Brief Remarks on Corporate Sustainability and Shareholder Activism[*]

Lucia Picardi
(Professore ordinario di Diritto commerciale, Università degli Studi di Napoli "Federico II" - Dipartimento di Giurisprudenza)

Abstract
Il saggio esamina il ruolo sempre più rilevante assunto dagli investitori istituzionali e dai gestori di "attivi" negli assetti proprietari delle società quotate anche italiane, rimarcandone la natura "ambivalente", atteso che tali soggetti, da un lato, sono chiamati a contribuire alla composizione degli interessi degli azionisti e degli *stakeholders* secondo i paradigmi della "responsabilità sociale d'impresa" e dell'attivismo a lungo termine mediante l'*engagement* e la *stewardship*; dall'altro, devono perseguire l'interesse dei beneficiari finali che hanno loro affidato la gestione delle proprie risorse finanziarie. Si tratta dunque di gestori dell'altrui risparmio in grado di incidere (in virtù delle fonti tanto di *soft law* quanto di *hard law*) nella *corporate governance* delle società partecipate attraverso i poteri di *voice* e la minaccia di *exit*. L'Autore affronta il conseguente tema – analizzato secondo il paradigma *principal/agent* – dell'allineamento fra le politiche di *engagement* di tali "azionisti per conto altrui" anche sotto il profilo della sostenibilità ESG e il perseguimento delle "preferenze" degli investitori finali rispetto al cui interesse gli stessi innanzitutto operano; né si sottrae al compito di esaminare la variegata tipologia degli "azionisti per conto altrui" sotto il profilo delle strategie di investimento (gestori attivi o passivi, orientati più al *long-term* o, al contrario, allo *short-term*; indicizzati o meno), del ruolo degli *stewardship team* di fronte all'elevata diversificazione dei portafogli e ai costi di monitoraggio, del ricorso alla consulenza dei *proxy advisors*, soffermandosi in particolare sugli *hedge funds*. Si interroga, quindi, sulla misura dell'influenza che gli "azionisti per conto altrui" sono in grado di esercitare sul controllo delle esternalità negative dell'impresa, senza trascurare la tematica della prevenzione e gestione dei rischi di *greenwashing*, con specifico riguardo ai paradigmi giuspolitici emergenti nella dimensione eurounitaria. Il saggio affronta i profili di intersezione fra la disciplina in materia di *corporate governance*

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dell'impresa quotata in prospettiva di *sustainability* (SHRD 2, proposta di direttiva CSDD) e quella in tema di gestione del risparmio con riferimento alla tassonomia (Reg. UE SFDR 2019/2088 modificato dal Reg. UE 2020/852) nonché alle modifiche al questionario di profilatura MiFID 2 sulle verifiche di adeguatezza con l'introduzione delle "preferenze di sostenibilità" (Reg. del. UE n. 2021/1253), al fine di verificare se la regolazione in campo finanziario sia idonea a ridimensionare i c.d. costi di agenzia e a contenere il rischio di *greenwahing*.

Institutional investors activism is one of the hottest corporate and securities law issues. Particularly, it is well worth asking whether institutional investors can pursue a sustainable corporate governance and how EU securities regulation can foster this role. Today most retail investors hold shares through institutional shareholders, which have therefore the power to request publicly hold corporations to pay attention to sustainability. However, they do so on behalf of their beneficiaries, because they are ultimately bearing the financial results of the corporate management. The key issue is whether the corporate governance behavior of institutional investors reflect the preferences of their beneficiaries, i.e. an agency cost problem. Moreover, institutional investors include a multi-faceted variety of financial intermediaries having different relationship with their beneficiaries. There are actively managed funds and funds passively tracking a market index, which have therefore different incentives to pursue sustainable corporate governance. On these premises the essay aims to provide a synthetic but comprehensive view of how different investment strategies and behaviors of institutional investors can ameliorate the quality of corporate decisions. For this purpose, it is crucial to investigate the role of self-regulation and that of EU securities regulation (particularly the EU Taxonomy Regulation) in coping with the principal-agent relationship's problem and curbing greenwashing.

Summary: 1. Introduction **2.** Institutional owners and their corporate governance activities. A short survey **3.** Engagement, activism, stewardship **4.** The approach taken by the EU legislatures **5.** Different investment strategies and level of engagement **6.** Hegde Funds' Entrepreneurial Activism **7.** Capacity and incentives problems **8.** The Role of EU Securities Regulation in Promoting Sustainable Corporate Governance **9.** Conclusions.

1. Introduction

Foreign institutional investors have been acquiring large block-holdings even in the Italian listed companies over the last decade[1]. The concentration of shareholder ownership in the hands of institutional investors has long been at the center of the international debate in corporate and securities law. In fact, it should be pointed out that only a minority of retail investors hold stock directly[2] and they hardly vote their shares[3]. Most retail investors hold shares through institutional investors, which are therefore the most influential shareholders of publicly held corporations worldwide.

There is indeed a widespread view that the inertia of those investors in monitoring the performance of the investee companies was one of the main causes of the financial crisis of 2008 and that in order to prevent any future crisis it is necessary to require greater accountability of institutional shareholders which can monitor how publicly held corporations act[4].

As a result, the institutionalization of the ownership of listed companies is considered as an instrument of corporate governance to promoting the long-term interests of shareholders and investing into the creation of "corporate wealth".

Particularly, institutional investors have the power to prompt the publicly traded corporations to pay attention to sustainability, but they do so on behalf of their beneficiaries (retail clients of mu-

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[1] According to CONSOB, *Rapporto sulla corporate governance delle società quotate italiane*, Roma, 2022, 4: "At the end of 2020 the presence of institutional investors in the major shareholders of Italian listed companies, although slightly declining compared to the previous year, remains more widespread in comparison with the long-term figure for foreign subjects (participating in 50 firms compared to 36 in 2011), and for the first time over the last decade records an increase for Italian investors (18 companies)".

[2] A. De La Cruz, A. Medina, Y. Tang, *Owners of the World's Listed Companies*, OECD Capital market Series, Paris, 2019, available at: www.oecd.org/corporate /Owners-of-the-Worlds-Listed-Companies.htm.

[3] J.E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, in *Minnesota Law Review*, 2017, vol. 102(1), 11.

[4] S. Alvaro, M. Maugeri, G. Strampelli, *Investitori istituzionali, governo societario e codici di* stewardship. *Problemi e prospettive*, Quaderni giuridici Consob, 2019, n. 19, 6.

tual funds, pension funds and comparable collective investment schemes), that are the so-called "residual claimants", because they bear the ultimately results of corporate management.
Therefore, a key question of sustainable corporate governance is whether the corporate governance behavior of institutional investors is aligned with the preferences of their beneficiaries. There is an agency cost problem.
Institutional investors include a multi-faceted variety of financial intermediaries having different kind of relationship with their beneficiaries. They differ particularly on whether they engage with companies ("voice") or avoid them altogether ("exit").
Under this scenario it is crucial to investigate whether negative externalities produced by corporations and affecting the well-being of individuals ("non-financial stakeholders") can be controlled through corporate governance tools or legislative regulation. Special attention has to be paid to EU securities regulation and its capacity to ameliorate the principal-agent relationship between institutional investors, which have the power to influence corporate decision-making, and their beneficiaries, who may be interested not only in financial results but also in the other stakeholders' wealth.
The remainder of this essay is as follows: the starting point is the analysis of the theoretical framework of institutional investors' activism and the principal-agent relationship between institutional shareholders and their beneficiaries. Secondly, I will try to depict the different investment strategies of institutional investors and how that affect their incentives in pursuing corporate sustainability. Finally, I will examine the approach taken by the EU regulation, particularly securities regulation, which poses the question how establishing mandatory disclosure can support sustainable corporate governance and curb greenwashing.

2. Institutional owners and their corporate governance activities. A short survey

The focus on the relationship between institutional investors and corporate management is not new. Qualitative social scientists have developed an analysis of the relationship between institutional investors and corporate managers. For instance, Useem[5] offers a

[5] M. Useem, *Investor Capitalism: How Money Managers are Changing the Face of Corporate America*, New York, 1996.

comparison of "the rival lenses through which corporate executives and money managers view each other"[6]. Useem's central thesis starts from the assumption that, due to the fact that institutional investors perform as shareholders on behalf of a myriad of savers, there has been a movement from an era of managerial capitalism to one of "investor capitalism", in which institutional investors have substantially reduced the agency costs in corporate governance.

To a certain extent the focus on the confrontation between money managers and executives leads to the idea that the corporate governance role of activist shareholders, besides the strengthening of the market for corporate control, is the best strategy in order to improve efficiency and maximize corporate performance[7].

A further step of this process is "fiduciary capitalism" where financial intermediaries, representing a spectrum of savers and investing widely in large public traded corporations, can play a relevant role in corporate governance as a part of their fiduciary duties to beneficiaries[8].

Since the last decade of the twentieth century some scholars asked for rules changes that enable financial institutions to effectively pressure underperforming companies. Such measures should allow, for example, institutions to coordinate their approach to a particular underperforming company and to communicate directly with management in ways that do not require expensive proxy mechanisms, which can expose institutions to large liabilities.

On these grounds, institutional owners have had to redirect the focus of their corporate governance activities to "monitoring", which encompasses "the informal and formal ways" by which institutions

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[6] J.C. Coffee, *jr.*, *The Folklore of Investor Capitalism*, in *Michigan Law Review*, 1997, 95:1970, 1970-1989, available at: https://scholarship.law.columbia.edu/faculty-scholarship-944.

[7] S. Rossi, *Il diritto della* Corporate Social Responsibility. The legal rules of Corporate Social Responsibility, in *Orizzonti del Diritto Commerciale. Rivista*, 2021, 1, 114-115. The proposition that governance – *i.e.* the rules and institutions by which agents are compelled to act – matters to corporate governance is central to the finance view. Good governance should be equal to the maximization of long-term shareholder wealth. Therefore, the financial model justifies the need for strong, active shareholders and provides an agenda to strengthen rules that allow institutions to force managers to maximize long term shareholders' wealth: see J.P. Hawley, A.T. Williams, *The Emergence of Fiduciary Capitalism*, in *Corporate Governance. An International Review*, 1997, vol. 5(4), 206-2013, 208.

[8] J.P. Hawley, A.T. Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic*, Univ. of Pennsylvania, 2000.

seek to influence the performance of corporations[9]. The various forms of monitoring – that may range from *ad hoc* and informal responses to a crisis to the so-called "just vote not" campaigns – have arisen because institutions have only a limited ability to exercise their right to exit[10].
However, although there is some evidence that while the institutional investor is a more credible antagonist on the political level, from an economic point of view it may be a far weaker opponent. As we are going to illustrate beyond, there are several reasons why organizationally institutional investors – particularly pension funds – are unable to affect behavior at their portfolio companies. Anyway, "the emphasis on how money managers and executives work and play together in the corporate sandbox illustrates the limitations of monitoring"[11].
In this context, a great deal of thinking on corporate governance has focused on developing ways to enable institutional shareholders to stimulate and support the board of directors in playing their traditional role of representatives of the owners. Moreover, some commentators[12] cast corporate governance in general and monitoring in particular in a wider political context. The conclusion was that monitoring of institutional investors has a political dimension in which the "rules of the game" have to be determined by rules and regulations.
This short survey of the reconcentration of the ownership in the hands of financial institutions and of the policy currents in the debate on corporate governance at the end of the twentieth century show some important implications deemed to be developed in the subsequent decades.
Apart from a long-term paradigm shift in corporate law and government policy, the advent of "fiduciary capitalism" with a great concentration of wealth in the hands of relatively few institutions raises serious concerns about "the monitoring of the monitors".

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[9] J.P. Hawley, A.T. Williams, *The Emergence of Fiduciary Capitalism*, cit., 209.

[10] Some scholars (J.C. Coffee, *jr.*, *The Folklore of Investor Capitalism*, cit., 1983 ff. argued that the US market is heavily concentrated and therefore is one with less liquidity. As a result, large investors cannot exercise the right to exit without cost when they are unsatisfied with a particular management performance. To the extent that investors find exit costly, they must turn to "voice" and then become more active shareholders.

[11] J.C. Coffee, *jr.*, *The Folklore of Investor Capitalism*, cit., 1986.

[12] M.J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, Princeton, NJ, 1996.

Such reconcentration in fact adds one more layer of agents between the "real" owners and the agents who runs the firms they own[13]. It is important to add that there is a great variety of beneficiaries for whom the institutional investors act as representatives.
Secondly, authors start to ask what "maximize shareholders wealth" mean, particularly whether the goal of profit maximization is subject to a set of social constraints, since some changes occurred in the structure of the American society and a "sense of community" started to grow[14]. In the effort to identify the model of "investor capitalist" or of "fiduciary capitalist", long-term interests of savers and public interest to long-term combine each other in a corporate economy which could create wealth and sustainability. However, some questions arose with regard to public policies that may benefit the country as a whole either socially or economically, but which may adversely affect individual firms.

3. Engagement, activism, stewardship

On these grounds, institutional investors have been viewed as able to act as "stewards" of the investee companies not only in the US, but also in the UK as well as at the European level.
Even though the variable and arguably inconsistent types of institutional investors make difficult to either frame institutions' role descriptively or conceptualize their role normatively, there seems to be a preponderant focus on the use of corporate governance rights as being expressive of an optimal form of investment management, which deliver a meaningful monitoring of corporate management.
Policy makers have shown an increasing commitment to promoting the quality of engagement between institutions and the management of the corporations. They basically assume that: a) a greater engagement of shareholders (mainly institutional investors) in the investee companies with a long-term perspective (*i.e.* conventionally more than five years) has been able to create positive external effects

[13] J.P. Hawley, A.T. Williams, *The Emergence of Fiduciary Capitalism*, cit., 210, who noted that "owners now have the compound agency problem of getting financial institutions to act in their best interests in getting the managers to act in their best interests. On the surface, an agency chain of this type would seem to make everything much more difficult"; see also R.J. Gilson, J.N. Gordon, *The Agency Costs of Agency Capitalism: Active Investors and the Revaluation of Governance Rights*, in *Columbia Law Review*, 2013, vol. 113, 863, 874 ff.
[14] J.P. Hawley, A.T. Williams, *The Emergence of Fiduciary Capitalism*, cit., 211-212.

for both the real economy as a whole and the investors themselves; b) the "entrepreneurial activism" of hedge funds (whose holding period is 1.7. years) is not to be supported[15].
As a result, many traditional institutional shareholders have moved from a role of mere monitoring of the management of the investee companies to an easier communication and cooperation with the managers, establishing a purposeful dialogue and trying to influence them.
In order to investigate some issues related to the development of corporate governance activities of institutional investors, it is important to distinguish, placing them in relation to each other, the concepts of stewardship, activism and engagement.
The activism embraces the set of initiatives that shareholders take in order to provoke a change of the business strategies of the management, as well as of the composition and functioning of corporate bodies. In other words, activism is the monitoring of management and intervention with the goal of a proper exercise of shareholders' rights.
On the other side, stewardship has been developed all over the world in self-regulated codes, premised upon the advantages of engagement between institutional investors and investee companies and aiming to improve the confrontation and cooperation with corporate boards. According to a changing view, engagement is expected to be more than a reaction to problems that have already developed and would require ongoing, close monitoring of the company's development, at least at a high strategic level[16].
According to the EFAMA Stewardship Code, the existence of engagement turns to be a "condicio sine qua non" for the stewardship activity[17]; however, enhancing the indications contained in the UK Stewardship Code 2020[18], it is not possible a complete assimilation

[15] S. Alvaro, M. Maugeri, G. Strampelli, *Investitori istituzionali, governo societario e codici di* stewardship, cit., 13-14.
[16] S. Alvaro, M. Maugeri, G. Strampelli, *Investitori istituzionali, governo societario e codici di* stewardship, cit., 6.
[17] EFAMA Stewardship Code. Principles for asset managers' voting on, voting in, engagement with investee companies, 2018, retrieved from https://www.efama.org.
[18] In the UK a Stewardship Code was adopted in the wake of the financial crisis of 2007-2009, as a result of a recommendation of the Walker's Review of corporate governance in UK banks and other financial industry entities of 2009. The first version of the Code, which appeared in 2010, was put together by the Financial Reporting Council (FRC), a quasi-governmental agency, but was substantially based on the "Sta-

between the phenomenon of stewardship and that of engagement. In the second version of the UK Stewardship Code, the techniques of stewardship are defined in a more expansive way, so that, although engagement is still given emphasis, it is only one among a broader set of recommended procedures. Stewardship techniques embrace "investment decision-making, monitoring assets and service providers, engaging with issuers and holding them to account on material issues, coalitions around approaches, and exercising rights and responsibilities"[19].

These developments have been driven by the heavy emphasis placed on environmental (especially climate change), social and governance factors (ESG). ESG factors are integrated into stewardship, not simply presented as an odd-on. The mainstreaming of ESG factors into stewardship can be seen also "in the definition of market-wide factors" such as the systemic risks, including the "climate change" [20].

It is remarkable that the EFAMA Stewardship Code expressly mentions the "environmental and social concerns" and "compliance,

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tement of principles" produced by the representative body of institutional shareholders itself about twenty years earlier and revised several times subsequently. The first version of the Code – that was quickly revised in 2012, perhaps because of its origins – was under criticism as it was "not effective in practice". The signatories to the SC, particularly the asset owners and asset managers, passed lightly over the implementation of the stewardship policies. Whilst the first version of the SC can be seen as an adjunct to UK Corporate Governance Code (CGC), which had been based on the model of a monitoring board, the second version contains a much broader concept of stewardship and of the techniques to be deployed to further it than does the first version: P.L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, ECGI Law Working Paper No. 56/2020, retrieved from https://ecgi.global/content/working-papers.

[19] UK Stewardship Code 2020, Principles for Asset Owners and Asset Managers, n. 7. It shall be noted that the second version of the UK Stewardship Code moves away from an almost exclusive focus on engagement as the recommended version of stewardship. Particularly, whilst engagement was a strategy based on "voice", so that "exit" was not thought to count as engagement, buy and sell decisions ("investment decisions") seem to have equal weight with engagement. Therefore, "if engagement is one technique for responsible management and oversight of capital, entrance and exit decisions are another, whilst allocation seems to refer primarily to entrance and exit decisions": P.L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?,* cit., 8.

[20] P.L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, cit., 8-9.

culture and ethics" as matters of engagement[21].
Equally significant is a shift in the UK Stewardship Code so as to have regard not just to the fortune of individual investee companies, but to the market as a whole. It "also recognizes that asset owners and asset managers play an important role as guardians of market integrity and in working to minimize systemic risks as well as being stewardship of the investment in their portfolio"[22].
The above results argue a prompt and "energetic" reaction by financial and economic institutions[23] to some important international agreements and initiatives which aim to encourage corporations to adopt policies of social and environmental sustainability[24]. The Corporate Social Responsibility (CSR) has uncovered the limitations of the "neoclassical" model. When government are unable to reach the first-best allocation of resources correcting the market failures and legislatures do not enact reasonable effective regulations controlling social problems others than the traditional "agency costs" [25], an academic debate arises over the "corporate purpose". The CSR approach claims that corporations acting to reflect the "prosocial" preferences of their stakeholders (including also the shareholders, but not limited to them) improve social welfare as second best.
The "dark side" of this trend could be the concern of institutional investors to avoid stricter regulations compelling them to pursue

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[21] UK Stewardship Code 2020, Principles for Asset Owners and Asset Managers, n. 7 and Reporting Expectation-Outcome, that provides: "Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities"; moreover, "Signatories should explain how information gathered through stewardship has informed acquisition, monitoring and exit decision".

[22] P.L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, cit., 8.

[23] See Blackrock CEO's January 2018 letter and 2019 Business Roundtable "Statement on the Purpose of a Corporation", that sets forth a broad and inclusive conception of the corporation purpose; in the Italian literature it is helpful to refer the essays in A. Perrone (ed. by), *Lo* statement *della* Business Roundtable *sugli scopi della società. Un dialogo a più voci*, in *Orizzonti del Diritto Commerciale. Rivista*, 3/2019, 589 ff.

[24] The various political proposals stemming from the critiques against the "shareholder primacy" are mentioned by E. Rock, *For Whom is the Corporation Managed in 2020?: The Debate over Corporate Purpose*, ECGI Law Working Paper No. 515/2020, 1 ff.

[25] E. Rock, *For Whom is the Corporation Managed in 2020?: The Debate over Corporate Purpose*, cit., 5, according to whom the above "agency costs" are fundamentally three and emerge from the divergence of interests between: shareholders and managers, controlling shareholders and non-controlling shareholders, shareholders and creditors.

long-term perspective in their asset management activity. Likewise, the renewed interest showed by the managers of corporations towards social responsibility could be explained on the basis of the relationship with the providers of capital and with the goal to constrain the pressure by institutional investors on the short-termism and to look at the non-financial stakeholders' interests[26].

4. The approach taken by the EU legislatures

The ideas referred to above seem to permeate even the efforts of the European Union (EU) in corporate matter.

The Directive (EU) 2017/828 (the so-called Shareholder Rights Directive II) regards the encouragement of long-term commitment by shareholders of listed companies in corporate governance in conjunction with the pursuit of ESG goals.

In developing the basic assumption that active commitment of investors may produce good results from a long-term perspective, the SRD II extends in turn in five main directions: a) facilitating the exercise of shareholders' rights in listed companies by means of the transmission of information along the whole "investment chain" (*i.e.* the chain of intermediaries that often hold shares for their beneficiaries); b) encouraging the communication of companies with their shareholders and the various stakeholders; c) increasing the disclosure of institutional investors and asset managers in relation to the policies of engagement towards the investee companies; d) providing for the involvement of shareholders in establishing policies for the remuneration of directors and voting on the Remuneration Report that outlines the fees paid; e) improving the transparency and control by shareholders concerning transactions with related parties.

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[26] S. Rossi, *Il diritto della* Corporate Social Responsibility, 102-103, nt. 5.; E. Rock, *For Whom is the Corporation Managed in 2020?*, cit., 4-5, who notes that "[t]he combination of frustration with legislative inaction and fear of radical future regulation has brought forth a plethora of ideas that can be implemented through private sector initiatives. This include Lipton's 'New Paradigm', the Davos Manifesto, and 'Commonsense Corporate Governance Principles', as well as new groups that are trying to forge a new consensus as the 'Investor Stewardship Group', and 'Coalition for Inclusive Capitalism'. The various efforts to bring greater attention to 'ESG' or 'Environmental Social and Govermance' matters in the boardroom, including a board level focus on climate change, diversity and human capital, are of a piece with the effort to converge on a more sustainable system".

The engagement policy has to include a description of the methods by which the investee companies are monitored on important issues such as strategy, financial and non-financial performance, risks, capital structure, the social and environmental impact and corporate governance.
Institutional investors are obliged to inform the market annually that their investment strategy is (or isn't) in line with the long-term prospects of their customers, providing a description of the behavior and an explanation of the most significant votes and any use of proxy advisors[27]. They must also disclose to the public how they voted at the general shareholders' meeting of the company of which they are shareholders.
In the approach taken by the European Commission, the participation of shareholders should be expressed by active supervision of the issuer, dialogue with the board of directors and exercise of the shareholders' rights, including possibly voting rights and cooperation with others shareholders in order to improve the governance of the company in which they invest their money.
The Commission encourages the long-term commitment by the investors and other non-market goals[28] on the assumption that the long-term perspective is better than the short-term one[29]. For this reason, the Shareholder Rights Directive includes a number of rules that curb, albeit marginally, hedge fund activism[30] for want of a long-term en-

[27] Art. 3 *octies*, para. 1, lett. b), of the Directive (EU) 2017/828; it is also relevant art. 3 *decies*, para. 1, referred to «Transparency of asset managers», which provides that the annual disclosure made by the asset managers to the institutional investors "shall also include information on whether and, if so, how, they make investment decisions based on evaluation of medium to long-term performance of the investee company, including non-financial performance, and on whether and, if so, which conflicts of interests have arisen in connection with engagements activities and how the asset managers have dealt with them".
[28] An impressive overview of the main contents of the SRD II is sketched by P. Montalenti, *L'interesse sociale: una sintesi*, in *Riv. soc.*, 2018, p. 312 ss., according to whom the EU legislatures are not only oriented to a long term perspective, but also towards profit oriented strategies taking account also of the stakeholders' interests; moreover, the EU encourages the introduction of corporate governance tools which should be able to promote the dialogue between "qualified shareholders" and management.
[29] At a theoretical level it is quite controversial that favoring the interests of long-term shareholders could increase the value generated by a firm over time: J.M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, in *Yale Law Journal*, 2015, 1554-1628; in the Italian literature, see – among others – M. Stella Richter, *jr.*, *Long-Termism*, in *Riv. soc.*, 2021, 16 ff.
[30] A.M. Pacces, *Hedge Fund Activism and the Revision of the Shareholders Right Directive*, ECGI-Working Paper No. 353/2017, 1-25, retrieved from: https://ssrn.com/ab-

gagement of institutional investors, such as pension funds and insurance companies, which are therefore set apart from the others. In the Commission's view, they should have in fact a primary interest in engaging actively in corporate governance.
Anyway, some prominent scholars[31] pose the question whether a profit-oriented strategy can take into account the interests of stakeholders. Moreover, given the increased number of the interested parties, who have to confront each other and reach proper compromises, it could be easier to reconcile the long-term and the short-term perspectives. It could be possible for some groups to concede immediately something with the view to get a compensation through a future benefit.
It shall be useful to add that the European Commission[32] and the European Parliament[33] have proposed a sustainable corporate governance framework based on due diligence obligations towards all company stakeholders. That approach to corporate sustainability due diligence can be seen as an attempt to make corporations internalize negative externalities on human rights and the environment by way of due diligence obligations in the group and the supply chains. Although the analysis of EU Corporate Sustainability Due Diligence Directive (CSDDD) proposal is out of the scope of this essay, there is some doubt that the proposal is able to impose direct constraint to the decision-making of the corporation requiring corporate managers not to pursue only profit, but to balance the different interests of shareholders and non-shareholders constituencies such as suppliers, customers, employees, and the society at a large[34].

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[31] F. Denozza, *Quale quadro per lo sviluppo della* corporate governance?, in *Orizzonti del diritto commerciale. Rivista*, 2015, 13; A.M. Pacces, *Hedge Fund Activism and the Revision of the Shareholders* Right Directive, cit., 4.

[32] European Commission, *Sustainable corporate governance. Inception Impact Assessment*. Ares (2020) 4034032 (30 July 2020), available at: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives /12548-Sustainble-corporate-governance_en.

[33] European Parliament, *Resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability*. 2020/2129(INL), available at: https://www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.html. After several delay, the Commission finally published its proposal for a Directive on Corporate Sustainability Due Diligence on February 2023, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0071.

[34] E. Barcellona, *La* sustainable corporate governance *nelle proposte di riforma del diritto europeo: a proposito dei limiti strutturali del c.d.* stakeholderism, in *Riv. soc.*, 2022, 1 ss.

5. Different investment strategies and level of engagement

When exploring whether the engagement of institutional investors is likely to produce better corporate decisions, it is useful to keep in mind that the answer may differ according to the investment strategy followed by asset owners and asset managers.
In fact, although investment strategy is a broad concept, different level or type of engagement can be contemplated according to the fact that funds are passively or actively managed. Active and passive funds can be considered separately, although the distinction is complicated by the fact that large asset managers – including, but not limited to the Big Three (BlackRock, Vanguard and State Street Global Advisors) – today combine passive and active strategies into so-called "fund-families"[35].
It should be pointed out that many commentators are skeptical that institutional investors can ameliorate corporate governance, let alone to lead to a sustainable corporate governance. The institutionalization of shareholders' ownership has produced a variety of institutional investors' typologies, whereas the role they play in terms of corporate governance is a tool of their investment strategy and reflects the commercial constraints connected to their business model.
Most institutional investors – particularly mutual funds and pension funds – are diversified, both for legal and non-legal reasons. Many are also "indexed", meaning that they make no decision as to which shares to invest in or about the weight of the investment in any specific stock. When they choose the index they will track, the only thing they have to do is making the buying and selling decisions consequently. In comparison with the other principal type of investment strategy, that is stock picking, index funds offer diversification at a lower price and cannot underperform the market[36].
Due to the diversification, the shareholding held in each company is normally only a small part of the total assets managed by the in-

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[35] A.M. Pacces, *Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?*, ECGI Law Working Paper No. 611/2021, 15, available at: https://ecgi.global/content/working-papers.

[36] J.C. Coffee, *jr.*, Pres*erving the Corporate Superego in a Time of Activism: An Essay on Ethics and Economics*, 2016, 11, available at: https://scholarship.law.columbia.edu/faculty_scholarship/2002.

stitutional investors, as well as of the specific funds.
The high portfolio diversification causes a disproportion between the costs of monitoring (collection of specific information on the company, communication with directors, organization of possible proxy solicitation) and the revenues earned in case of success. Where the institutional investor follows a policy of extreme diversification, its targets are necessarily constrained by its logistic inability to meaningfully engage with all the companies whose stocks they hold. Even the Big Three are underequipped. They have a thin staffing that must result in an overload problem that could discourage any serious attempt of engagement, whereas smaller index fund managers tend to follow the proxy advisors[37].
There is also a high degree of competition in the market of mutual funds and collective investment schemes. In case of pension funds, investment decisions are delegated to external money managers, who compete for the company's pension business. Thus, a large corporation may at any time have a number of outside pension managers handling in pension's assets, who all actively compete with one another. This create a coordination problem due to the fact that different fund managers can and do vote differently on the same issue and find it difficult to cooperate when they are in competition for the client's business[38].
Index funds as well as pension funds still face collective action and free-riding problem by other funds who have invested in the same companies. Collective action among a dispersed coalition will be costly. In the US those institutions who lead the fight must often incur the considerable expenses of proxy fights and litigation, but they have limited way of taxing the free-riders, who may benefit from these expenses but do not want to pay for them[39].
Some synergies reducing the cost of engagement and increasing its benefits can be developed by operating fund families, that ben-

[37] P.L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, cit. , 13-14, who points out that "not all forms of effective engagement are beyond index funds. In fact, in the case of management or hedge funds proposals, the functional capacity of institutional shareholders, even index funds, to engage appears not to be a serious cause for concerns". The point rather is that voting by index funds is often "reactive", so that "in the core area" for the UK Stewardship Code, index funds are not viewed as reliable initiators of fundamental corporate governance changes.
[38] J.C. Coffee, *jr.*, *The Folklore of Investor Capitalism*, cit., 1975-1976.
[39] J.C. Coffee, *jr.*, *The Folklore of Investor Capitalism*, cit., 1976.

efit from managing simultaneously index funds, which can not be distinguished from competitors, and active funds that are unique. These synergies within fund families can incentivize the use of voice, engaging with companies on "cross-cutting issues", such as environmental sustainability. Most importantly there can be flows of specific firm information between the investment teams and the engagement teams, who know where companies will be going in terms of cross-cutting issues. Therefore "index fund managers engaging with the companies on material sustainability issues generate returns for sister active funds that not only can rebalance their portfolio, but also benefit from higher inflows of sustainability-minded beneficiaries into the family. Active fund managers sharing information with engagement teams reduce the cost of tailoring general engagement policies to the specific company being engaged"[40].

And yet, someone could say that institutional investors, particularly index funds, are not yet completely aware of the opportunity and the role that they should play. Index funds have attracted enormous investment in recent years and thus have gained high voting power. Due to the fact that most retail investors do not exercise directly their voting rights, the stakes held by index funds often result in effective control by a handful of asset managers[41], especially in companies where there is a higher concentration of institutional investors ownership.

This scenario raises the problem of index funds incentives and provides comprehensive empirical evidence of their stewardship activities. Some commentators note that the Big Three and other institutional investors are "excessively deferential to corporate managers"[42]

[40] A.M. Pacces, *Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?*, cit., 17, who reminds the case of Blackrock, where engagement and investment teams share information on a platform called Aladin. However, conflicts of interests can arise among passive and active funds managed by the same adviser; and due to the fact that advisers charge higher fee to active funds than to passive funds, advisers who manage both types of funds may have incentives to benefit active funds at the expense of passive funds: E. Rock, M. Kahan, *Index Funds and Corporate Governance: Let Shareholders be Shareholders*, in *Boston University Law Review*, 2020, 100:1771, 1771-1815, 1811, available at: https://ssrn.com/abstract=3295098.

[41] L.A. Bebchuck, S. Hirst, *The Specter of the Giant Three*, in *Boston University Law Review*, 2019, 99(3), 721-741, who also analyze the key factors that have conducted to the heavy concentration of the index funds markets: scale economies, liquidity advantages offered by exchange-traded funds ("ETFs") having large assets and the ability of index funds managers to compete quickly with the new products launched by their rivals.

[42] L.A. Bebchuck, S. Hirst, *The Specter of the Giant Three*, cit., 729. In a different but

and rarely vote against them. One has to keep in mind that behind-the-scenes negotiations and compromise, where a number of large institutional investors are represented by a common agent, may be effective, including on corporate sustainability[43]. The presence of large institutional investors acts as a credible threat equally to voting particularly in countries where not all publicly listed companies have a controlling shareholder and many existing controlling shareholders can be outvoted by a coalition of institutional investors.

It is important to bear in mind that two factors may contribute to the success of the index funds' engagement and their dialogue with the investee companies.

Firstly, their expertise lies in tracking an index with minimum error and with minimum cost. Therefore, they are permanent shareholders apart from the extreme case of changing index[44].

Secondly, large index funds cannot do exit without costs when they are dissatisfied with a particular management performance. Rather they are locked in. To the extent that investors find exit costly, they have to turn to the alternative remedy of voice and then become more active shareholders[45]. It is relevant to take notice that institutional investors tend to favor broad goals, such as environmental policies on climate change, that apply to many firms and can be formulated in general terms, rather than firms-specific issues that require a particular analysis[46].

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complementary view, some scholars focus on the managers' deference to proxy advisors, because of the growing importance of their recommendations that tend to exceed even the relevance of the corporate governance codes: for a thorough analysis of the subject, see F. Murino, *Impegno, monitoraggio e consulenza di voto nella s.p.a. quotata "sostenibile"*, Pisa, 2023, 38 ff.

[43] It can be noted that behind-the-scenes engagement "may be effective economics, but poor politics". On these grounds, "both corporate managers and public pension funds may prefer high profile face-offs to quiet bargaining between a coalition of investors and an individual corporate management": J.C. Coffee, *jr.* (1997), *The Folklore of Investor Capitalism*, cit., 1978.

[44] J. Fichter, E.M. Hemskeerk, J. Garcia Bernardo, *Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and the new Financial Risk*, in *Business and Politics*, 2017, 19(2), 298-326, 300; in the Italian literature see S. Gilotta, *Il dialogo selettivo tra la società quotata e i suoi azionisti*, Milano, 2022, 23-24.

[45] J. Fichter, E.M. Hemskeerk, J. Garcia Bernardo, *Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and the new Financial Risk*, cit., 307, who warn about the implications that the index funds cannot credible claim to exit a company based on the assessment of corporate performance.

[46] Basically, the point is that the diversified institutional investor will virtually never

6. Hegde Funds' Entrepreneurial Activism

Activist funds are a subset of hedge funds. Originally, hedge funds claim to be better stock pickers thanks to better research and analysis, but, in reality, some of them failed to live up to this standard. Other hedge funds presented themselves as "quantitative" funds who can exploit market anomalies through the use of complex algorithms. Again, while some succeed, others failed. Such funds have only limited interest in voting. However, instead of seeking the best stocks, hedge funds started to identify mediocre companies and attempt to force a sale or break-up of these firms.

Hedge funds have a different business model than the other institutional investors, particularly the mutual funds, as the activist campaigns reveal: a) hedge funds are essentially undiversified, and most of them hold relatively small portfolios in terms of the number of stocks held; b) unlike mutual funds, they typically have significant staff, thus they can identify companies where management changes may unlock "negative synergy" (*i.e.* the difference between the value of the firm's assets and its lower stock price), or provoke a sale to a new bidder; c) hedge funds employ a compensation formula that encourages their managers to accept high risks[47].

Particularly, hedge funds' managers charge a performance fee in addition to a percentage of the assets under management. This aligns their incentives with investors having a relative high appetite for risk. Hedge funds profit from investing in stock that they can buy, hold and resell at a higher price. The purpose of entrepreneurial activists' engagement with the management of the target company is to accomplish meanwhile a change that will increase the stock price.

Hedge funds activism consistently succeed wherever institutional ownership is concentrated, but it is not always value increasing. Some prominent academics[48] pointed at the central issue of hedge

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initiate a firm-specific shareholder proposal. They usually vote against management because the proxy advisor had recommended such a vote (J.C. Coffee, *jr.*, *Preserving the Corporate Supergo in a Time of Activism*, cit., 12-13.). That happens because a "pro-active" engagement where a company is underperforming requires to develop "more precise measures, a more detailed analysis […]. Without such analysis, it is hard to pinpoint the cause for low performance and to recommend specific changes": see E. Rock, M. Kahan, *Index Funds and Corporate Governance: Let Shareholders be Shareholders*, cit., 1808.

[47] J.C. Coffee, *jr.*, *Preserving the Corporate Superego in a Time of Activism*, cit., 29.

[48] J.C. Coffee, *jr.*, *Preserving the Corporate Superego in a Time of Activism*, cit., 29, 16 ff., who noted further: "The point is not that hedge funds are evil, amoral or dangerous, but

funds' entrepreneurial activism: whist activist hedge funds are replacing traditional pension funds and mutual funds as the primary catalyst in corporate governance, it is remarkable to ask "why this transition imply a shift in the direction of a greater risk tolerance".
A fundamental critique moved at hedge funds is that they may succeed without any screening by institutional investors, if they act as a coalition, namely a so-called "wolf-pack"[49]. This tactic could enable the participants to engage in informed trading based on material non-public information, to escape old corporate defenses (most notably the poison pills) and to gain high profits at seemingly low risk. However, the impact of wolf packs tends to be overestimated[50].
Another recurrent objection to hedge funds' activism is short-termism. This is the most difficult concern to handle because short-termism is seldom well defined and means different things to different beholders.
In detail, the above referred concern is that the hedge funds' activism is associated with a pattern involving three key-changes in the target firm: 1) an increase of the leverage; b) higher payouts for the shareholders either by distributions of dividends or stock buybacks; 3) a reduction in the company's long-term investments in research and developments (R&D) and the resource to finance them. The leading proponents[51] of hedge funds' activism name this context "investment-limiting" interventions. They agree that such context is prevailing, but at the same time they affirm that it leads to optimal investments' levels.
In general, according to the "myopic-activist" claim intervention by activist hedge funds pushes for actions that are detrimental to

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that in their 'engagements' with public corporations, they will be regularly pushing the firms they engage towards higher leverage and riskier strategies. Because they are today the driving force behind shareholder activism, this implies that activism is increasingly leading to greater risk".

[49] J.C. Coffee, *jr.*, D. Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, Columbia University School of Law-Working Paper No. 521, 2015, 1-107, especially 28 ff., available at: https://ssrn.com/abstract=2656325; Y.T.W. Forrester, *Wolves at the Door: A Closer Look at Hedge Fund Activism*, October 2, 2016, available at: https: ssrn.com/abstract=2721413, providing empirical evidence that lead activists tip their trading partners before publicly disclosing or filing the Schedule 13D which the 1934 Security Exchange Act requires investors to file within 10 days of first acquiring five percent of any class of securities of a publicly listed company.

[50] A.M. Pacces, *Hedge Fund Activism and the Revision of the Shareholder Rights Directive*, cit., 9.

[51] L.A. Bebchuck, A. Brav, W. Jiang, *The Long-Term Effects of Hedge Funds Activism*, in *Columbia Law Review*, 2015, 115, 1085-1156, 1135 ff.

the long-term interests of companies and their shareholders. Again, this argument is rejected as it is not borne out by the empirical evidence[52].
Hedge funds are not short-terminist in the conventional sense of "cutting and running".
This result says nothing about whether the stock market is myopic relative to some horizon longer than the activist's holding period (1.7. years on average).
The "right" horizon to maximize profit is endogenous to the company's business and the state of product market competition.

7. Capacity and incentives problems

One should ask whether activist hedge funds could be able to reduce agency problems between corporate managers and their dispersed shareholders. If abnormal stock returns occur because of the hedge funds' actions in reducing managerial agency problems, then one should observe changes in real variables, including changes in corporate governance, reduction of excessive managers' compensation, movement away from non-optimal capital structure. However, most of evidence suggested the positive abnormal returns are not significantly related to such changes[53]. These results show that hedge funds have strong stock selection skills and the ability to identify underperforming firms as targets, but do not support the hypothesis that activists cause positive abnormal stock returns: in fact, target stocks do not outperform control stocks over the long-term[54].
In addition, some academics[55] claim that it is myopic to applaud the rise of activism and to see its underlying corporate governance issues as involving only the tensions between managers and shareholders. Other stakeholders have interests that are put in trouble by hedge funds activism, particularly creditors. But whilst creditors can legitimately contract with the corporation to protect themselves,

[52] L.A. Bebchuck, A. Brav, W. Jiang, *The Long-Term Effects of Hedge Funds Activism*, cit., especially 1101 ff., who find that buy and hold stock returns are positive in the three-years and five-years after the Schedule 13D filing.
[53] J.C. Coffee, *jr.*, D. Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism in Corporate Governance*, cit., 75 ff.
[54] K.J.M. Cremers, E. Giambona, S.M. Sepe, Y. Wang, *Hedge Fund Activism and Long-Term Firm Value*, 2018, 1-66, available at: https://www.ssrn.com/abstract=2693231.
[55] J.C. Coffee, *jr.*, *Preserving the Corporate Superego in a Time of Activism*, cit., 31.

other non-financial stakeholders, such as workers, local communities and consumers, can be harmed by the use of governance leverage by hedge funds. If these inchoate communities are not in a position to contract, the board should be able to act on behalf of them. This test should cast light whether the board is called to mediating a conflict between shareholders and stakeholders.

The key point for our reflections is again that institutional investors (especially pension funds and mutual funds) are themselves agents and not ultimate investors[56]. Therefore, the question is whether the institutional investors' decisions – as agents who monitors the company's board – truly reflect the views and values of the ultimate beneficial owners. There is some widespread opinion that, in determining the best interests of the beneficiaries, institutions and money managers can take into account the prosocial preferences of the beneficiaries themselves and, on this basis, can legitimately decide to avoid socially controversial assets, that put financially at risk their portfolios[57]. Not very differently, some authors argue that institutional investors are allowed to pursue goals other than profit maximization only if they have a specific ESG mandate, that would naturally lead to exit from non-ESG investments.

The relevant issue is how institutional investors respond in terms of corporate governance activities to the increased saliency of environmental sustainability for their beneficiaries.

On the other hand, some authors[58] note that both index funds and stock pickers have only limited incentives to engage beyond voting or the enforcement of market-wide best practices. Therefore, it is ques-

[56] One should consider that the notion of stewardship itself is a functional concept, in so far as it is characterized by the obligation on the manager to act in the best interests of its "own" clients and by the subsequent consideration of the exercise of shareholders rights as a part of the "whole investment process" carried by the manager. In Italy, according to art. 35-*decies*, lett. e), TUF, intervention and voting by fund managers, Sicav and Sicaf, are significantly influenced by the pursue of the ultimate owners' interest. Voting, that is not exhaustive of stewardship, is typically the object of an obligation aimed to pursuing an others' interest, or a power, that is a "purpose" in its technical meaning: M. Maugeri, Proxy advisors*, esercizio del voto e doveri "fiduciari" del gestore*, in *Orizzonti del diritto commerciale. Rivista*, 1-17; M. Stella Richter, *jr.*, *Intervento e voto con strumenti finanziari di pertinenza di fondi comuni di investimento*, in R. D'Apice (*ed. by*), *L'attuazione della MiFID in* Italia, Bologna, 2010, 437-461, 444.

[57] M. Maugeri, *Informazione non finanziaria e interesse sociale*, in *Riv. soc.*, 2019, 992-1031, 1023.

[58] P.L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, cit,, 18.

tionable whether reputational incentives can change the situation.
In the UK there is some evidence that reputational incentives encourage adherence to the soft law, particularly to the Stewardship Code. Under the first version there has been the introduction of a public tiering system, based on the assessment of the quality of the Stewardship Code signatories' engagement policies.
Although there were no overt sanctions for an institution which failed to achieve to top-tier, many did. One can argue that an incentive operating here was to avoid governmental action which might turn a "comply or explain" approach into a more intrusive regulation[59].
The reporting requirements for Stewardship Code signatories in relation to their engagement outcomes have been enhanced under the second version. Besides disclosing their engagement strategies (including its escalation if the initial engagement is unsuccessful), the Stewardship Code 2020 requires signatories to disclose "the outcomes of engagement that is ongoing or completed in the preceding 12 months", included the results of any collaborative engagement or escalated engagement. The annual reporting requirement aims obviously at "keeping up the pressure of signatories to the Code", but it is uncertain that it represents the appropriate one. Ironically the result of the detailed annual reporting requirement of engagement could be that it will undermine the commitment to increase the long-term value of investee companies, but it will certainly produce reportable events[60].
Reputational incentives may in fact operate more effectively in relation to ESG factors, including climate change. If beneficiaries change their preferences in favor of ESG, the investment model of institutional investors will adjust accordingly.
It is significant that according to the UK Stewardship Code the benefits for the economy, the environment and the society are expected to be produced by the creation of a long-term value for investors,

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[59] P.L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, cit., 18; however, some authors complains that the Financial Reporting Council's tiering has only "limited impact on the stewardship topics revealed by the disclosure statement": D. Katelouzou, *The Rhetoric of Activist Shareholder Stewards*, EGCI-Law Working Paper No. 636/2022, 2022, 1-84, 11, available at: http://ssrn.com/abstract_id=4057118.
[60] P.L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, cit., 22.

not independently of investor value[61].

However, if the argument that companies with high ESG scores perform better than companies with lower ones is true, then the case for ESG investing will fit easily with the standard business models of both index tracking and stock picking funds, without the need to identify reputational incentives to add to the business model incentives[62].

To such extent non-financial disclosure[63] can ensure a link between ESG disclosure and firm performance and act as an incentive for the corporate management to pursue interests of communities other than shareholders. It also provides an essential basis in order to permit asset managers to fulfill the obligation to disclose how much of their total investment are taxonomy-aligned[64].

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[61] See UK Stewardship Code, Principle 1.

[62] P.L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, cit., 24. A very interesting perspective looks at the positive externalities stemming from the adoption of socially responsible behaviors by some firms even though they could contrast the profit maximization. Such positive externalities can lead to a whole increase of the portfolio's value managed by institutions and money managers and, as a result, of the share owned by the single beneficiary. This is the case of the so-called "big polluters", few multinational firms producing the most part of greenhouse gas emissions and thus causing the problems related to the climate change, that is in turn the source of systemic risks. If the big polluters are compelled to reduce the greenhouse gas emissions also through actions which contrasts with the profit maximization's goal, their stock value decreases, but it leads to positive returns for other stock values. Even the investor moved by appetite for profit, but who holds a share of that portfolio will be rationally interested in such actions. To sum up, institutional investors have been increasing their engagements with portfolio companies on environmental issues, whereas the presence of institutional share ownership significantly increases portfolio firms' environmental performance. Quite surprisingly, they are pursuing profit maximizing goals unrelated to any personal moral agenda, but this profit maximization is directed at the portfolio, rather than at firm level. Investors address negative externalities at their source, as they want to minimize harms to their broader portfolio: see M. Condon, *Externalities and the Common Owner*, in *Washington Law Review*, 2020, 95: 1, 1-81.

[63] The definition "non-financial reporting" is used as synonymous with "sustainability reporting", which is preferred in the context of the Corporate Sustainability Reporting Directive (CSRD), which entered into force on January 5th 2023, as it is more comprehensive embracing also relevant financial information released by the listed companies and principally addressed to shareholders and investors: G. Strampelli *L'informazione finanziaria tra sostenibilità e profitto*, in *Analisi giuridica dell'economia*, 1/2022, 145-164, 145-146.

[64] G. Strampelli, *L'informazione finanziaria tra sostenibilità e profitto*, cit., 147; see para. 8, *infra*.

However, a problem of greenwashing has to be faced. On one hand, the availability of many ESG metrics, which diverge to a large extent, creates incentives for companies and institutional investors to arbitrage between ratings to get a good score at the least cost. On the other, someone[65] argues that "ESG combines different prosocial goals, most of which are hard to measure and even harder to weight against each other. Although rating providers publish more granular information about the single E, S, and G elements, this does not solve the problem. Not surprisingly unreliable ESG ratings undermine beneficiaries' ability to reduce negative externalities by picking institutional investors committed to sustainable corporate governance. Likewise, unreliability weakens institutional investors' capacity to commit because of adverse selection".
In the European dimension, it is necessary to investigate whether the law can enable beneficiaries to distinguish the behavior of institutional investors focusing on climate change from greenwashing and support sustainable corporate governance on a broader scale. A way to curb greenwashing should be a regulation establishing mandatory disclosure that supports institutional investors' credible commitment, recognizable by beneficiaries, to pursue the environmental sustainability of the investee companies. Disclosure should be based on a standardized metric, allowing for comparison and external verification, for instance by courts enforcing the commitment. These characteristics should have a credible "signaling" effect, then costlier to imitate by greenwashing. Regulation should also include rules of conduct ensuring that retail investors understand mandatory disclosure and use it in making investment choices which are able to match their nonfinancial preferences[66].

8. The Role of EU Securities Regulation in Promoting Sustainable Corporate Governance

The final remarks of this essay will look at the EU securities regulation and its ability to reduce the agency problems in the relationship between institutional investors and their beneficiaries.
Assuming that a prominent goal of securities regulation is investor

[65] A.M. Pacces, *Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?*, cit., 8.
[66] A.M. Pacces, *Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?*, cit., 8-9.

protection, including the enhancement of retail investors' knowledgeable choice of investment products, and this goal has been traditionally pursued by securities regulation through mandatory disclosure, one has to be mindful either of the limitations of such approach[67], in general, or of the further implications of sustainability, in particular.

Notwithstanding, the European legislator has embarked on a very ambitious and comprehensive strategy not limiting its initiatives to engagement, but also aiming at reforming the whole securities regulation having regard to the sustainability.

From this point of view, it is important to mention the Sustainable Finance Action Plan[68], which has resulted in a significant overhaul of EU securities regulation, introducing a regulatory taxonomy of sustainable economic activities. In order to implement the above Action Plan, the EU legislator has taken three regulatory initiatives: 1) first, the Sustainable Finance Disclosure Regulation (SFDR)[69], introducing a system whereby every institutional investor offering financial products in the EU must publish qualitative and quantitative information about the impact of their investments on sustainability; 2) second, the Taxonomy Regulation (TR)[70], that has established a system whereby every investment, offered in the EU, that claims an impact on sustainability must corroborate this claim quantitatively, in terms of alignment with a regulatory taxonomy of sustainable economic activities; 3) third, the overhaul of the MiFID[71], that will mandate the inclusion of sustainability preferences – framed in terms of the above-mentioned regulations – in suitability and prod-

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[67] J. Armour, J. *et a*l., *Principles of Financial Regulation*, Oxford, esp. 80 ff.; N. Moloney, *How to Protect Investors. Lessons from the EC and the UK*, Cambridge, 2010, 45 ff.; for the Italian sectoral discipline, A. Perrone, *Servizi di investimento e regole di comportamento. Dalla trasparenza alla fiducia*, in *Banca borsa titoli di credito*, 2015, I, 31-42.

[68] European Commission, *Financing Sustainable Growth*, Bruxelles, March 8, 2018, COM (2018) 97 final.

[69] Regulation (EU) 2019/2088 of the European Parliament and the Council on sustainability-related disclosures in the financial services sector (SFDR), Official Journal, L317, 1-16, 2019.

[70] Regulation (EU) 2020/852 of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088 (Taxonomy Regulation), Official Journal, L198, 13-43, 2020.

[71] Directive 2014/65/EU of the European Parliament and the Council amending Directive 2013/34/EU as regards disclosures of non-financial and diversity information by certain large undertaking and groups (NFRD), Official Journal, L330, 1-9, 2014.

uct governance obligations of financial intermediaries[72].
The SFDR has a very broad scope, as long as it applies to virtually every institutional investor and asset manager that offers financial products in the EU. It requires fund managers to disclose in their reports and websites how they tackle sustainability risk and the Principal Adverse Impacts (PAIs) of their investments on sustainability goals, detailed by secondary regulation. If institutional investors choose not to disclose, they must explain their choice. Extensive disclosures are mandated at the product level as well. There are three types of financial products that can be offered in the EU according to the SFDR. First are art. 9, or so-called 'dark green' products, which have sustainable investment (*i.e.* contributing to an environmental or social goal, without harming any of these and featuring good governance practices) as their objective and must disclose how this objective is pursued concretely. Second are art. 8, or 'light green' products, which promote, among others, environmental or social factors and must disclose how these factors are met concretely. Third are all conventional financial products, which do not pursue sustainability, but must nevertheless disclose how they integrate sustainability risks into investment decision-making (art. 6) and their PAIs on sustainability factors (art. 7), unless they explain why either sustainability risks or PAIs are irrelevant for their investments[73]. The attention paid to the quantitative dimension is important in this framework because, in principle, it enables retail investors to compare institutional investors and their financial products' scores in terms of negative externalities. However, to the extent that sustainability also involves the transition to technologies that generate fewer negative externalities, the SFDR mainly prescribes on the investment in transition explanations in a narrative way, which are complemented by the EU Taxonomy.
The Taxonomy Regulation is the first step of a very comprehensive project of the EU, aiming to establish a full classification of sustainable economic activities based on standards endorsed by regulation.

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[72] For a detailed overview of the three main characteristics of the Action Plan and their ability to align institutional investors' incentives with the sustainability preferences of their beneficiaries, see A.M. Pacces, *Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?*, cit., 9 ff.
[73] The SFDR is in force since March 2021. The disclosure templates and the quantitative and qualitative indicators of PAIs are specified by Regulatory Technical Standards that applied from 2022.

The project has started from environmental sustainability, focusing on two environmental objectives: climate change mitigation and adaptation, whose pertinent standards already apply since 2022.
Basically, according to the TR an investment is taxonomy-aligned to the extent that it finances taxonomy-aligned activities. Due to the fact that the standards set a quantitative threshold for every activity considered, an investment's degree of taxonomy alignment is represented through a straight percentage which is easy to identify by retail investors. The Taxonomy Regulation mandates disclosure of taxonomy alignment for several entities – including the financial and nonfinancial firms subject to the Non-Financial Reporting Directive (NFRD)[74] and now all companies subject to the Corporate Sustainability Reporting Directive (CSRD)[75] – and financial products, adding a straightforward quantitative dimension to the broad scope of SFDR. The Taxonomy also applies to the three categories of financial products defined by the SFDR. Dark green products will have to disclose the proportion of sustainable investment that is taxonomy-aligned in connection to a specific objective, as a percentage of all investments. Likewise, light green products will have to include such a disclosure to the extent that they promote environmental characteristics by including sustainable investments, specifying that the remaining portion of the underlying investments "does not take into account the EU criteria for environmentally sustainable activities". Such a negative disclosure also applies to all the conventional products that make no sustainability claim. These will have to include a warning that the financial product "does not take into account the EU criteria for environmentally sustainable activities" (art. 7 TR).
In this context, all asset managers offering products in the EU will have to disclose how much of their total investments are taxonomy-aligned. However, as mentioned before, institutional investors

[74] Directive 2014/95/EU of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosures of non-financial and diversity information by certain large undertakings and groups (NFRD), Official Journal, L330, 1-9, 2014.

[75] It is worthy of note that the already mentioned Directive 2022/2464 of the European Parliament and the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, and Directive 2013/34/EU, as regards corporate sustainability reporting, Official Journal, L 322/15, 16.12.2022, extends the scope of reporting obligations to a much wider set of companies headquartered or operating in the European Union, included the listed SMEs, expect listed micro enterprises.

must rely on issuers for fulfilling this obligation, but issuers are only obliged to publish the proportion of taxonomy-eligible activities for the year 2022 (in 2023) and their taxonomy alignment for the year 2023 (in 2024). Moreover, non-EU issuers are not subject to the Taxonomy and many economic activities are not included in the Taxonomy. Thus, in the initial phase disclosing this kind of information will be challenging for institutional investors[76], who are expected to have a strong incentive to calculate – and ask their investee companies to calculate – their degree of taxonomy alignment to avoid losing clients to competitors.

Meanwhile, because the EU regulator has intentionally put a narrow definition of environmental sustainability (referring to 'substantial contribution' to climate change mitigation and adaptation), the commentators[77] claims that "the first data on taxonomy-alignment

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[76] According to the Market and Securities Stakeholder Group (SMSG), *Advice to the ESMA Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements*, 3 May 2022, ESMA22-106-4032, p. 3: "legislation will be implemented in a context where several pieces of the puzzle are still missing. In particular, lack of data on investee companies will make the alignment of sustainability preferences and investment products difficult. In this context, it will be almost impossible for financial institutions to go beyond a 'best effort' compliance. This is neither appropriate nor desirable, but in the present context firms cannot be charged beyond best efforts with (i) the responsibility to make investors understand such a complex set of issues and (ii) completing the lack of regulation and data".

[77] A.M. Pacces, *Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?*, cit., 11, who consequently fears that a problem of greenwashing might arise, as "institutional investors managing mainly conventional index funds, such as the Big Three, might well disclose the taxonomy alignment of their products, too, if only to avoid the stigma of negative disclosure". However, this fear seems to be not supported by some recent empirical data, as in the last year funds managing assets tor a total value of 25 billion euro have asked for a downgrade from art. 9 to art. 8 likely pushed by the concern to avoid the risk of greenwashing: see Barclays Report, *Sfdr tracker: article 8 now the norm*, by C. Edwards-S. Gordon, September 14, 2022. Therefore, regulators should be aware that, due to the problem of data scarcity, "there could also be a reverse problem: green-bleaching, meaning fund managers that invest in sustainable activities but refrain from claiming so to avoid the data problems arising from the disclosure obligations": Securities and Market Stakeholder Group (SMSG), *Advice to the ESMA Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements*, *cit.*, 11; see also *SMSG advice to ESMA on the ESA's Call for Evidence on Greenwashing*, 18 January 2023, ESMA22-106-4384, 1, according to which "apart from greenwashing, also 'green-bleaching' is problematic, where financial market participants choose not to claim ESG features of their product in order to avoid extra regulation and potential legal risks". Finally, the Securities and Market Stakeholder Group asks that ESMA should play an important role to monitoring the declining number of art. 9 funds (*SMSG advice to*

are expected to be modest and only improve with time".
Furthermore, if the regulatory function concerning the topic of sustainability is to mandate the disclosure of a credible signal – that could curb greenwashing and make it easier for beneficiaries to compare and for courts to verify the information provided by issuers and mutual funds – the signal is credible because it is based on sustainability measures established and enforced by regulation. The assumption might be true, but not without certain qualifications. Firstly, environmental sustainability is not entirely measurable, because it is an uncertain concept on continuous transition, whereas measures reflect the state of knowledge. For that reason, the narrative disclosure – which the Taxonomy regulation mandates too – is as relevant as quantitative information[78].
A second characteristic under criticism it that these metrics reflect a political compromise and thus may be flawed. However, the Taxonomy improves the adverse selection problem deriving from the ambiguity of private-label ESG indicators and lead beneficiaries to choose institutional investors who match their sustainability preferences[79].
In principle, the Taxonomy regulation should also permit beneficiaries to knowledgably choose institutional investors matching their sustainability preferences, thereby reducing agency cost. To this purpose, it should be important for retail investors, who are available to give up financial return in exchange for reduction of negative externalities. However, retail investors are not necessarily prepared to look at indicators such as PAIs or the degree of taxonomy alignment, or anyway they might fail to appreciate the consequences of these indicators on their investment choice. Most retail investors buy financial products through financial intermediaries, such as investment firms or banks providing investment services, who have to guide them to make knowledge investment choices.
It is not odd that a third, important aspect of the Sustainable Finance Action Plan is the inclusion of investor sustainability prefer-

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ESMA on additional questions relating to greenwashing, 16 March 2023, ESMA22-106-4551, 1 ss.).

[78] G. Strampelli, *L'informazione finanziaria tra sostenibilità e profitto*, cit., 160, who emphasizes the importance of a balance between quantitative data and narrative way to present non-financial information.

[79] A.M. Pacces, *Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?*, cit., 12.

ences into the conduct of business rules governing the provision of investment services, particularly the obligation to provide suitable personal recommendations[80] and product governance. The EU legislator has recently amended the MiFID Delegated Regulation[81], so that to include the consideration for the client "sustainability preferences" in the suitability test. The sustainability preference will have to be expressed in terms of SFDR or the Taxonomy Regulation, indicating, in particular: i) a minimum proportion of taxonomy-aligned activities; or, ii) a minimum proportion of sustainable investment; or, iii) qualitative or quantitative elements of acceptable PAIs. In the provision of advisory investment services, investment service providers will have to ask their clients whether they request a minimum sustainability threshold, and only then advise on the suitable risk/return trade-off. It has to be pointed out, however, that according to the EU sectoral financial regulation, the suitability rule applies only if investors receive personalized recommendations, whereas they often receive investment advice as marketing communications[82].

This problem might be tackled considering the guidelines released by the supervisory Authorities, particularly ESMA[83], oriented to expand the notion of investment advice, thus enlarging the scope of the suitability rule and adopting consequently a paternalistic model of investor protection[84].

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[80] Particularly, investment firms providing investment advice or portfolio management have to provide suitable personal recommendations to their clients or have to make suitable investment decisions on behalf of their clients for their preferences about risk/return trade-off.

[81] Commission Delegated Regulation of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organizational requirements and operating conditions for investment firms. Official Journal, L277, 1–5, 2021. The amendments apply from August 2nd 2022, as a "part of a broader Commission initiative on sustainable development and lay the foundation for a EU framework which puts sustainability considerations at the heart of the financial system to support transforming Europe's economy into a greener, more resilient and circular system in line with the European Green Deal objectives": see ESMA, Final Report. Guidelines on certain aspects of the MiFID II suitability requirements, 23 September 2022, ESMA35-43-3172, 8.

[82] A.M. Pacces, *Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?*, cit., 12-13.

[83] ESMA, *Guidelines on certain aspects of the MiFID suitability requirements*, July 2012, in www.esma.europa.eu.

[84] A. Perrone, *Servizi di investimento e tutela dell'investitore*, in *Banca borsa titoli di credito*,

9. Conclusions

Institutional investors may contribute to reconcile and harmonize the conflicting interests of shareholders and stakeholders, but they must fundamentally fulfill the obligation to pursue the interests of their beneficiaries. Therefore, broadly speaking, asset owners and money managers are not expected to push for the adoption of ESG policies by the investee companies when the financial interests of their beneficiaries will suffer. The relationship between asset managers and their customers or owners is different form the relationship between institutional investors and their portfolio companies. A further principal-agent layer is added to the traditional ones and further agency costs potentially occur. Moreover, the exercise of shareholder rights is embedded in the organizational structure according to which the asset managers perform their activity. Therefore, the focus is not only on voting, but also on monitoring and divestment.
As a result, asset managers and their investment advisors have a significant leeway in determining the extent to which they will take into account ESG factors, whist still remaining within the legal framework. The pivotal issue is the development of institutional investors' incentives to take a broad view of their powers and duties in relation to ESG elements.
Recently, inflows into ESG funds tend to exceed those into conventional funds within the mutual funds industry. Asset managers could deal with the increasing demand for ESG funds adopting a greenwashing strategy, focusing on the dimensions of sustainability which are easier to achieve, but eventually less material, and thus leading to a sub-optimal level of sustainability.
In order to curb greenwashing, it is essential the provision of a harmonized and credible mandatory disclosure, that should be able to act as a strong incentive for financial institutions and to align the ESG investments with the preferences of the institutional investors' ultimate owners. In the EU this task can be carried out by securities regulation which traditionally plays a complementary role to the corporate law in increasing efficiency, governing systemic risk and achieving sustainability.

Institutional investors; Monitoring; Engagement; Activism; Stewardship Codes; ESG factors; Agency problems; EU Non-Financial Disclosure Regulation;

2019, I, 1-16.

EU Taxonomy Regulation