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Systematic Stewardship

Law Working Paper N° 566/2021
Revised February 2022

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Abstract

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

Keywords: Stewardship; Institutional Investors; Climate Change; Systematic Risk, Common Ownership

JEL Classifications: G 23, G 34, K 22, L 21, L 44

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ABSTRACT

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

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INTRODUCTION

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

The core of the idea is this: The insight of "Modern Portfolio Theory," which has served as the foundational investment strategy for the asset management industry, is that investors' utility takes account of both risk as well as expected returns, so that investors' objective is to maximize *risk-adjusted* expected returns.[1] Accordingly investors compete to create diversified portfolios to eliminate risk and thus are generally compensated for bearing only that risk that cannot be diversified away. Risk that pertains to a particular company, so-called "idiosyncratic" risk can be diversified away; risk that will affect returns throughout the portfolio, "systematic risk," remains. Engagements that may improve firm-specific performance are generally idiosyncratic; they will not improve the performance of the portfolio as a whole. The possible exception requires the perhaps heroic assumption that such engagements are part of a pattern designed to produce "governance externalities" that lift the performance of all firms on average, that produce positive economy-wide effects.

The straightforward implication is that advisors of extensively diversified portfolios, especially broad-based index funds, should focus on addressing the systematic risk elements in their portfolios rather than new forays into firm-specific performance-focused engagement. This could take many forms. For example, it could mean voting in support of management of a systemically important financial firm in a face-off with activist investors who want the firm to take

[1] See Harry Markowitz, Portfolio Selection, 7 J. Fin. 77(1952); The Utility of Wealth, 60 (2) J. Pol. Econ. 151 (1952), *operationalized in* PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS (1959). Nobel Prize Lecture, Foundations of Portfolio Theory (Dec. 7, 1990), available at https://www.nobelprize.org/prizes/economic-sciences/1990/markowitz/lecture/.

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greater risks to enhance shareholder returns. As the financial crisis of 2007-09 vividly illustrated, the failure of a SIFI can indeed result in losses across an entire portfolio. In deciding whether to support the risk-loving activist, the index-fund advisor ought to consider not only the return proposition at a single firm but the systematic risk effects. Portfolio theory teaches that investors in the index fund are seeking to maximize risk-adjusted returns, and so assessment of systematic risk effects becomes even more important in this case than the impact on single firm returns, an idiosyncratic effect.

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

Although systematic stewardship seems most obviously to fit the broad-based index mutual fund or ETF, it also can underpin engagement behavior by other institutional investors, such as defined benefit pension plans. Private sector defined benefit pension plans are subject to ERISA's "exclusive benefit" standard.[2] Although recent presidential administrations differ on the tightness of implantation,[3] the standard resists the trade-off of economic benefits for plan beneficiaries against other social values. But engagements aimed at reducing systematic risk do not run afoul of the "exclusive benefit" criterion; rather they are in service to it. Indeed, pension fund managers who are *not* thinking about the systematic dimension in their engagements are falling short of the objective of maximizing risk-adjusted returns.

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[2] Employee Retirement Income Security Act of 1974, §§ 403(c), 404(a).

[3] *Compare* U.S. Dep't of Labor, Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846 (Nov. 13, 2020) (implementing "exclusive benefit" provisions so that "ERISA plan fiduciaries may not subordinate return or increase risks to promote non-pecuniary objectives … [their] evaluation must focus solely on the plan's financial risks and returns … solely on economic considerations that have a material effect on the risk and return of an investment based on appropriate investment horizons, consistent with the plan's funding policy and investment policy objectives," 85 Fed. Reg. at 72848) *with* U.S. Dep't of Labor, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272 (Oct. 14, 2021) (proposed rule that would permit "evaluation of the economic effects of climate change and other ESG factors on the particular investment or investment course of action," 86 Fed. Reg. at 57276).

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

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

The portfolio approach is more pervasive, however. Diversified investors have a different approach to risk than undiversified investors. This affects the attitude toward business failure, meaning the optimal level of risk-taking and capital structure, and fundamental questions about the organization of the firm – against conglomeration and unrelated diversifying acquisitions, for example. A view that shareholders are obliged to take an "own firm" approach to corporate governance or voting cannot withstand widespread contemporary practice; nor can a claim that directors cannot manage in what they know to be the preferences of diversified investors.[5]

Systematic stewardship also takes a portfolio approach. The distinctive twist is the focus not on how to increase expected returns across the portfolio, but how to reduce systematic risks,

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[4] See Mats Andersson, Patrick Bolton & Frederic Samama, Hedging Climate Risks, 72(3) Financial Analysts Journal 13 (2016), available at https://doi.org/10.2469/faj.v72.n3.4.

[5] This point is developed more fully infra at ---.

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

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

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

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

[7] See John Armour, The Case for "Forward Compliance," Brit. Acad. Rev. (Autumn 2018) at 19.

[8] See Michael Barzuza, Quinn Curtis & David Webber, Shareholder Value(s): Index Fund Activism and the New Millennial Corporate Governance, 93 So. Calif. L. Rev. 1243 (2020) (promotion of social goals like gender diversity as product differentiation and marketing tool).

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

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

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[9] Jan Fichtner & Eelke M. Heemskerk, The New Permanent Universal Owners: Index Funds, Patient Capital, and the Distinction between Feeble and Forceful Stewardship, 49(4) Economy and Society (2020); Lucian Bebchuk & Scott Hirst, The Spector of the Giant Three, 99 B.U. L. Rev. (2019); Bebchuk & Hirst, Index Funds and the Future of Corporate Governance, 119 Colum. L. Rev. 2029 (2019).

[10] Bebchuk & Hirst (2019).

[11] See nn infra, discussing competition concerns.

[12] See Frederick Alexander, An Honorable Harvest: It is Time for Universal Owners to Take Responsibility for Their Portfolios (2019), available at https://ssrn.com/abstract=3433845. Parties associated with the Shareholder Commons have proclaimed 2021 as "Year One of the Universal Owner." The term "universal owner" entered the corporate governance lexicon in 1990s. See Robert Monks & Nell Minow, WATCHING THE WATCHERS: CORPORATE GOVERNANCE IN THE 21ST CENTURY (1996). The universal owner change agent was then said to be the pension funds, holder of 30% of the US public equity. See Robert A.G. Monks & Nell Minow, Ownership-Based Governance: Corporate Governance for the New Millennium, Sept. 1999, available at https://ssrn.com/abstract=6148; Also see James Hawley & Andrew Williams, THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE AMERICA MORE DEMOCRATIC (2000).

[13] See generally Michael J. Graetz & Ian Shapiro, THE WOLF AT THE DOOR: THE MENACE OF INEQUALITY AND HOW TO FIGHT IT (2020) (tracing multiple examples of the importance of business support, acquiescence, or opposition to proposed social legislation). Cf. Eleonora Broccardo, Oliver Hart & Luigi Zingales, Exit vs. Voice, ECGI W.P. No. 694/2020 (Dec. 2020), available at https://ssrn.com/abstract=3671918.

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

This paper proceeds as follows. Part I addresses the engagement conundrum for the asset manager of diversified investment products, which range the spectrum from actively-managed funds to fully-diversified index funds and ETFs. What exactly is the case for firm-specific engagement, which seems at the heart of the demand for "stewardship" by institutional investors? For an active fund, trading seems a stronger strategy than engagement, not only because that is best for the fund but also because of information content of "exit" may itself exert a disciplinary force; moreover, serious shortfalls in management's strategy or operational acumen may become the target of an activist, an engagement specialist. The index fund case is more complicated, in part because "exit" is not an option and in part because its business model leaves little space for an investment in engagement. This is reflected in a vigorous debate on whether and how index funds should vote their shares.[17] A portfolio perspective reveals this: it (ordinarily) does not matter.

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[14] Federal Reserve Board, Survey of Consumer Finances (2019), The Fed - Wealth and Income Concentration in the SCF: 1989–2019 (federalreserve.gov) (stock ownership highly concentrated toward the top deciles); Alina Bartscher et al., Monetary Policy and Racial Inequality (FRBNY Staff. Report No. 959 (Jan. 2012) (low interest rates that increase asset values exacerbate racial inequality because of pre-existing distribution of share ownership).

[15] See Frederick P. Schlingemann & Rene M. Sulz, Has the Stock Market Become Less Representative of the Economy? (NBER W.P. 27942, Oct. 2020) (because of shift from manufacturing to services, public firms contribute less to employment and GDP in the 2010s than in the 1970s); McKinsey & Co., Private Markets Comes of Age; McKinsey Global Private Markets Review 2019.

[16] Cf. Jack Goldsmith & Tim Wu, WHO CONTROLS THE INTERNET?: ILLUSIONS OF A BORDERLESS WORLD (2006) (notwithstanding early beliefs about the power of the internet to transcend borders and "to change everything," governments have successfully asserted territorial boundaries and governmental power).

[17] Compare, e.g., Dorothy Lund, The Case Against Passive Shareholder Voting, 43 J. Corporation L.493 (2018);, with Edward Rock & Marcel Kahan, Index Funds and Corporate Governance: Let Shareholders Be Shareholders,

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Performance improvement to the holder of a fully diversified portfolio is substantially "idiosyncratic."[18] It is the kind of risk that the portfolio by construction is designed to diversify away. Instead, the asset managers should attend to systematic risk.

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

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

Part III outlines the approaches that a fund manager of broad index funds might take to implement "systematic stewardship." There is both a portfolio approach and a firm specific approach. Index fund managers should favor, as a portfolio matter, disclosure of firms' exposure to systematic threats, with sufficient granularity to enhance efficient market pricing of the risk. Such disclosure is likely to put pressure on firms to take measures that would reduce the systematic risk (and thereby improve risk-adjusted returns for the portfolio) and also help the fund manager in its systematic risk assessment, which will be important in evaluating firm specific proposals that

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100 B.U. Rev. 1771 (2020). See also Jill Fisch, The Uncertain Stewardship Potential of Index Funds, WP January 2022, available at https://ssrn.com/abstract=3525355, and Mutual Fund Stewardship and the Empty Voting Problem, WP 2021, available at https://ssrn.com/abstract=3939112.

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

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purport to mitigate systematic risk.[19] Support for such disclosure could come through adoption of guidelines for proxy voting on shareholder proposals, support of disclosure standards emerging through global governance efforts now best reflected in the aborning International Sustainability Standards Board ("ISSB") and support of SEC initiatives for mandatory disclosure. This would aid in pricing firm-specific exposure to systematic risk and bring additional market pressures to bear for its mitigation. Index fund managers should also promote the creation of market instruments that provide quantitative measures of different sources of systematic risk. For example, economists are developing different measures of financial stability risk and as well as climate change risk. Assets managers could encourage the development of derivative markets keyed to these indices, which could provide early warning signs of emergent risks that could threaten portfolio values and which can better price risks that already exist. Support for regulatory measures or new market instruments might most effectively be presented through an asset manager trade association, perhaps a new trade association formed to focus on systematic stewardship issues, rather than by any particular asset manager.

When it comes to firm-specific engagement, such a manager would be justified in taking a stance of "rational reticence," to engage in reactive rather than active mode. For prudential reasons an asset manager might well decide to act on its systematic concerns chiefly in response to initiatives promoted by other shareholders, such as ESG funds, voting its shares on issues as framed for shareholder decision. Indeed, the business model of widely-diversified passive funds, emphasizing low fees, is most consistent with this approach.[20] To take some examples: A fund with a systematic perspective could readily vote in favor of a shareholder initiative calling for disclosure of a company's plan to address climate change risks and other elements relating to "sustainability." Disclosure leads both to better capital market pricing of the risks in question, which is both informative and disciplinary, and deepens the fund's ability to evaluate systematic risk associated with a particular company's activities. As noted above, the manager's approach could be based on a general portfolio guideline of support for such disclosure.[21]

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[19] See Madison Condon, Market Myopia's Climate Bubble (forthcoming 2022, Utah Law Review) (documenting climate risk information shortfalls under current disclosure standards).

[20] Cf. Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. 863 (2013) (activist shareholders teeing up issues for decision by majoritarian institutional owners). When it comes to matters of systematic concerns, ESG funds are more likely to be driving the activism agenda rather than hedge funds, but the dynamic of large widely-diversified funds responding to, rather than initiating, activists' proposals seem likely to recur.

[21] There is evidence that such engagement has indeed been effective in reducing CO2 emissions. See Jose Azar, Miguel Duro, Igor Kadach, & Gaizka Ormazabal, The Big Three and Corporate Carbon Emissions Around the World," 142 J. Fin. Econ. 674 (2021).

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A fund could cast its votes in an activist-driven proxy battle based on its assessment of the implications for systematic concerns. It could support an activist slate that would push for the company to reduce its carbon emissions, even if the strategy would lower the company's current earnings and the stock price, if the fund determined that this approach would reduce systematic risk.[22] The company's (which is to say, the board's) implementation of the strategy might well be challenged by other shareholders claiming it transgresses the broad latitudes of the business judgment rule, but the fund need not make such a determination in voting its shares.[23] A fund could also support *management* (and the board) that followed a carbon-reducing policy against an activist slate pushing the contrary for purported higher profits. Similarly, a fund could support management's resistance to activist proposals for a private sale of the company's "brown" assets on the view that creating "green" public companies by take-privates of brown assets exacerbates systematic concerns by hiding them.[24] A final example: the fund could support management that resisted layoffs despite reduced profitability based on the fund's determination about the connection between a layoff policy and the systematic risk of social instability.

The asset manager could devise a forward-leaning systematic risk-attentive strategy that combines both portfolio and firm specific approaches by taking account of the attention of activist shareholders. Here are four different examples. First, the asset manager could articulate principles that it regards as important, for example, identifying an area of systematic risk and inviting company managements to respond; this signals a threshold willingness to cooperate with activists. Second, in areas where activists have been engaged but the proposals seem an over-reach, the asset manager could articulate clearly the features of a proposal that it would be prepared to support. Third, in areas that the asset manager think should be examined from a systematic risk perspective, it could put out an "RFP," a request for proposals, that could catalyze a process that could lead activists to generate firm-specific proposals. One example is the connection between compensation arrangements and systematic risk mitigation; the subsequent activist channel is the annual Say on Pay vote and the election of compensation committee directors. Fourth, where an asset manager is concerned about systematic risk implications of a common practice, it could initiate public discussion. For example, the structure of severance arrangements in change-in-control transactions, "golden parachutes," may induce an inefficiently high level of mergers and

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[22] See, e.g., Matt Levine, "Exxon Lost a Climate Proxy Fight," Bloomberg, May 27, 2021 (describing success of ESG activist Engine No. 1 in electing 4 directors to ExxonMobil Board).

[23] I argue below that the directors have strong defense against such a claim in any event.

[24] See Stanley Reed, "Third Point, an activist investor, is calling for a breakup of Royal Dutch Shell," N.Y. Times, Oct. 18, 2021, updated Nov. 15, 2021. Rachel Adams-Heard, What Happens When an Oil Giant Walks Away, Bloomberg Green (Apr. 15, 2021), https://www.bloomberg.com/graphics/2021-tracking-carbonemissions-BP-hilcorp/?srnd=premium (Post-BP sale of its Alaska assets, private buyer's use of such assets increase emissions relative to BP).

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acquisitions activity, which in turn imposes extra social stability risk through layoffs that produce "synergy gains."[25] Here the asset manager could, consistent with its business model, trigger debate that could lead to subsequent activist proposals. In short, in pursuing the beneficiary welfare gains of systematic stewardship, an asset manager needs to be mindful of the limits of its business model, including the persistent features of American political economy that periodically erupt against large financial intermediaries.[26] One might call this strategy "leading from behind."

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

Can a fund pursue a systematic approach in its voting decisions even no single firm's actions would have a systematic impact? In the case of a SIFI, a single firm's failure could have a systematic consequence, as Lehman's failure illustrates. But for climate change, no single firm's conduct could itself trigger a systematic shock.[27] The nexus between the systematic approach and

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[25] See Albert Choi, Andrew Lund & Robert Shonlau, 73 Vand. L. Rev. 223 (2020) (increasing levels of golden parachutes and complicated structures); Brian J. Broughman, CEO Side-Payments in Mergers and Acquisitions (2016), available at https://ssrn.com/abstract=2584699 (additional payments beyond golden parachutes); Robert Chatt, Mathew Gustafson & Adam Welker, Firing Frictions and the U.S. Mergers and Acquisitions Market (2017), available at https://ssrn.com/abstract=2747579 (post-merger employee turnover is a first-order source of value in large m&a).

[26] See, e.g., Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10 (1991);Phil Gramm & Mike Solon, Keep Politics Out of the Boardroom, Wall St. J., July 18, 2018 (political risks).

The change of presidential administrations might offer a new political calculus. Asset managers under scrutiny for the alleged anti-competitive effects of large scale common ownership might well seek political immunity through pressuring large global firms to address climate change issues, a top priority of the incoming administration. The size of their ownership stake then switches from a concern to a virtue.

[27] Prof. Condon has developed an example in which a large fossil fuel firm, Exxon Mobil, responsible for downstream CO_2 emissions of approximately 1% of the global burden, is subject to a shareholder initiative that results in a massive cutback of its production. Using the Nordhaus model that connects emissions to global economic output the example shows why such an initiative would be worthwhile for a diversified investor even

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the single-firm case is less tight than in the case of a SIFI. Nevertheless the fund could take account of systematic concerns at a single firm as part of a systematic risk reduction policy that it would apply across the sector and could also look to the "governance externalities" across the sector resulting from a single firm outcome. Indeed, this is the way that activism generally works: corporate managers see the outcome of contests at similar firms, infer general shareholder preferences and judgments, and modify their behavior accordingly. Activism generally has value because of its portfolio effects; that is certainly true where the objective is systematic risk reduction.

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

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

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if Exxon's market value sharply declined. See Madison Condon, Externalities and the Common Owner, 95 Wash. L. Rev 1, 45-47 (2020). Strictly speaking, the example shows a portfolio-wide improvement in expected returns after the emissions reduction vs. "business as usual," rather than a reduction in systematic risk in the portfolio theory case. But it does illustrate the value of a portfolio approach to systematic risk questions. The fragility of the particular example lies in the fact that other firms, including state owned petroleum companies, may cover the ExxonMobil production cut. This objection is pointed out in Marcel Kahan & Edward Rock, Systemic Stewardship With Trade-Offs, https://ssrn.com/abstract=3974697 . See also Bernard Sharfman, Opportunism in the Shareholder Voting and Engagement of the "Big Three" Investment Advisors to Index Funds, January 2022 (additional objections), https://ssrn.com/abstract=3995714.

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important allies in the attempt to mitigate systematic risk. Their potential influence may be particularly important in the case of climate change.

Part V concludes.

Part I: Stewardship for Fully Diversified Passive Funds Should Have a Strong Systematic Focus

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

A. Shareholder voice: Active Managers

Ever since the reconcentration of share ownership began in the US in the 1980s, institutional investors have been looked to as the solution to the problem first identified by Berle and Means in the 1930s, the way that diffusion of stock ownership among the general public left the managers in control of large corporations.[28] In particular, the hope was that institutions exercising "voice" could constrain various sorts of mis-management better than control market devices like hostile tender offers, which were feasible economically only where strategic or operational shortfalls had become very serious and which were, in any event, highly disruptive. The relatively large stakes held by institutional owners coupled with access to sophisticated securities analysis would reduce collective action barriers and would thus open the way to superior

[28] See Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. Rev. 811 (1992); Ronald Gilson & Reiner Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 Stan. L. Rev. 863 (1991); Jeffrey N. Gordon, Institutions as Relational Investors: A New Look at Cumulative Voting, 94 Colum. L. Rev. 124 (1994).

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"voice" strategies. That was the hope. The reality has deviated considerably from an Athenian ideal of shareholder engagement.

The business model of many institutional investors as it interacted with developing theories and empirics of investment management has muted their corporate governance role. At the beginning of the period a substantial fraction of institutional money was actively managed. This became the heart of the case for the proponents of institutional investor activism. The research that was associated with active management would inform the investors' judgments about governance or performance shortfalls and fuel their capacity to exercise "voice" to address them. This vision faltered because it turned out that sustained monitoring was inconsistent with the business model of the key channel for institutional investment, the asset managers, both in the economic incentives and the legal exposure.[29]

In general, an active asset manager's success is measured in terms of relative performance. If the asset manager is advisor to a mutual fund, superior relative performance will lead to greater "assets under management." Investors and investment advisors pay keen attention to relative performance measures and allocate funds accordingly. Asset manager compensation is ordinarily set as percentage of AUM. Accordingly, since research and other portfolio management costs are relatively fixed, manager profits increase (decrease) sharply as AUM increases (decreases), even where the fee percentage varies negatively with AUM. If the asset manager is advisor to a pension fund or endowment, relative performance is similarly used in retention and compensation decisions. Relative performance measures directly affect "voice." Assume the manager's research reveals serious governance problems or performance shortfall. There are two ways that the manager can capitalize on this information: sell in anticipation of the market's eventual realization of these problems that leads to downward share price adjustment, or undertake active measures to remedy them, through the exercise of voice. Meaningful "voice" in this context is costly because success against a recalcitrant company management team will require organizational efforts with other shareholders. Moreover, the gains will necessarily be shared with other shareholders, who can free ride on the voice-exerciser's effort. So: in cases where "voice" has been successfully employed, the active manager has occurred a positive cost not borne by other shareholders (and unlikely to be reimbursed by the company) for a gain that is shared by all. This is not a winning proposition from a relative performance perspective.

For the asset manager to a mutual fund, a "voice" strategy also runs into the demands of daily liquidity. Unanticipated redemption requests may require the manager to sell out positions

[29] This argument is spelled out in greater detail in Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. 863 (2013). Subsequent work in the political science literature has come to similar conclusions. **[cite]**

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to raise cash. The optimal dispositions from a liquidity perspective may be in tension with a sustained "voice" engagement with a particular company. Moreover, since the manager is always in the hunt for superior relative performance, it may decide that redeployed investment of its limited funds in another company will outperform the voice target, even if the target were to improve.

Finally, an asset manager is likely to advise a host of funds as part of a fund "family," which may raise thorny legal complications. Aggressive voice strategies by portfolio manager at one fund could well be attributed to the asset manager parent, which is deemed to be the beneficial owner of all the securities that it manages because of its control over the disposition and voting of those interests. This will raise on-going legal questions under sections 13(d) (disclosure) and 16(b) (short swing profits) of the 1934 Securities Exchange Act alongside concerns that active voice may trigger a target's poison pill.[30]

These forces will produce a style of voice that Gilson & Gordon (2013) describe as "rational reticence."[31] Funds (via their managers) ordinarily will not generate firm-specific proposals but will evaluate and respond to others' proposals. This explains the success of activist hedge funds in the current governance ecology in the United States. Hedge funds have a different business model, based on absolute returns: They seek out companies where they perceive strategic or operational shortfalls and invest heavily in research and organizational efforts to persuade institutional shareholders (and their advisors) of the value of a different approach. Asset managers are called upon to adjudicate such disputes on the shareholder value "merits." In making such decisions, asset managers can evaluate not only the current activist proposal but also the track record of the particular activist in creating sustainable gains, its "reputation."[32] In this way hedge fund activists act as kind of governance intermediary, performing a complementary role in light of the current ownership pattern. Thus active asset managers can realize the value of research that reveals problems at a particular portfolio company by holding in anticipation of an activist intervention (perhaps even nudging an activist) as well as by selling. From a corporate governance perspective this is an improvement, since the active manager can employ both this intermediated voice as well as exit.

This interaction between active managers and activist shareholders in specific contests produces portfolio effects as well, through "governance externalities." Managers and their advisors observe the pattern of activist success (which channels shareholder views) and integrate

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[30] John D. Morley, Too Big to Be Activist, 92 USC L. Rev. 1407 (2019).
[31] Gilson & Gordon (2103), supra.
[32] For empirical confirmation of the value of reputation in this context, see Travis L. Johnson & Nathan Swem, Reputation and Investor Activism: A Structural Approach 139 J. Fin. Econ. 29 (2021).

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the lessons into their strategic and operational decision-making. Thus the main impact of hedge fund activism is not through the particular encounters that attract attention, but through the own-firm action of corporate managers who are eager to avoid becoming an activist target. [33]

The form of shareholder "voice" that has arisen from the interaction between hedge funds/other shareholder activists and the active asset managers has not received universal acclaim, to put the point mildly.[34] The two core objections are that this style of corporate governance is (i) short-termist, sacrificing long term shareholder interests for immediate payoffs and/or (ii) excessively focused on shareholder interests, to the detriment of other stakeholders. The objectors frequently hold onto the forlorn hope that the conflicts *among* stakeholders and the time-varying conflicts *between* shareholders and (some of) the stakeholders can be resolved if only planning looked to the long term.

"Stewardship" has been offered up as an alternative to the kind of voice that would emerge solely from the rational self-interested behavior of asset managers and institutional investors. "Stewardship" in its simplest form calls on asset managers and other institutional investors to exercise their rights as shareholders, their voice, on a firm-by-firm basis, even when the strictly rational approach might be to minimize, even avoid altogether, the administrative costs of shareholder voting. At least on the Anglo-American model stewardship can also be understood as an effort to use "soft law" to take into account a broad set of governance and social concerns, to fulfill in some way the better governance-through-engagement aspiration associated with institutional ownership.[35]

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[33] See, e.g., Shane Goodwin, Management Practice in an Age of Engaged Investors, Col. Busn School R.P. No. 17-97 (Sept. 2017, available at https://ssrn.com/abstract=3045411 (developing a proprietary Vulnerability Score for use by managers seeking to avoid becoming an activist target).

[34] See, e.g., Leo Strine, Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and our Strange Corporate Governance System, 126 Yale L. J. 1870 (2017); John C. Coffee, Jr. & Darius Palia, The Wolf at The Door: The Impact of Hedge Fund Activism on Corporate Governance, 1 Annals of Crop. Governance 1 (2016).

[35] This is illustrated by the evolution of the UK Stewardship Code from its initial promulgation in 2010, calling for institutional "engagement" with individual companies, to the 2020 version, including particular activities within the stewardship responsibilities of institutional investors, most notably directing attention to "material environmental, social, and governance issues and climate change" and other market wide factors. See Paul Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet?*, in GLOBAL SHAREHOLDER STEWARDSHIP: COMPLEXITIES, CHALLENGES AND POSSIBILITIES 4-22 (Dionysia Katelouzou & Dan W. Puchniak eds., Cambridge Univ. Press, forthcoming 2022), working paper version available at https://ssrn.com/abstract=3553493.

For a typology of stewardship that identifies four distinct "stewardship supportive regulatory measures" across 14 countries, see Mark Fenwick and Erik P.M. Vermeulen, How to Create a 'Stewardship Culture'", TILEC Discussion Paper February 2018, available on SSRN at https://ssrn.com/abstract=3098235. "Stewardship" has a different meaning/is put to different use by regulators, depending in part on whether initial ownership

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B. Shareholder voice: The rise of broadly-diversified passively managed funds

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

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

The belief in stocks but not stock-pickers led to the rise of passive investment vehicles, in particular broad-based index funds. These follow two prescriptions drawn from modern portfolio theory. The investor has only two sure-fire ways to achieve optimal investment performance in a

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conditions were dispersed or concentrated. See generally Dionysia Katelouzou & Dan W. Puchniak, eds., GLOBAL SHAREHOLDER STEWARDSHIP: COMPLEXITIES, CHALLENGES AND POSSIBILITIES (forthcoming 2022); Geno Goto, Alan K. Koh, Dan W. Puchniak, Diversity of Shareholder Stewardship in Asia: Faux Convergence, 53(3) Vand.J. Transnational Law 829 (2020).

The European Commission has recently laid the ground for a different kind of engagement by institutional investors, one aimed at aligning the corporate governance activity of institutional investors (particularly mutual fund) with the purported pro-"sustainability" objectives of the institutional investor's beneficiaries. See Alessio M. Paces, Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?, ECGI WP Nov. 2021, available on SSRN at http://ssrn.com/abstract_id=3940375 .

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securities portfolio, meaning, the best risk-adjusted returns: minimize fees (to increase expected returns); diversify maximally (because the investor is compensated only for bearing risk that cannot be eliminated through diversification). Broad-based index mutual funds and ETFs have been a roaring success. Assets under management in such funds sponsored by BlackRock, Vanguard, State Street, and Fidelity now account for approximately 20% of the market capitalization of US public companies. [36]

The structure of broad-based index funds has generated certain anomalies in the governance debate. On the one hand, index funds, passive not active by design, are the ultimate "buy and hold" investor, so, one might think, if "exit" is not an option, such funds are leading candidates for "voice." Yet their core business model is simply to offer the market return at lowest cost. Investment in firm-specific engagement will not benefit the fund or generally its beneficial owners. As to the fund, remembering the relative performance model: Serious engagement is costly, yet any benefits will be necessarily be shared with all other funds following the same index. A passive fund, unlike an active fund, cannot benefit through overweighting or underweighting portfolio positions in light of firm-specific interventions. Moreover, the portfolios of index funds are formed without *any* firm-specific securities research, meaning: without a substantive basis for the exercise of voice, structural ignorance one might say. Engagement is not only inconsistent with an index fund's business model; it is purely a bolt on.[37]

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[36] *See* Matthew Backus, Christopher Conlon, Michael Sinkinson, *Common Ownership in America: 1980-2017*, 13(3) AEJ: Microeconomics 273 (Aug. 2021). The so-called "Big Three," BlackRock, Vanguard, and State Street, own significant stakes in companies throughout the world. See, for example, Jan Fichtner & Eelke M. Heemskerk, The New Permanent Universal Owners: Index Funds, Patient Capital, and the Distinction between Feeble and Forceful Stewardship, 49(4) Economy and Society (2020). See also Jose Azar, Miguel Duro, Igor Kadach, Gaizka Ormazabal, The Big Three and Carbon Emissions Around the Word, 142 J. Fin Econ. 674 92021) (Big Three own approximately 4.8% of large global public firms that collectively account for 56% of global CO2 emissions).

"Index funds" can be created to mimic returns on market segments, not just the broad-based market measures such as the S&P 500 or CRSP U.S. Total Market. The AUM of the funds indexed to broad-based market measures dominate the targeted indexers. See Adriana Z. Robertson, Passive in Name Only: Delegated Management and "Index" Investing, 26 Yale J. Reg. 795 (2019) (Table 2). This article particularly addresses the broad-based funds.

[37] This functional indifference has led some scholars to propose that passive funds should lose their votes or would gladly buy shares without votes, compare Dorothy S. Lund, The Case Against Passive Shareholder Voting, 43 J. Corp. L 101 (2018) with Dorothy S. Lund, Non-Voting Shares and Efficient Corporate Governance, 71 Stan. L. Rev. 687 (2019. Others claim that since passive funds generally are sponsored by asset managers that include active funds in the family, the actives can guide informed choices by the passives whose votes will add clout and thus improve the performance of the actives. Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, The New Titans of Wall Street: A Theoretical Framework for Passive Investors, 168 U. Pa. L. Rev 17, 42-43 (2020). This doesn't deal with might be called the "Vanguard" problem – a fund family consisting almost

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As to the beneficial owners: by construction, a broad-based index fund will diminish, perhaps eliminate, idiosyncratic risk. A performance change in a company is the kind of idiosyncratic element that broad-based diversification is designed to suppress. Performance improvements by Company A in a business sector is likely to come at the expense of another company in broadly-diversified index, not result in an absolute increase in the value of the portfolio.[38]

In thinking about firm-specific performance engagement, it's valuable to think about comparative advantage. As observed previously, hedge funds and other shareholder activists have made a business of identifying underperforming companies, generating an alternative strategy, and undertaking the organizational work to mobilize other shareholders. The activists make concentrated investments in particular companies and receive concentrated returns in proportion to gains. This obviously gives the activist stronger incentives to get it right than a passive index fund manager who may make a diversified set of engagement decisions. If the activists will pursue under-performers, why isn't the optimal index fund manager strategy to free ride? Or, at most, to engage in the "rational reticence" strategy of active investors, that is, evaluate specific engagement cases teed up buy the activists.[39] What is the evidence for an undersupply of shareholder activists that ought to motivate additional initiatives by notionally passive investors?[40] Moreover, the "undersupply" hypothesis needs to take account of the governance externalities associated with the current level of activism. To avoid becoming an activism target, managers often engage in

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exclusively of passive index funds; or the BlackRock counter-example: in response to investor demand, shifting resources away from active funds (laying off portfolio managers, ideally situated to exercise voice) in favor of quantitative funds. Replacing portfolio managers with "stewardship" staff is likely to degrade BlackRock's capacity to evaluate firm-specific performance proposals.

This functional indifference has also led some to insist that index funds should face carrots and sticks to take a more assertive governance role, carrots in the regulatory permission to charge a certain level of firm-specific engagement expenses directly to the fund; sticks, in a requirement to do so. See Lucian Bebchuk & Scott Hirst, Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy, 119 Colum. L. Rev. 2029 (2019).

[38] See note 15 supra. (discussing "substantially idiosyncratic").

[39] Indeed, the presence of passive shareholders seem to incline activists to pursue a director-replacement strategy that is consist with the passives' interest in improving director quality generally as a way of improving portfolio performance. See Ian R. Appel, Todd A. Gormley & Donald B. Keim, Standing on the Shoulders of Giants:The Effects of Passive Investors on Activism, 32 Rev. Fin. Stud. 2720 (2019).

[40] Lund draws the analogy to the way that stock markets can remain informationally efficient even if only some investors engage in securities research and trading and that positive returns will be sufficiently likely to motivate an adequate level of such activity. Dorothy S. Lund, Passive Investing and Corporate Governance: A Law and Economics Analysis, available at https://ssrn.com/ abstract_id=3623381 (referencing Sanford J. Grossman . & Joseph E. Stiglitz, , On the Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 3939 (1980)).

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self-scrutiny and follow-on action. Yet some object that this already leads too many companies to focus on too narrowly on shareholder value.[41]

Some have argued that the very size of index fund positions give fund managers incentives to make substantial firm-specific engagement investments.[42] Apple, for example, carries a market capitalization of nearly $3 trillion dollars. An intervention that produces a 5% increase in value for a fund holding 5% of Apple's stock results in a gain for the fund of $7.5 billion; assume the fund earns a management fee of 10 basis points, 0.1% (on the high side these days), so the manager earns additional fees of $7.5 million, annually, assuming that the gains are sustained; if capitalized at current stock price multiples, maybe $150 million! Surely that potential gain is sufficient to evoke some useful performance-based engagement. To state the hypothetical is to show how unrealistic, since we don't observe behavior that this example suggests would be rational by economically motivated parties.[43]

There are two key points. The first is that the nature of diversification means that firm specific gains do not generally translate into portfolio gains. Perhaps some of Apple's gains will come from market share or profits captured from private market companies that are not reflected in a public market index; or perhaps from small companies in the Russell 3000 not in the S&P 500. Nevertheless the overwhelming fraction of any such gains will be at the expense of other large public players, Google/Android and Microsoft/Surface, just because of the magnitudes; in short, idiosyncratic. From a portfolio perspective, at best such engagements would add to the general

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[41] Some may claim that hedge fund activism leaves a significant margin of managerial agency costs unaddressed. This seems to be the premise of Bebchuk & Hirst, supra note --. On average hedge fund activism is associated with a 7 percent increase in the target's stock price, and the hedge fund's profit typically comes from appreciation on equity positions obtained before announcement of the activist intervention. Thus hedge fund activism places a cap on "managerial slack" (seen from a shareholder perspective) of this 7 percent. Thus there is a margin of managerial agency costs that theoretically could be addressed through firm specific engagements. Let us put aside that such firm-specific interventions are likely to be idiosyncratic only. Fact is, our "science" of corporate governance is hardly refined enough to what interventions will create own-firm value without deep engagement with firm specific features. Repeat-play activist success requires not costly firm-specific research but also skill in assessing and offering remedies for operational or strategic shortfalls. The activist engagement model works only if "reputation" markets drive out under-performers, ie, will discourage engagements that would *reduce* value. Thus, as argued in the introduction, firm-specific engagement by asset managers of fully diversified funds should focus on issues that resonate on the systematic dimension, because of the correct incentive alignment for a fully diversified funds in reducing systematic risk.

[42] Edward Rock & Marcel Kahan, Index Funds and Corporate Governance: Let Shareholders Be Shareholders, 100 B.U. Rev. 1771 (2020).

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

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performance pressure already associated with the current level of shareholder activism, the governance externalities already abundantly supplied. Nor does the size of the index fund investment in specific large capitalization stocks give such funds a unique opportunity to pursue performance improvements in such firms, a narrow version of the undersupply hypothesis. Activist engagements have taken on the biggest firms; size is no protection.[44]

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

C. Shareholder voice: Towards Systematic Stewardship

As a matter of current policy most index funds focus their corporate governance activities on portfolio-wide guidelines that comport with a normative idea of "best practice" corporate governance. Presumably the asset managers believe that such governance measures will increase, on average, expected returns across the portfolio.[45] There may be prudential considerations. The SEC requires mutual funds to disclose their shareholder votes.[46] Precisely to avoid vote-stripping and other regulatory interventions, index funds want to look like usual shareholders in exercising their governance rights but also want to conserve on such costs. This strongly inclines them to voting guidelines formulated in interaction with proxy advisors.[47] In general such guideline

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[44] Eg, Icahn, Apple; Jana Partners, Apple; Trian, du Pont; Third Point, Intel. See Wachtell, Lipton, Rosen & Katz, "Dealing with Activist Hedge Funds and Other Activist Investors" (Jan. 17, 2020) ("No company is too large, too popular, too new or too successful" to "consider itself immune from hedge fund activism"), available at https://corpgov.law.harvard.edu/2020/01/20/dealing-with-activist-hedge-funds-and-other-activist-investors-3/.

[45] For positive evidence on this proposition, see Fatima-Zahra Filali Adib, Passive Aggressive: How Index Funds Vote on Corporate Governance Proposals, available at: https://ssrn.com/abstract=3480484.

[46] See SEC, Proxy Voting by Investment Advisers, Release No. IA-2106 (Jan. 31, 2003); 17 CFR 275.206(4)-6. Mutual fund votes are filed on Form N-PX.

[47] See Giovanni Strampelli, Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing, 55 San Diego L. Rev. 803, 816-826 (2018); Asaf Eckstein, The Rise of Corporate Guidelines

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positions are chosen to enhance the latent power of shareholders, including resistance to classified boards, annual advisory say-on-pay votes, preference for single class common stock, and endorsement of a majority vote for director election.[48] Firm specific engagements tend to focus on the quality of directors, as part of portfolio-wide strategy to sustain and improve the quality of boards.[49] In a majority of activist challenges, index funds favor managements against activist challenges, though votes in favor of an activist director are not uncommon.[50] Indeed, the presence of passive shareholders seem to incline activists to a campaign for board seats rather than an immediate strategy change.[51] This is consistent with the view in Gilson & Gordon (2019, 2020) that institutional investors understand the limitations of the present board model, are inclined to support management if they are sufficiently confident in the current directors, and believe (and hope) that willingness to reject weak directors will have portfolio-wide effects on director quality, yet another governance externality.[52]

"Systematic stewardship" is another portfolio approach but importantly difference: focusing not on increasing expected returns across the portfolio but reducing systematic risk and in this way improving risk-adjusted portfolio returns. Actually the current stewardship movement began with an intuition about the need for institutional investors to assert their governance rights to reduce systematic risks. Adoption of the UK Stewardship Code came in the wake of the 2007-

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in the United States, 2005-2021: Theory and Evidence, WP January 2022 rev., available at https://ssrn.com/abstract=3705140

[48] See Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. Fin. Econ. 111, 114 (2016) (increased ownership by passives is associated with more independent directors, elimination of takeover defenses, more single class common).

[49] See, e.g., BlackRock Investment Stewardship: Proxy Voting Guidelines for U.S. Securities (Eff. Jan. 2021) at 3 ("…BlackRock focuses on directors in many of our engagements and sees the election of directors as one of our most critical responsibilities.")

[50] See See Giovanni Strampelli, Are Passive Funds Active Owners? Corporate Governance Conequences of Passive Investing, 55 San Diego L. Rev. 803, 827-830 (2019).

[51] See Ian R. Appel, Todd A. Gormley & Donald B. Keim, Standing on the Shoulders of Giants:The Effects of Passive Investors on Activism, 32 Rev. Fin. Stud. 2720 (2019).

[52] Ronald Gilson & Jeffrey Gordon, Board 3.0: An Introduction, 74 The Business Lawyer 351 (2019) and Board 3.0: What the Private-Equity Governance Model Can Offer Public Companies, 32:3 J. App. Corp. Fin. 43 (Summer 2020).

Some argue that the current willingness of index funds to vote in favor of ESG issues is a marketing strategy based on the social tastes of millennial investors. See Michal Barzuza, Quinn Curtis & David F. Webber, Shareholder Values(s): Index Fund ESG Activism and the New Millennial Corporate Governance (supra). To the contrary I think index investors are acting from motives that I would associate with a portfolio approach. To take their example of an appealing "social issue," the promotion of gender diversity on corporate boards. This is consistent with a portfolio-wide increased expected return strategy: high end talent is scarce and eliminating barriers to the infusion of new talent onto boards and otherwise should produce better performance, particularly over time.

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09 Global Financial Crisis. In a post-crisis assessment the Walker Committee concluded that one of the crisis causes had been a corporate governance defect, namely, the failure of institutional investors to rein-in excessive risk-taking by the largest banks and other large financial firms,[53] and the subsequently promulgated Stewardship Code called for such institutional investor engagement.[54] However, the Stewardship Code and the subsequent discussion did not sufficiently attend to the distinctive reason that institutional investors should focus on such firm-specific behavior: because failure of a systemically important financial firm is not just a firm-specific problem but rather will produce losses across the entire portfolio (across the entire economy). The risk of failure of such a firm is not idiosyncratic. It is not diversifiable. The risk of a systemic shock is "systematic." In the run-up to the financial crisis, to produce the optimal risk-adjusted returns to investors, a widely diversified institutional investor should have attended to this risk and tried to mitigate it.[55] The foremost stewardship mission of a diversified institutional investor or an asset manager is thus to mitigate and avert such risk realizations.

This distinctive case for "systematic stewardship" has been lost in the ensuing discussion, although a glimmer of it has emerged in the 2020 UK Stewardship Code, which begins to frame "ESG" analysis by institutions in this way, albeit through a glass darkly.[56] It is not just a systematic stewardship *duty* that should evoke such behavior (soft law) but rather: a focus on systematic risk mitigation is rational for asset managers. A systemic shock, a realization of systematic risk, will abruptly reduce AUM and thus reduce the fee-based revenues and the manager's profits, even if on a relative performance basis the particular manager is no worse than others. That's a crucial distinction from firm-specific engagement generally. Precisely because any performance improvement is idiosyncratic, the portfolio value will not increase. The invocation of "stewardship" in that context is at best a soft law cudgel to coerce a largely unwilling actor to perform. "Systematic stewardship" calls on the manager to take steps that could lower the undiversifiable portfolio risks and thus improve beneficiary welfare, and, if successful, will reduce the likelihood

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[53] David Walker, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities. Final Recommendations 24 (Nov. 26, 2009), https://ecgi.global/sites/default/files/codes/documents/walker_eview_261109.pdf.

[54] UK STEWARDSHIP CODE, FIN. REPORTING COUNCIL (2010), https://www.frc.org.uk/getattachment/e223e152-5515-4cdc-a951-da33e093eb28/UK-Stewardship-Code-July-2010.pdf.

[55] See John Armour & Jeffrey Gordon, Systemic Harms and Shareholder Value, 6 Journal of Legal Analysis 35 (2014).

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

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of events that could abruptly shrink portfolio values and thus reduce manager profits. It is "incentive compatible." [57]

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

Part II: Systematic Risk: Theory and Candidates

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

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

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manage and defend trade-off of investor welfare for socially desirable ends.[58] To be sure, there may be quantification issues in assessing the welfare effects of a potential trade off of lower expected returns for reduced systematic risk, but specifying and calibrating the necessary models is within the competence of asset managers.

Many elements of social policy can be said to have economy-wide effects and will be likely to improve expected returns across the portfolio. For example, investments in education and infrastructure historically have been associated with substantial economic gains. But these investments typically reflect choices made by government actors, not portfolio companies, nor do they reflect systematic *risk* factors of the kind that an asset manager of a conventional financial product is readily in a position to evaluate. On the other hand, regulatory interventions that directly bear on systemic risk-taking by portfolio companies could well be within the asset manager's domain because of the foreseeable impact on portfolio values. A more complicated question is whether an asset manager should develop a view about macro-prudential policies by a central bank designed to constrain systematic risk build-up.[59] Such measures will almost certainly have negative price effects for some companies in a fully diversified portfolio even if risk-adjusted returns across the portfolio are superior. Accepting such potential trade-offs is within the scope of a systematic stewardship approach. Some managers may be along a path to develop such analytic capacity; this one way to understand the "policy" letters most famously associated with BlackRock's chief executive officer.[60]

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[58] For elaboration of some of the tensions in the current ESG investing model for financial fiduciaries, see Max M. Schanzenbach & Robert H. Sitkoff, Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee, 72 Stan. L. Rev. 381 (2020). In general Schanzenbach & Sitkoff argue that in many circumstances a financial fiduciary will be obligated to fashion an investment strategy for the "sole benefit" of the beneficiary, which would mean that in those contexts that ESG can pursued only as part of a risk-return maximization investment strategy. Id. at 397-399. The permissible risk-return associated with such ESG investing on their account seems based on own-firm considerations only, without considering the systematic implications, meaning the portfolio-wide implications, of a firm's activity. From the perspective of this article, a financial fiduciary that is engaged in active investment management surely can take account of any risks that can affect own-firm returns, but since such a fiduciary will almost invariably construct a diversified portfolio, the fiduciary is also entitled to consider the systematic implications of the firm's behavior. So, for example, avoiding fossil fuel equity investments may reduce portfolio diversification (the classic objection) but if reasonably related to a strategy to reduce climate change risk may improve risk-adjusted returns on the remaining portfolio because of a reduction in systematic risk.

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

[59] See, e.g., Alejandro Van der Ghote, Benefits of Macro-Prudential Policy in Low Interest Rate Environments, European Central Bank WP No. 2498, Dec. 2020.

[60] E.g., Larry Fink, 2020 Letter to CEOs: "evidence on climate risk is compelling investors to reassess core assumptions about modern finance"; "BlackRock announced a number of initiatives to place sustainability at the

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1. The Nature of Systematic Risk

The central argument on behalf of "systematic stewardship" is that managers of a broadly-diversified investment vehicle would improve the portfolio's risk-adjusted returns (and thus improve the welfare of their beneficiaries) through mitigating systematic risk. This effort can be operationalized within the existing framework of asset pricing, which has paid increasing attention to systematic risk. The initial operationalization of portfolio theory focused only single factor associated with stock price co-movement, returns on the market index. Contemporary asset pricing models decompose that "systematic risk" into various other factors that explain systematic return variation. Nevertheless these models generally retain an irreducible level of "market risk" that becomes a target for systematic stewardship.

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

The initial translation of portfolio theory into an asset pricing model, the Capital Asset Pricing Model, assessed overall market variance, presumably stemming from shocks or other phenomena that broadly affected the real economy, as a singular factor. The famous "beta" variable measured a stock's performance vis-a-via changes to the market index. Subsequent asset pricing models based on arbitrage pricing theory[61] have decomposed systematic risk into a series of factors that account for the co-movement of stocks of particular characteristics. The Fama-French model in its various versions includes factors that take account of firm size and firm value (proxied by book-to-market) but always includes excess return on the market, meaning the return

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center of our investment approach, including: making sustainability integral to portfolio construction and risk management"; "[W]e will be increasingly disposed to vote against management and board directors when companies are not making sufficiently sufficient progress on sustainability-related disclosures and the business practices and plans underlying them." Available at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

[61] Stephen A. Ross, The Arbitrage Theory of Capital Asset Pricing, 13 J. Econ. Theory 341 (1976); Richard Roll & Stephen A. Ross, An Empirical Investigation of the Arbitrage Pricing Theory, 35 J. Fin. 1073 (1980).

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on the market index minus the risk free rate.[62] For a particular firm, these factors can be time-varying. Various empirical analyses have produced a proliferation of purported systematic elements, notorious as "the factor zoo."[63] The empirical technology employed to identify these factors and weight them properly especially in high frequency trading era has become advanced.[64]

Another approach to explaining at least some systematic influences on returns is to look at the influence of "rare disasters."[65] Any particular "disaster" is a black swan, but as seen as a class, "rare" disasters are foreseeable. Indeed, parallel to the development of asset pricing models has been a growing appreciation that the risk of "rare disasters" exerts a pervasive influence over market pricing, perhaps explaining all or part of the "equity premium puzzle," the unexplained excess returns of a diversified stock portfolio over the risk free asset, US Treasury bills[66]; at minimum, these "tail risks" have a strong effect on asset prices.[67] This "rare disasters" analysis

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[62] See Eugene Fama & Kenneth French, Common Factors in the Returns on Stocks and Bonds, 33 J. Fin. Econ. 3 (1993) The Carhart variant adds a firm's stock price "momentum" to the Fama-French factors. Mark Carhart, On Persistence in Mutual Fund Performance, 52 J. Fin. 57 (1997). Fama and French have recently derived a revised set of five factors that they regard as having more explanatory power, ie, fit the data better. Eugene Fama & Kenneth French, A Five-Factor Asset-Pricing Model, 116 J. Fin. Econ. 1 (2015).

[63] Guanhao Feng, Stefano Giglio, Dacheng Xiu, Taming the Factor Zoo: A Test of New Factors, 75 J. Fin 1327 (2020)

[64] See, e.g., Markus Pelger, Understanding Systematic Risk: A High Frequency Approach, 75 J. Fin.2179 (2020).

[65] Robert J. Barro, Rare Disasters and Asset Markets in the Twentieth Century, 121(3) Q.J. Econ. 823 (2006); Robert J. Barro & Jose F. Ursa, Rare Macroeconomic Disasters, 4 Annual Review of Economics 83 (2012); Francois Gourio, Disaster Risk and Business Cyckes, 106 Am. Econ. Rev. 2734 (2012); Robert J. Barro & Gordon Liao, Tractable Rare Disaster Probability and Options-Pricing, WP (2019); Thomas A. Rietz, The Equity Risk Premium: A Solution, 22 J. Monetary Econ. 117 (1988).

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

[67] The effort to quantify the return effects of extreme downside risk has been the subject of several recent papers. See, e.g., Brian Kelly & Hao Jiang, Tail Risk and Asset Prices, 27 Rev. Fin Studies 2841 (2014). Brian Weller, Measuring Tail Risks at High Frequency, 32 Rev. Fin Stud. 3571 (2019); Sofiane Aboura & Y. Eser Arisoy, Can Tail Risk Explain Size, Book-to-Market, Momentum, and Idiosyncratic Volatility Anomalies? 46 J. Business Fin. & Acctg 1263 (2019); Turan G. Bali & Hao Zhou, Risk, Uncertainty, and Expected Returns, 61 J. Fin. & Quant. Analysis 707 (2016); Marteen van Oordt & Chen Zhou, Systematic Tail Risk, 51 J. Fin. & Quant. Analysis 685 (2016). See also Jessica A. Wachter, Can Time-Varying Risk of Rare Disasters Explain Aggregate Stock Market Volatility, 68 J. Fin. 987 (2013).

Another approach is to distinguish "uncertainty" from "risk," which are separately priced in an asset pricing model, and to reduce one source of uncertainty through addressing systematic risk drivers. See Turan G. Bali & Hao Zhou, Risk, Uncertainty, and Expected Returns, 51 J. Fin. & Quant. Anal. 707 (2016) (extent of portfolio correlation with economic uncertainty significantly affects portfolio returns).

Models are beginning to emerge that attempt to model price effects of climate effects, for example, rising temperatures, which can shows how reducing climate effects can improve returns. Such models do not

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fits the experience of the breakout of "systemic risk" commonly associated with financial sector distress: the kind of risk that can lead to a sudden collapse in stock prices because of a pervasive negative impact on the real economy that threatens the profitability, even viability, of many firms. This systemic risk-as-systematic risk overhangs stock market prices generally and of course a realization of this risk would produce a dramatic decline in stock prices. Systematic risk can also reduce the expected return on a portfolio if it leads to costly financing or operational decisions that would be avoided in an environment of lower systematic risk.[68] Systematic stewardship consists in the effort of managers to reduce these risks.

In creating asset pricing models finance scholars seem to take market risk as exogenous and normally distributed.[69] Indeed, modern portfolio theory is based on producing a portfolio that is mean-variance efficient. Yet our experience with systemic breaks, as in the Great Financial Crisis, which triggered great volatility in market risk and led to massive effort at financial regulation reform, would seem to confirm an intuition that "systematic risk," because it depends on a set of government and market preconditions, can be reduced by mitigatory reforms. In particular, such reforms can flatten out at least some disruptive risk realizations, the "fat tails." Conventional asset pricing models take market risk as exogenous in part because the pricing questions they address are generally firm-specific. The claim of systematic stewardship is two fold: first, that institutional investor and asset managers can undertake measures that target systematic risk (it can be endogenized by investor behavior); and second, such actions would serve the interests of their beneficiaries, who care about the value of the portfolio as a whole.

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

2. Candidate Systematic Risks for Systematic Stewardship

i. *Climate change risk*. A particularly strong candidate for systematic stewardship is the risk associated with climate change associated with increasing levels of atmospheric CO_2. Diverse

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capture, except inferentially, the non-linearity of the risk function. See Ravi Bansal, Dana Kiku & Macelo Ochoa, The Price of Long-Run Temperature Shifts in Capital Markets, NBER WP w22529 (July 2021 rev.), available at http://www.nber.org/papers/w22529.

[68] See Michael Schwert & Ilya Strebulaev, Capital Structure and Systematic Risk, 2014, available at http://ssrn.com/abstract=2421020 (firms with higher exposure to systematic risk reduce leverage).

[69] See Jon Lukomnik & James P. Hawley, Moving Beyond Modern Portfolio Theory: Investing That Matters mss.(2020) (arguing that finance scholars and others regard systematic risk as exogenous when it should be the target of mitigation).

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analysts describe first order economic effects associated with the resulting temperature rises.[70] A 2017 report in *Science*, for example, estimates a loss of 1.2% of GDP for each degree centigrade rise; without intervention, analysts predict up to a 4 degree increase; the GDP impact would exceed the recession associated with the Great Financial Crisis.[71] Other analysts predict even starker outcomes, with an impact that would rival the massive impact of the SARS-CoV-2 pandemic.[72] The World Economic Forum's 2022 Global Risk Report put climate change issues as the top three in a ranking of ten issues overall.[73]

There are multiple channels through which massive economic harms could result from unmitigated climate change risk. There is of course the physical damage from extreme weather events; damage from rising sea levels; agricultural losses from lost arability, and all the disruptions that would result from these physical manifestations. Postponement of firm-specific adaptations necessary to eliminate CO_2 emissions and reverse atmospheric CO_2 would only increase the eventual transition costs; the "stranded assets" would pile up. As the physical disruption from climate change becomes manifest, firms that significantly added to CO_2 emissions either through fossil fuel production or consumption (like public utilities or even automobile manufacturers) could face liability risk.[74] Another channel is the threat to financial stability that has led many

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[70] These are canvassed in Madison Condon, Externalities and the Common Owner, 95 Washington L. Rev. 1, 43-48 (2020) and in John Armour, Luca Enriques & Thom Wetzer, Mandatory Corporate Climate Discosures: Now, but How? (forthcoming Colum. Bus. L. Rev. 2022).

[71] Solomon Hsiang et al., Estimating Economic Damage From Climate Change in the United States, 356 Science 1362 (2017). Also see Peter H. Howard & Thomas Sterner, Few and Not So Far Between: A Meta-Analysis of Climate Damage Estimates, 68 Envtl & Resource Econ 197 (2017) (Approximately 10% GDP loss from predictable temperature rises). Schroders Climate Dashboard Points to Four Degree Rise - Despite Increase in Carbon Prices, Schroders (Oct. 19, 2018), https://www.schroders.com/en/au/institutions/insights/investmentinsights/schroders-climate-dashboard-points-to-four-degree-rise—despite-increase-in-carbon-prices/ [https://perma.cc/NE73-78JJ] (permanent damage 3 to 4 times that of the GFC; NCA (National Climate Assessment). 2018. Fourth National Climate Assessment. Volume II: Impacts, Risks, and Adaptation in the United States. NCA. https://nca2018.globalchange.gov/ (10% GDP loss).

[72] Tom Kompas, Pham Van Ha & Tuong Nhu Che, The Effects of Climate Change on GDP by Country and the Global Economic Gains From Complying With the Paris Climate Accord, 6 Earth's Future 1153 (2018);

[73] World Economic Forum, The Global Risks Report 2022, available at https://www.weforum.org/reports/global-risks-report-2022. The top three risks are Climate Action Failure; Extreme Weather; and Biodiversity Loss.

[74] See Mark Carney, A Transition in Thinking and Action, International Climate Risk Conference for Supervisors, De Nederlandsche Bank, Amsterdam (Ap. 6, 2018) (including liability risk along with physical risks, transition risks, and financial stability risk), available at https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/a-transition-in-thinking-and-action-speech-by-mark-carney.pdf?la=en&hash=82F57A11AD2FAFD4E822C3B3F7E19BA23E98BF67.

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central bankers to focus on climate change.[75] Profs. Conti-Brown and Wishnick describe the systemic channels as first, the risk that a particular climate shock would produce a "rising tide of debtor defaults" that would bring down significant banks, and second, more generally, the risk of "a global, correlated set of threats to our current forms of economic production."[76]

Climate change risk is thus a worthy target for systematic stewardship not just because its impacts may produce sharp declines in GDP and thus losses across a diversified securities portfolio but also because its manifestations will be unpredictable, like the weather. Many of the climate-change affected systems are non-linear. The flow of ocean currents, Greenland's glaciers, and the Antarctic ice shelf, for example, are all candidates for a "rare disaster," indeed, a "Green Swan" event, an irreversible change to the global eco system with far-reaching adverse consequences.[77] Climate change risk systematically overhangs a fully diversified portfolio, reducing risk-adjusted returns.

ii.. Financial stability risk. The Global Financial Crisis demonstrated the systematic impact of the distress of systemically important financial institution. Looked at solely from the prospective of stock market participants, the consequence was a dramatic loss to holders of the market portfolio. The S&P 500 experienced a peak-to-trough loss of 57% over the October 2007 to March 2009 period,[78] overall stock market losses of nearly $8 trillion. This was associated with

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[75] See Open Letter on Climate-related Financial Risks (Mark Carney, Governor, Bank of England et al) (April 17, 2019) (describing work of Network for Greening the Financial System, 66 central banks and supervisors), https://www.bankofengland.co.uk/news/2019/april/open-letter-on-climate-related-financial-risks. See NGFS Climate Scenarios for Central Banks and Supervisors (June 2020), available at https://www.ngfs.net/sites/default/files/medias/documents/820184_ngfs_scenarios_final_version_v6.pdf The Federal Reserve has recently joined this Central Bank network and , for the first time identifying climate change as a risk for financial stability. See Board of Governors, Financial Stability Report (Nov. 2020) at 58-59. The Financial Stability Oversight Council has described "Climate change [as] an emerging threat to the financial stability of the United States." See FSOC Report on Climate-Related Financial Risk (2021), available at https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf.

[76] Peter Conti-Brown & David Wishnick, Technocratic Pragmatism, Bureaucratic Expertise, and the Federal Reserve (forthcoming 2020 Yale Law Journal). Also see Seraina Grunewald, Climate Change as Systemic Risk – Are Macroprudential Authorities Up to the Task?, Eur. Banking Inst WP 2020-62 (April 2020); Nahiomy Alvarez, Alessandro Cocco & Ketan Patel, A New Framework for Assessing Climate Change Risk in Financial Markets, Chicago Fed Letter, No. 448 (Nov. 2020), available at A New Framework for Assessing Climate Change Risk in Financial Markets - Federal Reserve Bank of Chicago (chicagofed.org); Lael Brainard, Strengthening the Financial System to Meet the Challenge of Climate Change (Dec. 18, 2020), available at Speech by Governor Brainard on strengthening the financial system to meet the challenge of climate change (federalreserve.gov) (describing Fed's efforts to model climate change risk for financial stability).

[77] See Patrick Bolton, Morgan Despres, Luiz Awazu Pereira da Silva, Fredric Samama, and Romain Svartzman, The Green Swan (2020), available at https://www.bis.org/publ/othp31.pdf.

[78] The high was October 9, 2007, 1565; the low was 677. The Dow Jones and Nasdaq indices experienced comparable declines.

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a comparable loss in GDP of 4.3% over the period and resulted in the longest post-War II recession. A break down in financial stability rapidly rolls into the real economy because of the disruption in credit provision; the uncertain solvency of many financial firms means that many parties will "run" on such firms generally. These runs will produce a further contraction in credit availability, both because solvent firms will refrain from additional lending to hoard cash and because insolvent firms will simply collapse.

The Global Financial Crisis of course had many causes but a critical feature was the balance sheet fragility of many large publicly traded financial firms and the risk-taking that was incentivized by option-heavy executive compensation.[79] Senior managers felt pressure to pursue aggressive strategies to enhance return-on-equity and other quantitative measures of shareholder advancement irrespective of the consequent build-up of systemic risk. Financial firm managers seemed to be unheeding of the risks to financial stability. "As long as the music plays, you dance."[80] Precisely because of the widespread portfolio losses associated with a financial crisis, financial stability is an appropriate target for systematic stewardship.[81] Financial distress produces losses across the full economy and thus a diversified portfolio; the risk of an outbreak of financial distress is a systematic overhang for portfolio values generally. Systematic stewardship brings a distinct perspective to the behavior of systemically important financial firms, realizing that the traditional corporate governance pressure for own-firm maximization does not give due weight to the systematic costs.[82]

iii. Social stability risk

The US corporate governance system is set up for firms to be highly responsive to changes in the economic environment but in a way that results in the imposition of the adjustment costs of economic change on various stakeholders, in particular the employees. The structure of share ownership – the reconcentration into diversified investment vehicles -- has produced pressures and incentives that have diminished the capacity of firms to provide stakeholder insurance against such adjustment costs. In turn the outward shift of adjustment costs have made it easier for firms to

[79] Ing-Haw Cheng, Harrison Hong & Jose Scheinkman, Yesterday's Heroes: Compensation and Risk at Financial Firms, 70(2) J. Fin. 839 (2015).

[80] The full quote of the remarks by then Citibank CEO Chuck Prince in 2007 was: ""When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Financial Times, July 9, 2007.

[82] For further development of the differences in optimal corporate governance for financial firms vs. non-financial firms, see John Armour & Jeffrey Gordon, Systemic Harms and Shareholder Value, 6 Journal of Legal Analysis 35 (2014); Jeffrey Gordon, Corporate Governance and Executive Compensation in Financial Firms: The Case for Convertible Equity-Based Pay, 2012 Colum. Bus. L. Rev. 834.

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respond to and anticipate changes in the economic environment, producing a change in the rate of change.[83] The consequence is a heightening sense of social instability, not just though the dislocation in careers and life circumstances but in a growing sense that the set-up produces an unacceptable distribution of gains.[84] For a diversified portfolio investor, the potential backlash is a systematic risk, because the consequence could be changes that would impose losses across the entire portfolio. Measures that reduce this systematic risk would improve risk-adjusted returns. Breakdowns in financial stability that produce sharp declines in employment and other elements of social well-being also produce heighten risks of social instability, an additional reason why a systematic steward should particularly care about financial stability from a portfolio investor point of view.

The moving parts of this argument need some elaboration. The intuition behind diversification is an ancient one: it's generally best for an investor not to put all his/her eggs in one basket. The critical movement is the transformation of modern portfolio theory from a theory of investment management to a companion theory of economic organization. Investors can achieve diversification at the portfolio level rather than at the firm level, meaning that the investor can most efficiently eliminate uncompensated idiosyncratic risk by holding a portfolio of firms with a narrow focus rather than holding shares in firms that themselves operate in diverse business segments in the name of diversification. That has several implications. First, investors are risk neutral with respect to the failure of any particular firm in the portfolio (except for the limited group whose failure would have systemic implications). This means investors would support firms/management teams that took the highest net present value business risks, even if failure was a possible outcome, because this is the general way to increase expected returns of the portfolio without increasing the systematic risk.[85] Managers (and creditors) are compensated for this additional risk-taking through stock-based compensation, but employees rarely are.

Moreover, investors who are diversified at the portfolio level want managers to keep a tight control of diversification at the firm level. "Related diversification" that produces synergies and complementarities within the firm is acceptable; "unrelated diversification" as in a conglomerate firm is disfavored because managerial capacity is commonly over-stretched and rents in the best

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[83] See Jeffrey Gordon, Addressing Economic Insecurity: Why Social Insurance Is Better than Corporate Governance Reform (Aug. 20, 2019), available at http://clsbluesky.law.columbia.edu/2019/08/21/addressing-economic-insecurity-why-social-insurance-is-better-than-corporate-governance-reform/

[84] See Jeffrey Gordon Is Corporate Governance a First Order Cause of the Current Malaise?, 6 J. British Academy (Supp, Iss. 1) ("Reforming Business for the 21st Century") (Dec. 2018); Alex Raskolnikov, Distributional Arguments, in Reverse, 105 Minn, L. Rev. (forthcoming 2021).

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

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performing segments are commonly dissipated through cross-subsidy.[86] As the firm cuts back on diversification, it faces greater exposure to business risk. A diversified firm can shift profits from one prospering segment to another facing severe losses, socializing losses at the firm level.[87] A focused firm loses this cushion and thus is more likely to fail.[88] As noted above, managers are compensated for this extra risk through stock-based pay, a share of the upside, but employees, who have lost the protection of this within-the-firm safety net, commonly are not.[89] Moreover, facing declining profits, managers in this tightly-focused world are likely preemptively to engage in cost-reduction, further increasing the risk to employees.[90] Even though manager have been compensated ex ante for the extra risk, in the moment of firm-level distress, managers would prefer

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

[87] Oguzhan Ozbas & David Scharfstein, Evidence on the Dark Side of Internal Capital Markets, 23 Rev. Fin. Studies 581 (2010); David Scharfstein & Jeremy Stein, The Dark Side of Internal Capital Markets: Divisional Rent Seeking and Inefficient Investment, 55 j. Fin. 3537 (2000).

[88] Varouj A. Aivazian, Mohammad M. Rahaman, & Simiao Zhou, Does Corporate Diversification Provide Insurance Against Economic Disruptions? 100 J. Business Res. 218 (2019) (diversification hedges against extreme economic circumstances and reduces failure risk of the firm).

[89] Geoffrey Tate & Liu Yang, The Bright Side of Corporate Diversification, 28(8) Rev. Fin. Studies 2203 (2015) (internal labor markets in diversified firms better protect employees against economic shocks). Tate & Yang carries the further implication that internal labor markets of conglomerate firms are more efficient than external labor markets in redeploying labor after technological or economic change, meaning, better preservation of prior human capital investment and lower displacement costs. By contrast, external *capital* markets are more efficient than the internal capital markets of the conglomerate firm, at least in the US. See note – supra. [Scharfstein papers.] In consequence, the form of economic organization that best serves the interests of diversified investors may disserve the interests of undiversified employees. The investors get better markets for capital allocation; the employees may get worse markets for labor allocation and redeployment.

[90] See Kevin R. Foster, Downsizing: An Examination of the Consequences of Mass Layoffs, 17(2) J. Private Enterprise 109 (2002) (layoffs improve profitability). There is also evidence that even outside of the zone of financial distress, firm focus (vs. conglomerate diversification) is associated with reduced employee wages, perhaps because wages are at least partially set based on firm level profits rather than segment-specific performance only. See Annette Schoar, Effects of Corporate Diversification on Productivity, 57 J. Fin. 2379 (2002) (finding wage premium at conglomerate firms).

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to save the firm and thus will look to layoffs to achieve cost-reduction. Indeed, in light of their stock-based compensation, managers may benefit from the stock price appreciation that may follow.[91]

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

What's important to note is the way that diversified funds, including index funds, are very much part of this economic structure. These funds provide the low cost means for diversification at the portfolio level and play an essential role in the governance structure that results in the risk shift that may disfavor employees. This is not a story that relies on short-termism, but follows simply from the economic logic of portfolio theory, the investment vehicles produced by capital markets, and the kind of governance "voice" potentiated by the resulting ownership structure as energized by the activists. Some have argued that the best way to acknowledge and address the consequences is through robust forms of social insurance, as a complement to the kind of capitalism that our ownership structure facilitates.[92] But the point is this: that the heightened adjustment costs are tied to the ownership patterns; the costs, if unaddressed, may well generate a backlash that could have portfolio-wide, or systematic, implications. Social stability risk may well rise to systematic concern for an asset manager determined to provide the best risk-adjusted returns. In other words, portfolio diversification as an investment strategy contributes to a style of economic organization that shifts risk to employees. The resulting social stability risk is a cost of

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[91] See Henry S. Farber & Kevin Hallock, The Changing Relationship Between Job Loss Announcement and Stock Prices, 1970-1999, 16(1) Labor Economics 1 (2009) (stock price reaction after layoff announcement shifts from uniformly negative to mixed positive & negative over the period).

[92] E.g., Jeffrey N. Gordon, Addressing Economic Insecurity: Why Social Insurance Is Better than Corporate Governance Reform (Aug. 20, 2019), available at http://clsbluesky.law.columbia.edu/2019/08/21/addressing-economic-insecurity-why-social-insurance-is-better-than-corporate-governance-reform/; Gordon, Is Governance a First Order Cause of the Current Malaise?, 6 J. British Academy (Supp, Iss. 1) ("Reforming Business for the 21st Century") (Dec. 2018).

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this investing strategy that the sponsors of such investment vehicles should be mindful of and could well produce support for efforts to mitigate, in the name of improving risk-adjusted returns.

Part III – Implementation of Systematic Stewardship

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

Hedge fund activism, by contrast, has focused on firm-specific strategic and operational matters rather than governance features, and the mechanism has commonly been through contested director elections. Here the institutions' posture has been *responsive*; they may consider an activist's argument but will not *initiate* a proxy contest. Some have been critical of the institutions' current approach, invoking "stewardship" to call for initiatory firm-specific engagement by institutional investors, even on matters that relate to strategy or operations.[93]

Funds (and the assets managers) have generally been mindful of their status as *portfolio* investors. The guidelines, which describe and prescribe a particular conception of good corporate governance, "normative corporate governance," aim to improve expected returns across the portfolio, even if not ideally fitted to the circumstances of every firm in the portfolio. The guidelines generally call for exposure to shareholder pressure and thus capital market signals, presumably because of the expected returns implications. Guidelines that call for attention to diversity and inclusion at the board level and in the C-suite also make sense on portfolio expected

[93] Eg, Lucian A. Bebchuk & Scott Hirst, Index Funds and the Future of Corporate Governance: Theory, Evidence and Policy, 119 Colum. L. Rev. 2029 (2019); Sean Griffith & Dorothy Lund, A Mission Statement for Mutual Funds in Shareholder Litigation, 87 Univ. of Chicago L. Rev. 1149 (2020). (Initiating derivative or class action litigation against the firm, officers, and directors).

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return grounds. High end talent is valuable and scarce; elimination of barriers to its discovery and utilization will create value across a portfolio.[94]

In devising any engagement strategy, the fund and its managers need to take account of first, the cost constraints of its particular business model, which may limit its capacity to do "deep dive" analysis for many firms in the portfolio, and second, prudential limits on its freedom of action in an environment in which corporate managers are likely to push back hard against initiatory actions by large funds on "excessive power" grounds.[95] This has produced a stance of "rational reticence" when it comes to firm-specific engagement on matters that can be expected to affect the performance of the portfolio. An actively-managed fund that is overweight in target stock will surely support a measure that will increase the target's stock price. A fund that is underweight in the target may be ambivalent. It will do less well on an immediate relative performance measure but it may judge the governance externalities of activism to increase performance across the portfolio and see benefits that way. An index fund arguably is indifferent, in that most stock price effects will be idiosyncratic but it too may regard activism as a desirable part of the normative corporate governance model that achieves the best performance across the portfolio.[96]

Systematic stewardship presents a different menu of potential interventions. Of particular value would be uniform disclosure strategies that would enlist the market in the pricing of systematic risk. This would provide market measures of the extent to which specific firms are subject to systematic risk and therefore pressure at the firm level to reduce that risk, since a priced risk is a drag on the stock price. For example, in the effort to mitigate climate change risk, funds could favor, across the portfolio (or a relevant subsector), robust firm-level disclosure regarding activities that may contribute to climate change risk or regarding the firm's vulnerability to regulatory change that could abruptly occur as climate change risks materialize. The information can be put into models that assess the evolution of climate change risk and reveal a specific firm's

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

[95] See supra note -- [note on political backlash risks.] Of there may well be agency cost as well: many asset managers also provide retirement plan services to large companies and may be loath to challenge managers who have say-so over these arrangements.

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

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contribution and exposure. This approach might point to the notion that too much emphasis has been placed on augmenting disclosure by fossil fuel producers, with insufficient attention to more detailed disclosure of transition risks by those now dependent on the fossil-fuel economy[97] and those likely to be impacted by climate-related events.[98]

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

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

One particularly important question is the extent to which institutional investors and asset managers should take an *initiatory* vs. a *responsive* posture with respect to *firm-specific* measures that might mitigate systematic risk. The answer, I think, depends upon first, the existence or not of activist intermediaries who can tee-up a question for resolution by majoritarian institutional owners, and second, the importance of single firm behavior with respect to the systematic risk in question. Gilson & Gordon (2013) argue that with regard to firm-specific performance questions, activist shareholders act as governance intermediaries in a way that permits funds to be *responsive* rather than *initiatory*. The intermediaries have strong economic incentives to identify value-creating propositions for the target firm as seen from the institutional investor perspective. With respect to financial stability this approach will not work. An activist taking a long equity position

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[97] Eg, automobile companies and parts manufacturers to the internal combustion engine supply chain.
[98] Eg, broadband suppliers whose fiber optic cable infrastructure is subject to damage from sea level rise. See Madison Condon, Market Myopia's Climate Bubble (forthcoming Utah Law Review 2022).

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in a particular financial firm is likely to favor more aggressive risk taking that would produce higher expected returns at the particular firm (and thus a higher stock price), uncaring about a possible increase in systematic risk that, as an undiversified investor, it would not internalize. This is a glaring example of where the "unanimity rule," which holds that at least from a financial perspective all stockholders want the same thing -- to increase the stock price – breaks down. The economic motives of the activist intermediary and the portfolio investor will diverge. This divergence suggests that institutional investors and asset managers ought to devote more firm-specific (and sector-specific) attention to financial firms precisely because (i) they cannot rely on some of the standard intermediaries and (ii) a single-firm failure can present a systemic threat.[99]

In the case of climate change, the calculus works out in a way that favors *responsive* rather than *initiatory* firm specific actions by large diversified funds and asset managers. First, a host of climate change intermediaries are now emerging to tee-up firm specific initiatives for resolution through shareholder voting. These intermediaries include NGOs and other activist organizations focused on climate change risk, sovereign wealth funds that understand that they must internalize climate change risk, ESG funds that raise money from investors who themselves care about climate change risk, and conventional activist hedge funds that have come to have a negative view about the economic prospects of particular fossil fuel firms. Although these entities may not have the same economic incentives as the hedge funds, their business models may nevertheless encourage climate change activism. Moreover, they are much less likely to be susceptible to industry threats either because their small size protects them from the charge that they have too much power or because they stand outside the US political threat framework. They are in a much better position than a broadly diversified fund to frame a firm specific climate change proposal, whether pertaining to disclosure or a change in business strategy. Moreover, since climate change risk transcends the actions of any single company, these activist intermediaries are better positioned to organize a campaign across many companies. Thus the funds and the asset managers can play a sufficient role by *responding* to these proposals in light of an assessment of their impact on reducing climate change risk rather than *initiating* their own proposals.[100] In other words the large

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

[100] For example, before the Engine No. 1 proxy battle, Exxon announced movement toward a settlement of an activist campaign mounted by two shareholder activists seeking to force the company to reduce its carbon footprint. One was a conventional hedge fund activist; the other, an "impact investor." See Cara Lombardo, Emily Glazer & Dana Cimilluca, Exxon Planning Board, Other Changes Amid Activist Pressure, Wall St. J. Jan 27, 2021. Neither of the activist shareholders held a substantial percentage of Exxon's stock (apparently <1%), so, as with most activist campaigns, their negotiating leverage came from presumed support from the institutional

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broadly-diversified funds can take the same stance as with the hedge fund activists: they can count on others to tee-up the proposals that would bear on climate change risk, and then figure out which proposals would in fact create value, that is, would reduce the risk.[101]

Another set of choices relates private ordering vs. regulation. There are now several private and quasi-governmental organizations that are trying to create uniform disclosure standards on climate change risk and various "sustainability" and other ESG metrics that could be said to engage with matters of systematic concern. Under the aegis of the Financial Stability Board, a consortium of government regulators, a Task Force on Climate-Related Financial Disclosures ("TCFD") has produced a set of "voluntary, consistent climate-related financial risk disclosures" for use by companies "in providing information to investors, lenders, insurers, and other stakeholders."[102] The Climate Disclosure Standards Board ("CDSB") an international consortium of business and environmental NGOs formed in 2007, offers companies "a framework for reporting environmental

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shareholders who are the majoritarian owners. That dynamic was of course critical in – and may have prefigured -- the follow-on proxy battle in which Engine No. 1 succeeded with a similarly small ownership percentage.

[101] In December 2017 a group of climate-focused investors networks organized "Climate Action 100+," an "investor engagement initiative" that is aimed at climate change-related disclosure and business model modification at 160 global companies "that have significant greenhouse gas emissions and/or are critical to the net-zero emissions transition and to meeting the objectives of the Paris Agreement." Climate Action 100+, 2020 Progress Report. Asset managers and other institutions representing $52 trillion in assets under management have signed on, including BlackRock and State Street Global Asset Management. Climate Action provides information and technical assistance, but engagements with particular companies are carried out by specific funds. Other funds within the network make independent determinations whether to support particular initiatives through the shareholder governance machinery. Id. at 82: "All investor signatories are responsible for their own voting decisions … [the organization] does not seek to provide voting recommendations or to facilitate block voting." Id. This model is consistent with the "rational reticence" stance of index funds and other passive funds. It also seems structured to avoid "acting in concert" constraints under §13(d) of the 1934 Security Exchange Act (and the applicable regulations) and various poison pill beneficial ownership triggers.

Note that the fund/the asset manager is likely to bring a different analytic framework to the climate change risk mitigation proposal of the climate change activist than to the performance-enhancing proposal of the shareholder activist. The latter entails a judgment that the activist has the better of an argument with management, which also is focused on firm-specific performance. By contrast, management probably is not attending to systematic risk because its focus is on own-firm payoffs, not the portfolio.

[102] See TCFD Overview at https://www.fsb-tcfd.org/about/#. These "recommended disclosures," issued in 2017, relate to a company's governance of climate change risk, its strategy, its risk management of climate change risk, and its metrics and targets. TCFD, Recommendations of the Task Force on Climate-Related Financial Disclosures (June 2017). In October 2021, TCFD issued an extended "Guidance on Metrics, Targets, and Transition Plans" and a Status Report that described the take-up of voluntary disclosure standards and an annex on "Implementing the Recommendations of the TCFD." The annex makes specific disclosure recommendations for particular sectors, including asset management. Asset managers These documents are posted at https://www.fsb-tcfd.org/publications/

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information with the same rigor as financial information."[103] The Sustainability Accounting Standards Board ("SASB"), a private organization created in 2011 that models itself after the Financial Accounting Standards Board and the Internal Accounting Standards Board, recently issued 77 industry-specific reporting standards pertaining to material sustainability.[104] There are also several other reporting frameworks: for example, the Global Reporting Initiative, the Carbon Disclosure Project, and the International Integrated Reporting Council. Recently these groups joined forces in a "Statement of Intent to Work Together Towards Comprehensive Corporate Reporting."[105] Those cooperative efforts appear to have culminated in the announcement at the November 2021 COP26 meeting[106] in Glasgow by the IFRS Foundation of the formation of a new International Sustainability Standards Board ("ISSB") to develop "a comprehensive global baseline of high quality sustainability disclosure standards."[107] This effort will also consolidate, organizationally, the CDSB and the Value Reporting Foundation, which houses the SASB Standards and the Integrated Reporting Framework.[108] Moreover, in response to prodding by IOSCO, the international consortium of securities regulators, the ISSB "standards" will be based on the TCFD "pillars."[109] According the industry observers, this will bring about alignment of the two frameworks.[110] Since the TCFD is driven by the FSB, a consortium of governmental actors,

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[103] See CDSB Framework for Reporting Environmental and Climate Change Information (Dec. 2019), available at https://www.cdsb.net/sites/default/files/cdsb_framework_2019_v2.2.pdf

[104] "SASB connects businesses and investors on the financial impacts of sustainability. SASB standards enable businesses around the world to identify, manage, and communicate financially material sustainability information to investors. SASB standards are industry-specific and are designed to be decision-useful for investors and cost-effective for companies. They are developed using a process that is evidence based and market informed." http://www.globenewswire.com/news-release/2020/10/15/2109232/0/en/Seventeen-Data-and-Analytics-Providers-Now-Have-a-Licensing-Relationship-With-SASB-Improving-Access-to-Financially-Material-ESG-Information.html

[105] https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf

[106] The United Nations now organizes an annual climate change "conference of the parties" ("COP") to focus attention and catalyze agreement on measures to address climate change risk.

[107] "IRFS Foundation announces International Sustainability Standards Board, consolidation with CDSB and VRF, and publication of prototype disclosure requirements," Nov. 3, 2021, available at https://www.ifrs.org/news-and-events/news/2021/11/ifrs-foundation-announces-issb-consolidation-with-cdsb-vrf-publication-of-prototypes/ . The IFRS Foundation oversees "International Financial Reporting Standards," the international alternative to "Generally Accepted Accounting Principles" ("GAAP") that are required for use in the U.S., https://www.ifrs.org/about-us/.

[108] Id.

[109] Proposed Targeted Amendments to the IFRS Foundation *Constitution* to Accommodate an International Sustainability Standards Board to Set IFRS Sustainability Standards 38 (April 2021), https://www.ifrs.org/content/dam/ifrs/project/sustainability-reporting/ed-2021-5-proposed-constitution-amendments-to-accommodate-sustainability-board.pdf

[110] Cleary Gottlieb Alert Memorandum, A Global Overview of Sustainability Disclosure Rules for the Asset Management Industry 5 (January 18, 2022), available at

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and the ISSB is driven by the largely private IFRS, the result could be potentially the emergence of uniform climate change disclosure standards through the *bricolage* processes of global governance.

Reliable information presented with sufficient uniformity for comparison and analysis is critical for effective systematic stewardship. Moreover, more extensive and more reliable disclosure may help overcome what has been forcefully argued is the market's underpricing of climate change risk.[111] Should institutional investors and asset managers be "information takers" with respect to these largely private efforts or should they engage to strengthen this private ordering approach to disclosure? Because this disclosure would have implications across the portfolio, efforts to improve it would be cost effective. More extensive disclosure should lead to better pricing of systematic risk, which may discipline specific companies and also provide information useful to a systematic steward; it should enhance the effectiveness of activist climate change intermediaries in framing firm-specific initiatives.[112] These reporting standards are voluntary, at least for US issuers, and relatively few firms are compliant; reporting firms often attach "Sustainability Reports" outside the four corners of their financial statements.[113] Should institutional investors and asset managers undertake either initiatory or responsive firm-specific measures to establish standards of wider and deeper voluntary disclosure? One easy step would be for systematic stewards to insist on compliance with the reporting standards set by this new ISSB as part of their governance guidelines. Instead of a voluntary opt-in approach, facilitated by shareholder pressure, should they support mandatory disclosure, a regulatory approach that would standardize and compel disclosure?[114]

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https://client.clearygottlieb.com/63/2279/uploads/2022-01-18-a-snapshot-of-global-sustainability-disclosure-rules-for-asset-managers.pdf

[111] See Madison Condon, Market Myopia's Climate Change Bubble (forthcoming Utah L. Rev. 2022); Armour et al, supra; Emirhan Ilhan, Zacharias Sautner & Grigory Vilkov, Carbon Tail Risk, 34. Rev. Fin. Stud. 1540 (2021).

[112] Some elements of climate change risk are already impounded in stock prices. Patrick Bolton & Martin Jacperczyk, Do Investors Care About Carbon Risk?, 142 J. Fin. Econ. 517 (2021) (higher returns for firms with higher total CO2 emissions indicate that investors already demand compensation for exposure for carbon emission risk);

[113] See, e.g., Governance & Accountability Institute, 65% of the Russell 1000 Index Published Sustainability Reports in 2019 (only 23% aligned with SASB standard; 4% reported with "detailed alignment" with the TCFD), available at https://www.ga-institute.com/research/ga-research-collection/sustainability-reporting-trends/2020-russell-1000-flash-report.html

[114] For expression of investor frustration with current ESG reporting and consideration of private ordering vs. regulatory alternatives, see GAO, Public Companies: Disclosure of Environmental, Social and Governance Factors and Options to Enhance Them, GAO-02-530 (July 2020), available at https://www.gao.gov/assets/710/707949.pdf. In his 2021 letter to CEOs, BlackRock's Larry Fink emphasized the importance of disclosure on climate-related matters, both the company's own emissions and "how [the

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Mandatory disclosure of course of course comes only after official regulatory action, which would involve, if not enmesh, the institutional investors and the asset managers in the political process. In August 2020 the SEC updated provisions of its major disclosure guide, Regulation S-K. Although the SEC broadened the "human capital" reporting requirement, many were disappointed for its recourse to a "principles based" approach only.[115] Moreover two Commissioners voted against the proposal because of its failure to move toward "standardized, consistent, reliable and comparable ESG disclosures that [investors] need to protect their investments and allocate capital toward a sustainable economy."[116]

The change in US presidential administrations is a double-edged sword. In light of President Biden's highlighting of climate change risk in his campaign, the current administration is likely to push for a regime of mandatory disclosure.[117] SEC rule-making is inevitably a drawn-out process because of the process requirements of the Administrative Procedure Act. Deeper and more extensive disclosure requirements, which may increase the capacity of markets to price firm-specific climate change risk and help sharpen of ESG activists' proposals, will also increase the likelihood of litigation challenge under cost-benefit standards that invite judicial hard-look.[118]

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company's] business model will be compatible with a net zero [CO2 emissions] economy," as well as the importance of "a single global standard" for such disclosure. Available at www.Blackrock.com/corporate/investor-relations/larry-fink-ceo-letter. For a forceful argument on behalf of mandatory disclosure, see John Armour, Luca Enriques, Thom Wetzer, Mandatory Corporate Climate Disclosures: Now, but How? (forthcoming Colum. Bus. L. Rev. 2022).

See also John C. Coffee, The Future of Disclosure: ESG, Common Ownership, and Systematic Risk, ECGI W.P. No. 541/2020 (Sept. 2020, available at https://ssrn.com/abstract=3678197 (tension between disclosure needs of diversified institutional investors and undiversified investors).

[115] Modernization of Regulation S-K Items 101, 103, and 105, Sec. Rel. No. 33-10825, 85 Fed. Reg. 73726, 63737-63740 (Oct. 8, 2020) (amending Item 101(c)(2)(ii)).

[116] Thomas Riesenberg, SASB, A View on the SEC Rules Regarding Human Capital Disclosures, Harv. Corp. Gov. Blog, Sept. 12, 2020, available at https://corpgov.law.harvard.edu/2020/09/12/a-view-on-the-sec-rule-regarding-human-capital-disclosures/

[117] In public remarks in July 2021 SEC Chairman Gary Gensler stated that he has asked the Commission staff to produce a proposed rule on climate change disclosure "buy the end of the year." See Prepared Remarks Before the Principles for Responsible Investment "Climate and Global Financial Markets" Webinar, https://www.sec.gov/news/speech/gensler-pri-2021-07-28#_ftnref3. As of January 2022 no rule proposal has emerged.

[118] See, e.g., Business Roundtable v. SEC, 674 F.3d 1144 (2011) (invalidating SEC proxy access rule); MetLife Inc v. Financial Stability Oversight Council, 177 F.Supp. 3d 219 (D.D.C. 2016), appealed dismissed (2018) (rejecting designation of insurer as "systemically important").

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Moreover, the SEC may produce a disclosure rule that is inconsistent with the standards that may emerge from the ISSB-TCFD efforts at global standards creation.[119]

This leads to another binary choice: should large diversified fund and asset managers act through trade associations in pursuing systematic risk mitigation rather than acting on an own-fund basis. Particularly if systematic risk reduction entails controversial political steps or may best be advanced through a legislative or regulatory change rather than through the corporate governance channel only, a representative intermediary may be wise. Wall Street firms have benefited enormously through their capacity to act through the Securities Industry/Financial Market Association (SIFMA)[120] and the large banks have similarly made good use of The Clearing House (TCH), both energetic participants in the legislative and regulatory process. "Asset Managers Concerned About Systematic Risk" (AMCASR), a just-invented trade association, could act for asset managers and institutional investors collectively in the regulatory and legislative domain.[121] But isn't this just the aggregation of power on which alarums about the Big Three[122] and the Problem of Twelve[123] rest? Actually no. Industry participants acting collectively to petition the government for action or relief is core first amendment activity, even if the requested action would affect prices or output; it is immune from antitrust challenge.[124] But the real problem is otherwise: Whatever the Big Three's purported power over managers, there is no reason to believe it carries over with regulators, much less legislators. The institutional investors and asset managers can replace corporate managers, not regulators or legislators. Moreover, they are not the source of major campaign contributions and their clout is likely to suffer accordingly.

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[119] See Gary Gensler (2021), supra,: "I've asked staff to learn from and be inspired by these external standard-setters. I believe, though, we should move forward to write rules and establish the appropriate climate risk disclosure regime for our markets, as we have in prior generations for other disclosure regimes."

[120] SIFMA describes itself as "the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets, " https://www.sifma.org/about/

[121] One action this new trade association should promote is the development of a robust derivatives market in climate change risk. Risks that are not visibly priced may have an insufficient impact on investor behavior. The run up to the Global Financial Crisis provides a compelling example. The introduction of the Markit ABX Index in 2006, which made publicly available the increasing cost of credit default swap protection for various tranches of mortgage-backed securities (and thus the increased default risk), vastly changed investor sentiment about the subprime real estate bubble.

[122] Lucian Bebchuk & Scott Hirst, The Specter of the Giant Three, 99 BU L. Rev 721 (2019).

[123] John C. Coates, The Future of Corporate Governance Part I: The Problem of Twelve (September 20, 2018). Harvard Public Law Working Paper No. 19-07, available at SSRN: https://ssrn.com/abstract=3247337.

[124] This is referred to as the Noerr-Pennington doctrine, after two Supreme Court cases in the 1960s, Eastern Railroad Conference v. Noerr Motor Freight, 365 U.S. 127 (1961); United Mine Workers of America v. Pennington, 381 U.S. 657 (1965). See Charles H. Samel & Jennifer A. Carmassi, Trade Associations: Boundaries in Antitrust Litigation, 6 (1) Am. Bar Ass'n, Antitrust Litigator 9 (2007).

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The concern about action by "common owners" cuts the other way: precisely because systematic risk reduction does not immediately, visibly result in increased AUM – it mostly obviously preserves the value of AUM – asset managers may have insufficient incentives to pursue this. Here is where "systematic *stewardship*" becomes relevant. "Stewardship" is an effort to use soft law incentives to induce pro-social behavior where the incentives point to passivity. The pursuit of systematic stewardship ought to be framed as a distinctive positive contribution that these parties are in a unique position to appreciate and push forward. It can become an offset to concern about their power in the corporate realm, consideration for their on-going social license.[125]

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

Part IV: Addressing Certain Objections

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

A. Corporate governance concerns. The first order corporate governance objection to a systematic stewardship approach relates to the investor's prioritization of portfolio returns versus a purported shareholder duty to exercise corporate governance rights only in a way that would maximize own-firm shareholder interests. [126] There is no such shareholder duty, particularly for

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

[126] Profs. Kahan and Rock identify this with a strong "single firm focus" in corporate law versus a "multi-firm focus," although the claims are not identical. Marcel Kahan & Edward Rock, Systemic Stewardship with Tradeoffs (Jan. 2022), https://ssrn.com/abstract=3974697.

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a non-controlling shareholder,[127] and even for a controller except in frank self-dealing.[128] There are several protective layers that would protect a systematic steward from a credible liability claim.

First, we have accepted virtually without question that a portfolio investor can use its shareholder rights to promote a corporate governance regime that may indeed promote the value of portfolio firms on average – and thus increase the value of its portfolio -- but will not necessarily be well-tailored for every firm. For example, there is significant evidence that a classified board might increase value for a subset of firms,[129] yet many institutional investors have exercised corporate governance rights – threatening to withhold votes for directors – to push for destaggering boards across their portfolio. Although the proponents of the campaign came under attack and so did the proxy advisors who put "classification" on their negative guideline list,[130] no one seemed to think that the *shareholders* could be sued for trying to maximize the value of their portfolios through a uniform rule. The whole idea of corporate governance guidelines (addressing, e.g., board structure and composition or various elements of executive compensation), promoted and sometimes enforced through the exercise of shareholder voting rights, is premised on assumptions about performance improvements on average, not what will maximize shareholder value for *this* firm particularly.

We have also accepted without question allowing the risk preferences of diversified shareholders to shape our theory of optimal firm structure in a way that has firm specific consequences. Diversified investors are "risk neutral" and insensitive to idiosyncratic risk. Their

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[127] Stephen M. Bainbridge, MERGERS AND ACQUISITIONS 118(3d ed. 2012); Roberta S. Karmel, Should a Duty to the Corporation Be Imposed on Institutional Shareholders?, 60 Bus. Law. 1, 13 (2004) (shareholders do not have duties to other shareholders or the corporation). See generally Matteo Gatti, It's My Stock and I'll Vote If I Want to: Conflicted Voting by Shareholders in (Hostile) M&A Deals, 47 U. Mem. L. Rev. 181 (2016); .Hewlett v. Hewlett-Packard Co., 2002 WL 549137 (Del. Ch. Ap. 8, 2002) ("Shareholders are free to do whatever they want with their votes, including selling them to the highest bidder."); Weinstein Enters, Inc. v. Orloff, 870 A.2d 499, 507-08) (Del. 2005) (non-controlling shareholders can vote as they please; controllers may be subject to fiduciary duty); Tanzer v. Int'l General Industries, Inc., 379 A.2d 1121, 1124 (Del. 1977) (semble), but cf. In re CNX Gas Corp. S'holders Litig., 4 A.3d 397, 400, 416-17 (Del Ch. 2010) (dispositive shareholder on both sides may not count for assessing "majority of disinterested minority" test in parent-subsidiary freezeout).

[128] It is a commonplace that controllers commonly enjoy the non-pecuniary benefits of control, for example, the paternalism of the family firm, and some of the pecuniary benefits short of self-dealing. See Ronald Gilson & Jeffrey Gordon, Controlling Controlling Shareholders, 152 U. Pa. L. Rev. 785, 786-87 (2003) (permissible routes to private benefit extraction).

[129] E.g., Robert Daines, Shelley Xin Li & Charles C.Y. Wang, Can Staggered Boards Improve Value? Evidence from the Massachusetts Natural Experiment, Oct. 2018, https://ssrn.com/abstract=2836463.

[130] See Daniel Gallagher and Joseph Grundfest, Did Harvard Violate Federal Securities Law? The Campaign Against Classified Boards of Directors (Rock Center for Corporate Governance at Stanford University Working Paper No. 199, December 4, 2014), available at https://bit.ly/2IE1bEu.

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preference for diversification at the portfolio level rather than the firm level disfavors unrelated acquisitions and conglomerate-style structures and favors business risk-taking, including through leveraged capital structures, that will increase the risk of business failure. Such investors vote for directors and approved compensation packages that align managerial interests with these objectives. In short, we have accepted without serious dispute the way diversified ownership results in portfolio-maximizing business strategies that produce own-firm actions that may be inconsistent with the interests of the undiversifieds.

We have also accepted the idea in that in mergers and acquisitions transactions, a portfolio shareholder can vote to maximize the value of the portfolio even if stock price reactions suggest that the transaction may not be optimal, perhaps even value reducing, for one of the merger parties in which it owns shares. In other words, the portfolio investor is entitled to consider whether the transaction produced a general surplus, even if one of the parties was adversely treated (whether the combined market capitalization increased) and to consider, in case of unbalanced holdings, whether the transaction produced a specific surplus for its own portfolio, given stakes in target and acquirer. Obviously the rules would be different if the investor were a controller holding shares in both firms and arranged a transaction that distributed in favor of the firm in which it had the larger economic stake, but that's not the case of a minority shareholder with a many firms in its portfolio.

At times the Delaware courts seem to have bright line test for "control," a majority of the stock or something like 40 percent with specialized control rights.[131] More recently the Chancery Court seemed to embrace a "sliding scale" of stock ownership that could be conjoined with various other mechanisms of influence over the company and the directors to evidence "control," in one case in which a strategic investor held approximately 35 percent of the stock[132] and various "founder" cases of which less than 30 percent coupled with other indicia of domination sufficed

[131] See Kahn v. Lynch Communications Systems, Inc., 638 A.2d 1110 (Del. 1994) (43% plus domination of the board); In re Cysive, Inc. Shareholders Litigation,836 A.2d 531 (Del. Ch. 2003) (35%); Corwin v. KKR Fin. Holdings LLC 125 A.3d 304, 307 (Del. 2015) ("combination of potent voting power and management control such that stockholder could be deemed to have effective control of the board without actually owning a majority of its stock";regarding In re Cysive as "aggressive"). See generally Note, Controller Confusion: Realigning Controlling Stockholders and Controlled Boards, 133 Harv. L. Rev 1706 (2020).

[132] Voigt v. Metcalf, CV 2018-0828-JTL, 2020 WL 614999, at *12 (Del. Ch. Feb. 10, 2020).

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for "control."[133] And rather infamously, Chancery also conjured the threat of "negative control" to validate a poison pill targeted at an activist owning less than 20 percent of the target.[134]

Certainly no single institutional investor is likely to come close to those ownership percentages. More to the point, no large asset manager will occupy itself with day-to-day management of the business and the exertion of comprehensive "control" that counted in the low-ownership percentage "founder" cases. Nevertheless conjure this scenario: an ESG activist puts forth a director slate for a fossil fuel company on a platform of down-scaling its production and exploration and, with the support of the large institutions, the directors are elected. Suppose further that the activists succeed in their business objectives, which results in diminished profits and reduced dividend payouts. Then assume that some public shareholders sue for breach of the duty of loyalty. The private motives of the non-controlling shareholders should be irrelevant to any liability concern: the board is responsible for all business decisions, having full authority under the statutes and internal governance documents; the directors have an independent fiduciary duty after they are elected.[135] Presumably the ESG-focused directors could generate a business judgment rule defense based on the long term interests of the oil producer and its shareholders that seeks to avoid the accumulation of "stranded assets" and to redirect the organizational capacity and engineering skill of a large fossil fuel company in anticipation of stringent regulatory measures.

Instead, assume a law suit alleging that the Big Three (or some other group of diversified portfolio investors) agreed to act in concert to elect the ESG-seeking directors (who are judgment proof), and used their "control" as majoritarian shareholders to shift value *away* from the fossil fuel target *towards* the rest of their portfolio, that is, self-dealing. Such an allegation misunderstands the nature of the ESG action. The point was to prevent the target from generating externalities, CO_2 emissions that would produce third party harms. Nothing about the shareholder

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[133] In Re Tesla, 2018 WL 1560293 (Del. Ch 2018); In re Oracle Cor. Derivative Litig., 2018 WL 1381331 (Del. Ch March 19, 2018). FrontFour Capital Group LLC v. Taube, 2019 WL 1313408 (Del. Ch. March 22, 2019), finding that two brother who jointly held 15 percent of the stock "controlled the board," is an outlier, in tension with *Corwin*, and stands separately on the peculiarities on the 1940 Investment Company Act, a pyramidal ownership structure, and the failure of special committee process. By contrast is In re Dell, Inc., Shareholder Litigation, Rulings of the Court (transcript of bench conference, June 19, 2013, released June 27, 2013) at 8-9, 36-37 (Dell's approximately 16.5 percent is "not anywhere close to the level of stock ownership that's ever been considered a controlling stockholder"; "is at a percentage level well below even the edgiest us," referring to Cysive), available at https://lawprofessors.typepad.com/files/dell-motion-to-expedite.pdf.

[134] Ronald J. Gilson & Jeffrey N. Gordon, The Sotheby's Poison Pill Case: The Plate Tectonics of Delaware Corporate Law, CLS Blue Sky Blog, May 15, 2014 (discussing Third Point, LLC v. Ruprecht, Del Ch. May 2, 2014).

[135] See, e.g., Air Products & Chemicals, Inc. v. Airgas, Inc., 16 A.3d 48 (Del. Ch. 2011).

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value norm should bar shareholders from deciding, via director elections, to reduce such harm imposition.[136]

Let's put this in the context of concrete example. Through tracing a document trove revealed in litigation, Profs. Shapira and Zingales show that DuPont, in manufacturing one of its signature products, Teflon, chose a lower-cost but pollution-creating production process despite knowing of the consequent significant health-based externalities imposed on the community, and knowing that mitigation was possible at cost much less than the externalities.[137] Shapira and Zingales show that this decision was probably ex-ante profit-maximizing in light of the low risk of detection and an adverse litigation outcome. Here's the point: nothing in corporate law requires the directors to pursue such a strategy; nothing in corporate law would provide a basis for liability imposition on directors who refused to impose externalities in trade-off for profits.[138] How can shareholders conceivably be held liable for insisting that directors follow business strategies that minimize or avoid such externalities?

A similar hypothetical could be framed in the context of a "systemically important financial institution." Suppose a shareholder activist puts forward a slate of directors committed to reducing "excessive risk-taking" by the financial firm, proposing, among other measures, to curb high-powered compensation arrangements. It is likely that curbing risk-taking will reduce immediate profits in part because it may make it harder to retain risk-loving traders. Of course, less risk reduces the likelihood that the firm will fail, with systemic consequences and the imposition of massive externalities. Surely it is not beyond shareholder power to curb such systemic threat creation.[139]

Stakeholder/other constituency interests are directly tied up in systematic stewardship: Yes, reducing systematic risk will increase risk-adjusted returns on the portfolio but this is not only a

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

[137] Roy Shapira & Luigi Zingales, Is Pollution Value Maximizing? The DuPont Case, NBER WP (2017), available at https://ssrn.com/abstract=3037091 . Nathan Atkinson generalizes the point, calculating that in Clean Air enforcement actions, 37.5% are profitable net of penalties imposed, increasing in the size of the violation. Nathan Atkinson, Do Corporations Profit from Breaking the Law? Evidence from Environmental Violations, WP Jan 2022.

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

[139] See John Armour & Jeffrey Gordon, Systematic Harms and Shareholder Value, J. Legal Analysis 35 (2014).

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private benefit for the portfolio owner. The systematic risk affects the portfolio because it runs through the real economy, affecting the interests of all the potential constituencies of the corporation and its stakeholders. Share values are threatened because systematic risk threatens the economic ecosystem on which all companies and communities rely and thus the well-being of various corporate constituencies. The constituency-statute states plainly give the directors latitude to balance these interests; [140] if directors can "balance," then so surely can the shareholders. Even in Delaware, the scope for constituency/stakeholder regard is quite broad, except in the limited "final period" in which the target is sold for cash or in which there is a control shift,[141] so long as the decisions can be framed as serving long-term shareholder interests or avoiding the imposition of external harm.

B. Common Ownership. A burgeoning literature has arisen to argue for the dark side of the rise of institutional investor ownership. The reconcentration of ownership has meant that a small group of large fund families own a large fraction of the stock in most public companies. Particularly in sectors characterized by oligopoly structure, such as airlines or banking, this "common ownership" is said to provides the glue to hold together an informal cartel, with consequent anti-competitive effects: higher prices, lower output.[142] The remedy, argue some, is to engage in antitrust actions of various types,[143] including limiting the capacity of funds to assemble fully diversified portfolios.[144] Many corporate law scholars are skeptical of the anti-competitive outcome associated with common ownership, observing the great reluctance of asset managers to employ the shareholder governance tools in a way that would hold together informal cartels or otherwise stabilize anti-competitive arrangements [145] and the energy of minority shareholder interests, including activist hedge funds, who vigorously pursue single-firm value

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[140] See Michal Barzuza, The State of State Antitakeover Law, 95 Va. L. Rev. 1973, 1989 (2009) (35 states have constituency statutes).

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

[142] This literature is reviewed in Martin C. Schmalz, Common-Ownership Concentration and Corporate Conduct, in 10 Annual Review of Financial Economics Dec. 2018) (Patrick Bolton, ed.), available at https://ssrn.com/abstract=3046829 and updated in Recent Studies on Common Ownership, Firm Behavior,and Market Outcomes, 66 Antitrust Bull.1 (2021). See also Jose Azar, The Common Ownership Trilemma, 87 U. Chi. L. Rev. 263 (2020).

[143] Antitrust arguments are surveyed in Einer Elhauge, Sumit K. Majumdar, & Martin C. Schmalz, Confronting Horizontal Ownership Concentration, 66 Antitrust Bull (forthcoming 2021).

[144] Remedies are surveyed in Eric Posner, Policy Implications of the Common Ownership Debate, 66(1) Antitrust Bulletin (forthcoming 2021).

[145] Edward Rock & Dan Rubinfeld, Antitrust for Institutional Investors, 82 Antitrust L. J. 221 (2018); Common Ownership and Antitrust Effects, 83 Antitrust L. J. 201 (2020).

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maximization.[146] It is hard to square a world in which managers complain about pressure to maximize for the short-term with a world in which rents are widespread, even if there are some local pockets of anti-competitive harm.[147] I argued above that current ownership patterns shift risk on the employees, a decided distributional effect, but this results from the logic of *diversification* not from ownership concentration in the Big Three or any other number resonant for antitrust purposes.[148]

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

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

Reducing the risk of an economy-wide negative event will improve consumer welfare across the board. That is, the beneficiaries of corporate governance interventions that lower

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[146] C. Scott Hemphill & Marcel Kahan, The Strategies of Anticompetitive Common Ownership, 129 Yale L.J. 1392 (2020).

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

[148] More generally, the competition policy concerns of "common ownership" arise from the logic of diversification, not ownership concentration in the "Big Three." The effects/concerns would be the same whether we had a Big Ten or a Big Twenty; the commonality arises from the logic of portfolio maximization. See Matthew Backus, Christopher Conlon, Michael Sinkinson, *Common Ownership in America: 1980-2017*, 13(3) AEJ: Microeconomics 273 (Aug. 2021. Actionable competition policy concerns are far more likely to arise from active investors who have outsize positions in key firms in particular sectors.

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systematic risks are not just the beneficial owners of index funds or other diversified funds but the populace generally. The channel to portfolio values runs through the real economy. Damage to portfolio values occurs because of damage to the real economy, meaning the livelihood of people generally. Avoidance of this welfare-reducing outcome should not be an objective of competition policy. [149]

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

C. *Overclaiming* In thinking through the implications of "systematic stewardship" it is important not to overclaim about its reach. Many critical social problems do not present "systematic risk" of the sort that would elicit the focused concern of a portfolio investor and so would not be addressed through this channel. In the event of a systemic break, the resulting social harm far exceeds the portfolio losses, meaning the asset manager has inadequate incentives to avoid the systemic event. Because of the importance to the S&P 500 to the indexed investor, many smaller public companies may be under-represented in asset manager portfolios. Private companies and state-owned enterprises are not generally available for inclusion in a portfolio. Companies with a controlling owner are relatively insulated from institutional investor pressure.[150] These factors all limit the effectiveness of systematic stewardship in the general theory of harm prevention.

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[149] Prof. Condon develops a firm-specific example of systemic risk mitigation that illustrates the point in another way. She hypothesizes that BlackRock has used governance technology in a way that produces a particular level of CO_2 emissions reduction at Exxon, which, applying some assumptions based on the Nordhaus model that translates emissions reduction to economic consequences, results in a net gain to BlackRock's portfolio of $3.4 billion (losses on Exxon; gains on most other portfolio securities). But then applying standard assumptions, the *social* value of such carbon reduction is $913 billion. See Condon (2020), supra note --, 46-47, 67-68. But Prof. Condon has other concerns: that the systematic stewards have insufficient incentives to undertake optimal carbon reduction. But that's only to say that action by asset managers, even if in pointing in the right direction, is not a substitute for the actions of governments.

[150] See Dhammika Dharmapala & Vikramaditya S. Khanna, Controlling Externalities: Ownership Structure and Cross-Firm Externalities, WP August 2021, available at https://ssrn.com/abstract=3904316.

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In these cases the reasonably expectable actions of a systematic steward will be *incomplete*. The steward's actions ought to be directionally correct but insufficient to address the serious social question at stake. So systematic stewardship is not a panacea; such investors do not internalize all the externalities, but the overlap between the interests of the holder of a diversified portfolio and general society for some "wicked hard" problems is meaningful.[151] If there is simply no escape from the need for governmental action, systematic stewards can nevertheless play a catalytic role by heightening the salience of particular issues and changing the political calculus of important actors. Moreover, systematic stewardship rests on a thin theory of justification, not a robust claim on behalf of the role of asset managers as political or regulatory actors[152] and thus reduces the exposure of asset managers to backlash.

CONCLUSION

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

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[151] Compare Roberto Tallarita, The Limits of Portfolio Primacy, WP. Nov 2021, available at https://ssrn.com/abstract=3912977.

[152] Compare Dorothy Lund, Shareholders as Regulators, WP Nov. 2021.

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