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ESG, Sustainability Disclosure, and Institutional Investor Stewardship

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ESG, Sustainability Disclosure, and Institutional Investor Stewardship

Giovanni Strampelli*

Abstract

This Article sheds new light on the link between sustainability disclosure and institutional investors' stewardship activities aimed at promoting improvements in the ESG performance of investee companies. On the one hand, sustainability disclosure is one of the information elements that may be relevant to institutional investors' stewardship activities. On the other hand, improving the quality of sustainability reports provided by investee companies is often the ultimate goal of investor engagement initiatives. The role of climate and social disclosure is problematic from both perspectives. First, institutional investors, especially those with broadly diversified portfolios, are unable to use sustainability information directly and rely on ESG ratings and indices for their investment and stewardship strategies due to the very high costs involved. Therefore, in addition to the fact that the regulatory framework still appears to be fragmented and that there are differences between different sets of sustainability disclosures, European legislation shows that it is not enough to provide for climate and social disclosure requirements and that regulation of ESG ratings and indices is essential to make them more transparent and reliable. Second, the decision by non-activist institutional investors to focus part of their engagement initiatives on sustainability disclosure, for example by requiring a higher degree of transparency or the adoption of a particular reporting

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framework, appears to be dictated by a desire to avoid more intrusive (and perceived as more aggressive) initiatives aimed directly at encouraging changes in the environmental strategies or policies of the companies concerned.

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INTRODUCTION

The European legislature's stated goal in numerous legislative interventions that are part of the "Green Deal" is to transition to a more sustainable economic model.[1] Two cornerstones of the European legislature's complex regulatory framework that is being developed to this end include sustainability disclosure and the set of provisions aimed at encouraging active conduct (so-called stewardship) by

1. *See The European Green Deal: Communication From the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions*, COM (2019) 640 final (Dec. 11, 2009).

institutional investors in order to promote the pursuit of sustainability goals by the companies in their portfolios.[2]

While these observations have now been fully shared, and the subject of wide attention by scholars and policy makers, the close link between sustainability disclosure and institutional investors' stewardship activities has not yet been fully investigated, at least from a legal perspective. Indeed, as noted elsewhere,[3] examining the relationship between these regulatory plexuses is essential in order to shed light on the function and discipline of nonfinancial disclosure as well as to highlight some of the gaps in sustainability legislation.

I. THE FUNCTION AND RECIPIENTS OF SUSTAINABILITY DISCLOSURE

The examination of the profiles just indicated requires, as a preliminary step, making some considerations in order to frame the subject in the legal and regulatory context that has become progressively more complex. To this end, the starting point is the regulation of non-financial information and, in particular, the role it plays in the broader European regulatory framework for sustainability.

As theorized by some authors[4] (and noted elsewhere[5]), the function of sustainability disclosure is broader than merely providing financial information. In fact, the Corporate Sustainability Reporting Directive (CSRD) makes clear, even more so than in the previous Non-Financial Reporting Directive (NFRD), that non-financial disclosure functions not only to

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2. For background on European legislation, see Gaia Balp & Giovanni Strampelli, *Institutional Investor ESG Engagement: The European Experience*, 23 EUR. BUS. L. REV 869 (2022).

3. *See generally* Gaia Balp & Giovanni Strampelli, *Institutional Investors as the Primary Users of Sustainability Reporting* (Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance, Working Paper No. 4495602), https://perma.cc/Q8F6-PAVW.

4. *See* Wolfgang Schön, *"Nachhaltigkeit" in der Unternehmensberichterstattung*, ZEITSCHRIFT FÜR DIE GESAMTE PRIVATRECHTSWISSENSCHAFT [ZFPW] 207 (2022) (Ger.).

5. *See* Balp & Strampelli, *supra* note 3, at 10 (noting that sustainability information provides additional information that cannot be inferred from financial reports including how a company's operations impact its surrounding environment and community and ESG issues that could impact the company's value).

inform shareholders and other categories of stakeholders but also (and, perhaps, above all) to affect the conduct of companies subject to disclosure obligations by incentivizing behavior oriented toward the pursuit of so-called ESG objectives and, in particular, the fight against climate change.[6] Indeed, the latter constitutes the primary objective of the CSRD, whereas other environmental issues in addition to social ones, such as the protection of workers and human rights or the fight against corruption, have been placed in the background, though not abandoned.

The fact that the CSRD, while formally posing only disclosure burdens, is, in reality, also intended to affect the organizational structure of companies within its scope is apparent, in particular, from Articles 19-bis and 29-bis (applicable to individual and consolidated sustainability reporting, respectively), which require disclosure of, among other things:

> the plans of the group, including implementing actions and related financial and investment plans, to ensure that its business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5°C in line with the Paris Agreement under the United Nations Framework Convention on Climate Change adopted on 12 December 2015 ("Paris Agreement") and the objective of achieving climate neutrality by 2050 as set out in Regulation (EU) 2021/1119 of the European Parliament and of the Council and, where relevant, the company's exposure to coal-, oil- and gas-related activities[7]

as well as "how the undertaking's business model and strategy take account the interests of the undertaking's stakeholders and of the impacts of the undertaking on sustainability issues"[8] and "how the undertaking's strategy has been implemented with regard to sustainability issues."[9] Finally, the same Articles

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6. *See* Schön, *supra* note 4, at 230.

7. Directive 2022/2464 of the European Parliament and of the Council of 14 December 2022 Amending Regulation (EU) No. 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, As Regards Corporate Sustainability Reporting, art. 19, 29, 2022 O.J. (L 322) 43.

8. *Id.*

9. *Id.*

require "a description of the group's policies in relation to sustainability matters."[10] In addition, the above information, if deemed appropriate by the directors, may also cover "the activities of the group and its value chain, including information regarding its products and services, its business relationships and its supply chain."[11]

That the ultimate purpose of the CSRD is not only to regulate the sustainability information that must be made available to investors and stakeholders of listed companies but also to pursue objectives of broader general interest seems, moreover, confirmed by the scope of the disclosure requirements. In fact, the latter concern not only listed companies but also other companies (constituted according to one of the legal forms provided for in Annex I of the CSRD) that exceed the size thresholds stipulated in Article 3 of the Directive.[12] Although not made explicit by it, the scope of the Directive is delineated to include companies that, because of their size, are likely to generate more significant externalities and thus have greater effects on the environment and climate more generally.

Such an orientation of the Directive appears to be reflected also in the extension of disclosure requirements to the supply chain as well as by the inclusion of non-EU resident companies that generate a net turnover of 150 million euros within the European Union and have at least one company located in the European territory in the scope of CSRD.[13]

The Commission's adoption of such a regulatory strategy has faced some criticism because, as has been noted, the CSRD dictates a material obligation, disguised as a reporting

10. *Id.*

11. *Id.* at 25.

12. Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013, On the Annual Financial Statements, Consolidated Financial Statements and Related Reports of Certain Types of Undertakings, Amending Directive 2006/43/EC of the European Parliament and of the Council and Repealing Council Directives 78/660/EEC and 83/349/EEC, art. 3, 2013 O.J. (L 182) 27–29 (establishing thresholds to distinguish between micro, small, medium-sized, and large undertakings to establish reporting requirements).

13. *See id.* at 20 (stating that third-country undertakings which generate more than 150 million euros in the Union should be accountable for their undertakings and required to provide sustainability information regarding their impacts on social and environmental matters).

obligation, for directors of companies within its scope to adjust their corporate policy in order to pursue collective interests and, in particular, the fight against climate change.[14] Since this is a measure of control over the real economy—i.e., the investment and production decisions of companies—according to this current of thought, such an objective should be pursued through mandatory rules that place specific prohibitions or limits—such as through the introduction of taxes or quantitative restrictions—as well as on the basis of democratically legitimate decisions, not through the system of "name and shame" based on sustainability disclosure and ultimately aimed at activating the initiative of companies and their shareholders and, in particular, institutional investors.[15]

As much as the criticisms levelled at the European legislator's modus operandi are in part shareable, it should be borne in mind that in turn, direct state intervention through the introduction of mandatory rules aimed at limiting the autonomy of companies does not have insignificant limitations and potential contraindications.[16] In addition to the well-known limitations characterizing imperative norms associated with their incompleteness, i.e., the impossibility of regulating ex ante all the cases that may then arise in practice and the substantial costs to be incurred in defining and enforcing such norms, a strategy based exclusively on the imposition of regulatory limits on the decision-making autonomy of enterprises appears impractical because of the weakness of states, even in comparison with large multinational companies whose turnover in some cases exceeds the gross domestic product of several medium-sized states.

Moreover, it is difficult for legislatures to adopt policies to combat climate change based on mandatory standards because of the consequences that such initiatives may have on political

14. *See* Andy Bounds et al., *EU's New Green Reporting Rules Are 'Impossible', Businesses Say*, FIN. TIMES (May 20, 2023), https://perma.cc/DG5S-EK5X (noting criticism of the EU's new green standards by directors of major European companies including BMW, Telefónica, and BP).

15. *See* Schön, *supra* note 4, at 238.

16. *See* Lawrence E. Mitchell, *Understanding Norms*, 49 U. TORONTO L.J. 177, 183 (1999) (discussing the role of norms and the law, as imposed by a sovereign, as means of creating compliance with the will of the community).

consensus given the social costs that, especially in the short term, may result from legislative initiatives oriented toward environmental protection.[17] On the other hand, it seems reasonable to assume that measures affecting companies and, in particular, larger companies might have less significant consequences in terms of political consensus, since there is a certain favor in public opinion (or at least in some parts of it) regarding the adoption of such initiatives against large multinational companies and those operating in the most polluting sectors.[18]

That said, the regulatory option implemented through the CSRD, which is essentially based on a "name and shame" system designed to penalize companies that do not adopt ESG policies deemed appropriate, also affects the identification of the target audience for sustainability information.

The main recipients of sustainability disclosure (included in the annual or consolidated financial statements) may be the shareholders whose monitoring function is essential, since the choices made by the directors (and in this particular case the adoption of the policies referred to in the aforementioned CSRD provisions) necessarily depend on the preferences of the shareholders, who, as "owners" of the company, have the right to appoint its managers. But it is clear from the CSRD provisions and the sustainability reporting principles adopted by European Financial Reporting Advisory Group (EFRAG) that the target audience for sustainability disclosure is broader than just shareholders,[19] and includes other categories of stakeholders such as consumers, suppliers, and third parties who come into contact with the company and may be affected by

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17. *See* Jonathan Ostry, *Politics, as Well as Economics, Matter When Making Climate Policy*, FIN. TIMES (Aug. 27, 2023), https://perma.cc/B3LJ-W9MW (noting that many politicians are hesitant to enact green policies out of fear of backlash from special impact groups that immediately impacts their political careers).

18. *See* Sherry Frey et al., *Consumers Care About Sustainability—and Back It Up with Their Wallets*, MCKINSEY & CO. (Feb. 6, 2023), https://perma.cc/48YN-AS54 (describing a joint study by McKinsey and NielsenIQ revealing that consumers care about corporate ESG claims and are willing to pay more for products that support sustainability goals).

19. *See infra* note 20 and accompanying text.

the company's activities as well as associations representing these categories of stakeholders such as NGOs.[20]

The sustainability reporting standard European Sustainability Reporting Standards (ERSR) 1, developed by EFRAG and adopted by the Commission on July 31, 2023, explicitly states that stakeholders, meaning those who are in a position to influence or be influenced by the enterprise, can be divided into two groups.[21] The first group consists of affected stakeholders," which are defined as individuals or groups whose interests are affected or could be affected–positively or negatively–by the undertaking's activities and its direct and indirect business relationships across its value chain."[22] The second group of recipients includes "users of sustainability statements," defined as "primary users of general-purpose financial reporting (existing and potential investors, lenders and other creditors, including asset managers, credit institutions, insurance undertakings), and other users of sustainability statements, including the undertaking's business partners, trade unions and social partners, civil society and non-governmental organizations, governments, analysts and academics."[23]

While a multiplicity of recipients is a basic assumption of the sustainability disclosure framework in the European Union,

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20. *See* Directive (EU) 2022/2464 2022, O.J. (L 322) 25 ("Likewise, information about the quality of the relationships between the undertaking and its stakeholders, including customers, suppliers and communities affected by the activities of the undertaking, is sustainability information relevant to social or governance matters that could also be considered as information on intangible resources.").

21. *See* Commission Delegated Regulation (EU) 2023/2772 of 31 July 2023 Supplementing Directive 2013/34/EU of the European Parliament and of the Council As Regards Sustainability Reporting Standards, annex 1, O.J. (L 2023/2772) 278 ("Stakeholders are those who can affect or be affected by the undertaking.").

22. *Id.*

23. *Id.* (further specifying that "employees and other workers, suppliers, consumers, customers, end-users, local communities and persons in vulnerable situations, and public authorities, including regulators, supervisors and central banks").

the point is controversial[24] and is not embraced by major international standard setters.[25]

The reporting standards developed by the International Sustainability Standard Board (ISSB)—established by the same entity (the IFRS Foundation) that promotes the development of the IFRS international accounting standards so it is conceivable that the IFRS Foundation could assume a central role in the process of harmonization of sustainability disclosure at the international level—are based on the assumption that sustainability reports are directed primarily to shareholders and investors. According to IFRS S1 (General Requirements for Disclosure of Sustainability-related Financial Information), "[i]nformation about sustainability-related risks and opportunities is useful to primary users because an entity's ability to generate cash flows over the short, medium and long term is inextricably linked to the interactions between the entity and its stakeholders, society, the economy and the natural environment throughout the entity's value chain."[26] The same accounting standard requires companies to "disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term."[27] Consequently, "[s]ustainability-related risks and opportunities that could not reasonably be expected to affect an entity's prospects" are not among the information that must be disclosed in sustainability reports prepared in accordance with the principles issued by the ISSB.[28]

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24. *See* Wolf-George Ringe et al., *A Critique of EU Policymaking on Sustainable Corporate Governance and Finance*, GROUPE D'ÉTUDES GÉOPOLITIQUES (Aug. 2022), https://perma.cc/UW5L-MPSR (critiquing E.U. sustainability regulations for not being solely investor facing and aiming to generate a broader understanding of external impacts to consumers, employees and civil society).

25. *See* INT'L FIN. REPORTING STANDARDS [IFRS], ED/2022/S1, IFRS S1 GENERAL REQUIREMENTS FOR DISCLOSURE OF SUSTAINABILITY-RELATED FINANCIAL INFORMATION 23 (2023), https://perma.cc/A2E7-KKGB (stating that the primary users of the financial reports are "[e]xisting and potential investors, lenders and other creditors").

26. *Id.* at 6.

27. *Id.*

28. *Id.*

II. THE CONTENT OF SUSTAINABILITY DISCLOSURE

The non-coincidental audience of the recipients of non-financial information outlined by the different standard setters is reflected, inevitably, by its content. In particular, on a technical level, the notion of materiality differs, which is the criterion on the basis of which to select the relevant information to be included in sustainability reports so that they are useful for their recipients, as identified by the different standard setters.[29]

In the European sphere, the approach embraced by the CSRD and the ESRS reporting principles issued by EFRAG (in continuity with the non-financial reporting principles called GRI, which have been the most widely used in Europe to date) involving multiple audiences is reflected in the adoption of the so-called principle of dual materiality whereby sustainability reports must include both information necessary for understanding how sustainability issues affect their business (inside-in), as well as information necessary for understanding the impact of companies on people and the environment (outside-in). In other words, from the outside-in perspective, the company considers the risks and opportunities arising from managing, correctly or otherwise, a given ESG issue and the impact that it might have on its economic and financial performance. In contrast, the inside-out perspective considers the possible effects, positive and negative, actual and potential, that the company's management of a given ESG issue may have on its stakeholders.

ESRS Principle 1 clarifies that dual materiality has two dimensions, impact materiality and financial materiality. The two are closely related to each other in that,

29. This diversity of approaches can be only partly mitigated in application by the collaboration agreements in place between the different standard setters. For example, the collaboration agreement between the ISSB and the GRI provides that "[t]he ISSB represents the investor-focused pillar and the GRI is leading the charge on a broader stakeholder-focused pillar, with the collaboration emphasizing the interconnectedness of the two-pillar system and its purpose in the global baseline for corporate reporting." Heather Horn et al., *Navigating the ESG Landscape: Comparison of the "Big Three" Disclosure Proposals*, HARV. L. SCH. F. CORP. ON GOVERNANCE (Oct. 10, 2022), https://perma.cc/2GNB-3JNB.

> the starting point is the assessment of impacts, although there may also be material risks and opportunities that are not related to the undertaking's impacts. A sustainability impact may be financially material from inception or become financially material, when it could reasonably be expected to affect the undertaking's financial position, financial performance, cash flows, its access to finance or cost of capital over the short-, medium- or long-term. Impacts are captured by the impact materiality perspective irrespective of whether or not they are financially material.[30]

As evident, the acceptance of the notion of double materiality implies, at least on the theoretical level, a radical shift in perspective whereby the concept of materiality is considered to be "socio-economic and political" in nature and not merely technical accounting and, as such, primarily directed toward furthering the understanding of the process of sustainable development and the contribution to it made by the individual society.[31]

In line with what was noted earlier regarding the different group of recipients considered by this standard setter, the sustainability reporting criteria adopted by the ISSB do not recognize the double materiality criterion.[32] In fact, these standards embrace a notion of single materiality under which, as per IFRS S1 published in June 2023, the company "shall disclose material information about the sustainability-related

30. *Single, Double or Impact Materiality?*, ESG EXCH. (Sept. 28, 2023), https://perma.cc/C8WS-N7HF.

31. *See* CAROL A. ADAMS ET AL., THE DOUBLE-MATERIALITY CONCEPT APPLICATION AND ISSUES 5 (2021), https://perma.cc/YHJ8-42J5 (PDF) (summarizing the definition and use of double materiality in modern contexts); *see also* Brian W. Carpenter et al., *Materiality Judgments and Audit Firm Culture: Social-Behavioral and Political Perspectives*, ACCT. ORG. SOC'Y 355 (1994); Alessandro Lai et al., *What Does Materiality Mean to Integrated Reporting Preparers? An Empirical Exploration*, 25 MEDITARI ACCT. RSCH. 533, 536 (2017) ("[M]ateriality reflects an organization's significant economic, environmental and social impacts, together with their influence on stakeholders' assessments and decisions. In this respect, the guidelines embrace a concept of materiality based on thresholds, parallel to the interpretation in financial reporting context.").

32. *See The Challenge of Double Materiality Sustainability Reporting at a Crossroad*, DELOITTE, https://perma.cc/259Z-JAAZ (last visited Mar. 22, 2024) (contemplating the addition of double materiality to the ISSB standards).

risks and opportunities that could reasonably be expected to affect the entity's prospects"[33] given that,

> [i]n the context of sustainability-related financial disclosures, information is material if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that primary users of general purpose financial reports make on the basis of those reports, which include financial statements and sustainability-related financial disclosures and which provide information about a specific reporting entity.[34]

The divergence in approach that exists between the different standard setters and, in particular, between the European Commission and the ISSB may adversely affect the process of international harmonization of sustainability disclosure. However, the European Commission has initiated constructive cooperation with the main international initiatives and, in particular, with the ISSB in order to encourage greater uniformity and to prevent such fragmentation of the regulatory framework from leading to greater burdens on companies and, in particular, to prevent the risk for European companies that the preparation of sustainability reports on the basis of standards not used internationally may lead to reduced attractiveness to international investors and, in particular, to those who place greater weight on ESG factors in their investment policies.

On the other hand, sustainability risks and financial risks may tend, progressively, to overlap to an increasing extent (at least in relation to the effects on social activity of risks related to environmental variables) as markets' public policies evolve in response to climate change, as the positive and/or negative impacts that companies may have on the environment will increasingly translate into business opportunities and/or financially relevant risks, which as such will still need to show up in the sustainability reports (as well as the financial statements) of the companies concerned.

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33. INT'L FIN. REPORTING STANDARDS, *supra* note 25, at para. 17.
34. *Id.* at para. 18.

III. THE LIMITED ABILITY OF INSTITUTIONAL INVESTORS TO DIRECTLY USE SUSTAINABILITY DISCLOSURE FOR THEIR INVESTMENT AND STEWARDSHIP CHOICES

Having outlined, in its essential features, the framework of reference and moving on to consider, more strictly, the relationship existing between non-financial information and the role that this can assume for the purposes of stewardship (in terms of both voting and engagement) of institutional investors as increasingly important components of the shareholding structure of listed companies, it is necessary to consider that (as already illustrated) institutional investors are expressly included by the standard setters among the main recipients of sustainability information.[35] Particularly clear in this regard are the reporting principles issued by the ISSB, which identify "existing and potential investors" as the primary users of sustainability reports and indicates as its goal the development of "standards that will result in a high-quality, comprehensive global baseline of sustainability disclosures focused on the needs of investors and the financial markets."[36]

The orientation of standard setters is reflected in the policies adopted by many institutional investors. For example, BlackRock's Stewardship Global Principles from 2023 state that "[r]obust disclosure is essential for investors to effectively evaluate companies' strategy and business practices related to material sustainability-related risks and opportunities."[37] BlackRock advocates for continued improvement in companies' reporting, where necessary, and will express any concerns

35. *See* Balp & Strampelli, *supra* note 3, at 7 ("The main users of sustainability reports are indeed institutional investors and asset managers (in their capacity of corporate shareholders, or potential equity investors) and, in particular, widely diversified investors, such as the major passive investors whose investment strategies tend toward replicating certain benchmark stock indices.").

36. *About the International Sustainability Standards Board*, INT'L SUSTAINABILITY STANDARDS BD., https://perma.cc/LYE6-K7XR (last visited Apr. 4, 2024).

37. BLACKROCK INVESTMENT STEWARDSHIP GLOBAL PRINCIPLES 10 (2024), https://perma.cc/T5RB-3ATB (PDF).

through its voting where a company's actions or disclosures are inadequate.[38]

Thus, this evidence seems to indicate that sustainability information is central to the investment and stewardship strategies of institutional investors and that, in particular, broadly diversified asset managers are ideal candidates to monitor investment companies in order to incentivize their pursuit of sustainability-oriented strategies.

That said, however, it should be borne in mind that several orders of reasons make it at least uncertain, on the one hand, that institutional investors have real interest in playing such a driving role (as well as the willingness and ability to deploy the considerable resources necessary for this purpose), and on the other hand, that sustainability information can, in practice, foster such conduct, since it is doubtful whether investors are able to actually use, for the purposes of their investment and stewardship strategies, the sustainability information made available by companies.

Moving on from the first more general profile to institutional investors monitoring investment companies with the aim of improving their ESG performance reflects the progressive change in the preferences of end investors, both institutional and retail.

On the one hand, there is now a growing number of asset owners, such as pension funds or sovereign wealth funds, that pay close attention to sustainability profiles and select managers to whom they entrust their capital with these elements in mind.[39] On the other hand, this trend is also likely to strengthen among retail investors as investment choices pass into the hands of the generations of millennials (i.e., those born between 1981 and 1996) and GenZs (born in the early 2000s), who—as evidenced by the initiatives they have taken to solicit public attention on the effects of climate change—are

38. *See id.* at 12 ("We will express any concerns through our voting where a company's actions or disclosures do not seem adequate in light of the materiality of the business risks.").

39. *See Asset Owner Guide: Investment Manager Selection*, PRINCIPLES FOR RESPONSIBLE INV. (Oct. 27, 2020), https://perma.cc/U9JD-MBT9 (reporting that 68 percent of asset owners consider ESG factors when selecting asset managers).

particularly attentive to these issues.[40] Recently, a Blackrock study, noting that the incorporation of sustainability factors into portfolio construction represents a "tectonic shift" capable of transforming the asset management industry, pointed out that the demographic trend is one of the main factors behind this momentous change.[41]

This is borne out by the growing success of funds that pursue ESG objectives over traditional funds. For example, recent research by Goldman Sachs[42] shows that funds not classified as products that promote environmental or social characteristics or products that target sustainable investments (according to, respectively, Article 8 and Article 9 of the Sustainable Finance Disclosure Regulation-SFRD[43]) attracted 3.4 times as many flows as those directed to funds that do not pursue ESG objectives (under Article 6 of the SFRD).[44]

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40. *See* Chris Versace & Mark Abssy, *How Millennials and Gen Z Are Driving Growth Behind ESG*, NASDAQ (Sept. 23, 2022), https://perma.cc/YWG3-H9LU ("Millennials already played a significant role in ESG investing. . . . This trend is only set to continue . . . with 40% of Gen Z saying their investments decisions are driven by 'companies with a purpose.'").

41. *See* SUSTAINABILITY: THE TECTONIC SHIFT TRANSFORMING INVESTING 3 (2020), https://perma.cc/ZL5T-AJRC (PDF) ("Structural shifts are typically underappreciated for long periods of time by financial markets–as has been the case for demographic shifts such as the baby boom."); Giovanni Strampelli, *Can BlackRock Save the Planet? The Institutional Investors' Role in Stakeholder Capitalism*, 11 HARV. BUS. L. REV. 1, 5–10 (2021) (discussing BlackRock's assessment of the sustainability-centered tectonic shift in the asset management sector); *see also* David H. Webber et al., *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1244 (2020) ("[W]e argue that index funds are locked in a fierce contest to win the soon-to-accumulate assets of the millennial generation, who place a significant premium on social issues in their economic lives.").

42. *See* EVAN TYLENDA ET AL., SFDR, TWO YEARS ON–TRENDS AND ANATOMY OF ARTICLE 8 & 9 FUNDS IN 2023, at 1 (2023), https://perma.cc/7XMA-TB4Z (PDF) ("In this report, we assess large Article 8 and 9 funds to explore how they are tackling key requirements of SFDR, including Art. 8 & 9 classification; Sustainable Investment frameworks; Principal Adverse Impacts; Do No Significant Harm and Good Governance.").

43. *See* Regulation 2019/2088, of the European Parliament and of the Council of 27 November 2019 on Sustainability-Related Disclosures in the Financial Services Sector, art. 8, 9, 2019 O.J. (L 312) 9–13 (providing guidelines on how to promote and classify environmental characteristics in financial assets).

44. *See* TYLENDA ET AL., *supra* note 42, at 5 ("Flows into Article 8 & 9 funds have significantly outpaced Article 6 (or 'Not Stated'), with cumulative flows

However, especially in the United States, institutional investors' engagement with ESG issues is being challenged by the spread of initiatives, often promoted by conservative politicians, aimed at challenging the legitimacy of institutional investors' pursuit of ESG purposes.[45] Such developments, influencing a portion of end-clients who share these political views, have, in fact, prompted greater caution on the part of institutional investors in supporting sustainability-oriented investment and, especially, stewardship strategies.[46]

The disfavor of part of the political class toward the pursuit of ESG objectives may, moreover, lead to the introduction of more stringent regulatory constraints. Without prejudice to those related to market abuse regulations and the concert action rules of the European takeover bids framework, there is, for example, an increasingly frequent discussion of possible violations of competition law that can be traced to ESG engagement initiatives conducted collectively by several institutional investors (such as, the Glasgow Financial Alliance for Net Zero or Climate Action 100+), as the formation of such coalitions could allow the sharing of relevant information in order to engage in collusive conduct not permitted under antitrust law.[47]

As much as this trend against the pursuit of ESG objectives by investors (so-called ESG Backlash) is essentially confined to the United States, it could also affect the European context. Although in Europe the regulatory framework is clearly oriented toward the pursuit of ESG objectives consistent with

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into ESG equity funds in the past three years standing at 3.4x compared to non-ESG counterparts.").

45. *See* Diane-Laure Arjaliès & Tima Bansal, *ESG Backlash in the US: What Implications for Corporations and Investors?*, FIN. TIMES (June 11, 2023), https://perma.cc/4B8D-CXBD ("While many investors and fund managers want to use ESG frameworks to identify promising investments that also advance societal goals, some Republican lawmakers have argued they impose unnecessary constraints on corporations and undermine financial returns.").

46. *See id.* ("Although some investment funds celebrated Biden's decision, they have reconsidered ESG investments. Vanguard, the world's second-largest asset manager, pulled out of the Net Zero Asset Managers initiative, a coalition of 301 investors committed to reducing greenhouse gas emissions.").

47. *See* Amelia Miazad, *From Zero-Sum to Net-Zero Antitrust*, 56 U.C. DAVIS L. REV. 2067, 2091–94 (2023) (discussing how partisan antitrust threatens investor climate alliances).

the goals pursued by the European Green Deal, U.S. institutional investors are among the main investors in many European listed companies and their weight in the shareholder base of European listed companies is greater than that of European investors.[48]

Notwithstanding the above, the ability of institutional investors to promote strategies geared toward the pursuit of sustainability goals is also questioned from a financial-economic perspective. According to one current of thought, the consideration of ESG factors in their stewardship strategies by institutional investors would function to manage and contain systemic risk that affects portfolio value and return especially in the case of widely diversified funds, in particular those that replicate the benchmark indices of major financial markets.[49] Consequently on the basis of this assumption, consideration of ESG factors not only in investment strategies but also in engagement strategies would be appropriate, if not required, by virtue of investors' duties to end clients.[50]

However, this approach is not unanimously shared, as some question whether the implementation of so-called systematic stewardship strategies can actually lead to a reduction in systemic risk likely to affect portfolio performance.[51] More

48. *See* Luca Enriques & Giovanni Strampelli, *The Dialogue Between Corporations and Institutional Investors: An Introduction* 2–5 (Eur. Corp. Governance Inst., Working Paper No. 725/2023), https://perma.cc/K3N3-BXF3 (discussing data that shows large U.S. institutions owning significant assets across the world).

49. *See* Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. CORP. L. 627, 631 (2022) ("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.").

50. The debate over whether institutional investors can (or, indeed, should) take ESG factors into account in their investment strategies is particularly intense, not least because of some of the regulatory changes that have taken place in recent years as the President and majorities in Congress have changed. *See generally* Bernard S. Sharfman, *ESG Investing Under ERISA*, 38 YALE J. REGUL. BULL. 112 (2020).

51. *See* Marcel Kahan & Edward Rock, *Systemic Stewardship with Tradeoffs*, 48 J. CORP. L. 497, 497 (2023) ("We are quite pessimistic about the potential of systemic stewardship that entails substantial tradeoffs among portfolio companies."); Roberto Tallarita, *The Limits of Portfolio Primacy*, 76 VAND. L. REV. 511, 512 (2023) ("This analysis shows that we should have very

generally (but the profile is closely related to the one just mentioned), there is conflicting empirical evidence regarding the correlation between the return on equity investments and the performance in ESG terms of the companies being invested in.[52] In the absence of a clear correlation between the pursuit of sustainability goals and performance, it is therefore noted in several quarters that investment strategies geared toward such goals would result in the breach of managers' fiduciary duties to end clients.

Notwithstanding the diversity of views and the non-uniqueness of the available empirical evidence on the profiles just considered, it should also be noted that, as widely highlighted in the doctrine, there are additional factors related to the business model of institutional investors likely to limit, in practice, their (potential) interest in monitoring the activities of the companies being invested in, also in order to promote sustainability policies on their part.

First, given that the so-called company-specific engagement initiatives require the use of significant human and financial resources, they affect only a small part of the companies in the portfolio. In addition to costs, such initiatives are limited by so-called agency costs, i.e., by the circumstance that any benefits derived from them would benefit not only the activating investor but also all the other (remaining passive) portfolio companies with the company being engaged. Such factors likely to limit the engagement of institutional investors, moreover, assume greater importance precisely for larger asset managers and, in particular, for those that manage predominantly passive funds, which envisage lower fees, with lower margins available for engagement activities.

In light of the above and taking into account, in particular, the economic factors mentioned above, it does not seem realistic to assume that managers of widely diversified assets can, as a rule, examine and use for the purpose of defining their investment and stewardship strategies the sustainability reports published by the companies included in their portfolios,

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modest expectations about the role of portfolio primacy in the fight against climate change.").

52. *See* Laura T. Starks, *Presidential Address: Sustainable Finance and ESG Issues*–Value *Versus* Values, 78 J. FIN. 1837, 1852–54 (2023) (discussing empirical studies on the relationship between ESG investing and returns).

since the analytical examination of this source of information could possibly be limited to only a small part of them. The direct use of sustainability disclosure by institutional investors would require the deployment of human resources and, therefore, incur burdens to such a significant extent that it would not be compatible with the cost-effectiveness of the activities of institutional investors and, in particular, those that are larger and have the most diversified portfolios under management, which, theoretically, would have to analyze the sustainability reports of thousands of companies. The costs associated with the analysis of sustainability reports would be even higher due to the existence at the international level of different reporting standards that make it more difficult and, to some extent less useful, to compare reports prepared according to different criteria.

Although the CSRD is aimed at improving the relevance, reliability, and comparability of corporate sustainability reporting, the dysfunctions resulting from the adoption of different sustainability reporting frameworks internationally will not be overcome unless significant global convergence of these standards is achieved. For example, the substantial differences that exist between the reporting criteria dictated by CSRD and ESRS principles and those issued by the ISSB may induce distortions in the investment and stewardship strategies of international investors investing in companies residing in different continents and subject to different sustainability disclosure regimes.

IV. THE CENTRAL ROLE OF ESG RATINGS AND INDICES. THE LIMITS OF THE CURRENT SUSTAINABILITY DISCLOSURE FRAMEWORK: THE CASE OF THE EUROPEAN UNION

Considering what has just been said, as is evident from recurring practice, institutional investors, as a rule, make indirect use of the sustainability information disseminated by issuers the services provided by certain information intermediaries, especially ESG rating and index providers, who synthesize the sustainability information disseminated by companies into the indices and ratings they develop for the benefit of institutional investors.

ESG ratings and indices affect their investment choices much more significantly than information gleaned from

sustainability reports. Available empirical evidence shows, for example, that in about 60 percent of cases, institutional investors use ratings to assess the ESG performance of the companies in which they invest, while in only 29 percent of cases they use sustainability reports disseminated by companies.[53]

Indirectly, ESG ratings and indexes also influence institutional investors' stewardship strategies in that, due to the consideration of these elements in their investment choices, institutional investors frequently divest from companies that, according to rating and index providers, do not achieve adequate ESG performance even before they express their disagreement through voting against management proposals or initiating engagement.[54]

Despite their central importance, however, ESG ratings and indices have significant limitations. In particular, there is a lack of transparency regarding the methodologies used to define them and, with regard to ESG ratings, also a limited degree of correlation, noting significant differences between the ratings given to many companies by various ESG rating providers.[55] An additional concern regarding the companies that provide ESG ratings and indices is, moreover, the potential conflicts of interest between them due to the fact that, in some cases, they provide services (e.g. advice or data) to the same companies they rate for the purpose of assigning ratings or including them in indices.[56]

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53. ESG INVESTING (STATISTA 2023), https://perma.cc/RQ83-FAZZ.

54. This circumstance, as noted by an authoritative economic doctrine, would negatively affect the ability of institutional investors to promote a reduction in the externalities generated by the companies being invested in and, therefore, their achievement of better ESG performance. *See* Eleonora Broccardo et al., *Exit Versus Voice*, J. POL. EC. 3101 (2022).

55. *See* Florian Berg et al., *Aggregate Confusion: The Divergence of ESG Ratings*, 109 REV. FIN. 1315, 1341–43 (2022) ("Our findings demonstrate that ESG rating divergence is not merely a matter of varying definitions but a fundamental disagreement about the underlying data.").

56. *See* INT'L ORG. SEC. COMM'NS, ENVIRONMENTAL, SOCIAL AND GOVERNANCE, (ESG) RATINGS AND DATA PRODUCTS PROVIDERS FINAL REPORT 1 (2020), https://perma.cc/W3PA-Y7L6 (PDF) ("There may be concerns about the management of conflicts of interest where the ESG ratings and data products provider or an entity closely associated with the provider performs consulting services for companies that are the subject of these ESG ratings or data products.").

In light of these findings, it therefore appears that, despite the undoubted progress made compared to the former NFRD, the European sustainability disclosure framework dictated by the CSRD is not sufficient from the perspective of institutional investors nor is it sufficient to, in particular, channel investments toward companies that actually have the best ESG performance or to direct stewardship initiatives toward companies that do not practice effective sustainability policies or otherwise do not achieve satisfactory results from the investors' point of view.

Diverse and opaque ESG indices and ratings add an additional layer of complexity to investor assessments that is not directly answered by the CSRD. Rating development practices, in terms of determining which data to include and weighting metrics in terms of relevance, as well as subjective judgments about absolute and relative scores within and across sectors, vary widely, and index providers and rating agencies develop and sell ESG ratings and indices based on inherently different data and methodologies.[57] The ratings, data, and indices used by market participants to identify and evaluate companies adopting ESG best practices—both for making investment decisions and for taking stewardship actions—are not only highly diverse and non-comparable, but also opaque, due to a fundamental lack of transparency in the underlying methodologies.[58]

As a result, the problem of the opacity of ESG ratings and indices adds to (and is, in part, a consequence of) the inconsistency of companies' non-financial disclosure frameworks, and the underlying divergent concepts of

57. *See* Riccardo Boffo & Robert Patalano, *ESG Investing: Practices, Progress and Challenges*, ORG. FOR ECON. COOP. & DEV. 21 (2020), https://perma.cc/5JZY-5YE8 ("There is a wide range of rating practices in terms of determining which data to include, how to weigh metrics in terms of materiality, and layering subjective judgment as to absolute and relative sources within and across industries.").

58. *See id.* at 36 ("A series of issues surrounding these [factors] may lead investors to have reservations for . . . investing. A lack of standardization in reporting, diverse ways to measure and communicate key aspects for each industry, and the application of non-comparable methodologies by different providers . . . drive the need to investigate.").

materiality.[59] In particular, the poor correlation between the ratings assigned by different providers to the same companies, and the lack of transparency in how these scores are compiled, make it difficult for investors to resort to the essential and reliable information they need to properly perform a sustainability assessment. Interestingly, from this perspective, it is precisely the lack of transparency on ESG rating methodologies that is one of the reasons why some investors have adopted proprietary rating methodologies internally.[60] This option, however, is in fact limited to larger asset managers, as producing proprietary internal ESG ratings may not be feasible or cost-effective for small or medium-sized asset managers and does not, in any case, solve the problems related to the low correlation between indices developed by different parties.[61]

In relation to these profiles, the European regulatory framework is not yet satisfactory. EU Regulation 2016/1011 on benchmarks, i.e., indices, is relevant to ESG index providers but is not directly relevant to the wide range of ESG ratings and data[62] which are outside the scope of the Benchmark Regulation.[63] However, ESG indices are not independent of ESG

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59. *See* Dirk A. Zetzsche & Linn Anker-Sørensen, *Regulating Sustainable Finance in the Dark*, 23 EUR. BUS. L. REV. (forthcoming 2022) (manuscript at 48–49) (on file with authors) (noting three major issues with financial intermediary regulation under the EU Green Deal is lack of data on profitability of sustainable investments, a lack of theoretical insights into co-relation and causation of sustainability factors with financial data, and inconsistent application of sustainability-oriented financial regulation).

60. *See* INT'L ORG. SEC. COMM'NS, *supra* note 56, at 27 (detailing how almost all large asset managers are using or developing their own ESG ratings to supplement the lack of transparency around external rating methodologies).

61. *See id.* ("[Small or medium-sized asset] managers often have limited capabilities and resources available for analyzing external ESG ratings or developing in-house ESG ratings.").

62. *See id.* at 14 ("[T]he current situation would appear to be one in which there are few examples of legal and regulatory frameworks of direct relevance for ESG ratings and data products, and no voluntary frameworks of direct relevance outside of those being applied more generally by providers of Financial Benchmarks.").

63. Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on Indices Used as Benchmarks in Financial Instruments and Financial Contracts or to Measure the *Performance of* Investment Funds and Amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No. 596/2014, 2016 O.J. (L 171) 1–65 (emphasis added).

ratings. As highlighted by ESMA, the very low levels of correlation between different ESG ratings make the construction of ESG benchmarks problematic, "with the choice of ESG rating provider having a significant impact on the components of these indices."[64] Moreover, because some companies operating in highly polluting industries may obtain high environmental scores from some ESG rating providers, there is a risk, ultimately, that capital allocation aligned with sustainability goals will be compromised, undermining the sustainability-related efforts of both sustainability-conscious end investors and the E.U. Therefore, in light of the ever-increasing size of the industry and interest in ESG benchmarks, there is a need to ensure the credibility of ratings.

To this end, after identifying a number of key points for consideration, in early 2021, ESMA called on the European Commission to take appropriate regulatory measures to ensure the quality and comparability of ESG ratings and assessment tools,[65] following which the Commission launched a consultation that, in June 2023, led to the publication of a proposal for a regulation on the transparency and integrity of ESG rating processing and distribution, in order to fill a gap in European legislation and in the legislation of the Member States, none of which currently provides for such regulation.[66]

Without prejudice to the fact that the Commission's objective is not to standardize rating processing methodologies, the definition of which can only be left to individual providers, the Regulation intervenes on important limitations of the current ESG ratings market: the substantial opacity and potential conflicts of interest that can influence the activities of rating providers. To this end, the latter, according to the proposed Regulation, would be subject to authorization by ESMA and subject to specific disclosure and organizational requirements, as well as a ban on the provision of certain

64. Letter to the European Commission (Jan. 28, 2021), https://perma.cc/TD8S-EWE5.

65. *See id.* (highlighting the lack of legally binding definitions and comparability among providers of ESG ratings and other issues could be addressed through a legislative proposal).

66. *See Proposal for a Regulation of the European Parliament and of the Council on Transparency and Integrity in Environmental, Social and Governance (ESG) Rating Activities*, COM (2023) 314 final (June 13, 2023).

services to rated companies that are likely to give rise to potential conflicts of interest.[67]

In particular, with the aim of encouraging institutional investors' pursuit of investment and stewardship strategies based on reliable and transparent assessments of the ESG performance of portfolio companies, the provisions in the proposed Regulations that ESG rating providers should publish on their websites the methodologies, models, and key rating assumptions they use in their activities, and the methodologies they use should be verified at least annually, including requirements for recording the data sources used and how they are used, appear particularly relevant.

Although it is, at present, difficult to predict whether (if they are finally adopted) the measures contained in the proposed Regulation are sufficient to overcome the limitations affecting the ESG ratings market, the proposal is presented as an important step forward in making this market more efficient and a measure that can, together with CSRD, incentivize the driving role in sustainability that the Commission entrusts to institutional investors.

V. SUSTAINABILITY DISCLOSURE AS THE OBJECT OF ENGAGEMENT INITIATIVES: REAL GOAL OR DIVERSION?

The relevance of sustainability disclosure for institutional investor engagement initiatives can also be assessed from a different perspective than the one discussed so far. Sustainability disclosure, in fact, constitutes not only one of the elements of information that can assume relevance for the purpose of defining engagement policies and identifying companies toward which specific initiatives should be directed but, often, represents the very objective of such initiatives.

This is apparent, first, from the stewardship policies adopted by major institutional investors, which contain specific recommendations directed to the companies being invested in regarding sustainability disclosure, sometimes even with specific indications regarding the drafting standards whose adoption is desired. For example, the Proxy Voting Guidelines

67. *See id.* at 9 ("This proposal empowers ESMA to carry out a new function, namely to authorise and supervise ESG rating providers providing their services under this Regulation.").

for European, Middle Eastern, and African Securities for the year 2023 explicitly state,

> [w]here a company has failed to appropriately provide robust disclosures and evidence of effective business practices, BIS may express concerns through our engagement and voting. As part of this consideration, we encourage companies to produce sustainability-related disclosures sufficiently in advance of their annual meeting so that the disclosures can be considered in relevant voting decisions.[68]

Regarding the content of sustainability disclosures BlackRock recommends, in particular, to "publish material, investor-relevant, industry-specific metrics and rigorous targets, aligned with SASB (ISSB) or comparable sustainability reporting standards."[69]

The relevance of information on ESG profiles from the point of view of institutional investor engagement initiatives is reflected in empirical evidence (relating to the U.S. context) from which the most frequent outcome of asset managers' engagement initiatives is improved disclosure, while in the case of hedge funds there is a more frequent impact on company strategies.[70] Further studies confirm that the greater presence of institutional investors in the corporate structure corresponds to a wider sustainability disclosure[71] and that, the increase in

68. BLACKROCK INV. STEWARDSHIP, PROXY VOTING GUIDELINES FOR U.S. SECURITIES 17 (2024), https://perma.cc/S8WB-7U2S (PDF).

69. Sandy Boss et al., *Investment Stewardship Proxy Voting U.S. Guidelines 2023*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 18, 2023), https://perma.cc/A78G-SJK7.

70. *See* Matteo Gatti et al., *How Does Board-Shareholder Engagement Really Work? Evidence from a Survey of Corporate Officers and from Disclosure Data*, in *Board-Shareholder Dialogue. Best Practices, Legal Constraints and Policy Options* 20–21 (Bocconi University, Working Paper No. 4256925), https://perma.cc/FR99-SZWM (analyzing results of ESG profile information as "45.5% reported that the engagement resulted in a change in a corporate practice" for hedge funds, while "73.3% reported that the engagement prompted additional public disclosure" for institutional investors).

71. *See* Emirhan Ilhan et al., *Climate Risk Disclosure and Institutional Investors*, 36 REV. FIN. STUD. 2617, 2644 (2023) ("[I]nstitutional investors value and demand climate risk disclosures . . . [I]nstitutions have a strong investor demand for such disclosures, and [] they actively engage portfolio firms to improve them.").

the latter, in turn, is associated, on average, with a higher rate of investment in the company by institutional investors.[72]

The foregoing, while confirming the centrality of non-financial information in the stewardship perspective of institutional investors, nevertheless lends itself to a dual, divergent reading, which ultimately reflects the aforementioned opposing views regarding the actual ability and willingness of institutional investors to foster improved environmental and social performance of portfolio companies.

On the one hand, the fact that improved sustainability disclosure is a recurring focus of engagement initiatives can be seen as a direct consequence of the importance of such information in the investment strategies of institutional investors. Indeed, as mentioned earlier, the presence of institutional investors is higher in companies with better sustainability disclosure.[73] In this regard, however, it must be considered that only in relation to a small percentage of portfolio companies are investors in a position to examine the information made available by the company and, in particular, sustainability reports, so that the use of ESG ratings and indices is decisive for investment decisions. Although the latter are developed by providers also taking into consideration the information contained in sustainability reports, it is not, therefore, possible to say that stewardship activities aimed at fostering an improvement in the quality of non-financial disclosure are necessarily instrumental in encouraging more informed investment choices.

Partly because of what has just been observed, it cannot therefore be ruled out that the choice of non-activist institutional investors to focus part of their engagement

72. *See* George Serafeim, *Reporting and Investor Clientele*, 27 J. APPLIED CORP. FIN. 34, 64 (2015) ("I find that investor activism on sustainability issues and the presence of a sustainability crisis leads firms to practice more [Integrated Reporting] and this change in IR is related to changes in investor base."); Brian Gibbons, *The Financially Material Effects of Mandatory Nonfinancial Disclosure*, 61 J. ACC. RSCH. (forthcoming 2023) (manuscript at 35) (on file with author) ("I find that institutional ownership increases significantly for firms required to disclose E&S information. These results coincide with institutional investors' complaints about insufficient disclosure of E&S information . . . . Following this increase in institutional investment, firms subject to mandatory E&S disclosure increase investment in R&D.").

73. *See supra* note 72 and accompanying text.

initiatives on sustainability disclosure, requiring, for example, a higher degree of transparency or the adoption of a certain set of reporting, is dictated by a desire to avoid more incisive initiatives (usually perceived by the companies being invested in as more aggressive) aimed at encouraging, for example, changes in the environmental strategies or policies of the companies involved. The aforementioned empirical evidence from which it appears that the results of engagement vary depending on whether asset managers or activist funds are involved is indicative: while initiatives involving the latter lead, with greater frequency than the impact on disclosure, to a change in the company's practices or, in a significant number of cases, to the appointment of a director indicated by them or to a change in the agenda, in the case of nonactivist investors, the publication of more information by the company concerned is by far the most frequent outcome of engagement initiatives.

Another indication of this may be drawn from practice, which has shown over the past year how the largest institutional investors (and, in particular, the so-called "Big Three") have denied, in most cases, their support to shareholder proposals, especially in environmental matters, which are considered excessively prescriptive and therefore likely to affect companies' policies and strategies too stringently.[74] Although the number of proposals is largely smaller in the European context,[75] due to the more stringent regulations, investor support for proposals deemed more constraining has also declined significantly in Europe due to the fact that, as mentioned above, U.S. investors, exposed to the consequences of conservative politicians' opposition to the pursuit of ESG objectives, have a prevailing weight even in European-listed companies.[76]

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74. *See* Cindy Posner, *More Prescriptive Proposals, Less Support for 2022 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 22, 2023), https://perma.cc/M5C2-RC8W ("[T]he prescriptive nature of many of the [ESG] proposals, especially climate-related proposals, has prompted many shareholders, including major asset managers, to vote against these proposals.").

75. *See* Michael H.C. Bakker, *Shareholder Proposals and Sustainability: An Empirically-Based Critical Reflection*, 20 EUR. COM. FIN. L. REV. 276, 282–83 (2023) (illustrating in Table 1 the number of shareholder proposals by country and quantity).

76. *See* Garrett Muzikowski & Hetal Kanji, *Investor Support of E&S Proposals*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 14, 2023),

Such a course of action on the part of nonactivist investors would, moreover, appear to be consistent with what has been observed above regarding factors likely to limit the effective ability of investors to promote the pursuit of ESG goals by the companies being invested in. In addition to being perceived as less aggressive by the companies concerned, engagement initiatives concerning sustainability disclosure are, as a rule, less burdensome for investors because they can be implemented in a substantially standardized manner and with the incurring of lesser burdens.

This brings us back to the central question of whether institutional investors can actually play the driving role in favor of a more sustainable economic model that is often ascribed to them and is a key element of the European Commission's strategy to achieve this goal.

CONCLUSION

Sustainability disclosure requirements placed on listed companies are considered an essential element of the regulatory strategy aimed at fostering the transition to a more sustainable economic model. Several sets of sustainability standards have been adopted internationally. The European Commission recently adopted the CSRD, which places more stringent obligations and expanded the scope of companies, including unlisted ones, required to publish sustainability reports. On March 21, 2022, the SEC issued a proposed rule that would enhance and standardize climate disclosure requirements provided by public companies that should be finalized in the near future.

While such sustainability-related disclosure requirements may create a "name and shame" obligation for companies to take initiatives to improve their ESG performance, it is doubtful that such obligations can promote ESG-related stewardship activities by institutional investors.

Although they are considered the primary recipients of sustainability reports by many standard-setters, institutional investors and particularly those with widely diversified

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https://perma.cc/R68B-KAEJ ("Given the significant shareholding of large US institutional investors across European equities, the anti-ESG backlash in the US has likely impacted outcomes at European AGMs.").

portfolios are unable, given the very high costs this would entail, to use sustainability disclosures directly. This is also due to the fact that the regulatory framework is still fragmented and there are differences between the various sustainability disclosure sets, concerning in particular the notion of materiality, which make it difficult to compare sustainability reports prepared under different standards.

For these reasons, institutional investors rely on ESG ratings and indices for the purposes of their investment and stewardship strategies. As European legislation clearly demonstrates, providing climate and social disclosure requirements is therefore not sufficient, and regulation of ESG ratings and indices is essential to make them more transparent and reliable.

In addition, the choice of nonactivist institutional investors to focus part of their engagement initiatives on sustainability disclosure, requiring, for example, a higher degree of transparency or the adoption of a certain set of reporting, appears to be dictated by a desire to avoid more incisive initiatives (perceived as more aggressive) aimed directly at encouraging change in the environmental strategies or policies of the companies concerned.