

# EXTERNALITIES AND THE COMMON OWNER

by Madison Condon

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This Article expands the consideration of the effects of common ownership from the industry level to the market-portfolio level and argues that diversified investors should rationally be motivated to internalize intra-portfolio negative externalities. This portfolio perspective can explain the increasing climate change-related activism of institutional investors, who have applied coordinated shareholder power to pressure fossil fuel producers into substantially reducing greenhouse gas emissions.

## I. Introduction

The climate activism of investors of large companies presents two paradoxes for scholars of corporate governance. First, the theory behind the law of corporate governance rests on the assumption that shareholders' rational self-interest drives them to exercise their governance rights with the singular goal of maximizing corporate value.<sup>1</sup> Second, broadly diversified investors are typically described as poor monitors of corporate behavior.<sup>2</sup>

This Article argues that this paradoxical behavior can be explained by revising traditional corporate governance theory to account for institutional investors' motivations at a *portfolio* rather than a *firm* level. It argues that institutional investors' climate activism is motivated by their desire to mitigate climate change risks and damages to their economy-mirroring portfolios. Unchecked emissions contribute to an increase in global average temperature that is predicted to have a devastating effect on the world

economy. The institutional investors most active on corporate climate engagement have portfolios diversified across the entire economy. It is in their self-interest to reduce global emissions.

This Article contributes to the ongoing debate over common ownership by identifying the causal mechanisms by which institutional investors influence corporate directors into deviating from profit-maximizing objectives,<sup>3</sup> adding to the growing understanding of the net welfare effects of common ownership.<sup>4</sup> Diversified shareholder interests can diverge from the interests of concentrated shareholders and the objective of maximizing share price. This divergence undermines the efficiency-based rationale for shareholder primacy's ultimate service to social welfare maximization.<sup>5</sup> While most scholars have argued that managers should prioritize diversified shareholder interests because they are better-aligned with the goal of increasing social welfare,<sup>6</sup> this perspective has ignored diversified investor incentives to reduce inter-firm costs, and failed to consider the net welfare effects of common ownership.

This Article contemplates initial implications of diversified investor economy-wide control, including ambiguous net welfare effects and the concern that the market power to self-regulate operates as a form of unaccountable private governance.

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1. See, e.g., Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 961 (1984); Henry Hansmann & Reinier Kraakman, *End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 69-70 (1991).
2. See, e.g., Lucian Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 103 (2017); Edward B. Rock, *Institutional Investors in Corporate Governance* 12 (U. Penn., Working Paper No. 1458, July 21, 2015); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 472 (1991).

3. See Daniel P. O'Brien & Keith Waehrer, *The Competitive Effects of Common Ownership: We Know Less Than We Think*, 81 ANTITRUST L.J. 729, 761-64 (2017).
4. See Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership* 7 (NYU Law and Economics Research Paper No. 18-29, Nov. 2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3210373](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3210373).
5. See Hansmann & Kraakman, *supra* note 1, at 441; cf. Milton Friedman, *The Social Responsibility of Business Is to Increase Profits*, N.Y. TIMES MAG. (Sept. 13, 1970).
6. Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 434 (1998) (citing EASTERBROOK & FISCHEL, *supra* note 1, at 25-30, 339-40); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW*, 370-71, 380 (3d ed. 1986); Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 350 (1990); cf. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 583-85 (2006).

## II. Institutional Investors' Externality Internalization

This Article proposes that institutional investors are pursuing profit-maximizing objectives unrelated to any personal moral agenda by addressing negative externalities at their source, minimizing harms to their broader portfolio.

### A. Portfolio-Maximizing Objective of Common Owners

Institutional investor equity ownership has reached unprecedented proportions. Due to the embrace of modern portfolio theory,<sup>7</sup> most institutions diversify their public equity assets broadly across the stock market. Empirical studies on the market effects of concentrated ownership show that diversified investors maximize their portfolio returns by influencing choices made at the firm level.

A portfolio-wide investment strategy should look across industries. An owner whose portfolio success tracks the entire market should be motivated to curtail the negative externalities generated by individual portfolio firms if the owner's share of the cost of internalizing the externality are lower than its share of the benefits to the entire portfolio from the elimination of the externality.

### B. Reduction of Systemic Climate Risks

Modern portfolio theory identifies two types of financial risk: economy-wide, systematic risk, and firm-specific, unsystematic risk.<sup>8</sup> Systemic risk cannot be eliminated through diversification because its effects are felt economy-wide.<sup>9</sup> Three types of climate change-related risks—transition risk, physical risk, and liability risk—so broadly affect the economy, they are considered systemic risks.<sup>10</sup> Climate risk is a systemic risk that institutional investors can control.

### C. Shareholder Activism for Climate Change Mitigation

For outcomes to be characterized as internalizing negative climate externalities, they must result in emissions reductions beyond regulatory and market forces. Diversified shareholders must be forcing firms to forgo profit at the expense of share value maximization. Shareholders might characterize these interventions as for the benefit of individual firms.

### 1. Outcomes Sought From Portfolio Companies

Investor climate activism targeting fossil fuel companies can be grouped into three categories of outcomes sought.

#### a. Emissions Reduction Targets

In 2017, a group of institutional investors joined the Climate Action 100+ initiative, asking peers to sign a pledge committing their shareholder power to pressuring companies to adopt long-term emissions reduction targets.<sup>11</sup> By the 2019 proxy season, 360 institutional investors had signed the pledge, controlling a combined \$34 trillion in assets.<sup>12</sup> Shareholder resolutions requesting emissions reductions targets have been increasing in frequency and gaining support.<sup>13</sup> In 2018, 29 such proposals were filed.<sup>14</sup>

Institutional investors have also increasingly engaged in public-facing advocacy. In advance of the 2018 proxy season, investors managing a combined \$10.4 trillion in assets issued an open letter in the *Financial Times* urging oil and gas companies to make “concrete commitments to substantially reduce carbon emissions” and explain “how the investments they make are compatible with a pathway towards the Paris goal” of less than 2°C of warming.<sup>15</sup>

#### b. Suspension of Anti-Regulation Lobbying

Institutional investors pay increasing attention to the resources companies devote to lobbying efforts aimed at thwarting carbon regulation. In the 2018 proxy season, a coalition of 74 investors filed shareholder proposals at 14 emissions-intensive companies seeking disclosure of expenditures for lobbying.<sup>16</sup> The proposals specifically targeted companies for membership in groups devoted to fighting climate regulation.<sup>17</sup>

#### c. Climate Risk Disclosure

Investors have pressed for disclosure of climate change-related risks. In the 2017 proxy season, 18 shareholder proposals requested that fossil fuel and utility companies undergo and disclose two-degree scenario analysis.<sup>18</sup> The

7. See Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77, 79 (1952).

8. See RICHARD A. BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 168-70 (10th ed. 2011).

9. Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 200 (2008).

10. See UNIV. OF CAMBRIDGE INST. FOR SUSTAINABILITY LEADERSHIP, *UNHEDGEABLE RISK: HOW CLIMATE CHANGE SENTIMENT IMPACTS INVESTMENTS* 28 (2015), <https://www.cisl.cam.ac.uk/resources/publication-pdfs/unhedgeable-risk.pdf>.

11. *About Us*, CLIMATE ACTION 100+, <https://climateaction100.wordpress.com/about-us/>.

12. *Investors*, CLIMATE ACTION 100+, <https://climateaction100.wordpress.com/investors/>.

13. Maximilian Horster & Kosmas Papadopoulos, *Climate Change and Proxy Voting in the U.S. and Europe*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Jan. 7, 2019), <https://corpgov.law.harvard.edu/2019/01/07/climate-change-and-proxy-voting-in-the-u-s-and-europe/>.

14. *Id.*

15. Aberdeen Standard Investments et al., *Oil and Gas Groups Must Do More to Support Climate Accord*, FIN. TIMES (May 17, 2018), <https://www.ft.com/content/fda63c26-5906-11e8-b8b2-d6ceb45fa9d0>.

16. Press Release, Walden Asset Management, Institutional Investors Continue to Press Companies for Disclosure of Lobbying in 2018 (Mar. 9, 2018), <https://waldenassetmgmt.com/wp-content/uploads/2018/03/Announcement-of-2018-Lobbying-Disclosure-Resolutions-correct-Walden-Logo.pdf>.

17. See CERES, Engagement Tracker, available at <https://engagements.ceres.org/> [hereinafter CERES, Engagement Tracker].

18. Cristina Banahan, *Doubling Down on Two-Degrees: The Rise in Support for Climate Risk Proposals*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE &

proposals received an average of 41% support, with three passing with majority approval.<sup>19</sup> In the 2018 season, 12 of the 20 shareholder proposals related to two-degree scenario analysis were withdrawn prior to voting due to board acquiescence.<sup>20</sup>

## 2. Legitimacy of Firm-Specific Business Purpose

This investor activism targets the managers of individual companies to change corporate objectives at the firm level. These objectives serve the purpose of maximizing long-term portfolio returns, to the detriment of firm-specific returns.

### a. Assessing Outcomes

The outcomes identified above may not serve profit maximization at the targeted firm. The extent to which a firm-specific rationale is lacking serves as further evidence that investor motivations are guided by net portfolio returns.

*Emissions Reduction Goals:* Investors argue that the company is failing to adequately prepare for government regulation and the growth of renewable alternatives.<sup>21</sup> Institutional investors argue that they have a better understanding of the growth needed to meet expected demand than the executives within the energy industry. The business rationale for meeting emissions targets remains unclear.

*Disclosure of Lobbying:* In one set of shareholder proposals requesting disclosure of lobbying expenditures, institutional investors argued that “investors are concerned lobbying can pose reputational risks if it contradicts a company’s publicly stated positions.”<sup>22</sup> If disclosure is necessary because information on spending is not already publicly available, it is unclear where this reputational risk would originate. Disclosure would open the companies up to broader public sanction.<sup>23</sup>

*Disclosure of Climate Risk:* Demand for disclosure of energy companies’ exposure to climate risk is typically justified by the argument that they are inadequately prepared for the carbon-regulated future. This “transition risk” comes from a failure to adapt in time to a less carbon-intensive economy.<sup>24</sup> If climate risks are indeed mispriced,

investor statements regarding climate risk disclosure remain puzzling. A better explanation might be that retaining control in the company provides benefits to the wider portfolio. Index funds, who cannot sell their shares, have been some of the most vocal investors in demanding disclosure of climate risk.<sup>25</sup> Index funds are not supposed to be particularly concerned about firm-specific valuations or disclosure. Increased firm-level disclosure may ensure that the firm’s stock is more accurately priced, but this accuracy reduces only idiosyncratic risk.<sup>26</sup>

### b. Portfolio Purpose and Retail Opposition

Internalization of harmful climate externalities benefits the portfolio at the expense of the externality-generating firms. If these climate outcomes are in the best interest of the company, one would expect concentrated shareholders to lend their support. It appears, however, that they give less support to climate-related resolutions than their institutional co-owners.

## 3. Impact on Emissions Reductions

Under this theory of externality-internalization, economists are beginning to explore whether diversified investor ownership leads to emissions reductions in portfolio companies.<sup>27</sup>

*Emissions Goals:* Of the outcomes sought by shareholders, explicit emissions reductions goals have the clearest causal relationship to actual emissions reductions.

*Corporate Lobbying:* Investors are asking companies not only to disclose their spending on lobbying efforts to oppose carbon regulation, but also to refrain from such spending or proactively support emissions-limiting laws.

*Disclosure of Climate Risk:* Forcing companies to assess their carbon budget exceedances exposes the potential social undesirability of their business models. Transparent acknowledgement of plans at odds with combatting global warming enables regulators to better target their interventions.

Socially undesirable corporate practices can be reduced through disclosure alone.<sup>28</sup> Disclosure can also lead to decreased future emissions through limiting the capital that is allocated to the exploration and development of fossil fuel reserves. Disclosure of two-degree scenario analyses can correct both market-wide misassessment of risk or

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FIN. REG. (Jan. 23, 2018), <https://corpgov.law.harvard.edu/2018/01/23/doubling-down-on-two-degrees-the-rise-in-support-for-climate-risk-proposals/>.

19. *Id.*

20. Andrew Logan, *The Hidden Story of Climate Proposals in the 2018 Proxy Season*, CERES (May 29, 2018), <https://www.ceres.org/news-center/blog/hidden-story-climate-proposals-2018-proxy-season>.

21. See, e.g., EXXON MOBIL, EXXON EMISSIONS TARGETS PROPOSAL 2019, <https://www.osc.state.ny.us/press/docs/xom-resolved.pdf>.

22. *Investor Coalition Files Proposals at 50-Plus Companies on Lobbying Activities*, PENSIONS & INV. (Mar. 9, 2018, 12:00 AM), <https://www.pionline.com/article/20180309/ONLINE/180309806/investor-coalition-files-proposals-at-50-plus-companies-on-lobbying-activities>.

23. See, e.g., Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1212, 1294-95 (1999).

24. See RISKY BUSINESS, THE ECONOMIC RISKS OF CLIMATE CHANGE IN THE UNITED STATES (2014), [https://riskybusiness.org/site/assets/uploads/2015/09/RiskyBusiness\\_Report\\_WEB\\_09\\_08\\_14.pdf](https://riskybusiness.org/site/assets/uploads/2015/09/RiskyBusiness_Report_WEB_09_08_14.pdf).

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25. See, e.g., Gabriel T. Rubin, *Show Us Your Climate Risks, Investors Tell Companies*, WALL ST. J. (Feb. 28, 2019, 5:30 AM), <https://www.wsj.com/articles/show-us-your-climate-risks-investors-tell-companies-11551349800>.

26. See Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 253 (2009).

27. See José Azar et al., *The Big Three and Corporate Carbon Emissions Around the World* (working paper, on file with author); Sophie Shive & Margaret Forster, *Corporate Governance and Pollution Externalities of Public and Private Firms*, (Feb. 21, 2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3339517](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3339517).

28. Andrew Schatz, Note, *Regulating Greenhouse Gases by Mandatory Information Disclosure*, 26 VA. ENV'T L.J. 335, 336 (2008).

intentional misstatements leading to mispricing, which can have a regulating effect.<sup>29</sup>

This opens managers to liability for fraudulent misstatements and decreases the incentives for managers to conceal risk exposure. Disclosure in the form of two-degree scenario analysis requires the company to show how it would respond to regulation, and allows investors to assess the likelihood of such comprehensive regulation.

#### D. Internalization of Climate Externalities: Cost-Benefit Analysis of Climate Intervention

Predicting economy-wide costs of climate change is extremely challenging. What matters is how institutional investors themselves perceive the risks. For an investor diversified across the economy, climate damages' impact will result in proportional impacts to cash flows.<sup>30</sup>

Consider a hypothetical analysis BlackRock makes when weighing whether to take a measure to curtail production at Chevron and Exxon. Assume it forces each company to reduce its emissions by 40%, resulting in that company's share price falling by 20%. If it loses 20% of the value of each of these assets, it will lose \$6.3 billion total.

Emissions reduction was modeled using William Nordhaus' Dynamic Integrated Climate Economy Model (DICE). The business-as-usual pathway was modeled, first as a baseline, and then again, removing 1% of industrial emissions each year through 2100. The difference in the value of damages between these two model runs was compared, aggregated over 100 years, and discounted 7%. DICE predicts that by intervening, BlackRock could avoid damages to its portfolio of \$9.7 billion. It would be in BlackRock's economic interest to pursue this intervention.

This is an oversimplification of the trade offs an investor must analyze. A full understanding of the supply and demand effects of firm-specific targeting requires economic modeling beyond the scope of this Article.

### III. Ability and Incentives of Common Owners

While investors deny their ability to influence inter-firm competition, they advertise their power to pressure firms into reducing emissions. In addition, the internalization of portfolio externalities provides institutional investors with an *incentive* to intervene.

29. Fox, *supra* note 26.

30. UNEP FINANCE INITIATIVE & PRINCIPLES FOR RESPONSIBLE INVESTMENT, UNIVERSAL OWNERSHIP: WHY ENVIRONMENTAL EXTERNALITIES MATTER TO INSTITUTIONAL INVESTORS (2011).

#### A. Mechanisms for Influencing Managers

Scholars have identified several ways investors could influence managers to undertake portfolio-maximizing behavior.<sup>31</sup>

*Board Elections:* BlackRock's Larry Fink has said that the ability to vote against management serves as an "implicit sanction" and that this power has led to "serious" corporate changes.<sup>32</sup>

*Compensation:* Several studies have found that managerial compensation is less likely to be tied to relative firm performance when the firm shares more common owners with industry competitors.<sup>33</sup>

*Direct Communications:* Institutional investors regularly communicate with corporate management on climate-related issues. BlackRock has argued that "meetings behind closed doors can go further than votes against management."<sup>34</sup> Climate Action 100+ announced its intent to seek "private, not public proposals."<sup>35</sup>

*Shareholder Proposals:* The success of institutional investors' climate activism can be seen in the number of shareholder proposals that were withdrawn prior to being brought to a vote in recent years: 38 in 2017 and 39 in 2019.<sup>36</sup> Because withdrawn proposals signify that the investor has been appeased, they are "one of the best indicators of activists' success."<sup>37</sup>

#### B. Liability for Violation of Fiduciary Duty

While shareholders are under no legal obligation to vote their shares in the best interest of the corporation, asset managers have a duty to individual retail investors.<sup>38</sup> Further, managers and directors have a fiduciary duty to undertake actions in the best interest of their company.<sup>39</sup>

31. Einer Elhauge, *How Horizontal Shareholding Harms Our Economy—and Why Antitrust Law Can Fix It* 33-42 (Working Paper, Aug. 2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3293822](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3293822).

32. Tim Wallace, *Index Funds Must Use Their Huge Power Over Companies, Says BlackRock Chief Larry Fink*, TELEGRAPH (Apr. 29, 2018, 8:43 PM), <https://www.telegraph.co.uk/business/2018/04/29/index-funds-must-use-huge-power-companies-says-blackrock-chief/> (last visited Jan. 28, 2020).

33. Miguel Antón et al., *Common Ownership, Competition, and Top Management Incentives* 2-3 (Ctr. for Econ. Stud. & Info Inst., Working Paper No. 6178, 2018), <http://ssrn.com/abstract=2802332> (last visited Jan. 28, 2020).

34. Sarah Krouse et al., *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 24, 2016), <https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101> (last visited Jan. 28, 2020).

35. Lewis Braham, *Climate Change: Big Investors Bring Big Clout to the Debate*, BARRON'S (Apr. 27, 2018), <https://www.barrons.com/articles/big-investors-bring-big-clout-to-climate-battle-1524838935>.

36. See CERES, Engagement Tracker, *supra* note 17.

37. Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 689 (2016).

38. See, e.g., Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TENN. J. BUS. L. 175 (2017).

39. Thomas A. Lambert & Michael E. Sykuta, *Calm Down About Common Ownership*, 41 REG. 28, 31 (2018); O'Brien & Wachrer, *supra* note 3, at 765-66.

## 1. Investor Duty to Underlying Beneficiaries

A voting strategy that minimizes portfolio-wide negative externalities is likely not in the best interests of an individual investor whose assets are concentrated in the industry generating the externality. The practice of voting all funds in the same way is customary. If institutional investors are able to provide plausible business-purpose cover for the voting strategy, their true intentions may go undetected and unpunished.

Many institutional investors do not face this intra-beneficiary conflict. Pension funds pay out to all plan participants from one fund, so each beneficiary's diversification is the same. For these investors, it is arguable that their fiduciary duties *require* them to internalize firm-generating externalities to maximize portfolio returns. That only certain types of institutional investors face this conflict of fiduciary duties may explain their varying levels of climate engagement.

## 2. Fiduciary Duties of Managers

Firm managers have a fiduciary duty to manage in the best interests of “the corporation and its shareholders.”<sup>40</sup> The business judgment rule (BJR) protects managers from liability for decisions made under “any rational business purpose.”<sup>41</sup> A court “begins with the presumption that . . . the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>42</sup> The increasing acquiescence to shareholder demand for climate risk disclosure easily satisfies this standard.

## C. Incentive to Intervene: Amending Model of Rational Reticence

As institutional investors grew in size, scholars predicted that they might develop a solution to the separation of ownership from control.<sup>43</sup> Dispersed stakes concentrated under the oversight of fund managers might justify spending resources on firm monitoring to seek higher returns.<sup>44</sup> More recently, scholars agree that these predictions have not been borne out; institutional investors lack the capacity and the incentive to intervene.<sup>45</sup>

40. N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989).

41. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

42. eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 36 (Del. Ch. 2010).

43. Adolf Berle, *Implications of the Corporate Revolution in Economic Theory*, in ADOLF BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 81 (Harcourt, Brace and World rev. ed. 1968).

44. See, e.g., Bernard Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); Alfred Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117 (1988).

45. Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy* 12 (EUROPEAN CORP. GOVERNANCE INST., Working Paper Series in Law No. 433, 2018).

Institutional investors face their own collective action problems. They rarely own more than 10% of any company.<sup>46</sup> This leads to the “free-rider dilemma”<sup>47</sup> and the “rational apathy” problem.<sup>48</sup> However, any accurate model of the agency costs of institutional investors must account for the investors' motivations at the *portfolio level*.

In certain cases, the cost of firm-specific intervention may be overcome by benefits accruing to the wider portfolio. Because institutional investors increasingly hold portfolios that mirror one another's asset diversification,<sup>49</sup> they share similar portfolio-wide incentives. This is especially true of interventions that require a coordinated effort across firms, like limiting fossil fuel production. Here, reduction in supply only results in lower emissions if it is undertaken over a large enough portion of the industry, which incentivizes investors to coordinate through coalitions like Climate Action 100+.<sup>50</sup>

## IV. Implications of Diversified Shareholder Objectives

Most scholars have argued that the goals of diversified shareholders are more closely aligned with that of society and should be prioritized. There are reasons to be cautious about embracing this phenomenon as socially desirable: (1) the net welfare effects of common ownership are yet to be fully considered and (2) the ability of asset managers to “self-regulate” suggests this concentration of power can function as a form of private governance, raising questions regarding democratic accountability and the potential to displace the role of “traditional” government.

### A. Welfare Effects

This Article outlines one positive welfare effect that can occur: the internalization of negative externalities. An additional “bright side” of common ownership has also been greater investment in innovation.<sup>51</sup>

While the world's largest investors may have an economic incentive to mitigate the harms climate change impose on their portfolios, this incentive is not aligned with the *socially* optimal level of emissions.

46. Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 868-69 (2013).

47. Roberta Romano, *Institutional Shareholders and Corporate Governance in the U.S.*, in CORPORATE GOVERNANCE IN THE U.S. AND EUROPE: WHERE ARE WE NOW? 52, 55 (Geoffrey Owen et al. eds., 2006); Robert C. Pozen, *The Role of Institutional Investors in Curbing Corporate Short-Termism*, FIN. ANALYSTS J. 10 (Sept./Oct. 2015).

48. Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L. REV. 1259, 1268-69 (2009); Rock, *Significance of Institutional Shareholder Activism*, *supra* note 2.

49. See Matthew Backus et al., *Common Ownership in America: 1980-2017*, at 22-23 (NBER Working Paper 25454, 2019).

50. See, e.g., Press Release, CERES, Nearly 400 Investors With \$32 Trillion in Assets Step Up Action on Climate Change (Sept. 14, 2018), <https://www.ceres.org/news-center/press-releases/nearly-400-investors-32-trillion-assets-step-action-climate-change>.

51. Miguel Antón et al., *Innovation: The Bright Side of Common Ownership?* (Working Paper June 21, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3099578](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3099578).

Asset owners care about some externalities more than others depending on the aggregate impact on their portfolio. That is why common ownership can result in both the socially desirable internalization of climate externalities and the socially undesirable collusion to raise prices, resulting in deadweight welfare loss.

Institutional investors face many barriers to implementing their own interests in externality internalization. Optimal performance would require a general equilibrium model, which can simultaneously solve for all outcomes in the market, but does not exist in a perfect form.<sup>52</sup>

### B. Market Concentration and Investor as Regulator

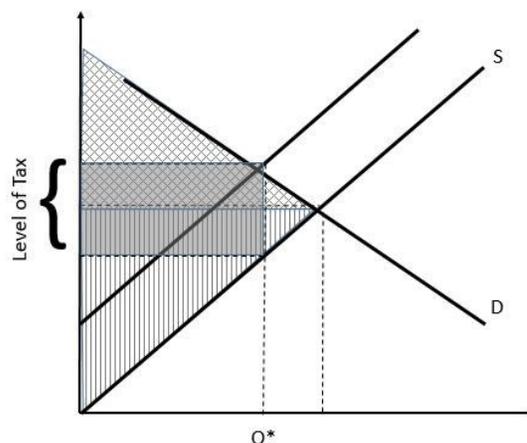
By facilitating a coordinated decline in the supply of fossil fuel company products, institutional investors are encouraging a rise in the price of those products. From this view, institutional investors' imposition of emissions goals at the producer level can be analogized to a carbon tax, except the increased costs paid by consumers are collected as corporate profits rather than revenue for the government. Producers incur their own losses in both scenarios. Under the coordinated decrease in supply, suppliers sell fewer products, but at a higher price. The net effect on profits depends on the elasticity of the demand curve. Overall, the same desired outcome may be achieved, by organizing a supply-side restriction without having to lose revenue to taxes.

The insight that self-regulation of externalities through market power can cost *less*, from a portfolio perspective, than implementation of a Pigouvian tax, suggests that investors may have an incentive to preempt government action.

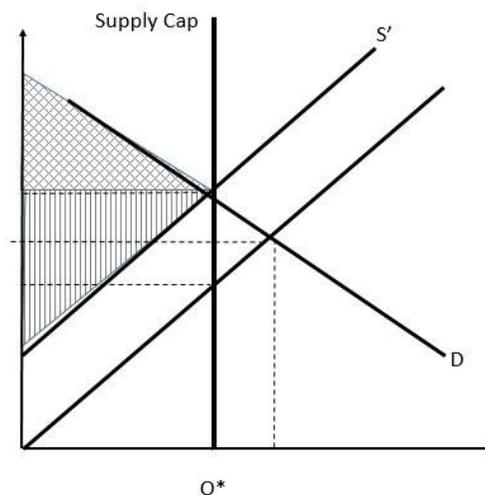
This Article makes a new contribution to the literature on voluntary corporate reduction of environmental harm. Several explanations have been advanced for the existence of private governance schemes. First, many of these initiatives exist in complement to public law.<sup>53</sup> Or they are an appeal to consumers or a reaction to environmental activist campaigns and motivated by the desire to avoid bad publicity. Commentators have neglected the influence of diversified investor self-interest. Under this explanation, private investors respond to the *absence* of government regulation. This explanation is consistent with traditional theories of utility-maximizing market actors.

Externalities have typically been seen as classic examples of market failure, requiring government intervention.<sup>54</sup> However, in the current political climate, the

**Figure 1. Government-Imposed Pigouvian Tax**



**Figure 2. Investor-Imposed Supply-Side Restriction**



world's largest asset managers have begun to serve as "surrogate regulators."<sup>55</sup>

While we may celebrate the ability of institutional investors to combat climate change,<sup>56</sup> we should question the desirability of a democratically unaccountable financial behemoth making centralized resource allocation decisions.

It may be possible to design a legal regime that encourages the positive effects of common ownership, like the diminution of systemic risks, while preventing harmful anti-competitive behavior.

52. See, e.g., Letter from the Science Advisory Board (SAB), to E. Scott Pruitt, Admin., U.S. Env't Prot. Agency 1 (Sept. 29, 2017), [https://yosemite.epa.gov/sab/sabproduct.nsf/0/4B3BAF6C9EA6F503852581AA0057D565/\\$File/EPA-SAB-17-012.pdf](https://yosemite.epa.gov/sab/sabproduct.nsf/0/4B3BAF6C9EA6F503852581AA0057D565/$File/EPA-SAB-17-012.pdf).

53. Michael P. Vandenbergh, *The Private Life of Public Law*, 105 COLUM. L. REV. 2029, 2030 (2005).

54. RICHARD N.L. ANDREWS, *MANAGING THE ENVIRONMENT, MANAGING OURSELVES: A HISTORY OF AMERICAN ENVIRONMENTAL POLICY* 2 (1999).

55. Cf. Davis Hess, *Public Pensions and the Promise of Shareholder Activism for the Next Frontier of Corporate Governance: Sustainable Economic Development*, 2 VA. L. & BUS. R. 221, 235 (2007).

56. See, e.g., Nathan Atkinson, *If Not the Index Funds, Then Who?*, BERKELEY BUS. L.J. (forthcoming), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3341620&download=yes/](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3341620&download=yes/) (last visited Jan. 28, 2020).

### C. Shareholder Primacy and Efficiency-Framing

Much of the theory behind corporate law norms rests on the assumption that shareholders' rational self-interest drives them to exercise their governance rights with the goal of maximizing corporate value.<sup>57</sup> Consideration of common owner incentives challenges these core assumptions by showing that diversified shareholder interests can diverge from both the interests of concentrated shareholders and the objective of maximizing share price.<sup>58</sup>

The interests of diversified and concentrated shareholders diverge in their preferences for how much risk a corporate manager should take on. Most scholars advocate that firm managers should serve the objectives of the diversified over the concentrated holder because this goal more closely conforms to the socially desired optimum.<sup>59</sup>

Because idiosyncratic risk does not (theoretically) affect share price, this deference to diversified shareholders over concentrated ones does not implicate a deviation from the mandate of share price maximization.<sup>60</sup> While "most scholars" advocate that "management should manage with the interests of diversified stockholders in mind,"<sup>61</sup> these arguments generally ignore the perverse inter-firm production effects this would bring about.

Economy-wide diversification means that investors become common owners of firms that compete and impose costs on one another. Proponents of shareholder primacy argue that requiring managerial devotion to shareholder interests is the best way to maximize aggregate social welfare.<sup>62</sup> This argument assumes that individual firms lack market power to internalize externalities directly without ceding market share to competitors willing to externalize their costs.<sup>63</sup> This Article provides evidence that diversified

investors can implement externality internalization and deviation from share price maximization can improve portfolio efficiency. However, diversified institutional investor market power to internalize externalities comes along with the power to influence other inter-firm behaviors.

The portfolio-maximizing objective of common owners suggests that the advocates of managerial duty to diversified shareholders have not fully considered its perverse effects.<sup>64</sup> Beyond the market distortions that such a duty might enable, it is unclear how a manager could meet it. Shareholder value maximization as a theory of corporate purpose rests, in part, on the simplicity of measuring managerial success through a single metric.<sup>65</sup>

### V. Conclusion

Institutional investors have the economic incentive to function as "surrogate regulators," sacrificing individual firm profits for the benefit of the broader portfolio. This explanation of *why* institutional investors pressure firms to voluntarily reduce emissions has challenged the assumption that shareholders uniformly seek to maximize share value. Further, investors have the ability to carry out their portfolio-maximizing agenda through their power over both the market and managers. This explanation of *how* institutional investors are able to pressure firms into deviating from a profit-maximizing objective challenges the traditional view of diversified investor passivity.

Discussion of the appropriate legal response to common ownership has focused on the law of antitrust. This Article shows that corporate law must also respond given its failure to account for the behavior and influence of diversified investors.

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57. See, e.g., Romano, *supra* note 1.

58. See Elhauge, *supra* note 31; cf. Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. ACCOUNT. 247, 266-67 (2017).

59. *Id.*

60. STEPHEN ROSS ET AL., CORPORATE FINANCE 363-67 (10th ed. 2013).

61. Booth, *supra* note 6.

62. Hansmann & Kraakman, *supra* note 1.

63. See, e.g., Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APP. CORP. FIN. 8, 16 (2001).

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64. See, e.g., Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1282 (1991).

65. See, e.g., Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 MINN. L. REV. 1951, 2008 n.249 (2018).

# A WELFARE FUNCTION FOR SHAREHOLDER ENGAGEMENT: RECOGNIZING PROFIT FOR WHAT IT IS

by Frederick Alexander

*Frederick Alexander is the Chief Executive Officer of The Shareholder Commons.*

Madison Condon's *Externalities and the Common Owner* (ECO) plays an important role in the growing literature around shareholder activism aimed at increasing portfolio returns, regardless of individual firm effects. The article raises important questions of political economy, power distribution, and anticompetitive activity. In this Comment, I introduce key terminology for discussing these issues, and then reframe several issues raised by the article.

## I. Proposed Definitions

Defining terms can go a long way toward establishing common ground for discussion and helping to properly frame critical questions.

*Alpha.* The relative financial return of a residual security (typically common stock) or a portfolio of residual securities compared to the average return of a security or portfolio with similar volatility over a fixed period.

*ESG integration.* The shareholder practice of exercising corporate governance rights and otherwise engaging with a portfolio company in order to improve the company's internal governance and social and environmental impacts, all with a goal of increasing the company's shareholder value.

*Beta activism.* In contrast to ESG integration, the shareholder practice of exercising corporate governance rights and otherwise engaging with portfolio companies with the goal of improving their impacts on society and the environment and, consequently, on the absolute return of diversified portfolios. Effective beta activism may result in reduced alpha for some companies.

*Beneficiaries.* The human beings who benefit from shares held by shareholders, including the owners of mutual funds, workers in retirement plans, citizens in sovereign wealth funds, foundations and endowments, insureds in insurance company assets, and retail shareholders themselves.

## II. Framing the Issues

### A. What Are the Costs of Shareholder Primacy?

As ECO points out, there is an efficiency-based rationale for shareholder primacy, or the idea that companies should maximize shareholder value: the use of profits is a good heuristic for value creation. This idea of the "invisible hand" is deeply embedded in folk economics, but profits do not equal value creation when negative externalities exist or markets are otherwise imperfect.<sup>1</sup>

Any discussion of the cost of abandoning shareholder primacy must reckon with costs as well as benefits by examining the threats to the long-term health of the economy that come from unrestrained profit-seeking. A recent study estimated that in 2018, listed companies produced \$4.1T in profits globally and more than \$2.2T in social costs, suggesting that the heuristic is off by at least a factor of two.<sup>2</sup> The cost may be even greater because profits can come at a cost to the climate, biodiversity, ocean health, clean water, diversity, equality and other valuable systemic factors not captured in the study. The annual value we receive from the endangered global ecosystem is greater than global GDP.<sup>3</sup> As Duncan Austin says:

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1. See, e.g., KAUSHIK BASU, *BEYOND THE INVISIBLE HAND: GROUNDWORK FOR A NEW ECONOMICS* 10 (2011) (explaining the First Fundamental Theorem of Welfare Economics as the strict conditions under which the invisible hand conjecture holds).
  2. Andrew Howard et al., *SustainEx: Quantifying the Hidden Costs of Companies' Social Impacts*, SCHRODERS (Apr. 11, 2019), <https://www.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/sustainability/sustainex/sustainex-short.pdf>.
  3. Duncan Austin, *Greenwish: The Wishful Thinking Undermining the Ambition of Sustainable Business*, PREVENTABLE SURPRISES (July 22, 2019), <https://preventablesurprises.com/wp-content/uploads/2019/07/2019-07-19-Greenwish-Essay.pdf>.

more of the environmental and social exchanges that shape our wellbeing may be unpriced than priced, yet we increasingly steer by the priced exchanges only.<sup>4</sup>

While research has measured the potential cost of climate change,<sup>5</sup> antimicrobial resistance,<sup>6</sup> racial injustice,<sup>7</sup> growing inequality,<sup>8</sup> and other costs that companies externalize in pursuit of profit, greater understanding of the relationship between shareholder value and externalized costs is necessary for policymakers, investors, labor leaders, and other economic power holders to make better decisions. Even with clarity that it is socially beneficial for shareholders to engage in beta activism, there is work to be done in defining the most effective interventions.

## B. Countervailing Managerial Power

It may be argued that externalities are best regulated by government, not shareholders, because, as ECO notes, (1) shareholders do not share identical interests with the full polity and (2) the concentration of power in large asset managers may be risky.

One important question is the extent to which shareholder governance can reduce externalities where government fails, such as those failures discussed above. One obvious difference is jurisdictional; companies can arbitrage laws by moving operations and tax situs, resulting in a governmental race to the bottom, whereas capital markets cross borders, potentially preventing such arbitrage. Legislation and regulation are also subject to political pressures from corporate managers that shareholders may not feel as strongly.

It is also important in the power analysis to consider the alternative. If corporate power is not held by shareholders, where is it? I would argue that it resides in corporate C-suites, where managers' investments are concentrated in the equity of a single company and thus much less-aligned with the economy overall. Power is also concentrated in hedge, venture, and private equity funds, where

managers are rewarded in a manner that sacrifices beta for alpha.

Finally, the idea that power concentrates at the largest money managers, like BlackRock, State Street, and Vanguard, must be closely examined. These are, after all, service providers. Larry Fink's famous letter is as much a marketing document as a directive to portfolio companies. These asset managers are competing for clients, and any ESG mandates they attempt to impose on companies are part of their attempts to satisfy the institutional and retail investors they are trying to attract and maintain. In this sense, large asset managers may reflect a semi-democratic process.

In sum, the question is not whether shareholders are an ideal proxy for the public interest, but whether they are better than, or an important countervailing to, the power that resides in corporate managers and financial system intermediaries, as well as a complement to the power that resides in political bodies.

## C. Can Purported ESG Integration Effectively Meet Systemic Threats and Systematic Risk?

ECO notes that shareholders might characterize beta activism as ESG integration and that corporate managers might disguise beta-focused strategies as alpha-producing under the business judgment rule. This blurring of lines is intended to eliminate the tension between the desire of shareholders to maximize portfolio values and the desire of corporate managers to maximize firm values.

It is important to ask whether this attempt to find common ground impedes necessary progress. It seems highly unlikely that companies with (1) significant sunk costs in business models that do not account for planetary and social boundaries or (2) profit opportunities involving extensive cost externalization will always be able to "do best by only doing good." Some examples provided in ECO illustrate the gap. For instance, the article points to long-term emission target reductions based on historical emissions, but these may fall short of what must be done to reach Paris alignment, which is more likely to require immediate milestones to allocate fair shares of our limited carbon budget.

The same issue is illustrated by the increasing focus on the use of disclosure standards created by the Sustainability Accounting Standards Board. While these have been celebrated by some of the world's largest shareholders and are being increasingly employed by companies, they are only designed to measure environmental and social impacts affecting shareholder value at the reporting company.<sup>9</sup>

4. *Id.*

5. See, e.g., Matthew E. Kahn et al., *Long-Term Macroeconomic Effects of Climate Change: A Cross-Country Analysis* 5 (Int'l Monetary Fund, Working Paper No. 19/215, 2019), <https://www.imf.org/-/media/Files/Publications/WP/2019/wpica2019215-print-pdf.ashx>:

Our counterfactual analysis suggests that a persistent increase in average global temperature by 0.04°C per year . . . reduces world real GDP per capita by more than 7 percent by 2100 . . . [A]biding by the Paris Agreement, thereby limiting the temperature increase to 0.01°C per annum, reduces the loss substantially to about 1 percent.

6. See, e.g., Olga B. Jones et al., *Drug-Resistant Infections: A Threat to Our Economic Future* 56 (The World Bank, Working Paper No. 114679, 2017), <http://documents1.worldbank.org/curated/en/323311493396993758/pdf/final-report.pdf> ("In the high antimicrobial resistance-impact scenario, the world will lose 3.8 percent of its annual GDP by 2050, with an annual shortfall of \$3.4 trillion by 2030.").

7. See, e.g., Dana M. Peterson & Catherine L. Mann, *Closing the Racial Inequality Gaps: The Economic Cost of Black Inequality in the U.S.*, CITI GLOB. PERSPECTIVES & SOL. (Sept. 2020), <https://www.citivelocity.com/citigps/closing-the-racial-inequality-gaps/>.

8. See, e.g., HEATHER BOUSHEY, UNBOUND: HOW INEQUALITY CONSTRICTS OUR ECONOMY AND WHAT WE CAN DO ABOUT IT (2019).

9. *Exploring Diversity & Inclusion in the SASB Standards*, SUSTAINABILITY ACCOUNTING STANDARDS BD. (Sept. 28, 2020), <https://www.sasb.org/blog/exploring-diversity-inclusion-in-the-sasb-standards/> (treating data on race and gender as material in only 13 or the 77 industries for which the SASB establishes disclosure standards, even though racial and gender injustice in

Consequently, this disclosure regime does not assist shareholders attempting to fill in any gap between ESG integration and beta activism.

#### D. *The Distinction Between Beneficiaries, Shareholders, and the Trustees Between Them*

ECO points out that a shareholder with concentrated ownership at a company or in an industry may have an economic motive consistent with externalizing costs, just as a manager at a company would. While this is true, the analysis should be done from the perspective of the beneficiaries, not the shareholders. Given the benefit that investors obtain from diversifying to eliminate idiosyncratic and industry risk—the central insight of Modern Portfolio Theory—it seems likely that most investors with fiduciary obligations would be quite diversified, even if some money is assigned to concentrated positions at hedge funds or similar vehicles.

In determining the calculus from the perspective of beneficiaries, it is also important to recognize that, in addition to interests in portfolios, they have both individual interests and community interests. Indeed, for many, if not most, people who have interests in a retirement or mutual fund, or who benefit from foundations or endowments, the most important financial asset is a job; companies' effects on access to good jobs, training, and education is more important to many beneficiaries than financial return. And feelings of obligation toward members of communities large and small is important as well. There is no doubt that, if asked, many beneficiaries who profited from the conditions that led to the loss of life at Rana Plaza or the *Deepwater Horizon* environmental disaster would gladly return the profit attributable to those losses in order to change outcomes.

The fact different beneficiaries have different interests in these issues cannot justify ignoring them, because ignoring the trade offs is itself a choice. If a company or portfolio manager maximizes company or portfolio value by externalizing costs, and if the ultimate beneficiaries of that company or portfolio have other financial interests, careers, people, and issues they care about affected by those costs, then the manager is trading off their interests for the interest of the hypothetical beneficiary whose interests are fully aligned with those of the company or portfolio.

#### E. *The Possibilities of Guardrails*

Even accepting that beneficiaries and overall economic efficiency could be better-served if shareholders took better account of externalities, ECO notes that it is unclear

how managers could put the idea into practice without losing the value of profit maximization as a corporate purpose tool.

How can we ask managers of individual companies to balance profit, pollution, inequality, job quality, and other social issues? They are deeply incommensurate. Moreover, decisions to forgo a practice at one company may be futile if others can exploit the opportunity, and this possibility may lead to a prisoner's dilemma equilibrium of everyone making the choice that provides the worst outcome.

The solution may be guardrails—rules that shareholders can apply equally to all companies—to reduce externalities by imposing baseline rules around emissions, worker treatment, racial injustice, and other issues. With these rules in place to limit cost externalization, managers can return to value maximization within these parameters, a modified shareholder primacy that (1) addresses the agency concerns and (2) fulfills the pricing and allocation function that competition plays in a free market.

#### F. *Distinction Between Price Collusion and Beta Activism*

ECO raises the concern that if shareholders work to improve beta by reducing externalized costs, they might also work together to improve the return of competitors through price collusion. More theoretical work needs to be done to ask if this is a false equivalency.

The fundamental insight of beta activism is that some companies must be asked to sacrifice financial return that comes from externalizing costs, thereby harming other companies in diversified portfolios. In a universe of three companies, for example, Company A might be required to sacrifice \$100 in profit it makes by polluting the environment if each of Companies A, B, and C would suffer a \$50 reduction in value from that pollution. This would mean shareholders as a group would enjoy a \$50 increase, which perfectly diversified shareholders would enjoy proportionately, while a shareholder concentrated in Company A would lose. Note that even though concentrated holders receive, on average, the same increase in expected returns, they also experience increased volatility. That is why beta activism relies on the diversification of portfolios.

The calculus for price collusion is different. For three airlines, A, B, and C, price collusion will raise the value of all three companies, so diversified and concentrated shareholders have the same motives.<sup>10</sup> If shareholders vote and engage with a goal of maximizing profits, then the earnings and projections of a company engaging in collusion are more likely to lead to votes that support management. It is true that a concentrated owner may feel the prisoner's dilemma pressure to be the first to defect from a collusion

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any industry can harm the social fabric); *SASB Conceptual Framework*, SUSTAINABILITY ACCOUNTING STANDARDS BD. (Feb. 2017), [https://www.sasb.org/wp-content/uploads/2020/02/SASB\\_Conceptual-Framework\\_WA-TERMARK.pdf](https://www.sasb.org/wp-content/uploads/2020/02/SASB_Conceptual-Framework_WA-TERMARK.pdf) (“SASB standards address the sustainability topics that are reasonably likely to have material impacts on the financial condition or operating performance of companies in an industry.”).

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10. While it is true that there will be less volatility for a shareholder with equal interests in all three during a collusion scheme that does not appear to be different from the reduced volatility experienced by a diversified holder in an initially competitive situation; indeed, that is the point of diversification—receiving the same expected return with less volatility.

scheme in order to capture market share as a first mover, but that is simply a question of finding a mechanism to ensure compliance, in which all three firms perform better on a risk-adjusted basis. This is very different from the beta activism question, which requires actual sacrifice of return from some firms.

The mechanism that common ownership provides for beta activism—the active direction of companies to sacrifice returns that rely on cost externalization—is clear. It is less clear what mechanism in support of price collusion is made available by common ownership. It would be something like managers of each company being comfortable that if the cartel fails because rival firms break the consortium, shareholders will not punish the non-defecting firms for losing market share. This feels much more attenu-

ated than enforcement of beta activism. Moreover, because diversified shareholders rely on an expanding economy and the success of a broad array of businesses, they would seem less likely than concentrated owners to favor collusion in an industry if it raises business costs and reduces economic productivity.

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With increasingly indexing markets, concentration, and externalized social and environmental costs rising, distinguishing common owners' promotion of responsible practices from welfare-shrinking price collusion is critical for economics, law, and finance. ECO is an important contribution to the field.

# CAN'T WE ALL JUST GET ALONG?: HOW DIVERSIFIED INVESTORS AND COMPANIES CAN MAINTAIN THEIR FIDUCIARY DUTY IN A CLIMATE CRISIS

by Natasha Lamb

*Natasha Lamb is the Co-founder of and Managing Partner at sustainable wealth management firm Arjuna Capital.*

Madison Condon's *Externalities and the Common Owner*<sup>1</sup> warrants serious attention and consideration by a broad variety of stakeholders—investors, public policymakers, academics, and citizens concerned about the systemic risks climate change pose to our economy, wealth, and sustainability. I am honored to have the opportunity to comment on her work from the perspective of an active investor and portfolio manager integrating Environmental, Social, and Governance (ESG) risks and opportunities into Arjuna Capital's client investment portfolios. Therefore, I will comment from the perspective of a practitioner engaging in many of the practices observed by Condon.

Arjuna Capital is a sustainable investment manager with a long history engaging with oil and gas companies on issues of climate risk—including carbon asset risk. That is, the risk that up to two-thirds of all fossil-fuel reserves could be stranded, unburnable, and devalued in the low-carbon future necessary to avoid catastrophic climate change. And while we have substantially divested our clients' assets from fossil fuels because of this serious and accelerating risk, we believe continuing oil company engagements as "universal" diversified investors is critical. Active/diversified investors can challenge conventional thinking within the companies and press companies to transition to a world where global temperatures rise less than 1.5 degrees Celsius—the threshold that scientists estimate triggers catastrophic climate change. It is critical to do so because no company operates in a silo—and the externalities of a few companies will have an outsized impact on most companies, and our economy broadly.

As diversified investors and fiduciaries, Arjuna recognizes the short-, medium-, and long-term impacts of

climate change and addresses them in three ways, by: (1) substantially **Divesting** from fossil-fuel investments; (2) **Engaging** with companies to improve efficiency and adaptability; and (3) **Investing** in solutions to our climate challenges.

The choice to divest from fossil fuels reflects the potentially insurmountable risks facing the fossil-based energy market. These risks include increasing regulation, competition from renewable sources, and a corresponding decrease in long-term fossil fuel demand. As investors, we also recognize the discouraging trends in corporate responses, ranging from climate denial and lobbying to a lack of comprehensive transition planning and net-zero emission goals. As diversified investors, we are concerned about the outsized impact these companies' externalities will have on the climate crisis, GDP, and therefore our clients' diversified investment portfolios.

As divestment does not mitigate systemic climate risk, for the last seven years, we have exercised our clients' share ownership to press for corporate change at the country's largest oil companies, Exxon and Chevron, as well as collaborated with European investors and companies to address this existential crisis. Our 2014 landmark negotiation with ExxonMobil led to the company's first report on carbon asset risk, and subsequent shareholder proposals have challenged the company's capital investments in high-cost, high-carbon reserves, their readiness to transition to a carbon-constrained future, and the preparedness of their boards to address the transition. This spring, hedge fund Engine No. 1, echoing our concerns, won two board seats at Exxon's annual meeting and gained support from Blackrock in its bid for better climate governance.

Condon's paper documents evidence showing we are not alone, and that "diversified investors seek to maximize profits at the portfolio, rather than firm, level and explains how this portfolio perspective can be extended to explain

1. Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 9 (2020).

why institutional investors seek to internalize harmful climate-change externalities.”<sup>2</sup> As institutional investors working in the fiduciary duty of our clients to minimize risk (beta) and maximize return (alpha), Arjuna Capital views investment portfolios in the same way—as a chess board, where performance is measured by the whole, not necessarily the sum of its parts. And when a few bad apples spoil the bunch, it needs to be addressed, which requires active ownership. In fact, as Condon contends: “If a subset of firms in a portfolio impose costs on the broader portfolio through the generation of negative externalities, a portfolio-wide owner should be motivated to curtail those externalities at the source.”<sup>3</sup> “Rational owner[s]” with “economy-mirroring portfolios” are therefore motivated to eliminate those externalities and can work to do so through active engagement.<sup>4</sup>

In that vein, our clients filed a proposal at Chevron this year asking the company to amend its certificate of incorporation to become a Public Benefit Corporation. The rationale being: the majority of Chevron’s shareholders are beneficial owners with broadly diversified portfolios, who are unalterably harmed when the company follows the “shareholder primacy” model, operates outside of a 1.5-degree Celsius climate model, and imposes serious environmental costs that lower economic productivity. Therefore, it is in investors’ interest to press for a governance model and business plan that can “maximize returns” within a 1.5-degree Celsius global-temperature-rise threshold, but not beyond it.

Our view that Chevron needs to operate within the bounds necessary to prevent catastrophic climate change may be different than the view held by shareholders concentrated in Chevron stock or the stock of any single company. But there are very few of those investors out there. As Condon points out, in the age of modern portfolio theory, today’s investors are highly diversified. Therefore: “diversified shareholder interests can diverge from both the interests of concentrated shareholders and the objective of maximizing share price.”<sup>5</sup> Diversified shareholders and “institutional investors seek to internalize harmful climate-change externalities” because “not only does investor climate action diminish future climate damages, it also reduces the systemic climate risks that cannot be diversified away.”<sup>6</sup>

And those systemic climate risks are for real. According to the United States’ Commodity Futures Trading Commission, “Climate change poses a major risk to the stability of the U.S. financial system and to its ability to sustain the American economy.”<sup>7</sup> The National Bureau of Economic Research warns if greenhouse gases are not cut

in line with the Paris Accord, United States’ GDP could be cut 10.5 percent by 2100.<sup>8</sup> This climate hit to the economy will ultimately show up in company earnings and investor portfolio returns. The United Nations Environment Programme Finance Initiative (UNEP FI) and Principles for Responsible Investment (PRI) reports in the paper “Universal Ownership” that over 50 percent of companies’ earnings are at risk from climate costs, creating systemic risk for diversified investors.<sup>9</sup> “Universal investors”—those with highly-diversified portfolios representative of the broad economy—are exposed to growing and widespread climate costs generated by some companies and ultimately incurred by other companies.

Condon’s cost-benefit analysis, like those sighted by the groups above, seeks to demonstrate the costs of these climate damages, asserting it is “enough so that the devaluation of the fossil fuel stock is outweighed by portfolio benefits.”<sup>10</sup>

As fiduciaries managing diversified portfolios, the onus is on institutional investors to maximize profit at the portfolio level, not necessarily the company level. Condon cites research asserting “voluntary emissions reduction is at odds with the aim of profit maximization,”<sup>11</sup> and while this may be true in the short-term, it depends on the time line. One can easily argue there are ways to both reduce emissions and maximize profitability and returns to investors while not growing fossil assets, but investors and company executives may have different views.

Condon notes a difference between the perceived fiduciary duty of company managers and directors and the fiduciary duty of institutional investors acting on behalf of their diversified investors/beneficiaries. Company executives may believe that growing fossil fuel assets is in their fiduciary duty, while emissions reductions are not.

To that point, incorporating as a Public Benefit Corporation could relieve this perceived conflict for companies, allowing them to operate for the benefit of all stakeholders, not just shareholders. That is, companies can maximize profits within the constraints of a 1.5-degree Celsius global temperature rise, but not beyond it. For investment managers, pressing for a 1.5-degree Celsius temperature threshold falls squarely in line with their fiduciary duty. And inaction on climate may be in conflict with investors’ fiduciary duty. Condon rightly notes that the “intentional passivity” of pension funds and passive investors like the “Big Three” asset managers—BlackRock, Vanguard, State Street—by not pressing for climate action, may actually

2. *Id.* at 9.

3. *Id.* at 6.

4. *Id.*

5. *Id.* at 76.

6. *Id.* at 9.

7. Commodity Future Trading Commission, *Managing Climate Risk in the U.S. Financial System* (September 2020) available at <https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Manag->

[ing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf](https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Manag-ing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf).

8. National Bureau of Economic Research, *Long-Term Macroeconomic Effects of Climate Change: A Cross-Country Analysis* (August 2019), available at [https://www.nber.org/system/files/working\\_papers/w26167/w26167.pdf](https://www.nber.org/system/files/working_papers/w26167/w26167.pdf).

9. UNEP Finance Initiative and Principles for Responsible Investment, *Universal Ownership* (2011), available at [https://www.unepfi.org/fileadmin/documents/universal\\_ownership\\_full.pdf](https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf).

10. Condon, *supra* note 1, at 10.

11. *Id.* at 3.

breach “their duties to those clients that invest broadly in a market-mirroring portfolio.”<sup>12</sup>

As fiduciaries, we have a history of expressing concerns about returns at both the company level and broad portfolio level. But given the record of inflexibility for companies like Exxon and Chevron to adapt, the latter portfolio-level concern now looms large. For example, at Exxon’s annual meeting in 2016, we presented a proposal asking the company to prioritize profitability and value over growth by returning more capital to shareholders, citing a -68 percent drop in profitability the prior decade and a downgrade to Exxon’s credit rating. We were squarely in the camp of pressing the company to adapt to protect returns *and* address the climate crisis. But at that meeting, then-CEO and Chairman, Rex Tillerson, noted that if global temperatures increased 4 or even 6 degrees Celsius, that the company would simply adapt. There was no sign of

the company adapting to *prevent* such a rise—or accepting culpability in that potential outcome. And that is why investors are so concerned—because a 4- to 6-degree rise is untenable. Perhaps not for Exxon (as they see it), but for diversified “universal” investors invested in an economy that will have to battle catastrophic climate change. As fiduciaries, catastrophic climate outcomes must be the central concern—and a Public Benefit Corporation model could very well assuage both investors’ and companies’ fiduciary concerns.

Condon’s exploration of the evolving nature of fiduciary duty is critical as the climate crisis escalates, and whether it is investors or regulators that press for change, that change is necessary to maintain a healthy, functioning economy that will serve to protect institutional investors’ “economy-mirroring” portfolios.

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12. *Id.* at 59.

# EXTERNALITIES AND THE COMMON OWNER: VIEW FROM A SHAREOWNER

by James Andrus and Anne Simpson

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California Public Employees' Retirement System (CalPERS) is the largest-defined benefit public pension fund in the United States, with about \$450 billion in global assets under management. CalPERS actively protects its rights as an investor and the Board Governance and Sustainability program sits at the center of this effort. Collectively, we have more than 40 years-experience in corporate governance and have been very close to CalPERS' work on engagement, advocacy and integration of climate change risk and opportunity, as well as the conduct of this work through partnerships. We appreciate Madison Condon's focus on the great work of Climate Action 100+ in her article *Externalities and the Common Owner* (the Article).<sup>1</sup> As the convener and co-founder of Climate Action 100+, we are delighted to provide background on CalPERS' focus on climate change, our work with Climate Action 100+, and some of our thoughts on the Article given our knowledge of the common ownership debate.

In 2020, CalPERS completed a Taskforce on Climate-Related Financial Disclosure (TCFD) report titled, "CalPERS' Investment Strategy on Climate Change."<sup>2</sup> In that report, we highlighted our work with various entities to address climate change. Such groups include the Principles for Responsible Investment (PRI), Ceres, the United Nations Global Investors for Sustainable Development, and the Vatican Dialogue on the Energy Transition and Care for Our Common Home. Likewise, we touched on our approach to leverage positions on the advisory boards of regulators to advocate for mandatory climate risk reporting. Such boards include the Investor Advisory Committee to the Securities and Exchange Commission, the Investor

Advisory Group to the Public Company Accounting Oversight Board (PCAOB), the Financial Accounting Standards Advisory Committee (FASAC), the Commodities and Futures Trading Commission (CFTC) special committee on climate change, and the International Financial Reporting Standards (IFRS) Advisory Council, on which we represent the Council of Institutional Investors (CII). Partnering with organizations allows CalPERS to share insights and pool resources with fellow investors with shared objectives.

The origins of Climate Action 100+ lie in CalPERS' commitment to mapping its carbon footprint. In 2014, CalPERS became the first U.S. signatory to the PRI Montréal Pledge, thereby agreeing to measure and publicly disclose the carbon footprint of our global equity investment portfolio. After analyzing more than 10,000 companies within our portfolio, we found approximately 80 companies were responsible for 50% of the portfolio's scope 1 and 2 greenhouse gas emissions. The emissions trajectory of these systemically important carbon emitters is critical in determining whether the global economy will meet the goal of the Paris Agreement to keep global warming to 1.5 degrees Celsius. CalPERS recognized that other global investors were likely to have similar holdings in their portfolios, so we convened a series of meetings hosted by the French mission to the United Nations. The result was a new partnership among regional and global investor networks (North America, Europe, Australia, and Asia) to launch Climate Action 100+. The list of companies in Climate Action 100+ cover a wide range of sectors including oil and gas, utilities, transportation, metals and mining, construction materials, industrials, chemicals, and food, beverages, and forestry. Climate Action 100+ was officially launched at the One Planet Summit in December 2018.

The initiative has since been recognized by the United Nations as one that will drive progress toward meeting the ambition of holding global warming to 1.5 degrees Celsius. CalPERS plays a leading role in Climate Action 100+ as

1. Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1 (2020), <https://digitalcommons.law.uw.edu/wlr/vol95/iss1/4>.

2. CalPERS' Investment Strategy on Climate Change, CALPERS (June 2020), [https://www.calpers.ca.gov/docs/board-agendas/202006/invest/item08c-01\\_a.pdf](https://www.calpers.ca.gov/docs/board-agendas/202006/invest/item08c-01_a.pdf).

the inaugural chair and a member of the Steering Committee, which sets the strategy for the initiative. Our Corporate Governance team assumed the lead role for 22 of the companies identified for engagement. The responsibilities include meeting in-person with the company's leadership, senior management, and board members to communicate and engage on the Climate Action 100+ goals of governance, targets, and transparency. Those goals are:

- **Governance:** Implement a strong governance framework for each company that clearly articulates the board's accountability for oversight of climate change risk and opportunities. This includes ensuring that corporate lobbying and executive compensation are aligned with the Paris Agreement to facilitate a low-carbon transition.
- **Targets:** Act to reduce greenhouse gas emissions across the company's value chain, consistent with the goal of limiting global average temperature increase to 1.5 degrees Celsius above pre-industrial levels.
- **Transparency:** Provide enhanced corporate disclosure in line with the TCFD recommendations to enable investors to assess the robustness of a company's strategy against a range of climate change scenarios.

CalPERS will continue to be a leader on climate change. For example, we recently committed to the United Nations' Net-Zero Asset Owner Alliance that reaffirms the same goal we are setting for the largest emitters in our portfolio. We will continue to innovate through research and integration by building climate resilience into our portfolio and seeking investment opportunities in the low-carbon economy. In all this work, our partnership with fellow investors, policymakers, the business sector, and civil society will continue to be of vital importance. Tackling the climate crisis is urgent work that requires a cohesive effort to meet the goals of limiting global warming to 1.5 degrees Celsius.

Four years ago, we reviewed common ownership research and concluded that such research did not support the conjecture that common owners controlled the pricing of products or services. On the contrary, research rejected such an argument.<sup>3</sup> Professor Condon's Article provides high-value insights, such as the economic arguments for (1) internalizing carbon emission externalities because of their impact on a broader portfolio, and (2) why universal owners are appropriately interested in the larger social issues given that they invest in the entire market.

The Article highlights extensively the successes of Climate Action 100+, the world's largest investment engage-

ment initiative that engages with the world's largest greenhouse gas emitters, to argue that the coordinated efforts to produce those successes are similar to coordinating efforts to control product pricing. This comparison is both unfortunate and inaccurate.

Part I of the Article argues that diversified investors seek to maximize profits at the portfolio, rather than firm, level and further argues that investors seek to internalize harmful climate-change externalities. Part II then extends the argument to the common owner debate and contends that there is clear evidence of shareowner power to influence managerial motives at the product level. Part III then contends that diversified investors inappropriately step into the shoes of regulators and act as if they understand the underlying businesses better than the industry experts.

Upon scrutiny, we found the argument to be lacking. Professor Condon's argument that internalization of externalities explains institutional investors' incentives to encourage carbon emitters to reduce emissions is novel. It is even a great after-the-fact explanation; however, she does not discuss any of institutional investors' actual motivations for reducing carbon emissions, such as their belief that a company can improve performance by improving its ability to adapt to the current transition to a lower-carbon-intensive economy. Professor Condon does not appear to believe that policy and market forces are causing a carbon transition. For instance, she contends that "it would be reasonable for a well-informed industry manager to conclude that the risks of imminent federal climate policy are low, even after Donald Trump leaves office."<sup>4</sup> That assumption appears to have been ill-informed and ill-advised as the Joseph Biden Administration is pursuing an aggressive agenda to reduce carbon emissions, and the U.S. Congress is following suit with its legislative proposals.

Professor Condon also does not adequately acknowledge that addressing climate change risk is a global issue and the companies engaged by Climate Action 100+ are global companies. Therefore, institutional investors in global companies need to examine what is happening with worldwide carbon emissions policy to determine the proper strategies for most large companies.

We are most concerned by the arguments laid out in Part III. Part III is problematic because it casts the common ownership debate as one-sided, failing to acknowledge substantial disagreement among researchers. For example, Edward Rock and Daniel Rubinfeld convincingly refute the foundations of Einer Elhauge's work<sup>5</sup> by showing that common owners do not commonly own the same percentage of each company. Therefore, shifting incentives for corporate profits in favor of the weighted average of holdings in an industry<sup>6</sup> does not reasonably hold when the investors would have differing mid-points. Rock and Rubinfeld also undermine arguments that common owners have the incentive and ability to control product price. According to

3. See, e.g., Menesh S. Patel, *Common Ownership, Institutional Investors, and Antitrust*, 82 ANTITRUST L.J. 279 (2018) <http://dx.doi.org/10.2139/ssrn.2941031>; Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance*, NYU Law and Economics Research Paper No. 17-05, (Mar. 1, 2017) <http://dx.doi.org/10.2139/ssrn.2925855>.

4. Condon, *supra* note 1, at 28.

5. See Einer R. Elhauge, *Horizontal Shareholding*, 109 HARV. L. REV. 1267 (2016) <http://dx.doi.org/10.2139/ssrn.2632024>.

6. Rock & Rubinfeld, *supra* note 3, at 4-6.

their work, there is “no evidence that shareholders vote on competitive strategy and no evidence that directors run on a platform that is directed toward a competitive strategy.”<sup>7</sup> Rock and Rubinfeld argue that none of the tools available to institutional investors provide “for the degree of micro-management necessary to implement the kind of alignment with the portfolio interests of actual shareholders.”<sup>8</sup> Seeing no general case, Rock and Rubinfeld examined the airline industry and found the whole idea to be “implausible theoretically.”<sup>9</sup> In examining airport-to-airport routes, they found that proponents of the common ownership theory did not adequately consider city-to-city competition posed by Southwest, and changes at Southwest may have been the actual reason why prices increased.<sup>10</sup>

The Article argues that because Climate Action100+ is successful, common owners can also place anti-competitive pressure on companies at the product level. Professor Condon, however, provides no examples that have not already been soundly debunked. Further, it is important to highlight that page 59 of the Article states that “Blackrock, Vanguard and State Street are not members of Climate Action 100+.”<sup>11</sup> Interestingly, the largest asset owners were the targets in the initial common ownership debates, but it is clear that they played a significantly lesser role in Cli-

mate Action 100+, yet there is no analysis of this change in composition or its impact on the debate.

Finally, Professor Condon argues that passive investment requires no equity analysis at all,<sup>12</sup> which is incorrect. Index-based investors have an adequate interest in engaging companies on climate risk and related topics because such investors actually own larger economic stakes, even if the percentage ownership appears small because companies are much larger now. Thus, it is economically feasible and even necessary to engage. Additionally, she argues in one place that engagement is too costly given small investment,<sup>13</sup> but later argues that investors have “enormous stakes” in companies targeted.<sup>14</sup> In 2021, investors have adequate monetary stakes in companies to show concern about carbon emissions. Moreover, pension funds like CalPERS have a fiduciary obligation to act if the government fails to act after being made aware of the economic risks posed by carbon emissions, so the Article’s contentions do not align with these fiduciary duties.

Although flawed, the Article provides interesting food for thought. It underscores that market observers need more input from asset owners and asset managers to improve their understanding of the incentives and motivations driving coordinated corporate governance actions.

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7. *Id.* at 9.

8. *Id.* at 10.

9. *Id.* at 11.

10. *Id.* at 13.

11. Condon, *supra* note 1, at 59.

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12. *Id.* at 33.

13. *Id.* at 3.

14. *Id.* at 5.