portfolio company ESG risks.[286] Such measures might curb short-term, risk-enhancing activism, or at least render it more transparent to other investors and to target firms. Even if voluntary, they may also motivate shareholders to engage firms on ESG issues that align with long-term investment goals.

Since most of the codes adopted thus far apply to both asset owners and asset managers, a further advantage of requiring or encouraging transparency about activists' goals and strategy is that these reforms might help strengthen investor monitoring of investment intermediaries and better align fund manager incentives with the interests of institutional investor fiduciaries and their beneficiaries. The ICGN has developed model contract terms for this purpose that require fund managers to disclose how portfolio turnover, commissions, voting or delegated engagement, and internal risk management are aligned with the client's time horizons and objectives so fund management advances the long-term interests of fund beneficiaries. Notably, the model clauses obligate the fund manager to integrate ESG factors into investment decisions and fund management practices and to disclose how these practices support market integrity or contribute to systemic risk.[287]

Further work is needed to determine whether any of these reforms can and should be integrated with existing disclosure rules that apply to public pension plans and ERISA fiduciaries, as well as into existing federal regulation of investment advisers. New transparency mandates, even if not accompanied by increased monitoring or engagement, would necessitate costs that could ultimately be passed onto investors. Limits on incentive compensation for investment advisers under the Investment Advisers Act of 1940 and similar provisions of ERISA may weaken investors' ability to align fund managers with a long-term investment horizon.[288] Limited voluntary compliance and weak enforcement have already stymied effective implementation of existing monitoring rules that apply to proxy voting delegation under ERISA.[289] Further research should therefore assess whether oversight mandates, like those outlined in the proxy advisory rules, are workable throughout investment fiduciary chains. Future work might also consider whether informal guidance from the SEC or the development of industry-based best practices for monitoring investment fiduciaries contractually might be more (or less) effective in encouraging asset owner oversight of fund managers. Other questions include the extent to which new

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286. *See Amendments Adopted on the Proposal for a Directive of the European Parliament and of the Council Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement and Directive 2013/34/EU as Regards Certain Elements of the Corporate Governance Statement*, P8_TA-PROV (2015) 0257 (July 8, 2015) (amending Art. 3(f) regarding engagement polices and Arts. 3(g) and 3(h) regarding investment strategy disclosure).

287. *See generally* INT'L CORP. GOVERNANCE NETWORK, ICGN MODEL MANDATE INITIATIVE: MODEL CONTRACT TERMS BETWEEN ASSET OWNERS AND THEIR FUND MANAGERS 8 (2012), cloudfront.net/intentional endowments/pages/27/attachments/original/1420777456/ICGN_Model_Mandate_Initiative.pdf?1420777456.

288. *See* Coffee, *supra* note 49, at 1363–65 (discussing these limits).

289. U.S. DEPT. OF LABOR, PROXY-VOTING MAY NOT BE SOLELY FOR THE ECONOMIC BENEFIT OF RETIREMENT PLANS 2 (2011). An in-depth analysis of stewardship practice among institutional investors in the Netherlands, an early adopter of a stewardship code, identifies similar challenges to stewardship codes. DANIELLE MIELS, THE INSTITUTIONAL STEWARDSHIP MYTH: A THEORETICAL, LEGAL AND EMPIRICAL ANALYSIS OF PRESCRIBED INSTITUTIONAL INVESTOR STEWARDSHIP IN A DUTCH CONTEXT (2014).

accountability tools or incentives should apply only to certain classes of asset owners or managers, how monitoring can be carried out across all asset classes, what level of monitoring is optimal for firms and investors, and whether explicit policy incentives should facilitate ESG integration as a way to facilitate better long-term monitoring. Trends in risk-related activism show that some institutional investors can engage portfolio firms as active owners but that others may need additional policy support to follow suit.

VI. CONCLUSION

The rise of shareholder activism has generated intense controversy over the impact of shareholder power on corporations and the financial markets. Much of this literature echoes earlier debates over the regulatory reforms that made shareholder voice a defining force in corporate governance. It is clear that many of the observed limits of institutional investor monitoring persist and must be taken seriously. However, since shareholder empowerment is already part of the corporate governance landscape, the more important task at present is to consider how to redirect shareholder power to promote corporate accountability and long-term wealth creation as corporate law presumes.

Although this Article offers starting points that could facilitate risk-related activism, ESG integration, and better institutional monitoring, the real barriers to these reforms are not regulatory, but conceptual. Despite the widespread acceptance by large firms of broader conceptions of risk and deepening efforts to address financial and nonfinancial risk through ERM and corporate strategy, institutional investors, investment advisers, and the legal community will remain skeptical, or even hostile, toward risk-related activism and related responsible investment practices so long as they perceive them as value-depleting, risk-enhancing, or otherwise at odds with investors' fiduciary duties and economic interests. This Article has shown that—contrary to prevailing wisdom—preserving value, reducing volatility, and improving the quality of risk-related information available to the market are among the core economic drivers of risk-related activism. This Article has also shown that many leading institutional investors are already using their influence to focus portfolio firms and investment intermediaries on better monitoring, managing, and disclosure of risk. Of course, not all investors share these goals or are equally able to advance them. Nor will all activism around ESG concerns drive long-term value or merit support from corporate boards. Nonetheless, past obstacles to risk-related activism should no longer stand in the way of clear efforts that can be made to expand the space for risk-related activism and foster better transparency and oversight throughout the investment chain as well.

APPENDIX: ESG METRICS

Table 1: Select Global ESG Standards

Standard	*Standard-Setting Body*	*End-User*	*Description*
Asset4	Thomson Reuters[290]	Asset owners, asset managers	Proprietary ESG Quantitative Analytics tool, ratings, indices, and benchmarking tools: 500+ indicators for over 4,700 companies
Bloomberg ESG	Bloomberg L.P.[291]	Asset managers	Proprietary ratings and risk analytics based on public data; portfolio carbon footprint tracker; 750+ indicators on over 5,000 listed firms in over 50 countries
CDSB Framework (2015)	Climate Disclosure Standards Board (CDSB)[292]	Firms, asset owners, asset managers, governments, NGOs	Reporting framework for environmental and natural capital within financial reports; materiality guidance
Corporate Social Responsibility Guidelines (2010, reviewed 2014)	International Organization for Standardization (ISO) 26000[293]	Firms	Sustainability reporting guidelines and indicators in 7 core subjects
GRI Standards (G4)	Global Reporting Initiative (GRI)[294]	Firms	Sustainability reporting and materiality guidelines; quantitative and qualitative indicators for economic, environmental and social impacts in 6 primary areas; 58 general and 92 specific indicators
KLD Indicators (1991, various revisions)	Kinder Lindberg Domini Research & Analytics[295]	Asset owners, asset managers, academic	Proprietary database (MSCI) of firm ESG ratings using over 80 performance indicators based on strengths and concerns in 7 qualitative areas; covers the S&P500, the Domini 400 Social Index (since 1991) and the Russell 3000 (since 2003)

290. THOMSON REUTERS, http://financial.thomsonreuters.com/ (last visited Feb. 16, 2016).
291. BLOOMBERG L.P., www.bloomberg.com (last visited Feb. 16, 2016).
292. CLIMATE DISCLOSURE STANDARDS BOARD, www.cdsb.net (last visited Feb. 16, 2016).
293. INTERNATIONAL ORGANIZATION FOR STANDARDIZATION, www.iso.org (last visited Feb. 16, 2016).
294. GLOBAL REPORTING INITIATIVE, www.globalreporting.org (last visited Feb. 16, 2016).
295. MSCI, https://www.msci.com/esg-integration (last visited Feb. 16, 2016).

MSCI ESG Metrics	MSCI[296]	Asset owners, asset managers	Proprietary ratings and risk analytics based on public data; screening tools; 96 governance metrics
SASB Standards	Sustainability Accounting Standards Board (SASB)[297]	Firms	Quantitative accounting metrics, qualitative disclosures, and materiality guidelines for 50 industry sectors

296. *Id.*
297. SUSTAINABILITY ACCOUNTING STANDARDS BOARD, www.sasb.org (last visited Feb. 16, 2016).

Table 2: Sample ESG Indicators[298]

ESG Area	*Subtopic*	*Indicator*	*Indicator Type*	*Industry*	*Source*
Governance	Business ethics & payment transparency	(1) Proved and (2) probable reserves in countries that have the 20 lowest rankings in Transparency International's Corruption Perception Index (Million barrels (MMbbls), Million standard cubic feet (MMscf))	Quantitative	Oil & Gas Exploration & Production	SASB
Governance	Business ethics & payment transparency	Description of the management system for prevention of corruption and bribery throughout the value chain	Qualitative	Oil & Gas Exploration & Production	SASB
Governance	Management policies, strategy and targets	Management policies, strategy and targets including indicators, plans, and performance assessment	Qualitative	All	CDSB
Governance	Management approach	Management discussion of its approach to managing material economic, environmental or social impacts	Qualitative	All	GRI (G4)
Environmental	Water management	Total fresh water withdrawn (m^3), percent recycled, percent in regions with high/extreme baseline water stress	Quantitative	Oil & Gas Exploration & Production	SASB

298. The indicators here are typically one of multiple indicators associated with the stated subtopic.

Environmental	Risks & opportunities	Material current and anticipated environmental risks and opportunities	Qualitative	All	CDSB
Environmental	Sources of environmental impact	Sources of environmental impact, including greenhouse gas (GHG) emissions	Quantitative and qualitative	All	CDSB
Social	Employee incentives & risk-taking	percentage of employee compensation that is variable for (1) executives and (2) all others	Quantitative	Asset Management & Custody	SASB
Social	Employment	Total number and rates of new employee hires and turnover by age, gender, region	Quantitative	All	GRI (G4)
Integrated	Integrated	Citi sustainable mining index (composed of 30 indicators in five risk areas) adjustment to discount rate	Quantitative	Mining	Citigroup 299
Integrated	Integrated	Sustainability adjustments to beta, the equity risk premium, or CAPM-derived cost of capital	Quantitative	All	Individual brokerage firms[300]

299. *Integrated Analysis*, PRINCIPLES FOR RESPONSIBLE INVESTMENT (2013), www.unpri.org/areas-of-work/implementation-spported-listed-equity/integrated-analysis/.
300. *Id.*