

Systematic Stewardship

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This Article frames a normative theory of stewardship engagement by large institutional investors and asset managers that is congruent with their theory of investment management—“Modern Portfolio Theory”—which describes investors as attentive to both systematic risk as well as expected returns. Because investors want to maximize risk-adjusted returns, it will serve their interests for asset managers to support and sometimes advance shareholder initiatives that will reduce systematic risk. “Systematic stewardship” provides an approach to “ESG” matters that serves both investor welfare and social welfare and fits the business model of large, diversified funds, especially index funds. The analysis also shows why it is generally unwise for such funds to pursue stewardship that consists of firm-specific performance-focused engagement: Gains (if any) will be substantially “idiosyncratic,” precisely the kind of risks that diversification minimizes. Instead, asset managers should seek to mitigate systematic risk, which most notably would include climate change risk, financial stability risk, and social stability risk. This portfolio approach follows the already-established pattern of assets managers’ pursuit of corporate governance measures that may increase returns across the portfolio, even if not maximizing for particular firms. Systematic stewardship does not raise the concerns of the “common ownership” critique because the channel by which systematic risk reduction improves risk-adjusted portfolio returns is to avoid harm across the entire economy that would damage the interests of employees and consumers as well as shareholders.

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INTRODUCTION.....	628
I. STEWARDSHIP FOR FULLY DIVERSIFIED PASSIVE FUNDS SHOULD HAVE A STRONG SYSTEMATIC FOCUS	638
A. <i>Shareholder Voice: Active Managers</i>	639
B. <i>Shareholder Voice: The Rise of Broadly Diversified Passively Managed Funds</i>	642
C. <i>Shareholder Voice: Towards Systematic Stewardship</i>	645
II. SYSTEMATIC RISK: THEORY AND CANDIDATES	648
A. <i>The Nature of Systematic Risk</i>	649
B. <i>Candidate Systematic Risk Targets for Systematic Stewardship</i>	652
1. <i>Climate Change Risk</i>	652
2. <i>Financial Stability Risk</i>	654
3. <i>Social Stability Risk</i>	655
III. IMPLEMENTATION OF SYSTEMATIC STEWARDSHIP.....	658
IV. ADDRESSING CERTAIN OBJECTIONS.....	666
A. <i>Corporate Governance Concerns</i>	666
B. <i>Common Ownership</i>	670
C. <i>Overclaiming</i>	672
CONCLUSION	673

INTRODUCTION

This Article aims to provide a foundation for a form of engagement by large institutional investors and asset managers with their portfolio companies and with the broader corporate governance environment that fits both their theory of investing and their low-cost business model. I call this “systematic stewardship,” an approach that is suited to an investment strategy that creates diversified portfolios while also minimizing costs. The canonical candidate is the broad-based index fund, which is constructed to replicate the performance of the stock market as a whole while charging tiny fees, even zero fees, to its beneficiaries. “Systematic stewardship” can also serve as a guide to any institutional investor pursuing a strategy consisting principally of wide-scale diversification and cost-minimization.

The core of the idea is this: The insight of “Modern Portfolio Theory,” which has served as the foundational investment strategy for the asset management industry, is that investors’ utility takes account of risk as well as expected returns so that investors’

objective is to maximize *risk-adjusted* expected returns.¹ Accordingly, investors compete to create diversified portfolios to eliminate risk and, thus, are generally compensated for bearing only the risk that cannot be diversified away. Risk that pertains to a particular company, so-called “idiosyncratic” risk, can be diversified away; risk that will affect returns throughout the portfolio, “systematic risk,” remains. Engagements that may improve firm-specific performance are generally idiosyncratic; they will not improve the performance of the portfolio as a whole. The possible exception requires the perhaps heroic assumption that such engagements are part of a pattern designed to produce “governance externalities” that lift the performance of all firms on average, producing positive economy-wide effects.

The straightforward implication is that advisors of extensively diversified portfolios, especially broad-based index funds, should focus on addressing the systematic risk elements in their portfolios rather than new forays into firm-specific, performance-focused engagement. This could take many forms. For example, it could mean voting in support of the management of a systemically important financial firm in a face-off with activist investors who want the firm to take greater risks to enhance shareholder returns. As the financial crisis of 2007-09 vividly illustrated, the failure of a systematically important financial institution (SIFI) can indeed result in losses across an entire portfolio. In deciding whether to support the risk-loving activist, the index-fund advisor ought to consider not only the return proposition at a single firm but the systematic risk effects. Portfolio theory teaches that investors in the index fund are seeking to maximize risk-adjusted returns, and so assessment of systematic risk effects becomes even more important in this case than the impact on single firm returns, an idiosyncratic effect.

A salient form of systematic risk is climate change risk. The disruptions associated with various realizations of climate change risk will ramify across the entire economy and thus across a diversified stock portfolio; climate change risk is systematic. Failure to mitigate climate change risks will thus reduce risk-adjusted returns for an index fund investor. Here is the importance of bringing a portfolio theory perspective: Many arguments for a climate-sensitive engagement entail a trade-off between expected returns and the social value of avoiding the potential for severe climate change harms, “socially responsible investing.” Systematic stewardship grounds engagement to reduce climate change risk in the economics of investor welfare. Such engagement aims to lower systematic risk and thus improve risk-adjusted returns for portfolio investors. There is no trade-off between investor welfare and social welfare.

Although systematic stewardship seems most obviously to fit the broad-based index mutual fund or exchange-traded fund (ETF), it also can underpin engagement behavior by other institutional investors, such as defined benefit pension plans. Private-sector-defined benefit pension plans are subject to ERISA’s “exclusive benefit” standard.² Although

1. See generally Harry Markowitz, *Portfolio Selection*, 7 J. FINANCE 77 (1952); Harry Markowitz, *The Utility of Wealth*, 60 J. POL. ECON. 151 (1952). For a text that operationalizes the theory, see HARRY MARKOWITZ, *PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS* (1959); see also Harry Markowitz, Economist, Nobel Lecture: Foundations of Portfolio Theory (Dec. 7, 1990), <https://www.nobelprize.org/prizes/economic-sciences/1990/markowitz/lecture/> [<https://perma.cc/KT9M-9XLC>].

2. Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 403(c), 404(a).

recent presidential administrations differ on the tightness of implementation,³ the standard resists the trade-off of economic benefits for plan beneficiaries against other social values. But engagements aimed at reducing systematic risk do not run afoul of the “exclusive benefit” criterion; rather, they are in service to it. Indeed, pension fund managers who are *not* thinking about the systematic dimension in their engagements are falling short of the objective of maximizing risk-adjusted returns.

The insights associated with systematic stewardship also have implications for investment strategies that propose to “de-carbonize” otherwise fully diversified funds. The “business case” is that such strategies produce equivalent returns while avoiding association with objectionable investments and are perhaps even advantaged given the option value of gains if fossil fuel producers suffer severe losses from climate-focused regulation.⁴ But once systematic risk is taken into account, this approach, along with other divestment strategies, can be defended only if “exit” is more likely to promote climate change risk-mitigation than “voice.” Why? In the event of severe climate distress, the impact will be felt across the entire portfolio, the losses swamping any gains that may have been obtained through avoiding fossil fuel investments.

In one sense, there is nothing new in the claim that diversified institutional investors should and do, in fact, take a portfolio approach towards their engagement activities. For example, such investors generally have developed a normative model of “good” corporate governance expressed in “guidelines” that generates voting positions across the entire portfolio. To take a concrete example, institutions in general firmly reject classified boards, insist on annual say-on-pay votes, and argue for single-class common stock, not dual-class common. Supported (sometimes) by empirical evidence and other times by a certain logic about the value of managerial accountability to shareholders, such investors believe that adoption of these positions will increase the value of the firm, on average. These views are then uniformly applied across the portfolio, even though firm-specific analysis would surely produce governance heterogeneity. Surely some firms would benefit from the relative stability or other properties associated with a classified board, for example. The institutional investor response is yes, bespoke governance might be better for some firms, but given the cost, including follow-up monitoring required by such tailoring, uniformity will increase expected returns across the portfolio as a whole.

The portfolio approach is more pervasive, however. Diversified investors have a different approach to risk than undiversified investors. This affects the attitude toward business failure, meaning the optimal level of risk-taking and capital structure, and fundamental questions about the organization of the firm – against conglomeration and unrelated diversifying acquisitions, for example. A view that shareholders are obliged to

3. *Compare* Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72,846, 72,848 (Nov. 13, 2020) (codified at 29 C.F.R. pts. 2509, 2550) (implementing “exclusive benefit” provisions so that “ERISA plan fiduciaries may not subordinate return or increase risks to promote non-pecuniary objectives. . . . [their evaluation] must focus solely on the plan’s financial risks and returns . . . solely on economic considerations that have a material effect on the risk and return of an investment based on appropriate investment horizons, consistent with the plan’s funding policy and investment policy objectives.”), *with* Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57,272, 57,276 (Oct. 14, 2021) (to be codified at 29 C.F.R. pt. 2550) (a proposed rule that would permit “evaluation of the economic effects of climate change and other ESG factors on the particular investment or investment course of action.”).

4. See Mats Andersson, Patrick Bolton & Frédéric Samama, *Hedging Climate Risks*, 72 FIN. ANALYSTS J. 13, 13 (2016).

take an “own firm” approach to corporate governance or voting cannot withstand widespread contemporary practice; nor can a claim that directors cannot manage what they know to be the preferences of diversified investors.⁵

Systematic stewardship also takes a portfolio approach. The distinctive twist is the focus not on how to increase expected returns across the portfolio but on how to reduce systematic risks and thus how to enhance risk-adjusted returns for the portfolio. This approach is not simply additive. It does not counsel: in *addition* to devising governance approaches that will increase expected returns, now *also* take into account systematic risk factors. Rather, reducing systematic risk may entail a trade-off with expected returns. For example, a diversified investor sensitive to systematic risk may have a different approach to risk-taking by large financial institutions and may favor rather than disfavor government regulation that targets such risk. It may regard its risk-adjusted returns as enhanced rather than reduced by measures that reduce expected returns on a portion of its portfolio.

In short, systematic stewardship provides a finance-based framework for the assimilation and assessment of concerns that fly under the flag of “ESG” (environmental, social, and corporate governance matters).⁶ Some such concerns, climate change, for example, get quick uptake by systematic stewardship. Some elements may reflect shareholder preferences that do not have a strong systematic effect and thus may require a different justification. Not all issues that motivate ESG proponents will register on the systematic risk scale. For example, pressure for certain environmental measures may reflect an ethical belief that the firm should not impose externalities or should comply with applicable law and even engage in “forward compliance” in anticipation of likely legal change.⁷ Similarly, various social issues may register differently on the systematic scale. One implication is that stewards of diversified funds should devote their engagement principally to thinking about portfolio-wide effects and, in particular, systematic implications in their use of corporate governance tools. Systematic stewardship is both their obligation from a beneficiary point of view and their comparative advantage because it is compatible with the economic core of their investment management strategy. Insofar as investors are drawn to funds that advance ESG concerns while not sacrificing risk-adjusted returns, index funds may find that public support for and pursuit of systematic stewardship is a persuasive point of competitive advantage.⁸ Asset managers can market their systematic stewardship stance to differentiate from other index funds and thereby increasing AUM.

Much of the recent work on the potential role of institutional investors in corporate governance has focused on the flow of funds to the largest asset managers, especially the “Big Three”—BlackRock, Vanguard, and State Street—and the flow into passive

5. This point is developed more fully in Part IV of this Article. *See infra* Part IV.A.

6. For an elaboration of some of the tensions in the current ESG investing model for financial fiduciaries, see generally Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381 (2020).

7. *See* John Armour, *The Case for “Forward Compliance”*, BRIT. ACAD. REV., Autumn 2018, at 19 (calling for firms to monitor emerging issues and respond in a rapid manner in anticipation of “regulatory lag”).

8. *See* Michael Barzusa, Quinn Curtis & David Webber, *Shareholder Value(s): Index Fund Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1276–79 (2020) (promoting social goals like gender diversity as product differentiation and marketing tools).

investment vehicles, especially index funds.⁹ Some see this constellation as now permitting the shareholder to squeeze out the last bit of inefficiency resulting from managerial agency costs.¹⁰ Recent scholarship sees the dark side of such concentrated common ownership, suggesting, among other things, that it reduces economic competition.¹¹ Others look to such developments as enabling the emergence of “universal owners” as change agents in corporate purposes and practices.¹² The call for “systematic stewardship” charts a path between such dystopian and utopian visions by framing a form of corporate governance engagement that flows directly from the investment theory behind the creation of maximally diversified portfolios and that is sensitive to the pro-consumer welfare effects of low-cost investment vehicles. The distinctive corporate governance vision does not depend on the accumulated power of a handful of asset managers but rather on the nature of the investment product: a broadly diversified portfolio, especially if passively managed. The nature of the investment vehicle, not the asset manager’s AUM, gives systematic stewardship its energy.

Any paper about corporate governance is implicitly embedded in a model of politics. For example, most who favor divestment from fossil fuel companies presumably believe that such symbolic speech will significantly contribute to legislative action on climate change because they surely know that you cannot exit an investment position without selling to someone else. (Some may have an exclusively ethical perspective.) Those who favor engagement over divestment presumably also think that if even one major fossil-fuel producer is induced to undertake profit-reducing measures in the name of reducing climate change risk, the “if me, then them too” dynamic will potentially add to the coalition of those promoting legislative action.¹³

9. See, e.g., Jan Fichtner & Eelke M. Heemskerk, *The New Permanent Universal Owners: Index Funds, Patient Capital, and the Distinction Between Feeble and Forceful Stewardship*, 49 *ECON. & SOC’Y* 493 (2020); Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 *B.U. L. REV.* 721 (2019); Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 *COLUM. L. REV.* 2029 (2019).

10. Bebchuk & Hirst, *The Specter of the Giant Three*, *supra* note 9, at 729.

11. See *infra* note 149 and accompanying text (discussing competition concerns).

12. See Frederick Alexander, *An Honorable Harvest: Universal Owners Must Take Responsibility for Their Portfolios*, 32 *J. APPLIED CORP. FIN.* 24, 24 (2020) (“[T]he global investor community is the appropriate locus for the collective decision-making necessary for a sustainable economy.”). Parties associated with the Shareholder Commons have proclaimed 2021 as “Year One of the Universal Owner.” *Alpha to Omega Follow-up*, SHAREHOLDER COMMONS, <https://theshareholdercommons.com/wp-content/uploads/2021/02/Alpha-to-Omega-follow-up.pdf> [<https://perma.cc/NWU5-EZN3>]. The term “universal owner” entered the corporate governance lexicon in the 1990s. The change agent was then said to be pension funds. See ROBERT MONKS & NELL MINOW, *WATCHING THE WATCHERS: CORPORATE GOVERNANCE IN THE 21ST CENTURY* 121 (1996) (“[P]ension funds can be concerned with a vocational education, pollution, and retraining, whereas an owner with a perspective limited to a particular company or industry would consider these to be unacceptable expenses because of competitiveness problems.”); see also JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE AMERICA MORE DEMOCRATIC* (2000) (sketching an agenda under which universal owners play an increasingly heavy hand in formulating public policy).

13. See generally MICHAEL J. GRAETZ & IAN SHAPIRO, *THE WOLF AT THE DOOR: THE MENACE OF INEQUALITY AND HOW TO FIGHT IT* (2020) (tracing multiple examples of the importance of business support, acquiescence, or opposition to proposed social legislation). On coalition-building in the climate change area, see generally Patrick Bolton & Marcin Kacperczyk, *Firm Commitments*, *COLUM. BUS. SCH.*, Nov. 2021, <https://ssrn.com/abstract=3840813> [<https://perma.cc/Q45N-RKTW>]. Cf. Eleonora Broccardo, Oliver Hart & Luigi

The appeal to “universal owners” seems an attractive way to transcend ordinary politics, *viz*: A full diversified investment vehicle internalizes many of the externalities that firms may create, so the portfolio managers have incentives to exercise corporate governance rights to mitigate them. And ownership is transnational, transcending the protectionism of a particular nation-state in the name of global interests. This appeal, in its visionary form, operates through a four-way sleight of hand: First, even if the investment product may indeed internalize various externalities, the beneficial owners, real people, may have interests apart from their portfolios. Second, in light of the skewed distribution of share ownership, cost internalization by investment portfolios will not necessarily take account of costs externalized onto non-shareholder interests.¹⁴ Third, a large part of the economy is privately held, so much activity never enters the universal portfolio;¹⁵ and finally, governments will never surrender power to asset managers.¹⁶ Nevertheless, systematic stewardship offers a route forward through focusing on the specific risks associated with portfolio investing and the legitimacy of asserting governance rights to minimize the characteristic portfolio risks. Systematic stewardship shows the possibilities as well as the limits of looking to a special class of stock market investors to address serious domestic and global social problems.

This Article proceeds as follows. Part I addresses the engagement conundrum for the asset manager of diversified investment products, ranging from actively managed funds to fully-diversified index funds and ETFs. What exactly is the case for firm-specific engagement, which seems at the heart of the demand for “stewardship” by institutional investors? For an active fund, trading seems a stronger strategy than engagement, not only because that is best for the fund but also because the information content of “exit” may itself exert a disciplinary force; moreover, serious shortfalls in management’s strategy or operational acumen may become the target of an activist, an engagement specialist. The index fund case is more complicated, in part because “exit” is not an option and in part because its business model leaves little space for investment in engagement. This is

Zingales, *Exit vs. Voice* 1 (Eur. Corp. Governance Inst., Working Paper No. 694/2020) (studying the “relative effectiveness of exit (divestment and boycott) and voice (engagement) strategies in promoting socially desirable outcomes in companies that generate externalities”).

14. Jesse Bricker, Sarena Goodman, Kevin B. Moore & Alice Henriques Volz, *Wealth and Income Concentration in the SCF: 1989–2019*, BD. OF GOVERNORS OF THE FED. RSRV.: FEDS NOTES (Sept. 28, 2020), <https://www.federalreserve.gov/econres/notes/feds-notes/wealth-and-income-concentration-in-the-scf-20200928.htm> [<https://perma.cc/HJP8-FADT>] (observing that stock ownership is highly concentrated toward the top wealth deciles); ALINA K. BARTSCHER, MORITZ KUHN, MORITZ SCHULARICK & PAUL WACHTEL, FED. RSRV. BANK OF N.Y., *MONETARY POLICY AND RACIAL INEQUALITY* 12–14 (2012) (suggesting that low-interest rates that increase asset values exacerbate racial inequality because of pre-existing distribution of share ownership).

15. See Frederick P. Schlingemann & Rene M. Sulz, *Has the Stock Market Become Less Representative of the Economy?* (Nat’l Bureau Econ. Rsch., Working Paper No. 27942, 2020) (stating that because many public firms shifted from manufacturing to services, public firms contributed less to employment and GDP in the 2010s than in the 1970s); MCKINSEY & CO., *PRIVATE MARKETS COMES OF AGE: MCKINSEY GLOBAL PRIVATE MARKETS REVIEW* 2–3 (2019) (discussing the growth in private investments since 2002).

16. Cf. JACK GOLDSMITH & TIM WU, *WHO CONTROLS THE INTERNET?: ILLUSIONS OF A BORDERLESS WORLD* (2006) (claiming that notwithstanding early beliefs about the power of the internet to transcend borders and “to change everything,” governments have successfully asserted territorial boundaries and governmental power).

reflected in a vigorous debate on whether and how index funds should vote their shares.¹⁷ A portfolio perspective reveals this: it (ordinarily) does not matter. Performance improvement to the holder of a fully diversified portfolio is substantially “idiosyncratic.”¹⁸ It is the kind of risk that the portfolio by construction is designed to diversify away. Instead, the asset managers should attend to systematic risk.

But there is a further implication: Even though the strongest fit for systematic stewardship is with a broad-based index fund that minimizes idiosyncratic risk, it has high relevance for almost all funds structured with a significant level of diversification. This is because systematic risk will figure strongly in portfolio returns. This means that most active managers should include systematic risk concerns alongside their firm-specific performance engagements.

Part II explores the nature of “systematic risk,” distinguishing it from firm-specific factors in asset pricing models and indicating its connection both to ideas of “systemic risk” developed in models associated with the financial crisis and to current ideas of “ESG.” In particular, the paper identifies three possible candidates for systematic risk mitigation: climate change risk, financial distress risk, and, more tentatively, social stability risk.

Part III outlines the approaches that a fund manager of broad index funds might take to implement “systematic stewardship.” There is both a portfolio approach and a firm-specific approach. Index fund managers should favor, as a portfolio matter, disclosure of firms’ exposure to systematic threats with sufficient granularity to enhance efficient market pricing of the risk. Such disclosure is likely to pressure firms to take measures that would reduce the systematic risk (and thereby improve risk-adjusted returns for the portfolio) and also help the fund manager in its systematic risk assessment, which will be important in evaluating firm-specific proposals that purport to mitigate systematic risk.¹⁹ Support for such disclosure could come through the adoption of guidelines for proxy voting on shareholder proposals, support of disclosure standards emerging through global

17. Compare, e.g., Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493 (2018), with Edward Rock & Marcel Kahan, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. REV. 1771 (2020) (engaging in an ongoing debate on whether and how index funds should vote their shares); see also Jill E. Fisch, *The Uncertain Stewardship Potential of Index Funds*, (Eur. Corp. Governance Inst., Working Paper No. 490/2020); Jill E. Fisch, *Mutual Fund Stewardship and the Empty Voting Problem*, (Eur. Corp. Governance Inst., Working Paper No. 612/2020).

18. “Substantially idiosyncratic” or “generally idiosyncratic” because some firm-specific performance improvement may improve total portfolio returns. For example, the case for index fund support for (some) hedge fund activism is that firm-specific cases will, in expectation, lead to better performance across the portfolio from management teams that want to avoid becoming targets, “governance externalities.” But in a competitive economy, most firm-specific performance gains are idiosyncratic in that they come at the expense of rivals. For instance, better run operations at Burger King are far more likely to steal market share from McDonald’s than to produce an innovation in fast-food production technology that expands the efficient frontier of the real economy as reflected in the market portfolio. An index fund, holding both the appreciating Burger King stock and the declining McDonald’s stock, would, in expectation, see little if any portfolio improvement. Moreover, it is hardly the comparative advantage of an index fund (versus an activist shareholder) to understand a particular business well enough to identify a path for performance improvement. More generally, economic growth, and thus higher portfolio returns, typically derive from technological, demographic, and macro-economic factors rather than changes associated with firm-specific institutional investor-driven engagements.

19. See generally Madison Condon, *Market Myopia’s Climate Bubble*, 2022 UTAH L. REV. 63, 70–108 (2022) (documenting climate risk information shortfalls under current disclosure standards).

governance efforts now best reflected in the aborning International Sustainability Standards Board (“ISSB”), and support of SEC initiatives for mandatory disclosure. This would aid in pricing firm-specific exposure to systematic risk and bring additional market pressures to bear for its mitigation. Index fund managers should also promote the creation of market instruments that provide quantitative measures of different sources of systematic risk. For example, economists are developing different measures of financial stability risk and climate change risk.²⁰ Asset managers could encourage the development of derivative markets keyed to these indices, which could provide early warning signs of emergent risks that could threaten portfolio values, and which can more accurately price risks that already exist. Support for regulatory measures or new market instruments might most effectively be presented through an asset manager trade association, such as a new trade association formed to focus on systematic stewardship issues rather than by any particular asset manager.

When it comes to firm-specific engagement, such a manager would be justified in taking a stance of “rational reticence”—i.e., to engage in reactive rather than active mode. For prudential reasons, an asset manager might well decide to act on its systematic concerns chiefly in response to initiatives promoted by other shareholders, such as ESG funds, voting its shares on issues as framed for shareholder decision. Indeed, the business model of widely diversified passive funds, emphasizing low fees, is most consistent with this approach.²¹ For instance, a firm with a systematic perspective could readily vote in favor of a shareholder initiative calling for disclosure of a company’s plan to address climate change risks and other elements relating to “sustainability.” Disclosure leads to better capital market pricing of the risks in question, which is both informative and disciplinary, and deepens the fund’s ability to evaluate the systematic risk associated with a particular company’s activities. As noted above, the manager’s approach could be based on a general portfolio guideline of support for such disclosure.²²

A fund could cast its votes in an activist-driven proxy battle based on its assessment of the implications for systematic concerns. It could support an activist slate that would push for the company to reduce its carbon emissions, even if the strategy would lower the company’s current earnings and the stock price if the fund determined that this approach would reduce systematic risk.²³ The company’s (which is to say, the board’s) implementation of the strategy might well be challenged by other shareholders claiming it transgresses the broad latitudes of the business judgment rule, but the fund need not make

20. See, e.g., William D. Nordhaus, *To Slow or Not to Slow: The Economics of the Greenhouse Effect*, 101 *ECON. J.* 920 (1991) (introducing the costs of greenhouse-gas emissions into standard economic-growth models).

21. Cf. Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 *COLUM. L. REV.* 863 (2013) (discussing activist shareholders teeing up issues for decision by majoritarian institutional owners). When it comes to matters of systematic concerns, ESG funds are more likely to drive the activism agenda than hedge funds. Still, the dynamic of large, widely diversified funds responding to, rather than initiating, activists’ proposals seems likely to recur.

22. There is evidence that such engagement has indeed been effective in reducing CO₂ emissions. José Azar, Miguel Duro, Igor Kadach & Gaizka Ormazabal, *The Big Three and Corporate Carbon Emissions Around the World*, 142 *J. FIN. ECON.* 674, 679–84 (2021).

23. See, e.g., Matt Levine, *Exxon Lost a Climate Proxy Fight*, *BLOOMBERG* (May 27, 2021), <https://www.bloomberg.com/opinion/articles/2021-05-27/exxon-lost-a-climate-proxy-fight> [<https://perma.cc/JZ6T-BTTP>] (describing the success of ESG activist Engine No. 1 in electing 4 directors to the ExxonMobil Board).

such a determination in voting its shares.²⁴ A fund could also support *management* (and the board) that followed a carbon-reducing policy against an activist slate pushing the contrary for purported higher profits. Similarly, a fund could support management's resistance to activist proposals for a private sale of the company's "brown" assets on the view that creating "green" public companies by take-privates of brown assets exacerbates systematic concerns by hiding them.²⁵ A final example: the fund could support management that resisted layoffs despite reduced profitability based on the fund's determination about the connection between a layoff policy and the systematic risk of social instability.

The asset manager could devise a forward-leaning systematic risk-attentive strategy that combines both portfolio and firm-specific approaches by taking account of the attention of activist shareholders. Here are four different examples. First, the asset manager could articulate principles that it regards as important—for example, identifying an area of systematic risk and inviting company managements to respond. This signals a threshold willingness to cooperate with activists. Second, in areas where activists have been engaged, but the proposals seem an over-reach, the asset manager could specify the features of a proposal that it would be prepared to support. Third, in areas that the asset manager thinks should be examined from a systematic risk perspective, the asset manager could put out a request for proposals (RFP) that could catalyze a process that could lead activists to generate firm-specific proposals. One example is the connection between compensation arrangements and systematic risk mitigation; the subsequent activist channel is the annual Say-on-Pay vote and the election of compensation committee directors.²⁶ Fourth, where an asset manager is concerned about systematic risk implications of a common practice, it could initiate public discussion. For example, the structure of severance arrangements in change-in-control transactions, "golden parachutes," may induce an inefficiently high level of mergers and acquisitions activity, which in turn imposes extra social stability risk through layoffs that produce "synergy gains."²⁷ Here, the asset manager could, consistent with its business model, trigger debate that could lead to subsequent activist proposals. In short, in pursuing the beneficiary welfare gains of systematic stewardship, an asset manager needs to be mindful of the limits of its business model, including the persistent

24. I argue below that the directors have strong defense against such a claim in any event. See *infra* Part IV.A.

25. See Stanley Reed, *Third Point, an Activist Investor, is Calling for a Breakup of Royal Dutch Shell*, N.Y. TIMES (Nov. 15, 2021), <https://www.nytimes.com/2021/10/28/business/third-point-shell-breakup.html> [<https://perma.cc/33B5-2Z6Y>] (discussing Third Point's possible plan of breaking up Royal Dutch Shell into "multiple stand-alone companies"); Rachel Adams-Heard, *What Happens When an Oil Giant Walks Away*, BLOOMBERG (Apr. 15, 2021), <https://www.bloomberg.com/graphics/2021-tracking-carbon-emissions-BP-hilcorp/> [<https://perma.cc/8JDQ-SLJS>] (describing post-BP sale of its Alaska assets, private buyer's use of such assets increase emissions relative to BP).

26. See generally Robert E. Bishop, *Investor Communication and Say-on-Pay (2022)* (Ph.D. dissertation, Yale University); Jill Fisch, Darius Palia & Steven Davidoff Solomon, *Is Say on Pay All About Pay? The Impact of Firm Performance*, 8 HARV. BUS. L. REV. 101 (2018).

27. See Albert H. Choi, Andrew C.W. Lund & Robert Schonlau, *Golden Parachutes and the Limit of Shareholder Voting*, 73 VAND. L. REV. 223, 230 (2020) (discussing increasing levels of golden parachutes and complicated structures); Brian J. Broughman, *CEO Side-Payments in Mergers and Acquisitions*, 2017 BYU L. REV. 67, 94–96 (2016) (describing additional payments beyond golden parachutes); Robert Chatt, Mathew Gustafson & Adam Welker, *Firing Frictions and the U.S. Mergers and Acquisitions Market*, J. BANKING & FIN., July 2021, at 1 (explaining that post-merger employee turnover is a "first-order source of value in large M&A").

features of American political economy that periodically erupt against large financial intermediaries.²⁸ One might call this strategy “leading from behind.”

Part IV addresses certain objections. Can a fund shareholder exercise governance rights in a way that would trade off increased expected returns at the own firm for the sake of portfolio benefits through the reduction of systematic risk? Frankly, we have already crossed that bridge. We permit shareholders to promote corporate governance models that might sacrifice value at a particular firm to obtain benefits across the portfolio as a whole and, more powerfully, by allowing the risk preferences of diversified shareholders to shape our theory of optimal firm structure. Shareholder diversification at the portfolio level has made conglomeration (diversification at the firm level) a strongly disfavored strategy. Similarly, managers are pushed to take greater business risks (including through higher leverage) because diversified shareholders are risk-neutral. A more homely answer would consider the distinction in corporate law between the voting preferences of a non-controlling shareholder, which are unbounded, versus the obligation of the directors, which are bounded under current law by the business judgment rule.

Can a fund pursue a systematic approach in its voting decisions even though no single firm’s actions would have a systematic impact? In the case of a SIFI, a single firm’s failure could have a systematic consequence, as Lehman’s failure illustrates. But for climate change, no single firm’s conduct could itself trigger a systematic shock.²⁹ The nexus between the systematic approach and the single-firm case is less tight than in the case of a SIFI. Nevertheless, the fund could take account of systematic concerns at a single firm as part of a systematic risk reduction policy that it would apply across the sector and could also look to the “governance externalities” across the sector resulting from a single firm outcome. Indeed, this is how activism generally works: corporate managers see the outcome of contests at similar firms, infer general shareholder preferences and judgments,

28. See, e.g., Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 10 (1991) (arguing that public corporation “is as much a political adaption as an economic or technological necessity”); Phil Gramm & Mike Solon, *Keep Politics Out of the Boardroom*, WALL ST. J. (July 18, 2018), <https://www.wsj.com/articles/keep-politics-out-of-the-boardroom-1531952912> [<https://perma.cc/QCE3-HW3R>] (explaining how reforms meant to give shareholders a voice has been hijacked by social activists). The change of presidential administrations might offer a new political calculus. Asset managers under scrutiny for the alleged anticompetitive effects of large-scale common ownership might well seek political immunity by pressuring large global firms to address climate change issues, a top priority of the incoming administration. The size of their ownership stake then switches from a concern to a virtue.

29. Professor Condon has developed an example in which a large fossil fuel firm, Exxon Mobil, responsible for downstream CO₂ emissions of approximately 1% of the global burden, is subject to a shareholder initiative that results in a massive cutback of its production. Using the Nordhaus model that connects emissions to global economic output, the example shows why such an initiative would be worthwhile for a diversified investor—even if Exxon’s market value sharply declined. See Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 45–47 (2020). Strictly speaking, the example shows a portfolio-wide improvement in expected returns after the emissions reduction vs. “business as usual,” rather than a reduction in systematic risk in the portfolio theory case. But it does illustrate the value of a portfolio approach to systematic risk questions. *Id.* The fragility of this particular example lies in the fact that other firms, including state-owned petroleum companies, may cover the ExxonMobil production cut. This objection is pointed out in Marcel Kahan & Edward Rock, *Systemic Stewardship With Trade-Offs* 9 (Law & Econ. Rsch. Paper Series, Working Paper No. 22-01, 2021), <https://ssrn.com/abstract=3974697> [<https://perma.cc/FES7-49BC>]; see also Bernard S. Sharfman, *Opportunism in the Shareholder Voting and Engagement of the “Big Three” Investment Advisors to Index Funds*, 48 J. CORP. L. (forthcoming 2022) (manuscript at 8), <https://ssrn.com/abstract=3995714> [<https://perma.cc/F7GQ-MUFW>] (providing additional objections that investment advisors are agents of individuals that invest in mutual funds).

and modify their behavior accordingly. Activism generally has value because of its portfolio effects; that is certainly true where the objective is systematic risk reduction.

Would announcement of and acting in sympathy to systematic concerns by large asset managers produce some of the negative effects associated with “common ownership”? First, each asset manager will be making individual judgments about how to cash out systematic concerns in any particular shareholder matter. Parties would not be acting in concert. But second, the welfare effects of possible systematic risk mitigation will differ from the purported anticompetitive effects associated with the common ownership literature. The reduced risk of an economy-wide negative event will improve consumer welfare across the board. That is, the beneficiaries of measures that reduce systematic risks are not only the beneficial owners of index funds or other diversified funds but the populace generally. The channel to portfolio values runs through the real economy. Damage to portfolio values occurs *because of* the damage to the real economy, meaning people’s livelihoods, generally. Avoidance of this welfare-reducing outcome should not be an objective of competition policy.

Indeed, the point might be flipped: if large assets managers/large owners influence companies in ways that governments do not, the managers’ willingness to engage on systematic issues—climate change, for example— may make “common ownership” a virtue rather than a matter of concern. It is through broad diversification that managers/owners see the need to reduce systematic risk, and through heft that the managers/owners have the power to promote systematic risk reduction. Systematic risks have a global dimension, yet the global governance tools are relatively weak. But because of global stock ownership patterns, *corporate* governance does have global reach, and so the asset managers could be seen as important allies in the attempt to mitigate systematic risk. Their potential influence may be particularly important in the case of climate change.

Part V concludes.

I: STEWARDSHIP FOR FULLY DIVERSIFIED PASSIVE FUNDS SHOULD HAVE A STRONG SYSTEMATIC FOCUS

This Part argues that the optimal stewardship strategy for a fully diversified passive fund is to focus on systematic risk factors rather than engagement with specific portfolio companies to improve the company’s “performance.” Such funds may establish governance “best practice” guidelines that they believe increase returns, on average, for the firms in the portfolio. Such funds may also support various forms of shareholder activism targeted at single firm performance issues, especially if they think that such activism generates “governance externalities” across the portfolio. But, in general, single firm engagement by the fund will not improve portfolio outcomes. This is because single firm performance improvement is substantially idiosyncratic; such idiosyncratic factors are precisely what full diversification is designed to eliminate. Fully diversified passive funds may choose, as a prudential matter, to engage in firm-specific engagement, but true “stewardship” by these unique capital market creations calls for a systematic perspective; that truly is the only way such funds can improve risk-adjusted returns for their beneficiaries.

A. Shareholder Voice: Active Managers

Ever since the reconcentration of share ownership began in the United States in the 1980s, institutional investors have been looked to as the solution to a problem first identified by Berle and Means in the 1930s: the way that diffusion of stock ownership among the general public enhanced the power of managers to dictate the decisions made by large corporations.³⁰ In particular, the hope was that institutions exercising “voice” could constrain various sorts of mismanagement better than control market devices, like hostile tender offers, which were economically feasible only where strategic or operational shortfalls had become very serious and were, in any event, highly disruptive. The relatively large stakes held by institutional owners coupled with access to sophisticated securities analysis would reduce collective action barriers and would thus open the way to superior “voice” strategies. That was the hope. The reality deviates considerably from this Athenian ideal of shareholder engagement.

The business model of many institutional investors as it interacted with developing theories and empirics of investment management has muted their corporate governance role. At the beginning of the period, a substantial fraction of institutional money was actively managed. This became the heart of the case for the proponents of institutional investor activism. The research that was associated with active management would inform the investors’ judgments about governance or performance shortfalls and fuel their capacity to exercise “voice” to address them. This vision faltered because it turned out that sustained monitoring was inconsistent with the business model of the key channel for institutional investment, the asset managers, both in the economic incentives and the legal exposure.³¹

In general, an active asset manager’s success is measured in terms of relative performance. If the asset manager is an advisor to a mutual fund, superior relative performance will lead to greater “assets under management.” Investors and investment advisors pay keen attention to relative performance measures and allocate funds accordingly. Asset manager compensation is ordinarily set as a percentage of AUM. Accordingly, since research and other portfolio management costs are relatively fixed, manager profits increase (decrease) sharply as AUM increases (decreases), even where the fee percentage varies negatively with AUM. If the asset manager is an advisor to a pension fund or endowment, relative performance is similarly used in retention and compensation decisions. Relative performance measures directly affect “voice.”

Assume the manager’s research reveals serious governance problems or a

30. Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 168–69 (1994); see also Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 813 (1992) (discussing the shareholder passivity problem in the Berle Means paradigm); Ronald Gilson & Reiner Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873 (1991) (noting how institutional investors have been effective at changing corporate governance).

31. This argument is spelled out in greater detail in Gilson & Gordon, *supra* note 21. Subsequent work in the political science literature has come to similar conclusions. See Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 298 (2017) (arguing that instead of actively exercising shareholder power, the Big Three universal owners, for the most part, merely vote with management); see also Benjamin Braun, *Asset Manager Capitalism as a Corporate Governance Regime*, in THE AMERICAN POLITICAL ECONOMY: POLITICS, MARKETS, AND POWER 270 (Alexander Hertel-Fernandez, Paul Pierson & Kathleen Thelen eds. 2021).

performance shortfall. There are two ways that the manager can capitalize on this information: sell in anticipation of the market's eventual realization of these problems that lead to downward share price adjustment or undertake active measures to remedy them through the exercise of voice. Meaningful "voice" in this context is costly because success against a recalcitrant company management team will require organizational efforts with other shareholders. Moreover, the gains will necessarily be shared with other shareholders, who can free ride on the voice-exerciser's effort. So: in cases where "voice" has been successfully employed, the active manager has incurred a positive cost not borne by other shareholders (and unlikely to be reimbursed by the company) for a gain that is shared by all. This is not a winning proposition from a relative performance perspective.

For the asset manager of a mutual fund, a "voice" strategy also runs into the demands of daily liquidity. Unanticipated redemption requests may require the manager to sell out positions to raise cash. The optimal dispositions from a liquidity perspective may be in tension with a sustained "voice" engagement with a particular company. Moreover, since the manager is always in the hunt for superior relative performance, it may decide that redeployed investment of its limited funds in another company will outperform the voice target, even if the target were to improve.

Finally, an asset manager is likely to advise a host of funds as part of a fund "family," which may raise thorny legal complications. Aggressive voice strategies by the portfolio manager at one fund could well be attributed to the asset manager parent, which is deemed to be the beneficial owner of all the securities that it manages because of its control over the disposition and voting of those interests. This will raise ongoing legal questions under Sections 13(d) (disclosure) and 16(b) (short-swing profits) of the 1934 Securities Exchange Act, alongside concerns that active voice may trigger a target's poison pill.³²

These forces will produce a style of voice that Gilson & Gordon describe as rational reticence.³³ Funds (via their managers) ordinarily will not generate firm-specific proposals but will evaluate and respond to others' proposals. This explains the success of activist hedge funds in the current governance ecology in the United States. Hedge funds have a different business model based on absolute returns: They seek out companies where they perceive strategic or operational shortfalls and invest heavily in research and organizational efforts to persuade institutional shareholders (and their advisors) of the value of a different approach. Asset managers are called upon to adjudicate such disputes on the shareholder value "merits." In making such decisions, asset managers can evaluate not only the current activist proposal but also the track record of the particular activist in creating sustainable gains, the activist's "reputation."³⁴ In this way, hedge fund activists act as a kind of governance intermediary, performing a complementary role in light of the current ownership pattern. Thus, active asset managers can realize the value of research that reveals problems at a particular portfolio company by holding in anticipation of an activist intervention (perhaps even nudging an activist) and selling. From a corporate governance perspective, this is an improvement since the active manager can employ both this

32. John D. Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407, 1435 (2019).

33. Gilson & Gordon, *supra* note 21, at 895.

34. For empirical confirmation of the value of reputation in this context, see generally Travis L. Johnson & Nathan Swem, *Reputation and Investor Activism: A Structural Approach*, 139 J. FIN. ECON. 29 (2021) (measuring the impact on reputation as proxy fights on investor activism, estimating through a dynamic model in which activists engage a sequence of target firms).

intermediated voice as well as exit.

This interaction between active managers and activist shareholders in specific contests produces portfolio effects as well, through “governance externalities.” Managers and their advisors observe the pattern of activist success (which channels shareholder views) and integrate the lessons into their strategic and operational decision-making. Thus, the main impact of hedge fund activism is not through the particular encounters that attract attention but through the own-firm action of corporate managers who are eager to avoid becoming activist targets.³⁵

The form of shareholder “voice” that has arisen from the interaction between hedge funds/other shareholder activists and the active asset managers has not received universal acclaim, to put the point mildly.³⁶ The two core objections are that this style of corporate governance is (i) short-termist, sacrificing long-term shareholder interests for immediate payoffs, and/or (ii) excessively focused on shareholder interests to the detriment of other stakeholders.³⁷ The objectors frequently hold onto the forlorn hope that the conflicts *among* stakeholders and the time-varying conflicts *between* shareholders and (some of) the stakeholders can be resolved if only planning looked to the long term.

“Stewardship” has been offered up as an alternative to the kind of voice that would emerge solely from the rational self-interested behavior of asset managers and institutional investors. “Stewardship,” in its simplest form, calls on asset managers and other institutional investors to exercise their rights as shareholders, their voice, on a firm-by-firm basis, even when the strictly rational approach might be to minimize, even avoid altogether, the administrative costs of shareholder voting. At least on the Anglo-American model, stewardship can also be understood as an effort to use “soft law” to take into account a broad set of governance and social concerns, to fulfill in some way the better governance-through-engagement aspiration associated with institutional ownership.³⁸

35. See, e.g., Shane Goodwin, *Management Practice in an Age of Engaged Investors* 8–13 (Colum. Bus. Sch., Working Paper No. 17-97, 2017), <https://ssrn.com/abstract=3045411> [<https://perma.cc/3CER-Y6A9>] (developing a proprietary Vulnerability Score for use by managers seeking to avoid becoming an activist target).

36. See, e.g., Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and our Strange Corporate Governance System*, 126 YALE L.J. 1870 (2017); John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545 (2016).

37. Strine, *supra* note 36, at 1907.

38. This is illustrated by the evolution of the UK Stewardship Code from its initial promulgation in 2010, calling for institutional “engagement” with individual companies, to the 2020 version, including particular activities within the stewardship responsibilities of institutional investors, most notably directing attention to “material environmental, social and governance issues, and climate change” and other market-wide factors. See Paul Davies, *The UK Stewardship Code 2010–2020: From Saving the Company to Saving the Planet?* 4–22 (Eur. Corp. Governance Inst., Working Paper No. 506/2020), <https://ssrn.com/abstract=3553493> [<https://perma.cc/KH4T-6259>]. For a typology of stewardship that identifies four distinct “stewardship supportive regulatory measures” across 14 countries, see Mark Fenwick & Erik P.M. Vermeulen, *Institutional Investor Engagement: How to Create a ‘Stewardship Culture’* (Tilburg L. & Econ. Ctr., Working Paper No. 2018-1, 2018), <https://ssrn.com/abstract=3098235> [<https://perma.cc/MG7U-DFCS>]. “Stewardship” has a different meaning or is put to different use by regulators, depending in part on whether initial ownership conditions were dispersed or concentrated. See generally Dionysia Katelouzou & Dan W. Puchniak, *Global Shareholder Stewardship: Complexities, Challenges, and Possibilities* (Eur. Corp. Governance Inst., Working Paper No. 595/2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3872579 [<https://perma.cc/5ZYH-PKXM>]; Geno Goto, Alan K. Koh & Dan W. Puchniak, *Diversity of Shareholder Stewardship in Asia: Faux Convergence*, 53 VAND.

B. Shareholder Voice: The Rise of Broadly Diversified Passively Managed Funds

The previous section argued that the business model of most active asset managers pointed towards a muted form of shareholder voice, most strongly expressed through interaction with hedge fund activists. “Stewardship” is an effort to channel the firm-specific knowledge that implicitly goes into portfolio composition by active managers into a more robust form of voice.³⁹ If you know enough to own the shares, goes the theory, you should know enough to engage with management in a constructive way and vote the shares accordingly. But this call for active asset manager “voice” has run into a serious issue: increasing disbelief in the capacity of most active managers to outperform the market, which in turn has led to a massive outflow from actively managed funds to passive funds structured to mimic market returns with the lowest possible fees.

The rise of institutional investors in the 1980s and 1990s coincided with increasingly strong evidence that few active managers of public securities portfolios could consistently deliver net-of-fees superior returns.⁴⁰ The “efficient market hypothesis” gained the status of received wisdom, at least in the variant that asserted that public stock markets are so quick and thorough at digesting new information that traders earn at best only a normal rate of return.⁴¹ An active investor with a record of success was quickly deluged with funds that washed out any niche investing acumen. So-called quants could seemingly deliver “alpha” through arcane strategies that plumbed pricing patterns for fleeting arbitrage opportunities, “scooping pennies in front of the bulldozer,” but there was no investment thesis in their activities.⁴²

The belief in stocks but not stock-pickers led to the rise of passive investment vehicles, in particular broad-based index funds. These follow two prescriptions drawn from modern portfolio theory. The investor has only two sure-fire ways to achieve optimal investment performance in a securities portfolio, meaning, the best risk-adjusted returns: minimize fees (to increase expected returns); diversify maximally (because the investor is compensated only for bearing risk that cannot be eliminated through diversification). Broad-based index mutual funds and ETFs have been a roaring success. Assets under management in such funds sponsored by BlackRock, Vanguard, State Street, and Fidelity now account for approximately 20% of the market capitalization of U.S. public companies.

J. TRANSNAT’L L. 829 (2020).

The European Commission has recently laid the ground for a different kind of engagement by institutional investors, one aimed at aligning the corporate governance activity of institutional investors (particularly mutual funds) with the purported “pro-sustainability” objectives of the institutional investor’s beneficiaries. *See generally* Alessio M. Paces, *Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?* (Eur. Corp. Governance Inst., Working Paper No. 611/2021), http://ssrn.com/abstract_id=3940375 [<https://perma.cc/CF3V-NTB2>].

39. Goto et al., *supra* note 38, at 13–14.

40. For a recent study that reaches this conclusion, see BERLINDA LIU & PHILLIP BRZENK, S&P DOW JONES INDICES, DOES PAST PERFORMANCE MATTER? THE PERSISTENCE SCORECARD (2019), <https://www.spglobal.com/spdji/en/documents/spiva/persistence-scorecard-december-2019.pdf> [<https://perma.cc/E92C-9Z66>].

41. For a run-of-the-mill recitation of the received wisdom, see Jim Holt, *The Price is Right, Isn’t It?*, WALL ST. J. (July 6, 1999), <https://www.wsj.com/articles/SB931229141798437182> [<https://perma.cc/Z8EE-5W37>].

42. Asif Suria, *Collecting Pennies in Front of a Bulldozer: How Likely Are You to be Run Over?*, SEEKING ALPHA (Sept. 9, 2016), <https://seekingalpha.com/article/4005234-collecting-pennies-in-front-of-bulldozer-how-likely-are-you-to-be-run-over> [<https://perma.cc/XC54-98HP>].

43

The structure of broad-based index funds has generated certain anomalies in the governance debate. On the one hand, index funds, passive not active by design, are the ultimate “buy and hold” investor, so, one might think, if “exit” is not an option, such funds are leading candidates for “voice.” Yet their core business model is simply to offer the market return at lowest cost. Investment in firm-specific engagement will not benefit the fund or generally its beneficial owners. As to the fund, remember the relative performance model: Serious engagement is costly, yet any benefits will necessarily be shared with all other funds following the same index. A passive fund, unlike an active fund, cannot benefit through overweighting or underweighting portfolio positions in light of firm-specific interventions. Moreover, the portfolios of index funds are formed without *any* firm-specific securities research, meaning without a substantive basis for the exercise of voice, structural ignorance, one might say. Engagement is not only inconsistent with an index fund’s business model; it is purely a bolt-on.⁴⁴

As to the beneficial owners: by construction, a broad-based index fund will diminish, perhaps eliminate, idiosyncratic risk. A performance change in a company is the kind of idiosyncratic element that broad-based diversification is designed to suppress. Performance improvements by Company A in a business sector are likely to come at the expense of another company in a broadly diversified index, not result in an absolute increase in the value of the portfolio.⁴⁵

In thinking about firm-specific performance engagement, it is valuable to think about

43. See Matthew Backus, Christopher Conlon & Michael Sinkinson, *Common Ownership in America: 1980–2017*, 13 AM. ECON. J.: MICROECONOMICS 273 (2021) (arguing that the “dramatic rise in common ownership” that has occurred since the 1980s “is driven primarily by the rise of indexing and diversification and, in the cross-section, by investor concentration . . .”). The so-called “Big Three,” BlackRock, Vanguard, and State Street, own significant stakes in companies worldwide. See, e.g., Fichtner & Heemsker, *supra* note 9, at 493; see generally Azar et al., *supra* note 23 (noting that the Big Three own approximately 4.8% of large global public firms that collectively account for 56% of global CO₂ emissions). “Index funds” can be created to mimic returns on market segments, not just the broad-based market measures such as the S&P 500 or CRSP U.S. Total Market. The AUM of the funds indexed to broad-based market measures dominates the targeted indexers. See Adriana Z. Robertson, *Passive in Name Only: Delegated Management and “Index” Investing*, 36 YALE J. ON REGUL. 795, 813 (2019) (addressing the broad-based funds in particular).

44. This functional indifference has led some scholars to propose that passive funds should lose their votes or would gladly buy shares without votes. Compare Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L 101 (2018), with Dorothy S. Lund, *Non-Voting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687 (2019). Others claim that since passive funds generally are sponsored by asset managers that include active funds in the family, the actives can guide informed choices by the passives whose votes will add clout and thus improve the performance of the actives. Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 42–43 (2019). This does not deal with what might be called the “Vanguard” problem—a fund family consisting almost exclusively of passive index funds; or the BlackRock counterexample: in response to investor demand, shifting resources away from active funds (laying off portfolio managers, ideally situated to exercise voice) in favor of quantitative funds. Replacing portfolio managers with “stewardship” staff is likely to degrade BlackRock’s capacity to evaluate firm-specific performance proposals.

This functional indifference has also led some to insist that index funds should face carrots and sticks to take a more assertive governance role, carrots in the regulatory permission to charge a certain level of firm-specific engagement expenses directly to the fund; sticks, in a requirement to do so. See generally Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, *supra* note 9.

45. See MCKINSEY & CO., *supra* note 15 (discussing “substantially idiosyncratic”).

comparative advantage. As observed previously, hedge funds and other shareholder activists have made a business of identifying underperforming companies, generating an alternative strategy, and undertaking the organizational work to mobilize other shareholders. The activists make concentrated investments in particular companies and receive concentrated returns in proportion to gains. This obviously gives the activist stronger incentives to get it right than a passive index fund manager who may make a diversified set of engagement decisions. If the activists will pursue under-performers, why isn't the optimal index fund manager strategy to free ride? Or, at most, to engage in the "rational reticence" strategy of active investors, that is, evaluate specific engagement cases teed up by the activists.⁴⁶ What is the evidence for an undersupply of shareholder activists that ought to motivate additional initiatives by notionally passive investors?⁴⁷ Moreover, the "undersupply" hypothesis needs to take account of the governance externalities associated with the current level of activism. To avoid becoming an activism target, managers often engage in self-scrutiny and follow-on action. Yet some object that this already leads too many companies to focus too narrowly on shareholder value.⁴⁸

Some have argued that the very size of index fund positions gives fund managers incentives to make substantial firm-specific engagement investments.⁴⁹ Apple, for example, carries a market capitalization of nearly \$3 trillion. An intervention that produces a 5% increase in value for a fund holding 5% of Apple's stock results in a gain for the fund of \$7.5 billion; assuming the fund earns a management fee of 10 basis points, 0.1% (on the high side these days), the manager earns additional fees of \$7.5 million annually, assuming that the gains are sustained; if capitalized at current stock price multiples, maybe \$150

46. Indeed, the presence of passive shareholders seems to incline activists to pursue a director-replacement strategy that is consistent with the passives' interest in improving director quality generally as a way of improving portfolio performance. See generally Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Standing on the Shoulders of Giants: The Effects of Passive Investors on Activism*, 32 REV. FIN. STUD. 2720 (2019).

47. Lund draws the analogy to the way that stock markets can remain informationally efficient even if only some investors engage in securities research and trading and that positive returns will be sufficiently likely to motivate an adequate level of such activity. Dorothy S. Lund, *Passive Investing and Corporate Governance: A Law and Economics Analysis*, ENCYC. L. ECON. 3 (2d ed. forthcoming 2020) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3623381 [<https://perma.cc/339Z-WALH>] (referencing Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393, 393 (1980)).

48. Some may claim that hedge fund activism leaves a significant margin of managerial agency costs unaddressed. This seems to be the premise of Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 9 (noting that, on average, hedge fund activism is associated with a seven percent increase in the target's stock price, and the hedge fund's profit typically comes from appreciation of equity positions obtained before announcement of the activist intervention). Thus, hedge fund activism places a cap on "managerial slack" (seen from a shareholder perspective) of seven percent, and there is a margin of managerial agency costs that theoretically could be addressed through firm-specific engagements. Let us put aside the fact that such firm-specific interventions are likely to be idiosyncratic only. The fact is that the "science" of corporate governance is hardly refined enough to determine which interventions will create own-firm value without deep engagement with firm-specific features. Repeat-play activist success requires not only costly firm-specific research but also skill in assessing and offering remedies for operational or strategic shortfalls. The activist engagement model works only if "reputation" markets drive out under-performers, i.e., will discourage engagements that would *reduce* value. Thus, as argued in the introduction, firm-specific engagement by asset managers of fully-diversified funds should focus on issues that resonate with the systematic dimension because of the correct incentive alignment for fully diversified funds in reducing systematic risk.

49. Kahan & Rock, *supra* note 17, at 1781–800 (2020).

million! Surely that potential gain is sufficient to evoke some useful performance-based engagement. To state the hypothetical is to show how it is unrealistic since we do not observe behavior that this example suggests would be rational by economically motivated parties.⁵⁰

There are two key points. The first is that the nature of diversification means that firm-specific gains do not generally translate into portfolio gains. Perhaps some of Apple's gains will come from market share or profits captured from private market companies that are not reflected in a public market index, or from small companies in the Russell 3000, not in the S&P 500. Nevertheless, the overwhelming fraction of any such gains will be at the expense of other large public players like Google/Android and Microsoft/Surface, just because of the magnitudes; in short, idiosyncratic. From a portfolio perspective, at best such engagements would add to the general performance pressure already associated with the current level of shareholder activism, the governance externalities already abundantly supplied. Nor does the size of the index fund investment in specific large-capitalization stocks give such funds a unique opportunity to pursue performance improvements in such firms, a narrow version of the undersupply hypothesis. Activist engagements have taken on the biggest firms; size is no protection.⁵¹

The second key point is that the legal risk taken on by managers of the broad-based fund through such firm-specific performance activism will be prohibitive. By construction, the fund holds shares in every large public company in the tech sector (to continue with the Apple example). In addition to the "fund family" legal risks associated with activism under the federal securities law, by opening a channel of direct influence over companies' operations, the fund manager would have created an existential business risk for the fund in light of antitrust concerns stemming from common ownership. Put otherwise, firm-specific performance engagement gives away the funds' best defense against the antitrust claim: "we have no channel." It cannot serve the interests of the beneficiaries of the funds for the managers to take on existential risk to this desirable investment vehicle for sustained firm-specific engagement activity that will have such an unlikely connection to beneficiary welfare.

C. Shareholder Voice: Towards Systematic Stewardship

As a matter of current policy, most index funds focus their corporate governance activities on portfolio-wide guidelines that comport with a normative idea of "best practice" corporate governance. Presumably, the asset managers believe that such

50. Some argue that the fund managers are conflicted because they hold more in AUM by increasing the take-up of their fund products and retirement planning services by the companies that might be eventual targets. If so, we might see a differential pattern of targeting divided between customer companies and non-customer companies that I do not think the literature has found. The funds also support activists in control contests on a regular basis, including behind the scenes, even if a majority of public votes favor management.

51. E.g., Icahn, Apple; Jana Partners, Apple; Triun, du Pont; Third Point, Intel. For a discussion of the growing number of companies targeted by activist intervention, see generally Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. ON CORP. GOV. (2020), <https://corpgov.law.harvard.edu/2020/01/20/dealing-with-activist-hedge-funds-and-other-activist-investors-3/> [<https://perma.cc/MAZ7-TR49>] ("No company is too large, too popular, too new or too successful" to "consider itself immune from hedge fund activism.").

governance measures will increase, on average, expected returns across the portfolio.⁵² There may also be prudential considerations. The SEC requires mutual funds to disclose their shareholder votes.⁵³ Precisely to avoid vote-stripping and other regulatory interventions, index funds want to look like usual shareholders in exercising their governance rights but also want to conserve on such costs. This strongly inclines them toward voting guidelines formulated in interaction with proxy advisors.⁵⁴ In general, such guideline positions are chosen to enhance the latent power of shareholders, including resistance to classified boards, annual advisory say-on-pay votes, preference for single class common stock, and endorsement of a majority vote for director election.⁵⁵ Firm-specific engagements tend to focus on the quality of directors, as part of portfolio-wide strategy to sustain and improve the quality of boards.⁵⁶ In a majority of activist challenges, index funds favor managements against activist challenges, though votes in favor of an activist director are not uncommon.⁵⁷ Indeed, the presence of passive shareholders seems to incline activists to a campaign for board seats rather than an immediate strategy change.⁵⁸ This is consistent with Gilson & Gordon's view that institutional investors who understand the limitations of the present board model are inclined to support management if they are sufficiently confident in the current directors and believe (and hope) that willingness to reject weak directors will have portfolio-wide effects on director quality, yet another governance externality.⁵⁹

"Systematic stewardship" is another portfolio approach but with an important difference: it focuses not on increasing expected returns across the portfolio but on

52. For positive evidence on this proposition, see Fatima-Zahra Filali Adib, *Passive Aggressive: How Index Funds Vote on Corporate Governance Proposals* (Nov. 20, 2019) (unpublished manuscript) <https://ssrn.com/abstract=3480484> [<https://perma.cc/YZX6-HQ65>].

53. See SEC, *Proxy Voting by Investment Advisers*, Release No. IA-2106, 68 FR 6585 (Feb. 11, 2003); 17 C.F.R. § 275.206(4)-6. Mutual fund votes are filed on Form N-PX.

54. See Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV. 803, 821, 816-26 (2018) ("[T]he Big Three rely largely on proxy advisory firms' services—mainly those of Institutional Shareholder Services . . . and Glass Lewis—which, in turn, adopt standardized voting policies."); Asaf Eckstein, *The Rise of Corporate Guidelines in the United States, 2005–2021: Theory and Evidence* 15–16 (Oct. 5, 2020) (unpublished manuscript), <https://ssrn.com/abstract=3705140> [<https://perma.cc/HGU7-WQFG>].

55. See Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 114 (2016) (finding that increased ownership by passives is associated with more independent directors, the elimination of takeover defenses, and equal voting rights).

56. See, e.g., BLACKROCK, *BLACKROCK INVESTMENT STEWARDSHIP: PROXY VOTING GUIDELINES FOR U.S. SECURITIES 3* (2021) ("BlackRock focuses on directors in many of our engagements and sees the election of directors as one of our most critical responsibilities.").

57. Strampelli, *supra* note 54, at 827–30.

58. Appel et al., *supra* note 46, at 2741–42 (2019).

59. See Ronald Gilson & Jeffrey Gordon, *Board 3.0: An Introduction*, 74 BUS. LAW. 351 (2019); Ronald Gilson & Jeffrey Gordon, *Board 3.0: What the Private-Equity Governance Model Can Offer Public Companies*, 32 J. APPLIED CORP. FIN. 43, 48 (2020).

Some argue that the current willingness of index funds to vote in favor of ESG issues is a marketing strategy based on the social tastes of millennial investors. Michal Barzuza, *supra* note 8. On the contrary, I think index investors are acting from motives that I would associate with a portfolio approach. Take their example of an appealing "social issue," the promotion of gender diversity on corporate boards. This is consistent with a portfolio-wide increased expected return strategy: high-end talent is scarce and eliminating barriers to the infusion of new talent onto boards and otherwise should produce better performance, particularly over time.

reducing systematic risk and, in this way, improving risk-adjusted portfolio returns. The current stewardship movement began with an intuition about the need for institutional investors to assert their governance rights to reduce systematic risks. Adoption of the UK Stewardship Code came in the wake of the 2007–09 Global Financial Crisis. In a post-crisis assessment, the Walker Committee concluded that one of the crisis causes had been a corporate governance defect; namely, the failure of institutional investors to rein in excessive risk-taking by the largest banks and other large financial firms,⁶⁰ and the subsequently promulgated Stewardship Code called for such institutional investor engagement.⁶¹ However, the Stewardship Code and the subsequent discussion did not sufficiently attend to the distinctive reason that institutional investors should focus on such firm-specific behavior: because failure of a systemically important financial firm is not just a firm-specific problem but rather will produce losses across the entire portfolio (across the entire economy). The risk of failure of such a firm is not idiosyncratic. It is not diversifiable. The risk of a systemic shock is “systematic.” In the run-up to the financial crisis, to produce the optimal risk-adjusted returns to investors, a widely diversified institutional investor should have attended to this risk and tried to mitigate it.⁶² The foremost stewardship mission of a diversified institutional investor or an asset manager is thus to mitigate and avert such risk realizations.

This distinctive case for “systematic stewardship” has been lost in the ensuing discussion. However, a glimmer has emerged in the 2020 UK Stewardship Code, which begins to frame “ESG” analysis by institutions in this way, albeit through a glass darkly.⁶³ It is not just a systematic stewardship *duty* that should evoke such behavior (soft law). Rather a focus on systematic risk mitigation is rational for asset managers. A systemic shock, a realization of systematic risk, will abruptly reduce AUM and thus reduce the fee-based revenues and the manager’s profits, even if, on a relative performance basis, the particular manager is no worse than others. That is a crucial distinction from firm-specific engagement generally. Precisely because any performance improvement is idiosyncratic, the portfolio value will not increase. The invocation of “stewardship” in that context is at best a soft law cudgel to coerce a largely unwilling actor to perform. “Systematic stewardship” calls on the manager to take steps that could lower the undiversifiable portfolio risks and thus improve beneficiary welfare, and, if successful, will reduce the

60. DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: FINAL RECOMMENDATIONS 25 (2009), https://ecgi.global/sites/default/files/codes/documents/walker_review_261109.pdf [https://perma.cc/JC8Y-YRBN].

61. FIN. REPORTING COUNCIL, UK STEWARDSHIP CODE (2010), <https://www.frc.org.uk/getattachment/e223e152-5515-4cdc-a951-da33e093eb28/UK-Stewardship-Code-July-2010.pdf> [https://perma.cc/8XN8-N4FD].

62. See John Armour & Jeffrey Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 39 (2014) (“[S]hare price maximization can in the presence of systemic externalities lead to reduced portfolio returns to investors. In relation to projects with such potential consequences, diversified investors should not want managers to single-mindedly maximize share prices. As a result, a system in which “shareholder value” is interpreted as share price maximization is *not* aligning managers’ interests with those of diversified shareholders, at least as regards systemic risks.”).

63. FIN. REPORTING COUNCIL, UK STEWARDSHIP CODE (2020), https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf [https://perma.cc/8FLA-ZRNR].

likelihood of events that could abruptly shrink portfolio values and thus reduce manager profits. It is “incentive compatible.”⁶⁴

Put otherwise, managers of a broad-based index fund should specialize in understanding the systematic risks that threaten the value of their portfolio, both in the persistent risk that cannot be diversified away and those risks whose realization could bring an immediate decline in portfolio values. This will be expressed both in “guideline” style strategies that operate across the portfolio as a whole and in firm-specific engagements. Systematic stewardship both fits the economic interests of the fund’s beneficiaries and looks to the comparative advantage of managers of such fully diversified funds in developing a portfolio approach. The low fee/broad-based index fund model constrains the capacity that such funds (their managers) will have for engagement. The work of addressing firm-specific performance issues can be addressed by other actors, including most notably the hedge fund activists in their interaction with institutional investors. Broad-based index fund managers have special reasons to think about the performance of the portfolio as a whole, in particular, the systematic risk dimension, and should devote their constrained resources accordingly.

II: SYSTEMATIC RISK: THEORY AND CANDIDATES

This Part sketches out the parameters of “systematic risk” that ought to be within the province of systematic stewardship. Many “systematic” elements (i.e., systematic in the sense of explaining the co-movement of stocks) that figure in the cross-section of returns in contemporary asset pricing models would not be suitable targets. But elements that ramify throughout the market portfolio because they affect the overall economy would be potentially suitable. In particular, *systemic* risk factors are particularly important because their potential for sudden adverse realizations produces the risk of abrupt price declines throughout the portfolio and, in consequence, will generate a negative overhang on portfolio values generally. Avoidance or mitigation of these risks, systemic risks-as-systematic, would surely improve risk-adjusted returns. This analysis provides a basis for analyzing “ESG” proposals within a framework that is consistent with an asset manager’s primary, perhaps sole, duty to investor welfare rather than a difficult to manage and defend trade-off of investor welfare for socially desirable ends.⁶⁵ To be sure, there may be

64. This point bears some further explication. Asset managers have first-order incentives to compete to offer wider diversification and lower fees; these measures improve their own-firm relative performance. Yet asset managers also spend resources on measures that improve performance across the portfolio, as a whole, even though the consequence will be to improve the performance of rivals as well, who can free ride. Thus, we commonly see “guidelines” and various other “stewardship” measures to improve expected returns across the portfolio. Fees linked to AUM make this incentive compatible; there may also be a marketing halo. In the same way, individual managers’ efforts to reduce systematic risk will both benefit competitors but should also increase own-manager AUM (since, in expectation, portfolio values should appreciate) and avoid sudden shocks that lead to investor withdrawals or portfolio rebalancing that may impose uncompensated administrative costs.

65. For an elaboration of some of the tensions in the current ESG investing model for financial fiduciaries, see Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381 (2020). In general, Schanzenbach & Sitkoff argue that, in many circumstances, a financial fiduciary will be obligated to fashion an investment strategy for the “sole benefit” of the beneficiary, which would mean that in those contexts, ESG can be pursued only as part of a risk-return maximization investment strategy. *Id.* at 397–99. The permissible risk-return associated with such

quantification issues in assessing the welfare effects of a potential trade-off of lower expected returns for reduced systematic risk, but specifying and calibrating the necessary models is within the competence of asset managers.

Many elements of social policy may have economy-wide effects and likely improve expected returns across the portfolio. For example, investments in education and infrastructure historically have been associated with substantial economic gains. But these investments typically reflect choices made by government actors, not portfolio companies; nor do they reflect systematic *risk* factors of the kind that an asset manager of a conventional financial product is readily in a position to evaluate. On the other hand, regulatory interventions that directly bear on systemic risk-taking by portfolio companies could well be within the asset manager’s domain because of the foreseeable impact on portfolio values. A more complicated question is whether an asset manager should develop a view about macro-prudential policies by a central bank designed to constrain systematic risk build-up.⁶⁶ Such measures will almost certainly have negative price effects for some companies in a fully diversified portfolio even if risk-adjusted returns across the portfolio are superior. Accepting such potential trade-offs is within the scope of a systematic stewardship approach. Some managers may be along a path to developing such analytic capacity; this is one way to understand the “policy” letters most famously associated with BlackRock’s chief executive officer.⁶⁷

A. *The Nature of Systematic Risk*

The central argument on behalf of “systematic stewardship” is that managers of a broadly diversified investment vehicle would improve the portfolio’s risk-adjusted returns (and thus improve the welfare of their beneficiaries) by mitigating systematic risk. This mitigation effort can be operationalized within the existing framework of asset pricing, which has paid increasing attention to systematic risk. The initial operationalization of

ESG investing on their account seems based solely on own-firm considerations without considering the systematic implications—meaning the portfolio-wide implications—of a firm’s activity. From the perspective of this Article, a financial fiduciary that is engaged in active investment management surely can take account of any risks that can affect own-firm returns, but since such a fiduciary will almost invariably construct a diversified portfolio, the fiduciary is also entitled to consider the systematic implications of the firm’s behavior. So, for example, avoiding fossil fuel equity investments may reduce portfolio diversification (the classic objection), but if reasonably related to a strategy to reduce climate change risk, it may improve risk-adjusted returns on the remaining portfolio because of a reduction in systematic risk.

To be clear, an investment vehicle that discloses that it will be guided in its investment and/or corporate governance activities by ESG principles is not subject to the same investor welfare objectives as a general-purpose fund such as a plain vanilla index fund.

66. See, e.g., Alejandro Van der Ghote, *Benefits of Macro-Prudential Policy in Low Interest Rate Environments* (Eur. Cent. Bank, Working Paper No. 2498, 2020) (advocating for macro-prudential policy in a particular environment).

67. E.g., Letter from Larry Fink, Founder, Chairman & Chief Exec. Officer, A Fundamental Reshaping of Finance, to CEOs (2020), <https://www.blackrock.com/americas-offshore/en/larry-fink-ceo-letter> [<https://perma.cc/DRK6-HFYB>] (“[E]vidence on climate risk is compelling investors to reassess core assumptions about modern finance. . . . BlackRock announced a number of initiatives to place sustainability at the center of our investment approach, including making sustainability integral to portfolio construction and risk management . . .” and thus, “we will be increasingly disposed to vote against management and board directors when companies are not making sufficiently sufficient progress on sustainability-related disclosures and the business practices and plans underlying them.”).

portfolio theory focused only on a single factor associated with stock price co-movement—returns on the market index. Contemporary asset pricing models decompose that “systematic risk” into various other factors that explain systematic return variation. Nevertheless, these models generally retain an irreducible level of “market risk” that becomes a target for systematic stewardship.

“Systematic risk” falls out naturally from the simplest account of portfolio theory: it is the risk that cannot be diversified away from a fully diversified portfolio of securities. It is also axiomatic that, in a competitive securities market environment, investors are compensated only for bearing such risk. Decades of work in financial economics have attempted to drill down on the nature of systematic risk and, in particular, how to analyze whether a particular security is accurately priced in light of its susceptibility to systematic risk. The effort to describe systematic risk more particularly might be said to vary between “structural” approaches (that is, based on a model about how the firm should perform conditional on changes in the real economy) and “statistical” approaches (that is, what factors have significant explanatory power in a data-mining exercise). Sometimes, the statistically relevant factors have an economically meaningful interpretation.⁶⁸

The initial translation of portfolio theory into an asset pricing model, the Capital Asset Pricing Model, assessed overall market variance, presumably stemming from shocks or other phenomena that broadly affected the real economy, as a singular factor. The famous “beta” variable measured a stock’s performance vis-a-vis changes in the market index. Subsequent asset pricing models based on arbitrage pricing theory⁶⁹ have decomposed systematic risk into a series of factors that account for the co-movement of stocks of particular characteristics. The Fama-French model in its various versions includes factors that take account of firm size and firm value (proxied by book-to-market) but always includes excess return on the market, meaning the return on the market index minus the risk-free rate.⁷⁰ For a particular firm, these factors can be time-varying. Various empirical analyses have produced a proliferation of purported systematic elements, notorious as “the factor zoo.”⁷¹ The empirical technology employed to identify these factors and weigh them

68. For structural approaches that are not directly linked to asset pricing models, see generally JONATHAN WILLIAM WELLBURN ET AL., RAND CORP., SYSTEMIC RISK IN THE BROAD ECONOMY: INTERFIRM NETWORKS AND SHOCKS IN THE U.S. ECONOMY (2020), available at <http://www.rand.org/t/RR4185> [<https://perma.cc/4RTD-JQPA>] (charting linkages within the economy for the propagation of systemic risk events, especially of non-financial firms); Mardi H. Dungey, Thomas J. Flavin, Thomas O’Connor & Michael Joseph Wosser, *Non-Financial Corporations and Systemic Risk*, 72 J. CORP. FIN. (forthcoming 2022) (identifying systemically important non-financial firms on the basis of contribution to systemic risk and vulnerability to it).

69. See generally Stephen A. Ross, *The Arbitrage Theory of Capital Asset Pricing*, 13 J. ECON. THEORY 341 (1976) (examining the arbitrage model as an alternative to the mean-variance model of capital asset pricing); Richard Roll & Stephen A. Ross, *An Empirical Investigation of the Arbitrage Pricing Theory*, 35 J. FINANCE 1073 (1980) (providing data and analysis supporting the arbitrage pricing theory).

70. See Eugene Fama & Kenneth French, *Common Risk Factors in the Returns on Stocks and Bonds*, 33 J. FIN. ECON. 3, 3–4 (1993). The Carhart variant adds a firm’s stock price “momentum” to the Fama-French factors. Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FINANCE 57, 57 (1997). Fama and French have recently derived a revised set of five factors that they regard as having more explanatory power, i.e., fit the data better. Eugene Fama & Kenneth French, *A Five-Factor Asset-Pricing Model*, 116 J. FIN. ECON. 1, 9 (2015).

71. Guanhao Feng, Stefano Giglio & Dacheng Xiu, *Taming the Factor Zoo: A Test of New Factors*, 75 J. FINANCE 1327, 1331 (2020).

properly—especially in a high-frequency trading era—has become advanced.⁷²

Another approach to explaining at least some systematic influences on returns is to look at the influence of “rare disasters.”⁷³ Any particular “disaster” is a black swan, but as seen as a class, “rare” disasters are foreseeable. Indeed, parallel to the development of asset pricing models has been a growing appreciation that the risk of “rare disasters” exerts a pervasive influence over market pricing, perhaps explaining all or part of the “equity premium puzzle,” the unexplained excess returns of a diversified stock portfolio over the risk-free asset, US Treasury bills⁷⁴; at minimum, these “tail risks” have a strong effect on asset prices.⁷⁵ This “rare disasters” analysis fits the experience of the breakout of “systemic risk” commonly associated with financial sector distress: the kind of risk that can lead to a sudden collapse in stock prices because of a pervasive negative impact on the real economy that threatens the profitability, even viability, of many firms. This systemic risk-as-systematic risk overhangs stock market prices generally, and of course, a realization of this risk would produce a dramatic decline in stock prices. Systematic risk can also reduce the expected return on a portfolio if it leads to costly financing or operational decisions that would be avoided in an environment of lower systematic risk.⁷⁶ Systematic stewardship

72. See, e.g., Markus Pelger, *Understanding Systematic Risk: A High-Frequency Approach*, 75 J. FINANCE 2179, 2193 (2020) (demonstrating the empirical study measuring these factors).

73. Robert J. Barro, *Rare Disasters and Asset Markets in the Twentieth Century*, 121 Q.J. ECONOMICS 823, 844 (2006); see also Robert J. Barro & Jose F. Ursa, *Rare Macroeconomic Disasters*, 4 ANN. REV. ECONOMICS 83, 83 (2012); Francois Gourio, *Disaster Risk and Business Cycles*, 106 AM. ECON. REV. 2734, 2762 (2012); ROBERT J. BARRO & GORDON Y. LIAO, BOARD OF GOVERNORS OF FED. RES. SYS., TRACTABLE RARE DISASTER PROBABILITY AND OPTIONS-PRICING 35–36 (2020); Thomas A. Rietz, *The Equity Risk Premium: A Solution*, 22 J. MONETARY ECON. 117, 126–31 (1988).

74. Rajnish Mehra & Edward C. Prescott, *The Equity Premium: A Puzzle*, 15 J. MONETARY ECON. 145, 154–55 (1985). The extent to which “rare disasters” resolve the equity premium puzzle is, of course, disputed, and the “puzzle” is still open. Nevertheless, it certainly seems the case that the prospect of extreme shocks—which repetitively recur, albeit in different ways—is indeed a systematic risk factor. Given the state of asset pricing models, it is part of the black box of influences that bear on the “excess returns” associated with the market index.

75. The effort to quantify the return effects of extreme downside risk has been the subject of several recent papers. See, e.g., Brian Kelly & Hao Jiang, *Tail Risk and Asset Prices*, 27 REV. FIN. STUD. 2841 (2014); Brian Weller, *Measuring Tail Risks at High Frequency*, 32 REV. FIN. STUD. 3571 (2019); Sofiane Aboura & Y. Eser Arisoy, *Can Tail Risk Explain Size, Book-to-Market, Momentum, and Idiosyncratic Volatility Anomalies?*, 46 J. BUS. FIN. & ACCT. 1263 (2019); Turan G. Bali & Hao Zhou, *Risk, Uncertainty, and Expected Returns*, 61 J. FIN. & QUANT. ANALYSIS 707 (2016); Marteen van Oordt & Chen Zhou, *Systematic Tail Risk*, 51 J. FIN. & QUANT. ANALYSIS 685 (2016); Jessica A. Wachter, *Can Time-Varying Risk of Rare Disasters Explain Aggregate Stock Market Volatility*, 68 J. FINANCE 987 (2013). Another approach is to distinguish “uncertainty” from “risk,” as they are separately priced in an asset pricing model, and to reduce one source of uncertainty by addressing systematic risk drivers. See Turan G. Bali & Hao Zhou, *Risk, Uncertainty, and Expected Returns*, 51 J. FIN. & QUANT. ANALYSIS 707, 708 (2016) (showing that the extent of portfolio correlation with economic uncertainty significantly affects portfolio returns). Models are beginning to emerge that attempt to model price effects of climate effects, for example, rising temperatures, which can show how reducing climate effects can improve returns. Such models do not capture, except inferentially, the non-linearity of the risk function. See, e.g., Ravi Bansal, Dana Kiku & Marcelo Ochoa, *The Price of Long-Run Temperature Shifts in Capital Markets* (Nat’l Bureau of Econ. Rsch., Working Paper No. 22529, 2021), https://www.nber.org/system/files/working_papers/w22529/w22529.pdf [<https://perma.cc/K8TB-V7E4>].

76. See Michael Schwert & Ilya Strebulaev, *Capital Structure and Systematic Risk* 14–15 (Rock Ctr. For Corp. Governance, Working Paper No. 178, 2014), <http://ssrn.com/abstract=2421020> [<https://perma.cc/W2PP-JL47>] (showing that firms with higher exposure to systematic risk reduce leverage).

consists in the effort of managers to reduce these risks.

In creating asset pricing models, finance scholars seem to take market risk as exogenous and normally distributed.⁷⁷ Indeed, modern portfolio theory is based on producing a portfolio that is mean-variance efficient. Yet our experience with systemic breaks, as in the Great Financial Crisis, which triggered great volatility in market risk and led to massive effort at financial regulation reform, would seem to confirm an intuition that “systematic risk” because it depends on a set of government and market preconditions, can be reduced by mitigatory reforms. In particular, such reforms can flatten out at least some disruptive risk realizations, the “fat tails.” Conventional asset pricing models take market risk as exogenous partly because the pricing questions they address are generally firm-specific. The claim of systematic stewardship is twofold: first, institutional investors and asset managers can undertake measures that target systematic risk (it can be endogenized by investor behavior); and second, such actions would serve the interests of their beneficiaries, who care about the value of the portfolio as a whole.

This Part II now turns to candidate risks for targeting by institutional investors and asset managers within the framework of systematic stewardship. Part III surveys the kinds of actions that such actors might pursue as systematic stewards.

B. Candidate Systematic Risk Targets for Systematic Stewardship

1. Climate Change Risk

A particularly strong candidate for systematic stewardship is the risk associated with climate change associated with increasing levels of atmospheric CO₂. Diverse analysts describe first-order economic effects associated with the resulting temperature rises.⁷⁸ A 2017 report in *Science*, for example, estimates a loss of 1.2% of GDP for each degree centigrade rise; without intervention, analysts predict up to a 4-degree increase; the GDP impact would exceed the recession associated with the Great Financial Crisis.⁷⁹ Other analysts predict even starker outcomes, with an impact that would rival the massive impact of the SARS-CoV-2 pandemic.⁸⁰ The World Economic Forum’s 2022 Global Risk Report

77. See generally JON LUKOMNIK & JAMES P. HAWLEY, MOVING BEYOND MODERN PORTFOLIO THEORY: INVESTING THAT MATTERS (2020) (arguing that finance scholars and others regard systematic risk as exogenous when it should be the target of mitigation).

78. These are canvassed in Madison Condon, *supra* note 29, at 43–48 and in John Armour, Luca Enriques & Thom Wetzer, *Mandatory Corporate Climate Disclosures: Now, But How?*, 2021 COLUM. BUS. L. REV. 1085.

79. Solomon Hsiang, Robert Kopp, Amir Jina, James Rising, Michael Delgado, Shashank Mohan, D.J. Rasmussen et al., *Estimating Economic Damage From Climate Change in the United States*, 356 SCIENCE 1362 (2017); see also Peter H. Howard & Thomas Sterner, *Few and Not So Far Between: A Meta-Analysis of Climate Damage Estimates*, 68 ENV’T & RES. ECON. 197, 215 (2017) (estimating approximately 10% GDP loss from predictable temperature rises); *Schroders Climate Dashboard Points to Four Degree Rise - Despite Increase in Carbon Prices*, SCHRODERS (Oct. 19, 2018), <https://www.schroders.com/en/au/institutions/insights/investmentinsights/schroders-climate-dashboard-points-to-four-degree-rise—despite-increase-in-carbon-prices/> [<https://perma.cc/NE73-78JJ>] (reporting permanent damage 3 to 4 times that of the GFC); U.S. GLOB. CLIMATE CHANGE RSCH. PROGRAM, FOURTH NATIONAL CLIMATE ASSESSMENT VOLUME II: IMPACTS, RISKS, AND ADAPTATION IN THE UNITED STATES (2018), <https://nca2018.globalchange.gov/> [<https://perma.cc/JN7V-GE85>].

80. Tom Kompas, Pham Van Ha & Tuong Nhu Che, *The Effects of Climate Change on GDP by Country*

ranked climate change issues as the top three of ten issues overall.⁸¹

There are multiple channels through which massive economic harms could result from unmitigated climate change risk. There is, of course, the physical damage from extreme weather events, damage from rising sea levels, agricultural losses from shrinking arable landmass, and all the disruptions that would result from these physical manifestations. Postponement of firm-specific adaptations necessary to eliminate CO₂ emissions and reverse atmospheric CO₂ would only increase the eventual transition costs; the “stranded assets” would pile up. As the physical disruption from climate change becomes manifest, firms that significantly added to CO₂ emissions through fossil fuel production or consumption (like public utilities or even automobile manufacturers) could face liability risk.⁸² Another channel is the threat to financial stability that has led many central bankers to focus on climate change.⁸³ Profs. Conti-Brown and Wishnick describe the systemic channels as first, the risk that a particular climate shock would produce a “rising tide of debtor defaults” that would bring down significant banks, and second, more generally, the risk of “a global, correlated set of threats to our current forms of economic production.”⁸⁴

and the Global Economic Gains From Complying With the Paris Climate Accord, 6 EARTH’S FUTURE 1153, 1153 (2018) (“For example, with the comparative case of a temperature increase of four degrees, the global gains from complying with [the Paris Accord’s] 2 [degree] target are approximately US \$17,489 billion per year in the long run (year 2100).”).

81. WORLD ECON. F., THE GLOBAL RISKS REPORT 7 (2022), <https://www.weforum.org/reports/global-risks-report-2022> [<https://perma.cc/6UKR-PLWE>] (the top three risks are Climate Action Failure, Extreme Weather, and Biodiversity Loss).

82. See Mark Carney, Governor of the Bank of Eng., A Transition in Thinking and Action, Speech Before the Int’l Climate Risk Conf. for Supervisors, De Nederlandsche Bank, Amsterdam (Apr. 6, 2018), <https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/a-transition-in-thinking-and-action-speech-by-mark-carney.pdf?la=en&hash=82F57A11AD2FAFD4E822C3B3F7E19BA23E98BF67> [<https://perma.cc/EG22-C856>] (including liability risk along with physical risks, transition risks, and financial stability risk).

83. See Mark Carney, François Villeroy de Galhau & Frank Elderson, *Open Letter on Climate-related Financial Risks*, BANK OF ENG. (Apr. 17, 2019), <https://www.bankofengland.co.uk/news/2019/april/open-letter-on-climate-related-financial-risks> [<https://perma.cc/G6TF-5UWW>] (describing work of Network for Greening the Financial System, consisting of 66 central banks and supervisors). See CENT. BANKS & SUPERVISORS, NETWORK FOR GREENING THE FIN. SYS., CLIMATE SCENARIOS FOR CENTRAL BANKS AND SUPERVISORS (2020), https://www.ngfs.net/sites/default/files/medias/documents/820184_ngfs_scenarios_final_version_v6.pdf [<https://perma.cc/M82T-FJYP>] (noting that the Federal Reserve has recently joined this Central Bank network and, for the first time, is identifying climate change as a risk for financial stability); See BD. OF GOVERNORS OF THE FED. RESRV. SYS., FINANCIAL STABILITY REPORT 58–59 (2020), <https://www.federalreserve.gov/publications/files/financial-stability-report-20201109.pdf> [<https://perma.cc/5P8V-VR4>]. The Financial Stability Oversight Council has described “[c]limate change [as] an emerging threat to the financial stability of the United States.” FIN. STABILITY OVERSIGHT COUNCIL, REPORT ON CLIMATE-RELATED FINANCIAL RISK 3 (2021), <https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf> [<https://perma.cc/CD9D-FLJ3>].

84. Peter Conti-Brown & David Wishnick, *Technocratic Pragmatism, Bureaucratic Expertise, and the Federal Reserve*, 130 YALE L.J. 636, 636 (2021); see also Seraina N. Grunewald, *Climate Change as Systemic Risk – Are Macprudential Authorities Up to the Task?* (Eur. Bank. Inst., Working Paper No. 2020-62, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3580222 [<https://perma.cc/79XM-VL8B>]; Nahiomy Alvarez, Alessandro Cocco & Ketan Patel, *A New Framework for Assessing Climate Change Risk in Financial Markets*, CHI. FED LETTER, Nov. 2020, <https://www.chicagofed.org/publications/chicago-fed-letter/2020/448> [<https://perma.cc/9G55-BH2V>]; Governor Lael Brainard, Strengthening the Financial System to Meet the Challenge of Climate Change, Speech at “The Financial System & Climate Change: A Regulatory Imperative” hosted by the Center for American Progress, Washington, D.C. (Dec. 18, 2020),

Climate change risk is thus a worthy target for systematic stewardship not just because its impacts may produce sharp declines in GDP and thus losses across a diversified securities portfolio but also because its manifestations will be unpredictable, like the weather. Many of the climate-change-affected systems are non-linear. The flow of ocean currents, Greenland's glaciers, and the Antarctic ice shelf, for example, are all candidates for a "rare disaster," indeed, a "Green Swan" event, an irreversible change to the global ecosystem with far-reaching adverse consequences.⁸⁵ Climate change risk systematically overhangs a fully diversified portfolio, reducing risk-adjusted returns.

2. Financial Stability Risk

The Global Financial Crisis demonstrated the systematic impact of the distress on systemically important financial institutions. Looking solely from the perspective of stock market participants, the consequence was a dramatic loss to holders of the market portfolio. The S&P 500 experienced a peak-to-trough loss of 57% from October 2007 to March 2009,⁸⁶ with overall stock market losses of nearly \$8 trillion. This was associated with a comparable loss in GDP of 4.3% over the period and resulted in the longest post-War II recession. A breakdown in financial stability rapidly rolls into the real economy because of the disruption in credit provision. The uncertain solvency of many financial firms will create "run risk," producing a sharp contraction in credit availability, both because solvent firms will refrain from additional lending to hoard cash and because insolvent firms will simply collapse.

The Global Financial Crisis, of course, had many causes, but a critical feature was the balance sheet fragility of many large publicly traded financial firms and the risk-taking that was incentivized by option-heavy executive compensation.⁸⁷ Senior managers felt pressure to pursue aggressive strategies to enhance return-on-equity and other quantitative measures of shareholder advancement irrespective of the consequent build-up of systemic risk. Financial firm managers seemed to be unheeding of the risks to financial stability. "As long as the music plays, you dance."⁸⁸ Precisely because of the widespread portfolio losses associated with a financial crisis, financial stability is an appropriate target for systematic stewardship. Financial distress produces losses across the full economy and thus a diversified portfolio; the risk of an outbreak of financial distress is a systematic overhang for portfolio values generally. Systematic stewardship brings a distinct perspective to the behavior of systemically important financial firms, realizing that the traditional corporate

<https://www.federalreserve.gov/newsevents/speech/brainard20201218a.htm> [https://perma.cc/BU9L-3PUZ] (describing Fed's efforts to model climate change risk for financial stability).

85. See PATRICK BOLTON, MORGAN DESPRES, LUIZ AWAZU PEREIRA DA SILVA, FREDRIC SAMAMA & ROMAIN SVARTZMAN, BANK FOR INT'L SETTLEMENTS, THE GREEN SWAN: CENTRAL BANKING AND FINANCIAL STABILITY IN THE AGE OF CLIMATE CHANGE 3 (2020), <https://www.bis.org/publ/othp31.pdf> [https://perma.cc/LW4D-KVLP] (distinguishing black and green swans).

86. The high, on Oct. 9, 2007, was 1565; the low was 677. The Dow Jones and Nasdaq indices experienced comparable declines. These figures are drawn from Yahoo Finance.

87. Ing-Haw Cheng, Harrison Hong & Jose Scheinkman, *Yesterday's Heroes: Compensation and Risk at Financial Firms*, 70(2) J. FINANCE 839, 870–71 (2015).

88. The full quote of the remarks by then Citibank CEO Chuck Prince in 2007 was: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Michiyo Nakamoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-Outs*, FIN. TIMES (July 9, 2007), <https://www.ft.com/content/80e2987a-2e50-11dc-821c-0000779fd2ac>.

governance pressure for own-firm maximization does not give due weight to the systematic costs.⁸⁹

3. Social Stability Risk

The U.S. corporate governance system is set up for firms to be highly responsive to changes in the economic environment but in a way that results in the imposition of the adjustment costs of economic change on various stakeholders, particularly the employees. The structure of share ownership—the reconcentration into diversified investment vehicles—has produced pressures and incentives that have diminished the capacity of firms to provide stakeholder insurance against such adjustment costs. In turn, the externalization of adjustment costs has made it easier for firms to respond to and anticipate changes in the economic environment, producing a change in the rate of change.⁹⁰ The consequence is a heightening sense of social instability, not just through the dislocation in careers and life circumstances but in a growing sense that the set-up produces an unacceptable distribution of gains.⁹¹ For a diversified portfolio investor, the potential backlash is a systematic risk because the consequence could be regulatory and other environmental changes that would impose losses across the entire portfolio. Measures that reduce this systematic risk would improve risk-adjusted returns. Breakdowns in financial stability that produce sharp declines in employment and other elements of social well-being also produce heightened risks of social instability, an additional reason why a systematic steward should particularly care about financial stability from a portfolio investor's point of view.

The moving parts of this argument need some elaboration. The intuition behind diversification is an ancient one: it is generally best for investors not to put all their eggs in one basket. The critical moment is the transformation of modern portfolio theory from a theory of investment management to a companion theory of economic organization. Investors can achieve diversification at the portfolio level rather than at the firm level, meaning that the investor can most efficiently eliminate uncompensated idiosyncratic risk by holding a portfolio of firms with a narrow focus rather than holding shares in firms that themselves operate in diverse business segments in the name of diversification. That has several implications. First, investors are risk-neutral with respect to the failure of any particular firm in the portfolio (except for the limited group whose failure would have systemic implications). This means investors would support firms/management teams that took the highest net-present value business risks, even if failure was a possible outcome, because this is the general way to increase the expected returns of the portfolio without

89. For further development of the differences in optimal corporate governance for financial firms vs. non-financial firms, see generally John Armour & Jeffrey Gordon, *supra* note 62; Jeffrey Gordon, *Corporate Governance and Executive Compensation in Financial Firms: The Case for Convertible Equity-Based Pay*, 2012 COLUM. BUS. L. REV. 834 (2012).

90. See Jeffrey Gordon, *Addressing Economic Insecurity: Why Social Insurance is Better Than Corporate Governance Reform*, COLUM. L. SCH.: BLUE SKY BLOG (Aug. 20, 2019), <http://clsbluesky.law.columbia.edu/2019/08/21/addressing-economic-insecurity-why-social-insurance-is-better-than-corporate-governance-reform/> [https://perma.cc/RT7K-3ABU].

91. Jeffrey Gordon, *Is Corporate Governance a First Order Cause of the Current Malaise?*, 6 J. BRITISH ACAD. 405, 427 (2018); Alex Raskolnikov, *Distributional Arguments, in Reverse*, 105 MINN. L. REV. 1583, 1600 (2021).

increasing the systematic risk.⁹² Managers (and creditors) are compensated for this additional risk-taking through monetary or stock-based compensation, but employees rarely are.

Moreover, investors who are diversified at the portfolio level want managers to keep tight control of diversification at the firm level. “Related diversification” that produces synergies and complementarities within the firm is acceptable; “unrelated diversification” as in a conglomerate firm is disfavored because managerial capacity is commonly overstretched and rents in the best performing segments are commonly dissipated through cross-subsidy.⁹³ As the firm cuts back on diversification, it faces greater exposure to business risk. A diversified firm can shift profits from one prospering segment to another; facing severe losses in one segment, it can socialize those losses at the firm level.⁹⁴ A focused firm loses this cushion and is thus more likely to fail.⁹⁵ As noted above, managers are compensated for this extra risk through stock-based pay, a share of the upside, but employees, who have lost the protection of this within-the-firm safety net, commonly are not.⁹⁶ Moreover, facing declining profits, managers in this tightly-focused world are likely

92. Judge Winter famously argued this as the basis for the business judgment rule in *Joy v. North*, 692 F.2d 880 (2d Cir. 1982).

93. See generally Monika Schommer, Ansgar Richter & Amit Karna, *Does the Diversification-Firm Performance Relationship Change Over Time? A Meta-Analytical Review*, 56 J. MGMT. STUD. 270, 271–78 (2018). Diversification, as expressed in the conglomerate movement in the 1960s and 1970s, quickly reversed in the 1980s and 1990s but stabilized thereafter. See Nilanjan Basu, *Trends in Corporate Diversification*, 24 FIN. MKTS. & PORTFOLIO MGMT. 87, 91–92 (2010). The most plausible explanation is that capital market pressures induced firms to select for efficient diversification, typically through “related” acquisitions that exploited strong complementarities, and to avoid “unrelated” acquisitions, whose main advantage was risk sharing. See Sheng-Syan Chen & I-Ju Chen, *Corporate Governance and Capital Allocations of Diversified Firms*, 36 J. BANKING & FIN. 395 (2012) (stating that firms with strong governance features experience a lower “diversification discount”). This view is supported by studies that indicate that the diversification discount and stronger governance (from a shareholder point of view) are inversely related. See, e.g., Daniel Hoechle, Markus Schmid, Ingo Walter & David Yermack, *How Much of the Diversification Discount Can Be Explained by Poor Corporate Governance?*, 103 J. FIN. ECON. 41 (2012); Panayiotis C. Andreou, John A. Doukas, Demetris Koursaros & Christodoulos Louca, *Valuation Effects of Overconfident CEOs on Corporate Diversification and Refocusing Decisions*, 100 J. BANKING & FIN. 182 (2019).

94. Oguzhan Ozbas & David Scharfstein, *Evidence on the Dark Side of Internal Capital Markets*, 23 REV. FIN. STUD. 581, 582 (2010); David Scharfstein & Jeremy Stein, *The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment*, 55 J. FINANCE 2537, 2538 (2000) (“[M]any observers have claimed that the cross-subsidies in internal capital markets often tend to be “socialist in nature—that is, strong divisions typically wind-up subsidizing weak ones.”).

95. See Varouj A. Aivazian, Mohammad M. Rahaman, & Simiao Zhou, *Does Corporate Diversification Provide Insurance Against Economic Disruptions?*, 100 J. BUS. RSCH. 218, 231 (2019) (concluding diversification hedges against extreme economic circumstances and reduces failure risk of the firm).

96. Geoffrey Tate & Liu Yang, *The Bright Side of Corporate Diversification*, 28 REV. FIN. STUD. 2203 (2015) (stating that internal labor markets in diversified firms better protect employees against economic shocks). The Tate & Yang article further implies that the internal labor markets of conglomerate firms are more efficient than external labor markets in redeploying labor after technological or economic change, meaning better preservation of prior human capital investment and lower displacement costs. See *id.* By contrast, external capital markets are more efficient than the internal capital markets of the conglomerate firm, at least in the US. See generally Ing-Haw Cheng et al., *supra* note 87 and accompanying text. In consequence, the form of economic organization that best serves the interests of diversified investors may disserve the interests of undiversified employees. The investors get better markets for capital allocation; the employees may get worse markets for labor allocation and redeployment.

preemptively to engage in cost-reduction, further increasing the risk to employees.⁹⁷ Even though managers have been compensated *ex ante* for the extra risk, in the moment of firm-level distress, managers would prefer to save the firm and thus will look to layoffs to achieve cost reduction. Indeed, in light of their stock-based compensation, managers may benefit from the stock price appreciation that may follow.⁹⁸

The final point is to appreciate the role of the reconcentration of share ownership in the hands of institutional investors. As argued above, such investors are “rationally reticent” but not passive. For these purposes, it means that they are at least persuadable by activist shareholders as to the existence of target management’s strategic or operational shortfalls, which would include diversification that is inefficient by this analysis but also the failure to adapt to changing economic circumstances. Under these arrangements, changes in the economic environment will rapidly be transmitted through capital market signals and the behavior of the relevant market actors to the firm and all of its stakeholders. The firm simply cannot credibly supply lifetime employment insurance. In a dynamic economic environment, the business cycle will be shorter than the career cycle, producing the adjustment costs now borne by employees.

What’s important to note is how diversified funds, including index funds, are very much part of this economic structure. These funds provide the low-cost means for diversification at the portfolio level and play an essential role in the governance structure that results in the risk shift that may disfavor employees. This is not a story that relies on short-termism but follows simply from the economic logic of portfolio theory, the investment vehicles produced by capital markets, and the kind of governance “voice” potentiated by the resulting ownership structure as energized by the activists. Some have argued that the best way to acknowledge and address the consequences is through robust forms of social insurance as a complement to the kind of capitalism that our ownership structure facilitates.⁹⁹ But the point is this: that the heightened adjustment costs are tied to the ownership patterns; the costs, if unaddressed, may well generate a backlash that could have portfolio-wide, or systematic, implications. Social stability risk may well rise to systematic concern for an asset manager determined to provide the best risk-adjusted returns. In other words, portfolio diversification as an investment strategy contributes to a style of economic organization that shifts risk to employees. The resulting social stability risk is a cost of this investing strategy that the sponsors of such investment vehicles should

97. See generally Kevin R. Foster, *Downsizing: An Examination of the Consequences of Mass Layoffs*, 17 J. PRIV. ENTER. 109 (2002) (concluding that layoffs improve profitability). There is also evidence that even outside of the zone of financial distress, firm focus (versus conglomerate diversification) is associated with reduced employee wages, perhaps because wages are at least partially set based on firm-level profits rather than segment-specific performance only. See Antoinette Schoar, *Effects of Corporate Diversification on Productivity*, 57 J. FINANCE 2379, 2399–401 (2002) (finding wage premium at conglomerate firms).

98. See generally Henry S. Farber & Kevin F. Hallock, *The Changing Relationship Between Job Loss Announcement and Stock Prices: 1970–1999*, 16 LABOUR ECON. 1 (2009) (finding that stock price reaction after layoff announcement shifts from uniformly negative to mixed positive & negative over the period).

99. See, e.g., Jeffrey N. Gordon, *Addressing Economic Insecurity: Why Social Insurance is Better Than Corporate Governance Reform*, COLUM. L. SCH.: BLUE SKY BLOG (Aug. 21, 2019), <http://clsbluesky.law.columbia.edu/2019/08/21/addressing-economic-insecurity-why-social-insurance-is-better-than-corporate-governance-reform/> [<https://perma.cc/U4SS-EP9P>] (analyzing why social insurance would work better to address economic insecurity than corporate governance reform); see generally Gordon, *supra* note 90 (providing available business reform that could enhance financial inclusion and lead to economic growth).

be mindful of and could well produce support for efforts to mitigate in the name of improving risk-adjusted returns.

III. IMPLEMENTATION OF SYSTEMATIC STEWARDSHIP

Stewardship calls upon institutional investors and the associated asset managers to “engage” rather than remaining “passive.” But in fashioning “engagement,” an institutional investor or asset manager faces multiple binary choices that interact to form a multi-dimensional array. These choices seem particularly important: firm-specific vs. portfolio (or subpart of the portfolio); corporate governance feature vs. strategic/operational; initiatory vs. responsive; regulation vs. private ordering; own-action vs. issue-focused consortium; consortium vs. trade association. To be more concrete: Engagement by institutional investors these days has depended heavily on guidelines focused on various corporate governance features that are meant to apply across the portfolio. Institutions are prepared to support the guidelines with respect to specific companies through “just vote no” or withhold-vote strategies on matters issuers must put to shareholders, like director elections or “say on pay.” So: for these matters, the institutions’ engagement would be described as *initiatory* in adopting *portfolio* guidelines, but *responsive* in enforcement at the *specific firm*.

Hedge fund activism, by contrast, has focused on firm-specific strategic and operational matters rather than governance features, and the mechanism has commonly been through contested director elections. Here the institutions’ posture has been *responsive*; they may consider an activist’s argument but will not *initiate* a proxy contest. Some have been critical of the institutions’ current approach, invoking “stewardship” to call for initiatory firm-specific engagement by institutional investors, even on matters that relate to strategy or operations.¹⁰⁰

Funds (and the assets managers) have generally been mindful of their status as *portfolio* investors. The guidelines, which describe and prescribe a particular conception of good corporate governance, “normative corporate governance,” aim to improve expected returns across the portfolio, even if not ideally fitted to the circumstances of every firm in the portfolio. The guidelines generally call for exposure to shareholder pressure and thus capital market signals, presumably because of the implications for expected returns. Guidelines that call for attention to diversity and inclusion at the board level and in the C-suite also make sense on portfolio expected return grounds. High-end talent is valuable and scarce; eliminating barriers to its discovery and utilization will create value across a portfolio.¹⁰¹

In devising any engagement strategy, the fund and its managers need to take account of first, the cost constraints of its particular business model, which may limit its capacity to do a “deep dive” analysis for many firms in the portfolio, and second, prudential limits on its freedom of action in an environment in which corporate managers are likely to push

100. See, e.g., Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*, *supra* note 9; Sean J. Griffith & Dorothy S. Lund, *A Mission Statement for Mutual Funds in Shareholder Litigation*, 87 U. CHI. L. REV. 1149 (2020) (initiating derivative or class action litigation against the firm, officers, and directors).

101. This is a different basis than what some might regard as a problematic belief about inherent gender or racial differences in handling business problems or the challenge of adding new elements in devising the right degree of “diversity” for optimal decision-making.

back hard against initiatory actions by large funds on “excessive power” grounds.¹⁰² This has produced a stance of “rational reticence” when it comes to firm-specific engagement on matters that can be expected to affect the portfolio’s performance. An actively managed fund that is overweight in target stock will surely support a measure that will increase the target’s stock price. A fund that is underweight in the target may be ambivalent. It will do less well on an immediate relative performance measure, but it may judge the governance externalities of activism as increasing performance across the portfolio and see benefits that way. An index fund arguably is indifferent in that most stock price effects will be idiosyncratic. Still, it, too, may regard activism as a desirable part of the normative corporate governance model that achieves the best performance across the portfolio.¹⁰³

Systematic stewardship presents a different menu of potential interventions. Of particular value would be uniform disclosure strategies that would enlist the market in the pricing of systematic risk. This would provide market measures of the extent to which specific firms are subject to systematic risk and, therefore, create pressure at the firm level to reduce that risk since a priced risk is a drag on the stock price. For example, in the effort to mitigate climate change risk, funds could favor, across the portfolio (or a relevant subsector), robust firm-level disclosure regarding activities that may contribute to climate change risk or regarding the firm’s vulnerability to regulatory change that could abruptly occur as climate change risks materialize. The information can be put into models that assess the evolution of climate change risk and reveal a specific firm’s contribution and exposure. This approach might point to the notion that too much emphasis has been placed on augmenting disclosure by fossil fuel producers, with insufficient attention to more detailed disclosure of transition risks by those now dependent on the fossil-fuel economy¹⁰⁴ and those likely to be impacted by climate-related events.¹⁰⁵

Think of it this way: A multi-factor asset pricing model like Fama-French still bundles many sources of systematic risk in the residual “market risk” term. Sufficiently robust disclosure about a particular type of firm-specific systematic risk would facilitate the estimation of an additional pricing term that would both reveal the firm’s risk exposure and provide market pressure for firm-level efforts to reduce that particular systematic risk to improve the stock price. Similarly, in pursuit of systematic stewardship, parties should also consider support for the creation of derivatives and a derivatives index based on the returns of firms especially exposed to certain systematic risks, like climate change or financial stability. This would aid in pricing the particular systematic risk and bring additional

102. See Roe, *supra* note 28, at 19 (discussing the political backlash risks that shadow large investment companies). There may be agency costs as well. Many asset managers also provide retirement plan services to large companies and may be loath to challenge managers who have say-so over these arrangements.

103. Some may argue that index funds particularly benefit from being part of a fund family that includes active funds because the research capabilities of the active funds guide the index fund’s decision-making. Actually, the subsidy may go in the other direction. The votes in the index fund add clout to the active fund’s judgment about a contested matter. This may be particularly important in a contested M&A scenario, in which the active fund’s unbalanced position means it cares about the distribution of gains, whereas the index may care only about the maximization of surplus from the transaction.

104. E.g., automobile companies and parts manufacturers that are part of the internal combustion engine supply chain.

105. E.g., broadband suppliers whose fiber optic cable infrastructure is subject to damage from sea-level rise. See Condon, *supra* note 19, at 65 (poor awareness of climate change impact on firm’s assets yields mispricing).

market pressures to bear for its mitigation.

Systematic stewardship considerations could also play out at the specific firm level, as activists offer shareholder proposals calling for greater own-firm disclosure or a modification in business conduct. Or perhaps a climate change activist might offer a short-slate challenge to the incumbent board on behalf of directors who might bring a different attitude. Obviously, no action by a single firm can make an appreciable dent in climate change risk. Still, the governance externalities of a successful campaign may lead to a behavioral shift in the sector. To take a different example: In the case of financial stability, the failure of a single firm can ramify broadly, so targeting a single firm in light of its risk-taking would be consistent with a systematic stewardship stance.

One particularly important question is the extent to which institutional investors and asset managers should take an *initiator* vs. a *responsive* posture with respect to *firm-specific* measures that might mitigate systematic risk. The answer, I think, depends upon, first, the existence or not of activist intermediaries who can tee up a question for resolution by majoritarian institutional owners, and second, the importance of single firm behavior concerning the systematic risk in question. Gilson and Gordon argue that with regard to firm-specific performance questions, activist shareholders act as governance intermediaries in a way that permits funds to be *responsive* rather than *initiator*.¹⁰⁶ The intermediaries have strong economic incentives to identify value-creating propositions for the target firm, as seen from the institutional investor perspective. With regard to financial stability, this approach will not work. An activist taking a long equity position in a particular financial firm is likely to favor more aggressive risk-taking that would produce higher expected returns at the particular firm (and thus a higher stock price), uncaring about a possible increase in systematic risk that, as an undiversified investor, it would not internalize. This is a glaring example of where the “unanimity rule,” which holds that at least from a financial perspective, all stockholders want the same thing—to increase the stock price—breaks down. The economic motives of the activist intermediary and the portfolio investor will diverge. This divergence suggests that institutional investors and asset managers ought to devote more firm-specific (and sector-specific) attention to financial firms precisely because (i) they cannot rely on some of the standard intermediaries and (ii) a single-firm failure can present a systemic threat.¹⁰⁷

In the case of climate change, the calculus works out in a way that favors *responsive* rather than *initiator* firm-specific actions by large, diversified funds and asset managers. First, a host of climate change intermediaries are now emerging to tee-up firm-specific initiatives for resolution through shareholder voting. These intermediaries include NGOs and other activist organizations focused on climate change risk, sovereign wealth funds that understand that they must internalize climate change risk, ESG funds that raise money from investors who themselves care about climate change risk, and conventional activist hedge funds that have come to have a negative view about the economic prospects of particular fossil fuel firms. Although these entities may not have the same economic incentives as the hedge funds, their business models may nevertheless encourage climate

106. Gilson & Gordon, *supra* note 21, at 864.

107. The Global Financial Crisis showed that portfolio investors could not rely on the regulators to protect financial stability. Sources of systemic risk may arise from financial firms outside of the official banking sector where the regulators are most focused, and clientelist pressures at the various (and competing) national and state regulatory bodies may lead regulators to underplay the build-up of systemic threats.

change activism. Moreover, they are much less likely to be susceptible to industry threats either because their small size protects them from the charge that they have too much power or because they stand outside the U.S. political threat framework. They are in a much better position than a broadly diversified fund to frame a firm-specific climate change proposal, whether pertaining to disclosure or a change in business strategy. Moreover, since climate change risk transcends the actions of any single company, these activist intermediaries are better positioned to organize a campaign across many companies. Thus, the funds and the asset managers can play a sufficient role by *responding* to these proposals in light of an assessment of their impact on reducing climate change risk rather than *initiating* their own proposals.¹⁰⁸ In other words, the large broadly-diversified funds can take the same stance as in the case of hedge fund activism: they can count on others to tee up the proposals that would bear on climate change risk and then figure out which proposals would, in fact, create value, that is, would reduce the risk.¹⁰⁹

Another set of choices relates to private ordering vs. regulation. There are now several private and quasi-governmental organizations that are trying to create uniform disclosure standards on climate change risk and various “sustainability” and other ESG metrics that could be said to engage with matters of systematic concern. Under the aegis of the Financial Stability Board, a consortium of financial-sector government regulators, a Task Force on Climate-Related Financial Disclosures (TCFD) has produced a set of “voluntary, consistent climate-related financial risk disclosures” for use by companies “in providing

108. For example, before the Engine No. 1 proxy battle, Exxon announced movement toward a settlement of an activist campaign mounted by two shareholder activists seeking to force the company to reduce its carbon footprint. One was a conventional hedge fund activist; the other was an “impact investor.” See Cara Lombardo, Emily Glazer & Dana Cimilluca, *Exxon Planning Board, Other Changes Amid Activist Pressure*, WALL ST. J. (Jan. 27, 2021), <https://www.wsj.com/articles/exxon-planning-board-other-changes-amid-activist-pressure-11611761874> [<https://perma.cc/J6F9-DRFR>] (reporting how Exxon Mobile Corp. is adding board members responsible for carbon footprint reduction amongst investor pressure). Neither of the activist shareholders held a substantial percentage of Exxon’s stock (apparently <1%). So, as with most activist campaigns, their negotiating leverage came from the presumed support of the institutional shareholders, who are the majoritarian owners.

109. In December 2017, a group of climate-focused investor networks organized “Climate Action 100+,” an “investor engagement initiative” that is aimed at climate change-related disclosure and business model modification at 160 global companies “that have significant greenhouse gas emissions and/or are critical to the net-zero emissions transition and to meeting the objectives of the Paris Agreement.” CLIMATE ACTION 100+, 2020 PROGRESS REPORT 5 (2020), <https://www.climateaction100.org/wp-content/uploads/2020/12/CA100-Progress-Report.pdf> [<https://perma.cc/79EG-LCUN>]. Asset managers and other institutions representing \$52 trillion in assets under management have signed on, including BlackRock and State Street Global Asset Management. *Id.* at 11. Climate Action provides information and technical assistance, but engagements with particular companies are carried out by specific funds. *Id.* Other funds within the network make independent determinations whether to support particular initiatives through the shareholder governance machinery. *Id.* at 82. “All investor signatories are responsible for their own voting decisions . . . [the organization] does not seek to provide voting recommendations or to facilitate block voting.” *Id.* This model is consistent with the “rational reticence” stance of index funds and other passive funds. It also seems structured to avoid “acting in concert” constraints under §13(d) of the 1934 Security Exchange Act (and the applicable regulations) and various poison pill beneficial ownership triggers. Note that the asset manager is likely to bring a different analytic framework to the climate change risk mitigation proposal of the climate change activist than to the performance-enhancing proposal of the shareholder activist. The latter entails a judgment that the activist has the better argument with management, which also is focused on firm-specific performance. By contrast, management probably is not attending to systematic risk because its focus is on own-firm payoffs, not the portfolio.

information to investors, lenders, insurers, and other stakeholders.”¹¹⁰ The Climate Disclosure Standards Board (CDSB), an international consortium of business and environmental NGOs formed in 2007, offers companies “a framework for reporting environmental information with the same rigor as financial information.”¹¹¹ The Sustainability Accounting Standards Board (SASB), a private organization created in 2011 that models itself after the Financial Accounting Standards Board and the Internal Accounting Standards Board, recently issued 77 industry-specific reporting standards pertaining to material sustainability.¹¹² There are also several other reporting frameworks: for example, the Global Reporting Initiative, the Carbon Disclosure Project, and the International Integrated Reporting Council. Recently these groups joined forces in a “Statement of Intent to Work Together Towards Comprehensive Corporate Reporting.”¹¹³ Those cooperative efforts appear to have culminated in the announcement at the November 2021 COP26 meeting¹¹⁴ in Glasgow by the IFRS Foundation of the formation of a new International Sustainability Standards Board (ISSB) to develop “a comprehensive global

110. See *About*, TASK FORCE ON CLIMATE-RELATED FIN. DISCLOSURES, <https://www.fsb-tcfd.org/about/#> [<https://perma.cc/RBE8-KDJM>]. These “recommended disclosures,” issued in 2017, relate to a company’s governance of climate change risk, its strategy, its risk management of climate change risk, and its metrics and targets. TASK FORCE ON CLIMATE-RELATED FIN. DISCLOSURES, RECOMMENDATIONS OF THE TASK FORCE ON CLIMATE-RELATED FIN. DISCLOSURES (2017), <https://assets.bbhub.io/company/sites/60/2021/10/FINAL-2017-TCFD-Report.pdf> [<https://perma.cc/TK8B-QT3L>]. In October 2021, TCFD issued an extended “Guidance on Metrics, Targets, and Transition Plans,” a 2021 Status Report that described the take-up of voluntary disclosure standards, and an annex on “Implementing the Recommendations of the TCFD.” The annex makes specific disclosure recommendations for particular sectors, including asset management. See generally 2021 TASK FORCE ON CLIMATE-RELATED FIN. DISCLOSURES, 2021 STATUS REPORT (2021), https://assets.bbhub.io/company/sites/60/2021/07/2021-TCFD-Status_Report.pdf [<https://perma.cc/GB29-XK93>]; TASK FORCE ON CLIMATE-RELATED FIN. DISCLOSURES, GUIDANCE ON METRICS, TARGETS, AND TRANSITION PLANS (2021), https://assets.bbhub.io/company/sites/60/2021/07/2021-Metrics_Targets_Guidance-1.pdf [<https://perma.cc/7AKX-BR2M>]; TASK FORCE ON CLIMATE-RELATED FIN. DISCLOSURES, IMPLEMENTING THE RECOMMENDATIONS OF THE TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES (2021), https://assets.bbhub.io/company/sites/60/2021/07/2021-TCFD-Implementing_Guidance.pdf [<https://perma.cc/3ANH-MCAL>].

111. See CLIMATE DISCLOSURE STANDARDS BD., CDSB FRAMEWORK FOR REPORTING ENVIRONMENTAL AND SOCIAL INFORMATION 2 (2022), https://www.cdsb.net/sites/default/files/cdsb_framework_2022.pdf [<https://perma.cc/WK3Q-3EWS>].

112. “SASB connects businesses and investors on the financial impacts of sustainability. SASB standards enable businesses around the world to identify, manage, and communicate financially material sustainability information to investors. SASB standards are industry-specific and are designed to be decision-useful for investors and cost-effective for companies. They are developed using a process that is evidence-based and market informed.” *Seventeen Data and Analytics Providers Now Have a Licensing Relationship with SASB, Improving Access to Financially Material ESG Information*, SUSTAINABILITY ACCT. STANDARDS BD. (Oct. 15, 2020), <http://www.globenewswire.com/news-release/2020/10/15/2109232/0/en/Seventeen-Data-and-Analytics-Providers-Now-Have-a-Licensing-Relationship-With-SASB-Improving-Access-to-Financially-Material-ESG-Information.html> [<https://perma.cc/H2BT-Q5HE>].

113. CDP ET AL., STATEMENT OF INTENT TO WORK TOGETHER TOWARDS COMPREHENSIVE CORPORATE REPORTING (2020), <https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf> [<https://perma.cc/A4N4-GMRP>].

114. The United Nations now organizes an annual climate change “conference of the parties” (COP) to focus attention and catalyze agreement on measures to address climate change risk.

baseline of high-quality sustainability disclosure standards.”¹¹⁵ This effort will also consolidate, organizationally, the CDSB and the Value Reporting Foundation, which houses the SASB Standards and the Integrated Reporting Framework.¹¹⁶ Moreover, in response to prodding by IOSCO, the international consortium of securities regulators, the ISSB “standards” will be based on the TCFD “pillars.”¹¹⁷ According to industry observers, this will align the two frameworks.¹¹⁸ Since the FSB—a consortium of governmental actors—drives the TCFD, and the largely private IFRS drives the ISSB, the result could be potentially the emergence of uniform climate change disclosure standards through the *bricolage* processes of global governance.

Reliable information presented with sufficient uniformity for comparison and analysis is critical for effective systematic stewardship. Moreover, more extensive and more reliable disclosure may help overcome what has been forcefully argued is the market’s underpricing of climate change risk.¹¹⁹ Should institutional investors and asset managers be “information takers” with respect to these largely private efforts, or should they engage in strengthening this private ordering approach to disclosure? Because this disclosure would have implications across the portfolio, efforts to improve it would be cost-effective. More extensive disclosure should lead to better pricing of systematic risk, which may discipline-specific companies and also provide information useful to a systematic steward; it should enhance the effectiveness of activist climate change intermediaries in framing firm-specific initiatives.¹²⁰ These reporting standards are voluntary, at least for US issuers, and relatively few firms are compliant; reporting firms often attach “Sustainability Reports” outside the four corners of their financial statements.¹²¹ Should institutional

115. *IFRS Foundation Announces International Sustainability Standards Board, Consolidation with CDSB and VRF, and Publication of Prototype Disclosure Requirements*, INT’L FIN. REPORTING STANDARDS FOUND. (Nov. 3, 2021), <https://www.ifrs.org/news-and-events/news/2021/11/ifrs-foundation-announces-issb-consolidation-with-cdsb-vrf-publication-of-prototypes/> [https://perma.cc/SGA7-EM6A]. The IFRS Foundation oversees “International Financial Reporting Standards,” the international alternative to “Generally Accepted Accounting Principles” (GAAP) that are required for use in the U.S. *About Us*, INT’L FIN. REPORTING STANDARDS FOUND., <https://www.ifrs.org/about-us/> [https://perma.cc/95HR-BHSU].

116. *Id.*

117. INT’L FIN. REPORTING STANDARDS FOUND., PROPOSED TARGETED AMENDMENTS TO THE IFRS FOUNDATION CONSTITUTION TO ACCOMMODATE AN INTERNATIONAL SUSTAINABILITY STANDARDS BOARD TO SET IFRS SUSTAINABILITY STANDARDS 38 (2021), <https://www.ifrs.org/content/dam/ifrs/project/sustainability-reporting/ed-2021-5-proposed-constitution-amendments-to-accommodate-sustainability-board.pdf> [https://perma.cc/7PE2-THQQ].

118. CLEARY GOTTLIEB, A GLOBAL OVERVIEW OF SUSTAINABILITY DISCLOSURE RULES FOR THE ASSET MANAGEMENT INDUSTRY 5 (2022), <https://client.clearygottlieb.com/63/2279/uploads/2022-01-18-a-snapshot-of-global-sustainability-disclosure-rules-for-asset-managers.pdf> [https://perma.cc/P92A-6E4Z].

119. *See generally* Condon, *supra* note 19 (arguing that the market is severely underestimating climate change-related risks to asset prices); Armour et al., *supra* note 78; Emirhan Ilhan, Zacharias Sautner, & Grigory Vilkov, *Carbon Tail Risk*, 34. REV. FIN. STUD. 1540, 1548 (2021).

120. Some elements of climate change risk are already impounded in stock prices. Patrick Bolton & Marcin T. Kacperczyk, *Do Investors Care About Carbon Risk?*, 142 J. FIN. ECON. 517, 539 (2021) (finding higher returns for firms with higher total CO₂ emissions indicating that investors already demand compensation for exposure to carbon emission risk).

121. *See, e.g.*, Governance & Accountability Inst., *65% of the Russell 1000 Index Published Sustainability Reports in 2019*, SUSTAINABILITY-REPORTS.COM (Oct. 26, 2020), <https://www.sustainability-reports.com/65-of-the-russell-1000-index-published-sustainability-reports-in-2019/> [https://perma.cc/5TZC-6VLZ] (stating that only 23% aligned with SASB standard; 4% reported with “detailed alignment” with the TCFD).

investors and asset managers undertake either initiatory or responsive firm-specific measures to establish standards of wider and deeper voluntary disclosure? One easy step would be for systematic stewards to insist on compliance with the reporting standards set by this new ISSB as part of their governance guidelines. Instead of a voluntary opt-in approach, facilitated by shareholder pressure, should they support mandatory disclosure, a regulatory approach that would standardize and compel disclosure?¹²²

Mandatory disclosure, of course, comes only after official regulatory action, which would involve, if not enmesh, the institutional investors and the asset managers in the political process. In August 2020, the SEC updated provisions of its major disclosure guide, Regulation S-K.¹²³ Although the SEC broadened the “human capital” reporting requirement, many were disappointed in its recourse to a “principles-based” approach only.¹²⁴ Moreover, two Commissioners voted against the proposal because it failed to move toward “standardized, consistent, reliable and comparable ESG disclosures that [investors] need to protect their investments and allocate capital toward a sustainable economy.”¹²⁵

The change in US presidential administrations is a double-edged sword in this regard. In light of President Biden’s highlighting of climate change risk in his campaign, it is no surprise that the SEC has proposed a climate-related disclosure standard.¹²⁶ Yet SEC rulemaking is inevitably a drawn-out process because of the process requirements of the Administrative Procedure Act. Deeper and more extensive disclosure requirements, which may increase the capacity of markets to price firm-specific climate change risk and help sharpen ESG activists’ proposals, will also increase the likelihood of litigation challenge

122. For expression of investor frustration with current ESG reporting and consideration of private ordering versus regulatory alternatives, see U.S. GOV’T ACCOUNTABILITY OFF., GAO-08-751, PUBLIC COMPANIES: DISCLOSURE OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS AND OPTIONS TO ENHANCE THEM (2020), <https://www.gao.gov/assets/710/707949.pdf> [<https://perma.cc/P257-LVZU>] (discussing the need for better transparency when reporting on environmental, social, and governance issues in publicly-traded entities). In his 2021 letter to CEOs, BlackRock’s Larry Fink emphasized the importance of disclosure on climate-related matters, both the company’s own emissions and “how [the company’s] business model will be compatible with a net-zero [carbon emissions] economy,” as well as the importance of “a single global standard” for such disclosure. Larry Fink, *2021 Letter to CEOs*, BLACKROCK, <https://www.blackrock.com/us/individual/2021-larry-fink-ceo-letter> [<https://perma.cc/JT3B-45N5>]. For a forceful argument on behalf of mandatory disclosure, see Armour et al., *supra* note 78; see also John C. Coffee, Jr., *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk* (Eur. Corp. Governance Inst., Working Paper No. 541/2020), <https://ssrn.com/abstract=3678197> [<https://perma.cc/7VRU-U3MR>] (describing tension between disclosure needs of diversified institutional investors and undiversified investors).

¹²³ Modernization of Regulation S-K Items 101, 103, and 105, Sec. Release No. 33-10825, 85 Fed. Reg. 63726, 63737–40 (Oct. 8, 2020) (codified as amended at 17 C.F.R. § 229.101(c)(2)(ii)) (drafting new Item 101(c)(2)(ii), which is an expanded version of “human capital” than under old Item 101(c)(1)(xiii)).

124. See, e.g., Alison Omens, Aleksandra Radeva, & Kavya Vaghul, JUST Capital, *The Current State of Human Capital Disclosure*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 31, 2021), <https://corpgov.law.harvard.edu/2021/10/31/the-current-state-of-human-capital-disclosure/> [<https://perma.cc/6WNY-ZUR9>] (discussing limitations in the resulting disclosure).

125. Thomas Riesenber, *A View on the SEC Rules Regarding Human Capital Disclosures*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 12, 2020), <https://corpgov.law.harvard.edu/2020/09/12/a-view-on-the-sec-rule-regarding-human-capital-disclosures/> [<https://perma.cc/FLB4-Q8JV>].

¹²⁶ The Enhancement and Standardization of Climate-Related Disclosures for Investors, Securities Act Release No. 33-11042, *reprinted in* 69 Fed. Reg. 21334 (Ap. 11, 2022).

under cost-benefit standards that invite judicial hard-look.¹²⁷ Moreover, the SEC's final product may well be inconsistent with the disclosure standards that may emerge from the ISSB-TCFD efforts at global standards creation.¹²⁸

This leads to another binary choice: should large, diversified fund and asset managers act through trade associations in pursuing systematic risk mitigation rather than acting on an own-fund basis? Particularly if systematic risk reduction entails controversial political steps or may best be advanced through a legislative or regulatory change rather than through the corporate governance channel only, a representative intermediary may be wise. Wall Street firms have benefited enormously through their capacity to act through the Securities Industry/Financial Market Association (SIFMA)¹²⁹. The large banks have similarly made good use of The Clearing House (TCH); both trade associations are energetic participants in the legislative and regulatory process. "Asset Managers Concerned About Systematic Risk" (AMCASR), a just-invented trade association, could act for asset managers and institutional investors collectively in the regulatory and legislative domain.¹³⁰ But is this not just the aggregation of power on which alarms about the Big Three¹³¹ and the Problem of Twelve¹³² rest? Actually, no. Industry participants acting collectively to petition the government for action or relief is a core First Amendment activity; even if the requested action would affect prices or output, it is immune from an antitrust challenge.¹³³ But the real problem is otherwise: Whatever the Big Three's purported power over managers, there is no reason to believe it carries over with the regulators, much less the legislatures. The institutional investors and asset managers can replace corporate managers, not regulators or legislators. Moreover, they are not the source of major campaign contributions, and their clout is likely to suffer accordingly.

The concern about action by "common owners" cuts the other way precisely because

127. See, e.g., *Bus. Roundtable v. SEC*, 674 F.3d 1144 (2011) (invalidating SEC proxy access rule); *MetLife Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219 (D.D.C. 2016), *appeal dismissed*, 2018 No. 16-5086, WL 1052618 (D.C. Cir. Jan. 23, 2018) (rejecting designation of insurer as "systemically important").

128. "I've asked staff to learn from and be inspired by these external standard-setters. I believe, though, we should move forward to write rules and establish the appropriate climate risk disclosure regime for our markets, as we have in prior generations for other disclosure regimes." Gary Gensler, Chair, Sec. Exch. Comm'n, Prepared Remarks for Responsible Investment "Climate and Global Financial Markets" Webinar (July 28, 2021).

129. SIFMA describes itself as "the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets." *About*, SIFMA, <https://www.sifma.org/about/> [<https://perma.cc/3AWS-YPL9>].

130. One action this new trade association should promote is the development of a robust derivatives market in climate change risk. Risks that are not visibly priced may have an insufficient impact on investor behavior. The run-up to the Global Financial Crisis provides a compelling example. The introduction of the Markit ABX Index in 2006, which made publicly available the increasing cost of credit default swap protection for various tranches of mortgage-backed securities (and thus the increased default risk), vastly changed investor sentiment about the subprime real estate bubble. Ingo Fender & Martin Schneider, *The ABX: How Do the Markets Price Subprime Mortgage Risk?*, BIS Q. REV., Sept. 2008, at 67.

131. See generally Bebachuk & Hirst, *The Specter of the Giant Three*, *supra* note 9 (examining the past and future growth of the Big Three index fund managers).

132. John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 13–14 (Harv. Pub. L., Working Paper No. 19-07, 2018), <https://ssrn.com/abstract=3247337> [<https://perma.cc/X2YE-DFVW>].

133. This is referred to as the Noerr-Pennington doctrine after two Supreme Court cases from the 1960s, *Eastern Railroad Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127 (1961) and *United Mine Workers of America v. Pennington*, 381 U.S. 657 (1965). See Charles H. Samel & Jennifer A. Carmassi, *Trade Associations: Boundaries in Antitrust Litigation*, ANTITRUST LITIG. NEWSL., Winter 2007, at 9.

systematic risk reduction does not immediately and visibly result in increased AUM. Rather, it most obviously preserves the value of AUM; asset managers may have insufficient incentives to pursue status quo protection. Here is where “systematic *stewardship*” becomes relevant. “Stewardship” is an effort to use soft law incentives to induce pro-social behavior where the incentives point to passivity. The pursuit of systematic stewardship ought to be framed as a distinctive positive contribution that these parties are uniquely positioned to appreciate and push forward. It can become an offset to concern about their power in the corporate realm—consideration for their ongoing social license.¹³⁴

The next Part addresses some of the concerns about the exercise of systematic stewardship.

IV. ADDRESSING CERTAIN OBJECTIONS

The two most serious objections to systematic stewardship come from first, interaction with a corporate governance model that structurally proceeds on a firm-by-firm basis, and second, emerging concerns about the anti-competitive implications of large “common owners” who might be seen as promoting an agenda that could possibly affect prices and outputs of targeted companies. Neither of these objections is weighty. In particular, it needs to be understood that actions as a systematic steward are tied up with avoiding harm to the real economy and people who depend on it; this pro-social objective is, in this respect, aligned with the investment positions of an asset manager. A final objection relates to implementation: can asset managers make the assessments/calculations from a systematic perspective? Part of the answer is that on the model I have proposed, the asset managers will, in many areas, be responding to ESG activists who can be made aware of the importance of a systematic risk reduction framing.

A. Corporate Governance Concerns

The first order corporate governance objection to a systematic stewardship approach relates to the investor’s prioritization of portfolio returns versus a purported shareholder duty to exercise corporate governance rights only in a way that would maximize own-firm shareholder interests.¹³⁵ There is no such shareholder duty, particularly for a non-controlling shareholder.¹³⁶ And, even for controlling shareholders, there are no shareholder

134. An alternative argument is that an index fund’s willingness to engage in systematic stewardship becomes a marketing tool and, in that way, increases AUM. More generally, in light of an increasing cohort of investors who would like to advance ESG objectives alongside their desire to maximize risk-adjusted returns, index funds may compete in their support of ESG measures that they can explain as increasing risk-adjusted returns.

135. Professors Kahan and Rock identify this with a strong “single firm focus” in corporate law versus a “multi-firm focus,” although the claims are not identical. Kahan & Rock, *supra* note 29, at 3.

136. STEPHEN M. BAINBRIDGE, *MERGERS AND ACQUISITIONS* 118 (3d ed. 2012); Roberta S. Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 *BUS. LAW.* 1, 13 (2004) (shareholders do not have duties to other shareholders or the corporation); *see generally* Matteo Gatti, *It’s My Stock and I’ll Vote If I Want to: Conflicted Voting by Shareholders in (Hostile) M&A Deals*, 47 *U. MEM. L. REV.* 181 (2016); *Hewlett v. Hewlett-Packard Co.*, No. CIV.A. 19513, 2002 WL 549137, at *1, *4 (Del. Ch. Apr. 8, 2002) (“Shareholders are free to do whatever they want with their votes, including selling them to the highest bidder.”);

duties, except in frank self-dealing.¹³⁷ There are several protective layers that would shield a systematic steward from a credible liability claim.

First, we have accepted virtually without question that a portfolio investor can use shareholder rights to promote a corporate governance regime that may indeed promote the value of portfolio firms on average—and thus increase the value of its portfolio—but will not necessarily be well-tailored for every firm. For example, there is significant evidence that a classified board might increase value for a subset of firms.¹³⁸ Yet, many institutional investors have exercised corporate governance rights by threatening to withhold votes for directors to push for destaggering boards across their portfolios. Although the proponents of the campaign came under attack, as did the proxy advisors who put “classification” on their negative guideline list,¹³⁹ no one seemed to think that the *shareholders* could be sued for trying to maximize the value of their portfolios through a uniform rule. The whole idea of corporate governance guidelines (addressing, e.g., board structure and composition or various elements of executive compensation), promoted and sometimes enforced through the exercise of shareholder voting rights, is premised on assumptions about performance improvements on average, not what will maximize shareholder value for *this* firm particularly.

We have also accepted without question allowing the risk preferences of diversified shareholders to shape our theory of optimal firm structure in a way that has firm-specific consequences. Diversified investors are “risk neutral” and insensitive to idiosyncratic risk. Their preference for diversification at the portfolio level rather than the firm level disfavors unrelated acquisitions and conglomerate-style structures and favors business risk-taking, including through leveraged capital structures, that will increase the risk of business failure. Such investors vote for directors and approve compensation packages that align managerial interests with these objectives. In short, we have accepted without serious dispute the way diversified ownership results in portfolio-maximizing business strategies that produce own-firm actions that may be inconsistent with the interests of the undiversified.

We have also accepted the idea that in mergers and acquisitions transactions, a portfolio shareholder can vote to maximize the value of the portfolio even if stock price reactions suggest that the transaction may not be optimal, perhaps even value reducing, for one of the merger parties in which it owns shares. In other words, the portfolio investor is entitled to consider whether the transaction produced a general surplus, even if one of the parties was adversely treated (whether the combined market capitalization increased), and

Weinstein Enters., Inc. v. Orloff, 870 A.2d 499, 507–08 (Del. 2005) (non-controlling shareholders can vote as they please; controllers may be subject to fiduciary duty); Tanzer v. Int’l Gen. Indus., Inc., 379 A.2d 1121, 1124 (Del. 1977). *But cf. In re CNX Gas Corp. S’holders Litig.*, 4 A.3d 397, 400, 416–17 (Del. Ch. 2010) (dispositive shareholders on both sides may not count for assessing the “majority of disinterested minority” test in parent-subsidiary freezeout).

137. It is commonplace that controllers commonly enjoy the non-pecuniary benefits of control, for example, the paternalism of the family firm and some of the pecuniary benefits short of self-dealing. See Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 786–87 (2003) (mapping permissible routes to private benefit extraction).

138. E.g., Robert Daines, Shelley Xin Li & Charles C.Y. Wang, *Can Staggered Boards Improve Value? Evidence from the Massachusetts Natural Experiment*, 38 CONTEMP. ACCT. RSCH. 3053 (2021).

139. See Daniel Gallagher & Joseph Grundfest, *Did Harvard Violate Federal Securities Law? The Campaign Against Classified Boards of Directors* (Rock Ctr. for Corp. Governance at Stan. U., Working Paper No. 199, 2014), <https://bit.ly/2IE1bEu> [<https://perma.cc/7WBR-VFKH>].

to consider, in the case of unbalanced holdings, whether the transaction produced a specific surplus for its own portfolio, given stakes in target and acquirer. Obviously, the rules would be different if the investor were a controller that held shares in both firms and arranged a transaction that distributed in favor of the firm in which it had the larger economic stake, but that is not the case for a minority shareholder with many firms in its portfolio.

At times the Delaware courts seem to have a bright-line test for “control,” deeming that a shareholder has control with a majority of the stock or something like 40 percent but with specialized control rights.¹⁴⁰ More recently, the Chancery Court seemed to embrace a “sliding scale” of stock ownership that could be conjoined with various other mechanisms of influence over the company and the directors to evidence “control.” In *Voight v. Metcalf*, for example, a case with a strategic investor, the Chancery Court determined that 35 percent sufficed for “control.”¹⁴¹ Additionally, there have been various “founder” cases in which a founding shareholder holding less than 30 percent of the company’s stock was deemed to have control when coupled with other indicia of domination.¹⁴² And, rather infamously, Chancery also conjured the threat of “negative control” to validate a poison pill targeted at an activist owning less than 20 percent of the target.¹⁴³

Certainly, no single institutional investor is likely to come close to those ownership percentages. More to the point, no large asset manager will occupy itself with the day-to-day management of the business and the exertion of comprehensive “control” that counted in the low-ownership percentage “founder” cases. Nevertheless, conjure this scenario: an ESG activist puts forth a director slate for a fossil fuel company on a platform of downscaling its production and exploration, and, with the support of the large institutions, the directors are elected. Suppose further that the activists succeed in their business objectives, resulting in diminished profits and reduced dividend payouts. Then assume that

140. See *Kahn v. Lynch Commc’n Sys., Inc.*, 638 A.2d 1110, 1112 (Del. 1994) (43% plus domination of the board); *In re Cysive, Inc. S’holders Litig.*, 836 A.2d 531, 535 (Del. Ch. 2003) (35%); *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304, 307 (Del. 2015) (“combination of potent voting power and management control such that stockholder could be deemed to have effective control of the board without actually owning a majority of its stock;” regarding *In re Cysive* as “aggressive.”); see generally Note, *Controller Confusion: Realigning Controlling Stockholders and Controlled Boards*, 133 HARV. L. REV. 1706 (2020).

141. See generally *Voigt v. Metcalf*, No. CV 2018-0828, 2020 WL 614999, at *12 (Del. Ch. Feb. 10, 2020).

142. *In re Tesla Motors, Inc. S’holder Litig.*, No. 12711, 2018 WL 1560293, at *12 (Del. Ch. Mar. 28, 2018) (noting that a minority stockholder may still be considered a controlling stockholder if they “exercise[d] control over the business affairs of a corporation”); see also *In re Oracle Corp. Derivative Litig.*, No. 2017-0337, 2018 WL 1381331, at *16 (Del. Ch. Mar. 19, 2018) (noting that Ellison held a 28% stake in Oracle and maintained a firm grip on the company, which raised serious questions of whether certain directors could maintain independence from Ellison); *FrontFour Cap. Grp. LLC v. Taube*, No. 2019-0100, 2019 WL 1313408, at *25 (Del. Ch. Mar. 22, 2019) (finding that two brothers who jointly held 15 percent of the stock “controlled the board” is an outlier, in tension with *Corwin*, and stands separately on the peculiarities on the 1940 Investment Company Act, a pyramidal ownership structure, and the failure of special committee process). *But see* Scheduling Office Conference on Plaintiffs’ Motion for Expedited Proceedings and Rulings of the Court, at 8, 36, *In re Dell, Inc., S’holder Litig.*, No. 8329, (Del. Ch. June 19, 2013) (Dell’s approximately 16.5 percent is “not anywhere close to the level of stock ownership that’s ever been considered a controlling stockholder;” and that it “is at a percentage level well below even the edgiest us,” referring to *Cysive*).

143. Ronald J. Gilson & Jeffrey N. Gordon, *The Sotheby’s Poison Pill Case: The Plate Tectonics of Delaware Corporate Law*, COLUM. L. SCH.: BLUE SKY BLOG (May 15, 2014), <https://clsbluesky.law.columbia.edu/2014/05/15/the-sothebys-poison-pill-case-the-plate-tectonics-of-delaware-corporate-governance/> [<https://perma.cc/QPF9-ZWEZ>] (discussing Third Point, LLC case that was before the Delaware Court of Chancery).

some public shareholders sue for breach of the duty of loyalty. The private motives of the non-controlling shareholders should be irrelevant to any liability concern as the board is given full authority—by statutes and internal governance documents—to make business decisions on behalf of the company (i.e., the directors have an independent fiduciary duty after they are elected).¹⁴⁴ Presumably, the ESG-focused directors could generate a business judgment rule defense, based on the long-term interests of the oil producer and its shareholders, that seeks to avoid the accumulation of “stranded assets” and redirect the organizational capacity and engineering skill of a large fossil fuel company in anticipation of stringent regulatory measures.

Instead, assume a lawsuit alleging that the Big Three (or some other group of diversified portfolio investors) agreed to act in concert to elect the ESG-seeking directors (who are judgment proof) and then used their “control” as majoritarian shareholders to shift value *away* from the fossil fuel target *towards* the rest of their portfolio, that is, self-dealing. Such an allegation misunderstands the nature of the ESG action. The point was to prevent the target from generating externalities, CO₂ emissions that would produce third-party harms. Nothing about the shareholder value norm should bar shareholders from deciding, via director elections, to reduce such harm imposition.¹⁴⁵

Let’s put this in the context of a concrete example. Through tracing a document trove revealed in litigation, Professors Shapira and Zingales show that DuPont, in manufacturing one of its signature products, Teflon, chose a lower-cost but pollution-creating production process, despite knowing of the consequent significant health-based externalities imposed on the community and, knowing further, that mitigation was possible at a cost much less than the externalities.¹⁴⁶ Shapira and Zingales show that this decision was probably *ex-ante* profit-maximizing in light of the low risk of detection and an adverse litigation outcome. Here’s the point: nothing in corporate law requires that directors pursue such a strategy; nothing in corporate law would provide a basis for liability imposition on directors who refused to impose externalities in trade-off for profits.¹⁴⁷ How can shareholders conceivably be held liable for insisting that directors follow business strategies that minimize or avoid such externalities?

A similar hypothetical could be framed in the context of a “systemically important

144. See, e.g., *Air Prod. & Chem., Inc. v. Airgas, Inc.*, 16 A.3d 48, 129 (Del. Ch. 2011) (noting “Delaware’s long-understood respect for reasonably exercised managerial discretion, so long as boards are found to be acting in good faith and in accordance with their fiduciary duties . . .”).

145. See Elizabeth Pollman, *The History and Revival of the Corporate Purpose Clause*, 99 TEX. L. REV. 1423, 1425 (2021) (observing that a corporation remains a collaboration between public and private spheres). Note that it is a separate question whether differently inclined shareholders determined to maximize profits could install new directors who would pursue profits up to the limit of applicable law.

146. Roy Shapira & Luigi Zingales, *Is Pollution Value Maximizing? The DuPont Case* (Nat’l Bureau Econ. Rsch., Working Paper No. 23866, 2017), <https://ssrn.com/abstract=3037091> [<https://perma.cc/5Q5Q-NNA4>]. Nathan Atkinson generalizes the point, calculating that of Clean Air enforcement actions, 37.5% are profitable net of penalties imposed, increasing the size of the violation. Nathan Atkinson, *Do Corporations Profit from Breaking the Law? Evidence from Environmental Violations 1* (June 25, 2020) (unpublished manuscript), <http://nathanatkinson.com/wp-content/uploads/2020/08/Atkinson-2020-Corporate-Environmental-Violations-1.pdf> [<https://perma.cc/DDK4-XJ32>].

147. See generally *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1 (Del. Ch. 2010). The *eBay* decision should not be understood to the contrary. The controllers in that case simply wanted to preserve “the Craigslist culture” without any attempt to show how that might promote profitability; the case was not about external harm avoidance. *Id.*

financial institution.” Suppose a shareholder activist puts forward a slate of directors committed to reducing “excessive risk-taking” by the financial firm, proposing, among other measures, to curb high-powered compensation arrangements. It is likely that curbing risk-taking will reduce current profits in part because it may make it harder to retain risk-loving traders. Of course, less risk reduces the likelihood that the firm will fail, with systemic consequences and the imposition of massive externalities. Surely it is not beyond shareholder power to curb such systemic threat creation.¹⁴⁸

Stakeholder and other constituency interests are directly tied up in systematic stewardship: Yes, reducing systematic risk will increase portfolio risk-adjusted returns, but this is not only a private benefit for the portfolio owner. The systematic risk affects the portfolio because it runs through the real economy, affecting the interests of all the potential constituencies of the corporation and its stakeholders. Share values are threatened because systematic risk threatens the economic ecosystem on which all companies and communities rely and thus the well-being of various corporate constituencies. Constituency statutes plainly give the directors latitude to balance these interests;¹⁴⁹ if directors can “balance,” then so can the shareholders. Even in Delaware, the scope for constituency/stakeholder regard is quite broad, except in the limited “final period” in which the target is sold for cash or in which there is a control shift,¹⁵⁰ so long as the decisions can be framed as serving long-term shareholder interests or avoiding the imposition of external harm.

B. Common Ownership.

A burgeoning literature has arisen to issue warnings about the dark side of the rise of institutional investor ownership. The reconcentration of ownership has meant that a small group of large-fund families own a large fraction of the stock in most public companies. Particularly in sectors characterized by oligopoly structure, such as airlines or banking, this “common ownership” is said to provide the glue to hold together an informal cartel, with consequent anti-competitive effects: higher prices and lower output.¹⁵¹ The remedy, argue some, is to engage in antitrust actions of various types,¹⁵² including limiting the capacity of funds to assemble fully diversified portfolios.¹⁵³ Many corporate law scholars are skeptical of the anti-competitive outcome associated with common ownership, observing

148. See John Armour & Jeffrey Gordon, *Systematic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 77 (2014) (noting that “when a firm’s actions affect systemic risk, the conventional wisdom is reversed: diversified shareholders want managers to take less risk.”).

149. See Michal Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1973, 1989 (2009) (noting that 35 states have constituency statutes).

150. Compare *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (stating interests of non-shareholder constituencies can be considered in erecting defensive measures), with *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986) (not when corporate purpose shifts from defending the bastion to selling the firm or countenancing a control shift).

151. This literature is reviewed in Martin C. Schmalz, *Common-Ownership Concentration and Corporate Conduct*, in 10 ANN. REV. FIN. ECON. 413 (2018), and updated in Martin C. Schmalz, *Recent Studies on Common Ownership, Firm Behavior, and Market Outcomes*, 66 ANTITRUST BULL. 12 (2021); see also José Azar, *The Common Ownership Trilemma*, 87 U. CHI. L. REV. 263 (2020).

152. Antitrust arguments are surveyed in Einer Elhauge, Sumit K. Majumdar & Martin C. Schmalz, *Confronting Horizontal Ownership Concentration*, 66 ANTITRUST BULL. 3 (2021).

153. Remedies are surveyed in Eric Posner, *Policy Implications of the Common Ownership Debate*, 66 ANTITRUST BULL. 140 (2021).

(i) the great reluctance of asset managers to employ the shareholder governance tools in a way that would hold together informal cartels or otherwise stabilize anti-competitive arrangements,¹⁵⁴ and (ii) the energetic presence of minority shareholder interests, including activist hedge funds, that vigorously pursue single-firm value maximization.¹⁵⁵ It is hard to square a world in which managers complain about pressure to maximize for the short-term with a world in which rents are widespread, even if there are some local pockets of anticompetitive harm.¹⁵⁶ Above, I argued that current ownership patterns shift risk on the employees, a decided distributional effect, but this results from the logic of *diversification*, not from ownership concentration in the Big Three or any other number resonant for antitrust purposes.¹⁵⁷

Systematic stewardship stands this debate on its head. The point is to use the tools of shareholder governance to persuade firms to reduce the activity that creates systematic risk. This may indeed restrict output and raise prices. Presumably, each large investor will eschew direct coordination, but the organizing activities of environmental coalitions like the Climate Change 100+ that include large asset managers among the signatories are readily observable. The key is to appreciate that the welfare effects of possible systematic risk mitigation will differ from the purported anticompetitive effects associated with the common ownership literature.

Mitigating systematic risk is not simply a private benefit obtained by private parties seeking to protect their portfolios. Rather, portfolio values are at risk because the real economy is at risk, meaning that the firms and economic ecosystems people depend upon for their livelihoods and well-being are at risk. The consumer welfare benefits of systemic risk mitigation swamp the portfolio benefits. The Global Financial Crisis produced a roughly 50% decline, peak to trough, in the S&P 500, but it has fully recovered and advanced. The welfare losses of the unemployment shock and career/life dislocation are not so easily recouped and helped create our fraught social environment.

Reducing the risk of an economy-wide negative event will improve consumer welfare across the board. That is, the beneficiaries of corporate governance interventions that lower systematic risks are not just the beneficial owners of index funds or other diversified funds, but the populace generally. The channel to portfolio values runs through the real economy. Damage to portfolio values occurs because of damage to the real economy, meaning the

154. Edward Rock & Daniel L. Rubinfeld, *Antitrust for Institutional Investors*, 82 ANTITRUST L.J. 221, 263 (2018); Edward B. Rock & Daniel L. Rubinfeld, *Common Ownership and Coordinated Effects*, 83 ANTITRUST L.J. 201, 201–03 (2020).

155. C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, 129 YALE L.J. 1392, 1395 (2020).

156. It might also be noted that diversification itself undercuts the motive to hold together anticompetitive cartels since the cartel's profits will come at the expense of other firms in the portfolio that are paying higher prices and seeing reduced profits. The purported benefits of common ownership depend on rents squeezed from the consumer sector exceeding the losses within the portfolio. In other words, the value of the Business-to-Consumer extraction exceeds the B-to-B losses. That seems hard to square with the airlines' business model (airlines are canonical in the literature) since the business passengers generate the highest margins, not leisure travelers.

157. More generally, the competition policy concerns of "common ownership" arise from the logic of diversification, not ownership concentration in the "Big Three." The effects/concerns would be the same whether we had a Big Ten or a Big Twenty; the commonality arises from the logic of portfolio maximization. See Matthew Backus et al., *supra* note 43, at 285. Actionable competition policy concerns are far more likely to arise from active investors holding oversized positions in key firms in particular sectors.

livelihood of people generally. Avoidance of this welfare-reducing outcome should not be an objective of competition policy.¹⁵⁸

Indeed, one might flip the common ownership point. A systematic threat, particularly one so daunting and pressing as climate change, may make the purported power of common ownership a virtue, not a problem. Systematic threats arise and persist in areas of government shortfall. If large asset managers, acting on behalf of beneficial owners, can influence companies in ways that governments do not, the asset managers' willingness to engage on systematic issues—climate change, for example—may make “common ownership” a positive, not a negative. It is through broad diversification that asset managers see the need to reduce systematic risk, and it is through heft that the asset managers have the power to promote systematic risk reduction.

C. Overclaiming

In thinking through the implications of “systematic stewardship,” it is important not to overclaim about its reach. Many critical social problems do not present “systematic risk” of the sort that would elicit the focused concern of a portfolio investor and so would not be addressed through this channel. In the event of a systemic break, the resulting social harm far exceeds the portfolio losses, meaning the asset manager has inadequate incentives to avoid the systemic event. Because of the importance of the S&P 500 to the indexed investor, many smaller public companies may be under-represented in asset manager portfolios. Private companies and state-owned enterprises are not generally available for inclusion in a portfolio. Companies with a controlling owner are relatively insulated from institutional investor pressure.¹⁵⁹ These factors all limit the effectiveness of systematic stewardship in the general theory of harm prevention.

In these cases, the reasonably expectable actions of a systematic steward will be *incomplete*. The steward's actions ought to be directionally correct but insufficient to address the serious social question at stake. So systematic stewardship is not a panacea; such investors do not internalize all the externalities, but the overlap between the interests of the holder of a diversified portfolio and general society for some “wicked hard” problems is meaningful.¹⁶⁰ If there is simply no escape from the need for governmental action, systematic stewards can nevertheless play a catalytic role by heightening the salience of particular issues and changing the political calculus of important actors. Moreover, systematic stewardship rests on a thin theory of justification, not a robust claim

158. Prof. Condon develops a firm-specific example of systemic risk mitigation that illustrates the point in another way. She hypothesizes that BlackRock has used governance technology in a way that produces a particular level of CO₂ emissions reduction at Exxon, which, applying some assumptions based on the Nordhaus model that translates emissions reduction to economic consequences, results in a net gain for BlackRock's portfolio of \$3.4 billion (losses on Exxon; gains on most other portfolio securities). But then, applying standard assumptions, the *social* value of such carbon reduction is \$913 billion. See Condon, *supra* note 29, at 46–47, 67–68. But Prof. Condon has other concerns: systematic stewards have insufficient incentives to undertake optimal carbon reduction. *Id.* at 35. But that is only to say that action by asset managers, even if pointing in the right direction, is not a substitute for the actions of governments.

159. Dhammika Dharmapala & Vikramaditya S. Khanna, *Controlling Externalities: Ownership Structure and Cross-Firm Externalities* 27 (Eur. Corp. Governance Inst., Working Paper No. 603/2021, 2021), https://ecgi.global/sites/default/files/working_papers/documents/dharmapalakhannafinal.pdf [<https://perma.cc/2ZAE-V3LS>].

160. But see Roberto Tallarita, *The Limits of Portfolio Primacy*, 76 VAND. L. REV. (forthcoming 2023).

on behalf of the role of asset managers as political or regulatory actors;¹⁶¹ and, thus, reduces the exposure of asset managers to backlash.

CONCLUSION

Ever since large institutional investors emerged in the 1980s and 1990s, they have been looked to as parties with a capacity to resolve some of the fundamental tensions in corporate governance between both managers and shareholders and between society and the shareholder-governed private firm. That is a tall order. At least two conclusions fall out of this paper: first, understanding the intellectual foundations of contemporary investment management helps us appreciate that addressing systematic risk factors is consistent with a fund's duty to its beneficiaries, perhaps its top priority. Second, both in pursuing enhanced performance and systematic risk reduction, the low-cost, diversified fund can work in interaction with market intermediaries—performance activists and ESG activists—who will make deep investments in proposals that the funds can then evaluate. “Systematic Stewardship” respects the value of the low-cost, diversified model while also appreciating how the managers of such funds can shape the environment in which returns are generated.

161. *But cf.* Dorothy Lund, *Asset Managers as Regulators*, 171 U. PA. L. REV. (forthcoming 2022).