Stewardship and ESG in Europe

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Keywords: Stewardship, institutional investors, sustainability, sustainability reporting, ESG, social value, stakeholders, disclosure regulation, fiduciary duties

JEL Classifications: G30, G34, G38, K20, M14, P12

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[*] An edited version of this paper will be published as a chapter in J. Binder, K. Hopt, and T. Kuntz (eds.), *Corporate Purpose, CSR, and ESG*, Oxford University Press, forthcoming 2014.

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I. INTRODUCTION

ESG is at the core of modern corporate governance, which in the view of many should promote not only the pursuit of profits, but also the environmental and social factors that are more relevant for the individual companies and for society in general.[1] Nonetheless, the discussion is still pending in academia and practice on whether and how the ESG orientation of corporate boards and managers should be enhanced.[2] Moreover, while adherence to ESG standards is recognized as a good practice internationally, it is less clear how managers and employees should be motivated to engage in ESG effectively. One possible answer is that compliance with ESG standards helps maximizing firm's value in the long-term and should therefore motivate the managers to take care of sustainability issues.[3] Another is that corporate purpose should extend beyond profits and include sustainability considerations to motivate employees properly.[4] Yet, agency problems may lead corporate managers to focus on short-term financial results, ignoring the adverse impacts of their firms on the environment and society[5] and possibly cheating investors and stakeholders through 'greenwashing'.

Therefore, the usual corporate governance mechanisms should intervene to promote true ESG focus of corporate management.[6] Firstly, boards of directors should exercise their monitoring role and direct corporate managers to take environmental

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[1] On the history, use and critique of the term ESG, see E. Pollman, 'The Making and Meaning of ESG' University of Pennsylvania Carey Law School ILE Research Paper 22-23, Available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4219857#. For an overview of corporate purpose from a comparative perspective, see G. Ferrarini, 'Redefining Corporate Purpose: Sustainability as a Game Changer, in D. Busch, G. Ferrarini and S. Grünewald, *Sustainable Finance in Europe*, Palgrave Macmillan, 2022, 85; for critical analysis of the relevant concepts and trade-offs, see G. Ferrarini, 'Firm Value *versus* Social Value: Dealing with the Trade-offs', in K. Alexander, M. Gargantini, and M. Siri (eds.), *The Cambridge Handbook of EU Sustainable Finance*, Cambridge University Press, forthcoming.

[2] See, from different perspectives, the contributions in B. Sjåfjell and C. Bruner (eds.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge University Press, 2020; and in P. Camara and F. Morais, *The Palgrave Handbook of ESG and Corporate Governance*, Palgrave Macmillan, 2022.

[3] The relevant concepts here are those of enlightened shareholder value (M. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' (2002) 22 Journal of Applied Corporate Finance 32, and (2002) 12 Business Ethics Quarterly 235) and of shared value (M. Porter and M. Kramer, 'Creating Shared Value: How to reinvent capitalism – and unleash a wave of innovation and growth' (2011) Harvard Business Review 3).

[4] See C. Mayer, *Prosperity*. Better Business Makes the Greater Good, Oxford University Press, 2018; R. Henderson, *Reimagining Capitalism*. How Business Can Save the World, Penguin Business, 2020.

[5] See R. Henderson, note 4, at 121 ff., underlining that managers are often led to short-termism by asset managers' pressure.

[6] See, in general, A. Edmans, *Grow the Pie*. How Great Companies Deliver both Purpose and Profit, Cambridge University Press, 2020, 97 ff.

and social factors into account in all corporate actions. To this effect, boards often link parts of executive remuneration to ESG parameters to incentivize the pursuit of sustainability targets by the managers.[7] Moreover, boards make sustainability goals explicit in their strategic plans and check proper execution of the same by the executives. Secondly, institutional investors and asset managers monitor the ESG performance of the investee companies in addition to financial performance. They include sustainability factors amongst those to consider in the management of their portfolios and engage companies on ESG issues. Furthermore, they consider the preferences of their clients, including retail investors, policy holders and pensioners, who are the ultimate beneficiaries of their investments. To this end, institutions ask their clients to specify their ESG preferences and offer them financial products which cater to such preferences. Clearly, the clients' preferences may vary to the extent that some may not be interested in ESG matters, while others are pro-social investors to different degrees.

In this paper, we analyse the role of soft law and hard law in promoting ESG stewardship by institutional investors and asset managers. Firstly, we examine the rules and incentives that stimulate institutional investors to integrate sustainability risks of investee companies in portfolio management, monitor their evolution and engage with companies when needed. Secondly, we analyse the rules and incentives that lead institutional investors and intermediaries to identify their clients' preferences as to environmental and social sustainability and to tailor their offer of financial products suitably. In addition, we examine how disclosure rules react to information asymmetries between financial institutions and clients and reduce the risk of 'green washing' in the offer of financial products. Thirdly, we consider the more general policy implications, such as the impact of recent reforms on the sustainability of companies and of the wider EU economy.

Three main legal strategies are used globally to pursue ESG stewardship: stewardship codes, disclosure regulation, and fiduciary duties.[8] In this paper, we compare these strategies focussing on the EU approach to ESG stewardship, which is mainly based on regulation. In section II, we introduce the three strategies from a comparative perspective. We briefly analyse the origins and practice of stewardship codes, and the main EU regulatory measures concerning ESG stewardship that we further examine throughout the paper. In section III, we analyse the extent to which institutional investors are incentivized by EU disclosure regulation to take ESG matters into account when investing in corporate securities. To this end, we analyse the integration of sustainability risks in investment decisions and the recourse to impact investing under the SFDR. Moreover, we

[7] L. Bebchuk and R. Tallarita, 'The Perils and Questionable Promise of ESG-Based Compensation', 48 Journal of Corporation Law (2022), 37; M. dell'Erba and G. Ferrarini, 'An Assessment of ESG & Executive Remuneration in Europe', in D. Busch, G. Ferrarini and S. Grünewald, *Sustainable Finance in Europe.* Corporate Governance, Financial Stability and Financial Markets, 2nd ed., Palgrave Macmillan, forthcoming 2024.

[8] D. Katelouzou and A. Klettner, 'Sustainable Finance and Stewardship: Unlocking Stewardship's Sustainability Potential' in D. Katelouzou and D. Puchniak (eds.) *Global Shareholder Stewardship: Complexities, Challenges and Possibilities*, Cambridge University Press, 2022, p. 16.

consider how institutional investors classify their investments in practice based on the relevance attributed to ESG considerations and summarize the criteria followed by institutional investors and their asset managers in the selection of investments from an ESG perspective. Furthermore, we examine what type of information issuers make available to investors about their ESG profile through the non-financial disclosure required from them under EU harmonized requirements. Finally, we examine the Commission Delegated Directives on fiduciary duties and sustainability and draw some conclusions on institutional investors' incentives to analyse ESG data and preferences and take investment decisions based on them. In section IV, we focus on investor engagement in ESG matters and ask whether regulation and/or voluntary codes enhance the incentives to engage. In section IV, we draw some general conclusions.

II. Main Legal Strategies

Stewardship codes opened the way to the policy discussion on stewardship activities of institutional investors and asset managers. More recently, they have also identified ESG issues as a core stewardship theme. Nonetheless, the EU approach to ESG stewardship has rapidly evolved from soft law to regulation especially for what concerns the disclosure of the activities of institutional investors. The motivation of disclosure duties is found in the information asymmetries which affect end-investors and in the risk of greenwashing that derives from such asymmetries.[9] Moreover, the latest trend of EU regulation focuses on fiduciary duties and on the behaviour of institutions and intermediaries towards their clients. In this section, we firstly analyse the origins and practice of stewardship codes and then introduce the main EU regulatory measures concerning ESG stewardship that we further examine throughout the paper.

1. *The origins of Stewardship Codes*

The UK Stewardship Code was the first document of this kind to be published. It was adopted by the Financial Reporting Council (FRC) just two years after the great financial crisis,[10] following a recommendation by Sir David Walker[11] and at the government's request.[12] Its purpose was "to enhance the quality of engagement

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[9] See A. Pacces, 'Will the EU Taxonomy Regulation Foster Sustainable Corporate Governance?' (November 2021) Sustainability 13(21), 12316. ·

[10] Fin. Reporting Council, The UK Stewardship Code, July 2010. The Code's origins had deeper roots in the principles for the responsibilities of institutional investors, initially developed by the Institutional Shareholders' Committee in 1991.

[11] Walker Review, A Review of Corporate Governance in UK Banks and other financial institutions: Final Recommendations, National Archive UK, Nov. 26, 2009. Published for consultation on 16 July 2009, the Walker's Review formulated 39 recommendations to improve corporate governance.

[12] D. Katelouzou and M. Siems, 'The Global Diffusion of Stewardship Codes' (May 29, 2020) European Corporate Governance Institute - Law Working Paper No. 526/2020, King's College London Dickson Poon School of Law Legal Studies Research Paper Series:

between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities." The Code was therefore grounded on the concept of responsible investment and the belief that institutional investors should exercise an active role in companies in view of curbing the short-term orientation of their managers. There was no specific reference to sustainability, a concept which was still at the margin of the corporate governance discussion and was mainly considered from the perspective of corporate social responsibility (CSR).

The Code reflected the UK approach to corporate governance, which already relied on a corporate governance code for listed companies since the Cadbury report was issued in 1992.[13] The experiment of the Stewardship Code was however deeply criticized in 2018 by the Kingman Review of the Financial Reporting Council which concluded that the Code was "not effective in practice".[14] The FRC was criticized for focusing its monitoring efforts on assessing the quality of stewardship policies, which signatories to the Stewardship Code are required to produce, whilst passing lightly over the implementation of those policies by the asset owners and asset managers which signed up to the Code.[15] The Review concluded that if a change of focus towards outcomes and effectiveness "cannot be achieved, and the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition."[16] The tacit implication was that failure of the Code should result in the adoption of legislation targeting similar goals.

As a result, the FRC deeply revised the Code in 2020.[17] The new version presents two main differences to the first.[18] Firstly, the "Guidance" to the principles has been replaced by "Reporting Expectations" designed to report in some detail what signatories have done by way of stewardship. Secondly, the 2020 Code contains a much broader concept of stewardship and of the techniques to further it by clearly

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Paper No. 2020-41, LawFin Working Paper No. 10, Available at SSRN: https://ssrn.com/abstract=3616798 or http://dx.doi.org/10.2139/ssrn.3616798.

[13] See The Report of the Committee on the Financial Aspects of Corporate Governance, 1st December 1992, downloadable at https://ecgi.global/sites/default/files//codes/documents/cadbury.pdf. The Committee was chaired by Sir Adrian Cadbury.

[14] See Independent Review of the Financial Reporting Council (FRC) 2018: Final Report by Sir John Kingman, 7 ff., downloadable at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf.

[15] P. Davies, 'The UK Stewardship Code 2010-2020 from Saving the Company to Saving the Planet?' (March 12, 2020). European Corporate Governance Institute - Law Working Paper No. 506/2020, Available at SSRN: https://ssrn.com/abstract=3553493 or http://dx.doi.org/10.2139/ssrn.3553493. A. Reisberg, The UK Stewardship Code: On the Road to Nowhere?, Journal of Corporate Law Studies, 2015, 15 (2) pp. 217-253.

[16] Note 13, at 12.

17 See FRC, UK Stewardship Code 2020, downloadable at https://www.frc.org.uk/investors/uk-stewardship-code.

[18] P. Davies, note15.

moving away from an almost exclusive focus on engagement as the recommended version of stewardship.[19] Although engagement is still emphasized, it is only one of several recommended activities: "Stewardship activities include investment decision-making, monitoring assets and service providers, engaging with issuers and holding them to account on material issues, collaborating with others, and exercising rights and responsibilities."[20] As we shall see throughout this paper, a similar concept of stewardship which includes not only engagement, but also investment and divestment activities and monitoring in general, is presently accepted also in jurisdictions like the EU which mainly follow a regulatory approach to sustainability.

The UK Stewardship Code is the prototype after which regulators and investors groups around the world have modelled their own private codes.[21] The principles of the UK Code have travelled with success especially in the former British colonial common law countries in Asia, in part due to the UK role as a leading exporter of legal concepts in corporate governance.[22] Nonetheless, the transplant of the UK Code principles also occurred in civil law countries, like Japan and Denmark, previous adaptation to the local context.[23] Generally, stewardship codes aim to ensure the long-term success of investee companies through enhanced investor monitoring and engagement with corporate management. In the EU, they are the result of market initiatives, save for the Danish Code which came out of a regulatory initiative.[24] Industry-led regulation is, to some extent, an expression of shared and

[19] P. Davies, note 15.

[20] UK Stewardship Code 2020, 7.

[21] The Stewardship Codes around the globe emanate from three different types of bodies: regulators or quasi-regulators, industry participants, and investors (J. Hill, Good Activist/Bad Activist: The Rise of International Stewardship Codes (September 1, 2017). Seattle University Law Review, 2017, p. 10, European Corporate Governance Institute (ECGI) - Law Working Paper No. 368/2017, Sydney Law School Research Paper 17/80, Available at SSRN: https://ssrn.com/abstract=3036357). Codes of regulatory origin are found in Denmark, Hong Kong, India, Kenya, Japan, Malaysia, Taiwan, and Thailand; codes issued by market participants are found in South Korea, South Africa and Singapore; codes of the third type are found in Australia, Brazil, Canada, Italy, Netherlands, Switzerland and the United States. The third category includes the transnational codes, drafted by the International Corporate Governance Network (ICGN), whose members represent governance professionals from over 45 countries, and the European Funds and Asset Management Association (EFAMA).

[22] B. Cheffins, Corporate Governance Reform: Britain as an Exporter, Corporate Governance and the Reform of Company Law, Hume Papers on Public Policy: Volume 8 No. 1, Edinburgh University Press, 2000. Available at SSRN: https://ssrn.com/abstract=215950 or http://dx.doi.org/10.2139/ssrn.215950.

[23] D. Katelouzou and M. Siems, note 12.

[24] Stewardship Codes can be regarded as voluntary instruments created by multi-stakeholder groups and intended to resolve some of the tensions that the current situation presents. See Brian R. Cheffins, The Stewardship Code's Achilles' Heel (July 2, 2010). University of Cambridge Faculty of Law Research Paper No. 28/2011, Available at SSRN: https://ssrn.com/abstract=1837344 or http://dx.doi.org/10.2139/ssrn.1837344

collective identity, mediating between different demands of market operators. Moreover, the focus on investors' priorities contributes to a flexible and dynamic pattern tailored on the specificities of the case, rather than subject to inflexible and pre-defined criteria.[25]

Despite scholarly scepticism about the effectiveness of voluntary codes,[26] empirical studies support the view that stewardship codes improve investor monitoring over investee companies,[27] showing that the introduction of a code in a country may increase the value of firms with high institutional ownership. Indeed, stewardship codes encourage institutional investors to engage in monitoring to improve their reputation and attract new funds. Moreover, they easily adapt to the changing needs of financial markets, avoiding the long path to legislation. As a result, successive versions of the existing codes have adjusted the scope and contents of stewardship activities. The inner dynamism and flexibility of soft law instruments allows them to respond to new challenges, especially concerning sustainability. In addition, "comply or explain" permits the stewardship principles to remain mostly suitable and up to date, pre-empting a "one-size-fits-all" approach.

2. *ESG in European Stewardship Codes*

Although stewardship codes support responsible investing and long-termism, the extent to which they specifically refer to ESG varies.[28] Some refer to "environmental, social and governance" or "ESG" or "environment and social" factors in their text, while others are less specific.[29]

2.1. *The Danish Code and the Dutch Code*

The Danish Stewardship Code refers to the aim "to promote the companies' long-term value creation and thereby contribute to maximising long-term return for

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[25] See G. Ringe, Investor-led Sustainability in Corporate Governance (November 1, 2021). European Corporate Governance Institute - Law Working Paper No. 615/2021, Available at SSRN: https://ssrn.com/abstract=3958960 or http://dx.doi.org/10.2139/ssrn.3958960.

[26] See B. Cheffins, The Stewardship Code's Achilles' Heel, cited above, note 24; P. Brest, R. Gilson and M. Wolfson, How Investors Can (and Can't) Create Social Value, 44 J. CORP. L. 205 (2018), available at: https://scholarship.law.columbia.edu/faculty_scholarship/2098.

[27] See Y. Shiraishi, N. Ikeda, Y. Arikawa, and K. Inoue, Stewardship Code, Institutional Investors, and Firm Value: International Evidence (January 14, 2022). Available at SSRN: https://ssrn.com/abstract=3462453 or http://dx.doi.org/10.2139/ssrn.3462453. They show that the introduction of stewardship codes in 13 countries increased the value of firms with high institutional ownership and mitigated the free cash flow problem of the portfolio firms with low investment opportunities.

[28] See D. Katelouzou and A. Klettner, note 8, p. 18.

[29] On the ESG concept, see E. Pollman, note 1.

investors", while mentioning "corporate social responsibility".[30] The comment has been made by scholars that in countries like Denmark, where the law on ESG is relatively good and corporate governance is stakeholder-focused, the need for emphasizing ESG in stewardship codes is lower.[31]

The Dutch Stewardship Code instead emphasises ESG factors. It provides that the "stewardship policy should promote long-term value creation at Dutch listed investee companies"[32] and that, in doing so, "it is critical to consider environmental (including climate change risks and opportunities), social and governance information (including board composition and diversity) besides financial information". The Dutch Stewardship Code was developed by the institutional investor platform Eumedion[33] and several institutional investors and came into force in January 2019. It was clearly influenced by the Shareholder Rights Directive II[34] (SRD II) that introduced new transparency obligations for institutional investors to encourage long-term shareholder engagement between companies and investors.[35]

In the Netherlands, corporate law is stakeholder oriented and focuses on long-term value creation, as recognised by Dutch scholarship, case law[36] and the Dutch

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[30] See the Committee on Corporate Governance, Stewardship Code, November 2016, 3 ff., downloadable at https://corporategovernance.dk/sites/default/files/erst_247_opsaetning_af_anbefalinger_for_aktivt_ejerskab_uk_2k8.pdf, last accessed on 19 August 2022.

[31] See D. Katelouzou and A. Klettner, note 8, p. 21.

[32] See Dutch Stewardship Code 2018, Guidance principle 2, downloadable at https://www.eumedion.nl/nl/public/kennisbank/best-practices/2018-07-nederlandse-stewardship-code.pdf, last accessed on 19 August 2022.

[33] Eumedion is an institutional investor's organization which promotes their interests in the fields of corporate governance and sustainability. See https://en.eumedion.nl/About-Eumedion.html, last accessed on 19 August 2022.

[34] Directive EU 2017/828 of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement [2017] OJ L132/60.

[35] See C. Van der Elst and A. Lafarre, Shareholder Stewardship in the Netherlands: The Role of Institutional Investors in a Stakeholder Oriented Jurisdiction (February 17, 2020). European Corporate Governance Institute - Law Working Paper 492/2020, Available at SSRN: https://ssrn.com/abstract=3539820 or http://dx.doi.org/10.2139/ssrn.3539820. The authors point out that the lobbying efforts of Eumedion (see note 32 above) led to the adoption of a qualified majority requirement of 75 percent for remuneration policy resolutions in the new article 2:135a(2) Dutch Civil Code providing institutional investors with a stronger tool to address pay issues in Dutch listed companies.

[36] See HR 29 May 2017, JOR 2017, 261 (Akzo Nobel), cited by C. Van der Elst and A. Lafarre, note 34. The case involved Dutch listed company AkzoNobel and US hedge fund Elliott Management Corp. AkzoNobel rejected three unsolicited friendly offers from the American Fortune 500 company PPG Industries in 2017, arguing that PPG did not make any serious commitments to AkzoNobel's stakeholders. Elliott requested to call a general meeting to remove AkzoNobel's chairman. Although the 10 per cent threshold required under Dutch law was met, the request was rejected by the company and Elliott started an

Corporate Governance Code.[37] The institutional investors are required to publicly disclose how they are accountable for those Dutch Corporate Governance Code provisions applicable to them[38] and may be fined by the Dutch Financial Supervisory Authority in the case of breach of this disclosure requirement. As proven empirically,[39] institutional investors show significantly higher opposition rates than other investors regarding voting items which could negatively affect shareholder rights (*e.g.* amendments to the articles of association or remuneration packages that contain insufficient or inappropriate incentives), while Eumedion members show even higher opposition rates than institutional investors in general. Therefore, many institutional investors take their engagement role seriously and play a significant role in pursing sustainable development goals and accelerating corporate ESG strategies.

2.2. *The Italian Code*

The Italian Stewardship code does not explicitly refer to either ESG or sustainability, while mentioning long-term value creation.[40] Specifically, Principle 3 of the Code states that "Investment Management Companies should establish clear guidelines on when and how they will intervene with investee companies to protect and enhance value"[41] and that "regular interaction with investee companies

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inquiry procedure before the Enterprise Chamber to investigate the decisions taken by the company for the rejection of PPG's offers. The Enterprise Chamber held that there were no serious grounds to question the proper management of the company in adherence to the ruling stakeholder model.

[37] The English version of the current Dutch Corporate Governance Code, issued in 2016, can be found at https://www.mccg.nl/?page=4738 accessed 7 April 2022. Principle 1.1 of the Code states: "The management board is responsible for the continuity of the company and its affiliated enterprise. The management board focuses on long-term value creation for the company and its affiliated enterprise and takes into account the stakeholder interests that are relevant in this context. The supervisory board monitors the management board in this".

[38] These provisions include one on the "Publication of institutional investors' voting policy" (4.3.5) and another on the "Report on the implementation of institutional investors' voting policy" (4.3.6).

[39] See C. Van der Elst and A. Lafarre, note 35.

[40] See the Italian Stewardship Principles for the Exercise of Administrative and Voting Rights in Listed Companies, 2016, downloadable at https://www.assogestioni.it/articolo/principi-italiani-di-stewardship. They were adopted by Assogestioni, the Italian Asset Managers Association, in 2013 and subsequently revised in 2015 and 2016.

[41] See the following definition contained in Italian Stewardship principles: "Investment Management Company: an Italian or foreign company that provides collective investment management and/or portfolio management services. If the Investment Management Company offers services other than the management of collective investment undertakings or portfolios, only the management of collective investment undertakings or portfolios shall be subject to these Principles; the other services provided are not affected. Self-managed SICAVs or similar entities are considered to be Investment Management Companies".

can help to protect and guarantee value in the long term". Institutional investors are expected to engage with investee companies in relation to corporate governance matters and their approach to environmental and social issues. In addition, long-termism is a yardstick for the fiduciary duties of Investment Management Companies who should "follow the investment strategy with long-term performance objectives indicated by the client/investor or reflected in the investment policies of collective investment undertakings".[42]

Despite a long tradition of controlling shareholders and ownership concentration in listed companies,[43] the Italian financial market has lately experienced an increasingly active role of institutional investors in the governance of investee companies.[44] According to a recent study, activism is relatively more frequent in Italy than in the US and the UK, where the number of engagements is however greater.[45] Indeed, Italian corporate law enhances activism through the mechanism of slate voting which allows for the appointment of independent directors by institutional investors.[46] Under the slate voting system, minority shareholders can appoint at least one director (generally independent) and one member of the statutory board of auditors.[47]

The submission of candidates to the board by institutional investors is a constructive form of engagement with investee companies and enhances the potential for monitoring. Also the board approach to ESG issues could improve as a result, given that minority directors "monitor investee companies on important issues, including strategy, financial and non-financial results as well as risks, capital structure, social and environmental impact and corporate governance".[48] Moreover, the new version

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[42] See the Purpose of Principles in Italian Stewardship principles for the exercise of administrative and voting rights in listed companies, 2020.

[43] See OECD, 'Capital Market Review of Italy 2020: Mapping Report' (OECD Capital Market Series, 2020), https://www.oecd.org/corporate/ca/OECD-Capital-Market-Review-Italy.pdf, accessed 6 April 2022.

[44] See M. Belcredi and L. Enriques, 'Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy', in J. Hill and R. Thomas (eds.), *Research Handbook on Shareholder Power*, Elgar, 2015, 383.

[45] See M. Becht, J. Franks, J. Grant, and H. Wagner, 'Returns to Hedge Fund Activism: An International Study' 30 *The Review of Financial Studies* (2017), 9, 2933.

[46] See, for detailed analysis, G. Strampelli, 'Institutional Investor Stewardship in Italian Corporate Governance' in D. Katelouzou and D. Puchniak (eds.), *Global Shareholder Stewardship*, Cambridge University Press, 2022, 130.

[47] Article 147-ter of the Consolidated Law on Finance (Testo Unico della Finanza, Legislative Decree 24 February 1998, n. 58) states that shareholders holding a minimum threshold of shares can present lists of candidates for election to the management board and the board of statutory auditors. At least one member must be elected from the minority submitted slate, having obtained the largest number of votes. However, the shareholders who submit the minority slate must not be related in any way, either directly or indirectly, to the shareholders who voted on the list that received the largest number of votes.

[48] Cfr. article 124-quinquies, of the Consolidated Law on Finance (Testo Unico della Finanza, Legislative Decree 24 February 1998, n. 58).

of the Italian Corporate Governance code sets the pursuit of "the sustainable success of the company's business"[49] as the main goal of the board, which should generate value for shareholders and contribute to the wider society.

2.3. *Non-EU countries*

As to Non-EU countries in Europe, the Swiss Stewardship Code[50] considers sustainability in the exercise of participation rights by institutional investors suggesting that they refer to the interest of their clients and adopt "a long-term and sustainable approach, unless the relevant investment guidelines stipulate to the contrary".[51] The Swiss Code concentrates more on beneficiaries/clients than investee companies, which might be explained by considering that the Code was the result of cooperation between public authorities and investor associations.[52]

The UK Stewardship Code 2020 mentions ESG by stating that "environmental, particularly climate change, and social factors, in addition to governance, have become material issues for investors to consider when making investment decisions and undertaking stewardship".[53] Moreover, the Code refers to climate change as a type of systemic risk that institutional investors should identify and respond to. It also requires asset managers and asset owners to integrate and report material ESG factors in their investment and engagement activities and explain how their decisions serve best the views and needs of their clients/beneficiaries.[54]

3. *EU stewardship regulation and ESG*

The EU approach to ESG stewardship is grounded on regulation rather than voluntary codes, which however complement regulation in some countries. The following regulatory instruments are relevant to present purposes: (a) Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector

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[49] See the 2020 version of the (Italian) Corporate Governance Code, approved in January 2020, available at https://www.borsaitaliana.it/comitato-corporate-governance/codice/2020eng.en.pdf, last accessed 18 August 2022.

[50] Swiss Association of Pension Fund Providers et al., Guidelines for institutional investors governing the exercising of participation rights in public limited companies, 2013, available at https://swissinvestorscode.ch/?lang=en.

[51] See Principle 2 of the Guidelines, note 50.

[52] See J. Hill, note 21. The Swiss code has been published by the Government (Swiss Federal Office for Social Security), ASIP (Swiss Association of Pension Fund Providers), Swiss Federal Social Security Funds, economiesuisse (Swiss Business Federation), Ethos (Swiss Foundation for Sustainable Development), Swiss Bankers Association, SwissHoldings (Federation of Industrial and Service Groups in Switzerland).

[53] See the Introduction to the UK Code, note 17.

[54] See Principles 1, 5 and 7 of the UK Code, note 17.

(SFDR);[55] (b) Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (Taxonomy Regulation);[56] and (c) the six Commission Delegated acts, including three Delegated Directives, concerning the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS),[57] investment firms and product governance obligations,[58] and three Delegated Regulations concerning similar issues with reference to Alternative Investment Fund Managers (AIFM),[59] insurance and reinsurance undertakings and insurance distributors.[60]

3.1. *Sustainable Finance Disclosure Regulation*

The SFDR Preamble argues that the Union is increasingly faced with the catastrophic and unpredictable consequences of climate change, resource depletion and other sustainability-related issues, so that urgent action is needed to mobilize capital not only through public policies but also by the financial services sector.[61] Therefore, financial market participants and financial advisers are required to disclose specific information regarding their approaches to the integration of sustainability risks and the consideration of adverse sustainability impacts. Always according to the Preamble, divergent disclosure standards and market-based

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[55] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Text with EEA relevance), OJ L 317, 9.12.2019, 1.

[56] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, OJ L 198, 22.6.2020, 13.

[57] Commission Delegated Directive (EU) 2021/1270 of 21 April 2021 amending Directive 2010/43/EU (Text with EEA relevance) as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS), OJ L 277, 2.8.2021, 141.

[58] Commission Delegated Regulation 2021/1256 of 21 April 2021 amending Delegated Regulation (EU) No 231/2013 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings, OJ L 277, 2.8.2021, 14; Commission Delegated Regulation (EU) 2021/1257 of 21 April 2021 amending Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products, OJ L 277, 2.8.2021, 18.

[59] Commission Delegated Regulation (EU) 2021/1255 amending Delegated Regulation (EU) No 231/2013 as regards the sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers, OJ L 277, 2.8.2021, 11.

[60] Commission Delegated Regulation (EU) 2021/1256, note 58; Commission Delegated Regulation (EU) 2021/1257, note 58.

[61] See 8th considerandum, SFDR. On the Directive in general, see D. Busch, 'Sustainability Disclosure in the EU Financial Sector', in D. Busch, G. Ferrarini and S. Gruenewald, note 1, 397.

practices make it very difficult to compare different financial products, create an uneven playing field, and erect additional barriers within the internal market.[62] Such divergences could be confusing for end-investors and distort their investment decisions. There is also a risk that Member States adopt divergent national measures to ensure compliance with the Paris Agreement, which could create obstacles to the smooth functioning of the internal market. Furthermore, the lack of harmonized rules relating to transparency makes it difficult for end-investors to effectively compare different financial products in different Member States with respect to their ESG risks and sustainable investment objectives.

The SFDR aims to reduce information asymmetries in principal-agent relationships with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts, the promotion of environmental or social characteristics, and of sustainable investment, by requiring financial market participants and financial advisers to make pre-contractual and ongoing disclosures to end-investors when they act as agents of those investors.[63] The SFDR maintains the requirements for financial market participants and financial advisers to act in the best interest of end-investors, including the requirement of conducting adequate due diligence prior to making investments.[64] However, in order to comply with their duties under those rules, financial market participants and financial advisers should integrate in their processes and should assess on a continuous basis not only all relevant financial risks, but also all relevant sustainability risks that might have a relevant material negative impact on the financial return of an investment or advice.

Yet, the open definition of 'sustainable investment' and the absence of an obligation to exclude harmful economic activities from financial products that have sustainable investment as their objective, threatens the proper functioning of the disclosure regime.[65] Therefore, the European Commission launched in 2023 a public consultation to understand how the SFDR has been implemented and any potential shortcomings, including in its interaction with the other parts of the European framework for sustainable finance, and to explore possible options improving the framework. [66]

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[62] See 9th considerandum, SFDR.

[63] See 10th Considerandum, SFDR.

[64] See 12th Considerandum, SFDR. These requirements are provided for in Directives 2009/65/EC, 2009/138/EC, 2011/61/EU, 2013/36/EU, 2014/65/ EU, (EU) 2016/97, (EU) 2016/2341, and Regulations (EU) No 345/2013 and (EU) No 346/2013, as well as in national law governing personal and individual pension products.

[65] E. Partiti, Addressing the Flaws of the Sustainable Finance Disclosure Regulation: Moving from Disclosures to Labelling and Sustainability Due Diligence (February 21, 2023). TILEC Discussion Paper No. 2023-05, Forthcoming in European Business Organisation Law Review, Available at SSRN: https://ssrn.com/abstract=4387626 or http://dx.doi.org/10.2139/ssrn.4387626.

[66] See https://finance.ec.europa.eu/news/financial-markets-commission-consults-sustainable-finance-disclosures-2023-09-14_en.

3.2. *Taxonomy Regulation*

The Taxonomy Regulation (TR) similarly aims at harmonizing the terminology and disclosure of sustainability.[67] The establishment of a unified classification system for sustainable activities is included in the 2018 Commission action plan on financing sustainable growth, which recognised that a shift of capital flows towards more sustainable activities had to be underpinned by a shared understanding of the environmental sustainability of activities and investments.[68] As argued in the TR Preamble, clear guidance on activities that qualify as contributing to environmental objectives would help inform investors about the investments that fund environmentally sustainable economic activities.[69] Given the systemic nature of global environmental challenges, there is a need for a systemic approach to environmental sustainability that addresses growing negative trends, such as climate change, the loss of biodiversity, the global overconsumption of resources, food scarcity, ozone depletion, ocean acidification, the deterioration of the fresh water system, and land system change as well as the appearance of new threats, such as hazardous chemicals and their combined effects.[70]

In view of the scale and costs of the challenge, the financial system should be gradually adapted to support the sustainable functioning of the economy. According to the Preamble, sustainable finance needs to become mainstream, and consideration needs to be given to the sustainability impact of financial products and services. Requirements for marketing financial products or corporate bonds as environmentally sustainable investments, including requirements set by Member States and the Union to allow financial market participants and issuers to use national labels, aim to enhance investor confidence and awareness of the environmental impact of those financial products or corporate bonds, and to address concerns about 'greenwashing'.[71] The criteria for determining whether an economic activity qualifies as environmentally sustainable should therefore be harmonised at Union level in order to remove barriers to the functioning of the internal market with regard to raising funds for sustainability projects, and to prevent the future emergence of barriers to such projects.[72]

With harmonization, economic operators should find it easier to raise funds across borders for their environmentally sustainable activities, as their businesses can be

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[67] See C. Gortsos, 'The Taxonomy Regulation: More Important Than Just as an Element of the Capital Markets Union' in D. Busch, G. Ferrarini and S. Gruenewald (eds.), note 1, 351; A. Pacces, note 9.

[68] See EC Communication, Action Plan: Financing Sustainable Growth, COM/2018/097 final.

[69] See 6th Considerandum TR.

[70] See 7th considerandum TR.

[71] In the context of the TR, greenwashing refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met (11th Considerandum).

[72] 12th Considerandum, TR.

compared against uniform criteria. Harmonisation therefore facilitates cross-border sustainable investment in the Union. The Taxonomy Regulation establishes the criteria for determining whether an economic activity qualifies as environmentally sustainable for the purposes of establishing the degree to which an investment can be defined as such. In this regard, an exhaustive list of environmental objectives is laid down. The six environmental objectives of the TR are: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems.[73]

3.3. *Commission' Delegated Acts*

The way in which the fiduciary duties of institutional investors and of their asset managers are formulated and enforced is also important to promote sustainable business. As we explain in section III, para. 3, EU law clarifies that sustainability characteristics should be factored in by institutional investors, asset managers, insurance undertakings and intermediaries, and investment intermediaries when taking investment decisions. Moreover, sustainability factors should be considered in product governance determinations and in advisory activities taking into account clients' preferences as to sustainability.

III. INVESTMENT ACTIVITIES AND ESG

In the present section, we enquire to what extent institutional investors are asked by EU regulation to take ESG matters into account when investing in corporate securities. In para. 1, we analyse the integration of sustainability risks in investment decisions and impact investing under the SFDR. Moreover, we consider how institutional investors classify their investments in practice based on the relevance attributed to ESG considerations. In para. 2, we summarize the criteria followed by institutional investors and their asset managers in the selection of investments from an ESG perspective. In addition, we examine what type of information issuers make available to investors about their ESG profile through the non-financial disclosure required from them under EU harmonized requirements. In para 3, we examine the Commission Delegated Directives on fiduciary duties and sustainability and draw some conclusions on institutional investors' incentives to analyse ESG data and preferences and take investment decisions based on them.

1. *SFDR requirements*

Principle 1 of the Principles for Responsible Investment (PRI)[74] requires institutional investors to integrate sustainability risks into their investment

[73] See 23rd Considerandum, TR.

[74] The principles are available at https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment.

decisions.[75] Consistently with international principles, Article 3 (1) SFDR provides what follows: "Financial market participants shall publish on their websites information about their policies on the integration of sustainability risks in their investment decision-making process".[76] Article 6 (1) SFDR further asks financial market participants "to include descriptions of the following in pre-contractual disclosures: (a) the manner in which sustainability risks are integrated into their investment decisions; and (b) the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available (…)".

1.1. *Sustainability risk*

Sustainability risk is defined by Art. 2 (22) SFDR as "an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment". Therefore, sustainability risks are considered by the SFDR mainly as affecting the investment at issue, whose value may suffer a material negative impact if the risk materializes (internalized risk). Whether the environment or society are negatively impacted by the risks in question is not directly relevant: in other words, double materiality does not apply. However, *adverse impacts* (i.e., negative externalities) must be taken into account by financial market participants under Article 4 SFDR requiring them to "publish and maintain on their websites (a) where they consider principal adverse impacts of investment decisions on sustainability factors, a statement on due diligence policies with respect to those impacts, taking due account of their size, the nature and scale of their activities and the types of financial products they make available; or (b) where they do not consider adverse impacts of investment decisions on

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[75] Similarly, Principle 6 of the ICGN Global Stewardship Principles (available at https://www.icgn.org/icgn-global-stewardship-principles) states: "Investors should promote the long-term performance and sustainable success of companies and should integrate material environmental, social and governance (ESG) factors in investment decision-making and stewardship activities". Along similar lines, Principle 7 of the UK Stewardship Code provides: "Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities".

[76] Under Art. 2 (1) SFDR, " 'financial market participant' means: (a) an insurance undertaking which makes available an insurance-based investment product (IBIP); (b) an investment firm which provides portfolio management; (c) an institution for occupational retirement provision (IORP); (d) a manufacturer of a pension product; (e) an alternative investment fund manager (AIFM); (f) a pan-European personal pension product (PEPP) provider; (g) a manager of a qualifying venture capital fund registered in accordance with Article 14 of Regulation (EU) No 345/2013; (h) a manager of a qualifying social entrepreneurship fund registered in accordance with Article 15 of Regulation (EU) No 346/2013; (i) a management company of an undertaking for collective investment in transferable securities (UCITS management company); or (j) a credit institution which provides portfolio management".

sustainability factors, clear reasons for why they do not do so, including, where relevant, information as to whether and when they intend to consider such adverse impacts".

The provision just quoted refers to adverse impacts which have been originated by portfolio companies. Financial market participants should have due diligence policies in place to ascertain the nature and extent of such impacts and the measures adopted by the companies in question to reduce or eliminate the same. The relevant information will be mainly provided by the issuers in the sustainability disclosure concerning their adverse impacts and relevant due diligence policies. Financial market participants will conduct their due diligence activities mainly with regard to similar information checking the same on the basis of other information which is publicly available or privately available to them.

1.2. *Impact investing*

Impact investing is a noteworthy step in the evolution of responsible investing. It is a type of sustainable investing in which investment decisions are made to deliver positive financial returns and a benefit to society and to the environment at the same time. As noted by three scholarly experts, it is 'very difficult to create social value through one's investments while nonetheless earning risk-adjusted financial returns'.[77] However, the same scholars disagree with those who define impact investing to include only concessionary investments, that is to say investments in which financial concessions are made over time.[78] In their opinion, the definition of impact investing should be reserved to investors who seek social value creation rather than only value alignment. 'Value alignment' occurs when investors seek to align their investments with their social values, while 'value creation' happens when they seek to cause the investee companies to create more social value.[79]

Impact investing is considered by the SFDR mainly for information purposes regarding the due diligence policies adopted by financial market participants.

1.3. *Special types of ESG investments*

Art. 8 and 9 SFDR acknowledge that financial market participants may attach special importance to the sustainability of investee companies by envisaging two hypotheses. Art. 8 (1) refers to a financial product that "*promotes*, among other characteristics, *environmental* or *social characteristics*, or a combination of those characteristics". In a similar case, "provided that the companies in which the investments are made follow good governance practices, the information to be disclosed pursuant to Article 6 (1) and (3) shall include the following: (a) information on how those characteristics are met; (b) if an index has been

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[77] P. Brest, R. Gilson and M. Wolfson, 'How Investors Can (and Can't) Create Social Value', Journal of Corporation Law (2019), 44 (2), 205, at 209.

[78] Ibidem.

[79] Ibidem, at 206.

designated as a reference benchmark, information on whether and how this index is consistent with those characteristics”.[80]

Art. 9 (1) SFDR envisages a financial product that has *sustainable investment as its objective*. According to Art. 2 (17) SFDR, ‘sustainable investment’ means an investment in an economic activity that contributes either to an *environmental objective* or to a *social objective*. ‘Environmental objectives’ are defined by Art. 9 of the Taxonomy Regulation as including: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; protection and restoration of biodiversity and ecosystems.[81] These objectives are measured by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land; on the production of waste, and greenhouse gas emissions; or on its impact on biodiversity and the circular economy. The social objectives regard an investment in an economic activity that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities (Art. 2 (17) SFDR). In all cases, such investments should not significantly harm any of those objectives and the investee companies should follow good governance practices with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

As to the environmental objectives, Art. 9 (3) specifies that a financial product can have a reduction in carbon emissions as its objective, in which case the information to be disclosed shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.[82] Indeed, climate change has become one of the biggest sustainability issues for investment portfolios, as investors have become aware that greater climate variability and more frequent extreme weather events have negative impacts on businesses. Overall, the SFDR criteria for distinguishing between different types of financial products are rather vague, given that the promotion of environmental or

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[80] Under Art. 8 (2), financial market participants shall include in the information to be disclosed pursuant to Article 6(1) and (3) an indication of where the methodology used for the calculation of the index referred to in paragraph 1 of this Article is to be found.

[81] Art. 3 Taxonomy Regulation provides that “an economic activity shall qualify as environmentally sustainable where that economic activity: (a) contributes substantially to one or more of the environmental objectives set out in Article 9 in accordance with Articles 10 to 16; (b) does not significantly harm any of the environmental objectives set out in Article 9 in accordance with Article17; (c) is carried out in compliance with the minimum safeguards laid down in Article 18; and (d) complies with technical screening criteria that have been established by the Commission in accordance with Article10 (3), 11(3), 12(2), 13(2), 14(2) or 15(2) of the same Regulation.

[82] Art. 9 (3) further provides: “By way of derogation from paragraph 2 of this Article, where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark in accordance with Regulation (EU) 2016/1011 of the European Parliament and of the Council (20) is available, the information referred to in Article 6 shall include a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement”.

social characteristics is not always neatly distinguishable from the pursuit of sustainable investment objectives. As noted above, one financial market participant classifies as Art. 8 SFDR all investments the management of which integrates sustainability risks, while another defines Art. 8 investments those targeting an internal sustainability score. Still another considers all impact investments as Art. 9 compliant. In the case of Art. 9 financial products the principle of no harm to any sustainability objective must be complied with. However, this principle is not part of the definition of an Art. 9 investment, rather assuming this definition as given.

As a result, financial market participants are given wide discretion as to the choice of the label to use for their financial products and will likely choose based on divergent criteria. The relative flexibility of the definitions was presumably intentional on the part of the EU legislator, given that the practice of sustainable investments is relatively new and difficult to standardize. However, the lack of standards may give rise to greenwashing if laxer criteria are applied by some participants in the definition of their financial products to make them appear more sustainable than they effectively are in practice.

2. *Investment criteria and processes*

Most institutional investors and asset managers today believe that the selection of companies with sustainable business models is important to maximize risk-adjusted returns to their clients over the long term. They regard ESG issues as important drivers of financial performance and investment returns and are committed to integrate them across their investment strategies. Moreover, ESG criteria help to identify companies which are effectively transitioning to new business models which are better suited to current economic and social environments.

2.1. *Risk-related risks*

ESG-related risks and opportunities are relevant both in the management of firms and in the selection of investments. Nevertheless, there is no universal definition of ESG-related risks, so that each company may define them based on its business model; internal and external environment; product or services mix; mission, vision, and core values.[83] ESG-related risks are not entirely new, to the extent that corporations and investors have been considering governance risks for many years, including those relating to financial accounting and reporting, board leadership and composition, anti-bribery and corruption, business ethics, and executive compensation.[84] However, the breadth of ESG-related risks has expanded rapidly over the last ten years. The World Economic Forum's Global Risks Report for 2021 highlighted that four of the top five risks by likelihood were environmental,

[83] See Committee of Sponsoring Organizations of the Treadway Commission (COSO) and World Business Council for Sustainable Development (WBCSD), Enterprise Risk Management. Applying enterprise risk management to environmental, social and governance-related risks, October 2018, 1.

[84] Ibidem.

including those concerning extreme weather events, climate action failure, human environmental damage, and biodiversity loss.[85]

The following are examples of organizations that experienced extraordinary ESG-related impacts over the last decades.[86] Starting from the E (environmental factors), in 2010 BP's oil rig Deepwater Horizon exploded in Mexico, killing and injuring workers, and creating an environmental disaster; in 2013, millions of Volkswagen cars were recalled after the company admitted to falsifying emissions tests; in 2014, flooding in Thailand resulted in disruptions to automotive and technology supply chain networks; in 2015, Samarco dam (Vale and BHP) collapse killed people and sent iron ore debris through southeast Brazil. Focusing on the S (social factors), in the 1980s Nestlé faced a boycott for misleading consumers as to baby milk formulas in emerging countries; in the 1990s Nike was accused of employing children and paying workers less than minimum wage; in 2013, the Rana Plaza factory building in Bangladesh, used by more than 25 brands, collapsed killing more than 1,100 workers; in 2017, Wells Fargo created millions of accounts in the names of its clients without their permission; in 2018, Oxfam faced alleged cover-up of sexual harassment scandal in Haiti; in 2017, Uber faced sexual harassment scandal leading to a #DeleteUber movement.

Most of these cases also concerned the G (governance factors) to the extent that either the E or the S failures (including human rights violation) had been caused or at least made possible by G weaknesses or failures. As a result, there is growing interest from investors in understanding how organizations identify and respond to ESG-related risks.[87] In the US, for example, environmental and social proposals in the annual meetings of corporations have accounted for around half of all shareholder proposals submitted (the other types of proposals included board issues, anti-takeover and strategic themes, and executive compensation).[88]

The above comments briefly explain why sustainability risk integration is recommended to institutional investors by international best practices and is widely followed by these investors in the management of their portfolios. Moreover, the special categories of financial products examined in the previous paragraph may require the recourse to additional criteria for the selection of investments by institutional investors and asset managers. As illustrated in the previous paragraph, Art. 8 SFDR refers to financial products that promote environmental or social characteristics, which must be indicated in the relevant disclosure document together with the reference benchmark (if any) which has been designated for the purpose of attaining those characteristics.[89] Art. 9 refers to financial products which

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[85] World Economic Forum, Global Risks Report 2021, https://www3.weforum.org/docs/WEF_The_Global_Risks_Report_2021.pdf.

[86] See COSO – WBCSD, note 94, at 3.

[87] Ibidem.

[88] Ibidem.

[89] According to Art. 6 of the Taxonomy Regulation, where a financial product as referred to in Article 8(1) of SFDR promotes environmental characteristics, Article 5 of the

have a sustainable investment objective, i.e. an investment in an economic activity that contributes to an environmental or social objective, provided that the investment does not significantly harm any environmental or social objective and that the investee companies follow good governance practices. Therefore, financial market participants do additional and specific research in relation to the offer of Art. 8 products - depending on the E and S characteristics that they promote - and Art. 9 products with respect to their sustainability objectives.

To make an example, for impact investments they need information on the environmental and social impacts pursued, which they can collect on the basis of either corporate disclosure or other publicly available data on the positive and negative impacts of investee companies on the planet and people. Consequently, asset managers will have to run due diligence processes directed to establish negative impacts whose presence may lead to excluding given investments and positive ones which may be required for an investment to be selected by them. Moreover, they will scrutinize the information concerning the corporate governance of firms to ascertain whether they follow good practices with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

2.2. *Sustainability reporting by issuers*

Sustainability reporting by issuers provides investors – as well as stakeholders and the public at large - with information on ESG issues and corporate sustainability in general that can be used in the activities and processes analysed in the previous paragraph. Under Article 19a of Directive 2013/34/EU, as recently modified by the Corporate Sustainability Reporting Directive (CSRD),[90] large undertakings, and small and medium-sized undertakings, except micro undertakings, which are public-interest entities shall include in the management report information necessary to understand the undertaking's impacts on sustainability matters, and

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Taxonomy Regulation shall apply mutatis mutandis. Therefore, the information to be disclosed in accordance with Articles 6(3) and 11(2) of the SFDR shall include the information on the environmental characteristic or characteristics to which the investment underlying the financial product contributes; and a description of how and to what extent the investments underlying the financial product are (if any) in economic activities that qualify as environmentally sustainable.

[90] See Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting, OJ L 322, 16.12.2022, usually referred to as the Corporate Sustainability Reporting Directive. Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OJ L 330, 15.11.2014, 1. See Balp G. – Strampelli G., Institutional investors as the primary users of sustainability reporting, in Kern Alexander, Michele Siri and Matteo Gargantini (eds), The Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance, Cambridge University Press (forthcoming).

information necessary to understand how sustainability matters affect the undertaking's development, performance and position.

This information shall describe the undertaking's business model and strategy, including the opportunities for the undertaking related to sustainability matters and the plans to ensure that its business model and strategy are compatible with the transition to a sustainable economy. It shall also describe how the business model and strategy take account of the interests of stakeholders and of the impacts of the undertaking on sustainability matters, and how the strategy has been implemented with regard to sustainability matters. Moreover, the information should contain a description of the targets related to sustainability matters set by the undertaking, including absolute greenhouse gas emission reduction targets at least for 2030 and 2050, a description of the progress the undertaking has made towards achieving those targets, and a statement of whether the targets related to environmental factors are based on conclusive scientific evidence. Furthermore, a description should be given of the role of the administrative, management and supervisory bodies with regard to sustainability matters, and of their expertise and skills in relation to fulfilling that role, together with information about the existence of incentive schemes linked to sustainability matters which have been offered to members of the administrative, management and supervisory bodies. In addition, the due diligence process implemented by the undertaking with regard to sustainability matters should be described, in line with prospective EU requirements concerning the conduct of such process.

On 31 July 2023, the European Commission adopted the European Sustainability Reporting Standards (ESRS) for use by all companies subject to the CSRD, as foreseen by Articles 19(a)(4) and 29(b) of the Accounting Directive as amended.[91] The standards cover the full range of environmental, social, and governance issues, including climate change, biodiversity, and human rights. They provide information for investors to understand the sustainability impact of the companies in which they invest. They also take account of discussions with the International Sustainability Standards Board (ISSB) and the Global Reporting Initiative (GRI) in order to ensure a very high degree of interoperability between EU and global standards and to prevent unnecessary double reporting by companies.[92] The ESRS were adopted by the Commission based on technical advice (draft standards) from

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[91] See Commission Delegated Regulation (EU) ... supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards, available at https://finance.ec.europa.eu/regulation-and-supervision/financial-services-legislation/implementing-and-delegated-acts/corporate-sustainability-reporting-directive_en.

[92] See the article "The Commission adopts the European Sustainability Reporting Standards" at https://finance.ec.europa.eu/news/commission-adopts-european-sustainability-reporting-standards-2023-07-31_en.

EFRAG.[93] They take a "double materiality" perspective, in the sense that they oblige companies to report both on their impacts on people and the environment, and on how social and environmental issues create financial risks and opportunities for the company.[94]

3. *Fiduciary duties and the integration of sustainability*

The EU Commission has created further incentives for financial market participants to integrate sustainability risks in their investment activities and services through the enactment of the six delegated acts already cited.[95] Three of them regard the integration of sustainability factors into investment selection and risk management, while the other three regard the integration of sustainability factors into product governance and rules of conduct.

3.1. *Investment selection and risk management*

Commission Delegated Directive 2021/1270 concerns the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS),[96] while Commission Delegated Regulation 2021/1255 concerns the same theme with reference to Alternative Investment Fund Managers (AIFM).[97] These two acts specify the fiduciary duties owed by UCITS and their asset managers, and AIFMs to their clients with respect to the sustainability of the investments offered to them. The Delegated Directive modifies Art. 4 (1) Directive 2010/43/EU on UCITS by adding a subparagraph providing *inter alia* that 'Member States shall ensure that management companies take into account sustainability risks when complying with the requirements laid down in the first subparagraph' (Art. 1 of the Commission Delegated Directive). Article 5*a* has also been added including the obligation for investment companies to integrate sustainability risks in the management of UCITS "taking into account the nature, scale and complexity of the business of the investment companies". Similar provisions are also found in the Delegated Regulation concerning AIFM.[98]

Commission Delegated Regulation 2021/1256 regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings.[99] Its Preamble states that insurance undertakings that disclose principal adverse impacts on sustainability factors in accordance with the SFDR should also adapt

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[93] See the Commission's Questions and Answers on the ESRS at https://ec.europa.eu/commission/presscorner/detail/en/qanda_23_4043.

[94] Ibidem.

[95] See Section II, para. 3.

[96] Commission Delegated Directive (EU) 2021/1270, note 57.

[97] See Commission Delegated Regulation (EU) 2021/1255, note 59.

[98] Commission Delegated Regulation 2021/1255, note 58.

[99] Commission Delegated Regulation (EU) 2021/1255, note 58.

their processes, systems and internal controls with respect to those disclosures.[100] In particular, the prudent person principle laid down in Article 132 of the Solvency II Directive[101] requires that insurance and reinsurance undertakings only invest in assets the risks of which they can identify, measure, monitor, manage, control and report properly. The implementation of this principle requires that climate and environmental risks are effectively managed by insurance and reinsurance undertakings and that the latter reflect in their investment processes the sustainability preferences of their customers as taken into account in the product approval process.[102] The provisions of Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing the Solvency II Directive[103] have been modified accordingly by the Delegated Regulation 2021/1256 that we are specifically considering.

Commission Delegated Regulation (EU) 2021/1253 regards the integration of sustainability factors, risks and preferences into the organisational requirements and operating conditions for investment firms.[104] As stated in the Preamble, investment firms should, when identifying conflicts of interest, include those conflicts that stem from the integration of the client's sustainability preferences.[105] Moreover, investment firms that provide investment advice and portfolio management should be able to recommend suitable financial instruments to their clients and potential clients and should therefore ask questions to identify a client's individual sustainability preferences.[106] Such recommendations should reflect both the financial objectives and sustainability preferences expressed by clients. Investment firms should therefore have in place appropriate arrangements to ensure that the inclusion of sustainability factors in the advisory process and portfolio management does not lead to mis-selling practices or to the misrepresentation of financial instruments or strategies as fulfilling sustainability preferences where they do not.[107]

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[100] See the 4th Considerandum.

[101] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), OJ L 335, 17.12.2009, 1.

[102] See the 6th Considerandum of Commission Delegated Regulation 2021/1256, note 58.

[103] See Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), OJ L 12, 17.1.2015, 1.

[104] Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, OJ L 277, 2.8.2021, 1.

[105] See the 4th Considerandum.

[106] See the 5th Considerandum.

[107] Ibidem.

The Preamble still notes that financial instruments with various degrees of sustainability-related ambition have been developed so far. To enable clients or potential clients to take informed investment decisions in terms of sustainability, investment firms that provide investment advice and portfolio management services should explain the distinction between three types of financial instruments: a) those that pursue, fully or in part, sustainable investments in economic activities that qualify as environmentally sustainable under Regulation (EU) 2020/852; b) sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088; c) financial instruments that consider principal adverse impacts on sustainability factors that might be eligible for recommendation as meeting the individual sustainability preferences of clients.[108]

3.2. *Integration of sustainability in product governance and rules of conduct*

Commission Delegated Directive 2021/1269 amends Delegated Directive 2017/593 regarding the integration of sustainability factors into the product governance obligations.[109] As explained in the Preamble, investment firms manufacturing and distributing financial instruments should consider sustainability factors in the product approval process of each financial instrument and in the other product governance and oversight arrangements for each financial instrument that is intended to be distributed to clients seeking financial instruments with a sustainability-related profile.[110] Moreover, considering that the target market should be set at a sufficient granular level, a general statement that a financial instrument has a sustainability-related profile should not be sufficient. Investment firms manufacturing and distributing financial instruments should rather specify to which group of clients with sustainability related objectives the financial instrument is supposed to be distributed.

Commission Delegated Regulation (EU) 2021/1257 of 21 April 2021[111] regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors. As explained in the Preamble, insurance undertakings and insurance intermediaries manufacturing insurance products should consider sustainability factors in the product approval process of each insurance product and in the other product governance and oversight arrangements for each insurance product that is intended to be distributed to customers seeking insurance products with a sustainability-related profile.[112] Considering that the target market should be set at a sufficient granular level, the insurance undertaking or insurance intermediary manufacturing the insurance product should specify to which group of customers with specific

[108] See the 6th Considerandum.

[109] Commission Delegated Directive (EU) 2021/1269 of 21 April 2021 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations, OJ L 277, 2.8.2021, 137.

[110] See the 5th Considerandum.

[111] Commission Delegated Regulation (EU) 2021/1257, note 58.

[112] See the 5th Considerandum.

sustainability-related objectives the insurance product is supposed to be distributed.[113]

Moreover, insurance intermediaries and insurance undertakings that provide advice on insurance-based investment products should be able to recommend suitable insurance-based investment products to their customers or potential customers and should therefore be able to ask questions to identify a customer's individual sustainability preferences. In accordance with the obligation to carry out distribution activities in accordance with the best interest of costumers, recommendations to customers or potential customers should reflect both the financial objectives and any sustainability preferences expressed by those customers.[114] The provisions of Delegated Regulation (EU) 2017/2358 and Delegated Regulation (EU) 2017/2358[115] have been amended accordingly by the Delegated Regulation 2021/1256 that we are specifically considering.

3.3. *Assessment*

EU regulation concerning sustainability disclosure is complemented by the provisions reviewed in this paragraph which foresee fiduciary duties and regulatory duties concerning the integration of sustainability by financial market participants. On one side, there are rules requiring the integration of sustainability in the selection of investments and in risk management processes of UCITS, asset managers, insurance undertakings and intermediaries, and investment intermediaries. On the other, sustainability factors must be considered in product governance processes and in portfolio management and advisory activities which must consider clients' preferences as to sustainability. The two sides of regulation – disclosure and fiduciary/regulatory duties – complement each other in the sense that disclosure contributes to incentivizing performance by financial market participants of their fiduciary/regulatory duties, while the latter reinforce the quality of disclosure by assuring that adequate processes and activities stand behind the reports published by financial market participants. Overall, the regulation that we have been considering aims to reduce the agency costs between financial market participants and their clients/investors aligning the investment activities of the former with the latter's preferences as to sustainability.

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[113] See the 6th Considerandum.

[114] See the 11th Considerandum.

[115] See Commission Delegated Regulation (EU) 2017/2358 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to product oversight and governance requirements for insurance undertakings and insurance distributors, OJ L 341, 20.12.2017, 1; and Commission Delegated Regulation (EU) 2017/2359 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to information requirements and conduct of business rules applicable to the distribution of insurance-based investment products, OJ L 341,20.12.2017, 8.

IV. ENGAGEMENT ACTIVITIES AND ESG

In sec. I, we noted that the 2020 edition of the UK Stewardship Code refers to "engaging with issuers and holding them to account on material issues, collaborating with others, and exercising rights and responsibilities." At the same time, the UK Code considers engagement along other stewardship activities, such as investment decision-making and monitoring assets and service providers. Other stewardship codes in Europe follow a similar approach to stewardship reflecting a holistic view of the activities that institutional investors and asset managers perform in the interest of end-investors. In sec. II, we further considered how ESG issues are factored in by financial market participants when deciding on investments and divestments, and monitoring assets and service providers.

In this section, we focus on engagement concerning ESG matters and analyse the incentives of financial market participants to engage with issuers and exercise their rights and responsibilities in investee companies, keeping however in mind that the different aspects of stewardship can be a substitute one for another. Indeed, stewards' monitoring on ESG issues can lead either to formal or informal engagement with issuers or to divestment from the relevant company. In para. 1, we examine how the second Shareholder Rights Directive (SRD II) has tried to enhance the incentives to engagement by requiring publication of an engagement policy. We also examine similar requirements under the SFDR as implemented by a Commission Delegated Regulation with special regard to ESG engagement. In para. 2, we consider the limited incentives to engagement and ask whether ESG engagement will be different. In para. 3, we draw some conclusions.

1. *Engagement disclosure under SRD II and SFDR*

The original Shareholder Rights Directive of 2007[116] was amended in 2017 by the second Shareholder Rights Directive (SRD II)[117] regarding the encouragement of long-term shareholder engagement. As stated by new Art. 1(1), the Directive establishes requirements in relation to the exercise of certain shareholder rights attached to voting shares in relation to general meetings of companies which have their registered office in a Member State and the shares of which are admitted to trading on a regulated market situated or operating within a Member State. It also establishes specific requirements to encourage shareholder engagement in the long term.

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[116] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007, 17.

[117] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, p. 1. For a definition of this Directive as a 'missed opportunity', see A. Pacces, 'Shareholder Activism in the CMU', in D. Busch, E. Avgouleas and G. Ferrarini (eds.), *Capital Markets Union in Europe*, Oxford University Press, 2018, 507, where a critical analysis of the policy choices made by the EU legislator as to shareholder engagement.

The Preamble to the Directive claims that, in many cases before the financial crisis, shareholders supported managers' short-term risk taking. Moreover, the level of 'monitoring' of investee companies and engagement by institutional investors and asset managers was often inadequate and focused too much on short-term returns, which may lead to suboptimal corporate governance and performance.[118] Consequently, in a 2012 Communication[119] the Commission announced several actions in corporate governance to encourage long-term shareholder engagement and to enhance transparency between companies and investors. In the Commission's view, effective and sustainable shareholder engagement is one of the cornerstones of the corporate governance model of listed companies, which depends on checks and balances between the different organs and different stakeholders.[120] Greater involvement of shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies including with regard ESG factors, as also argued in the Principles for Responsible Investment supported by the United Nations. In addition, greater involvement of all stakeholders in corporate governance is important to ensure a more long-term approach by listed companies.

Institutional investors and asset managers are often important shareholders of EU listed companies, so that they can play an important role in their corporate governance. However, the SRD II Preamble claims that experience of the last years has shown that institutional investors and asset managers often do not engage with companies in which they hold shares, while evidence shows that capital markets frequently exert pressure on companies to perform in the short term.[121] Moreover, institutional investors and asset managers often are not transparent about their engagement policies and the implementation of the same. However, "public disclosure of such information could have a positive impact on investor awareness, enable ultimate beneficiaries such as future pensioners optimize investment decisions, facilitate the dialogue between companies and their shareholders, encourage shareholder engagement and strengthen their accountability to stakeholders and to civil society".[122]

As a result, new Article 3g(1) SRD on engagement policy provides that Member States shall ensure that institutional investors and asset managers either comply with the requirements set out in points (a) and (b) or publicly disclose a clear and reasoned explanation why they have chosen not to comply with one or more of those requirements. Under point (a), institutional investors and asset managers are required to develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy. The policy shall describe how they monitor investee companies on relevant matters, including

[118] See the 2nd considerandum.

[119] See Commission Communication of 12 December 2012, 'Action Plan: European company law and corporate governance — a modern legal framework for more engaged shareholders and sustainable companies'.

[120] See 14th considerandum, SRD II.

[121] See 15th considerandum, SRD II.

[122] See 16th considerandum.

strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance; conduct dialogues with investee companies, exercise voting rights and other rights attached to shares; cooperate with other shareholders, communicate with relevant stakeholders of the investee companies and manage actual and potential conflicts of interests in relation to their engagement. Under point (b), institutional investors and asset managers shall, on an annual basis, publicly disclose how their engagement policy has been implemented, including a general description of voting behaviour, an explanation of the most significant votes and the use of the services of proxy advisors. They shall publicly disclose how they have cast votes in the general meetings of companies in which they hold shares. Such disclosure may exclude votes that are insignificant due to the subject matter of the vote or the size of the holding in the company.[123]

Specific disclosure of sustainability engagement by financial market participants is required by Commission Delegated Regulation of 6 April 2022 supplementing the SFDR.[124] Under Article 8 (1) of this Regulation, financial market participants shall provide in Table 1 of Annex I information as to their engagement policies including, where applicable, brief summaries of the engagement policies referred to in Article 3g of SRD II and brief summaries of any other engagement policies to reduce principal adverse impacts. Such brief summaries shall describe the indicators for adverse impacts considered in the relevant engagement policies and how those engagement policies will be adapted where there is no reduction of the principal adverse impacts over more than one period reported on.

2. *Limits of engagement*

The disclosure requirements examined in the previous paragraph react to the traditional passivity of institutional investors and asset managers, trying to stimulate their engagement both in general and with respect to ESG matters. Such passivity

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[123] Art. 3g(2) further provides that the information referred to in paragraph 1 shall be available free of charge on the institutional investor's or asset manager's website. Where an asset manager implements the engagement policy, including voting, on behalf of an institutional investor, the institutional investor shall make a reference as to where such voting information has been published by the asset manager. Para. 3 specifies that conflicts of interests rules applicable to institutional investors and asset managers, including Article 14 of Directive 2011/61/EU, point (b) of Article 12(1) and point (d) of Article 14(1) of Directive 2009/65/EC and the relevant implementing rules, and Article 23 of Directive 2014/65/EU shall also apply with regard to engagement activities.

[124] See Commission Delegated Regulation of 6 April 2022 supplementing the SFDR with regard to regulatory technical standards specifying the details of the content and presentation of the information in relation to the principle of 'do no significant harm', specifying the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts, and the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic reports, at https://ec.europa.eu/finance/docs/level-2-measures/C_2022_1931_1_EN_ACT_part1_v6%20(1).pdf.

has been explained with various arguments mostly grounded on the lack of incentives to activism.[125] Firstly, the market for asset managers is highly competitive and money goes to the managers offering higher returns, which do not necessarily depend on engagement with investee companies.[126] In addition, many funds track indices, so that superior returns only come from lowering distribution and management costs, while there is little interest for engagement.[127] Secondly, the costs of engagement are borne by the investors who engage, while the benefits are enjoyed by all shareholders in the company. This leads to rational apathy of investors (who do not engage because their private costs exceed their private benefits) and free riding of shareholders (who hope to benefit from the engagement of others). To the extent that the holdings of institutional investors have become more concentrated over the years and coordination amongst them has become easier, their rational apathy may gradually disappear.[128]

Thirdly, institutional investors typically earn commissions based on a percentage of assets under management, so that their dominant incentive is to increase their funds' size. This can be done through either marketing or better performance, with the link to fund performance being rather indirect.[129] Moreover, portfolio managers feel that engagement is generally a hard way to make money and prefer to walk away from a poor investment switching to a better one.[130] In addition, asset managers face a variety of conflicts of interests. For example, they may find it difficult to criticize a company while competing for the pension business of its employees; or, if they are part of a banking group, they may be pressured not to antagonize current or prospective clients by voting against the CEO's pay.[131]

One may wonder whether the incentives to engagement are stronger for institutional investors and asset managers with respect to the ESG characteristics of the investments offered. No doubt, also the market for the management of ESG investments is competitive, but competition does not necessarily depend on financial returns. The sustainability ratings of a given fund matter, to the extent that the end investors look at its ESG performance. Financial market participants will therefore also compete on ESG performance. Moreover, they will suffer less from rational apathy if they select the financial instruments in which to invest also based on sustainability considerations and keep monitoring them from an ESG

[125] See E. Rock, 'Institutional investors in corporate governance', in J. Gordon and G. Ringe (eds.), *Oxford Handbook of Corporate Law and Governance*, Oxford University Press, 2018, 363.

[126] Ibidem, 373.

[127] Ibidem.

[128] Ibidem.

[129]Ibidem. Rock adds that money managers may have perverse incentives regarding activism. To the extent that funds depart from an index, but still compete with managers of similar funds, a fund's relative performance improves when "underweighted" companies in their portfolio perform badly.

[130] Ibidem.

[131] Ibidem.

perspective. The private costs of their engagement could be lower as a result, particularly in the case of investments which pursue sustainability objectives and positive impacts. In addition, these costs may appear to be more justified if the relevant engagement shows a commitment of institutional investors and asset managers to ESG issues which are relevant to the end investors.

3. *Is ESG engagement more likely?*

To conclude, it is likely that the incentives for ESG engagement are greater than in the case of engagement related to financial performance, but only experience will show whether engagement in sustainability matters is more frequent and effective. We should also consider that environmental and social considerations may be relevant in terms of financial performance, so that engagement on them translates into a better financial performance of the company at issue.[132] The rules on disclosure examined in this paragraph may also contribute to enhance engagement to the extent that they rely on reputational incentives for financial market participants and allow better monitoring by the markets.

V. CONCLUDING REMARKS

In this paper, we have analysed the main regulatory strategies to promote ESG stewardship: voluntary codes, disclosure regulation and fiduciary duties. While stewardship codes opened the discussion in this area, recent trends show that regulation of ESG stewardship is on the rise in the EU. Disclosure regulation addresses the information asymmetries between financial market participants and their clients and aims to prevent greenwashing. Fiduciary duties regulation is intended to clarify how sustainability factors and risks should be dealt with in investment selection and portfolio management as a prudential requirement for all types of financial products. Moreover, regulation specifies that sustainability preferences of clients should be considered both in product governance and in the assessment of suitability of financial products to end-investors.

As a result, investor protection stems both from stewardship disclosure by financial market participants and from regulation and supervision of their management and distribution activities. End-investors in all kinds of financial products should communicate their sustainability preferences to the relevant financial institution and

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[132] See A. Dyck, K. Lins, L. Roth, H. Wagner, 'Do institutional investors drive corporate social responsibility? International evidence' Journal of Financial Economics 131 (2019), 693, showing that across 41 countries, institutional ownership is positively associated with E&S performance with additional tests suggesting this relation is causal. See also Balp, Gaia and Strampelli, Giovanni, Institutional Investor ESG Engagement: The European Experience (February 10, 2023). Final version published in Eur Bus Org Law Rev 23, 869–904 (2022), Bocconi Legal Studies Research Paper No. 4353703, Available at SSRN: https://ssrn.com/abstract=4353703 or http://dx.doi.org/10.2139/ssrn.4353703.

make their investments based on them. The suitability of such investments shall be assessed with reference to the clients' preferences, which are also classified to design the target market in product governance. To similar purposes, financial products are labelled under sustainability disclosure rules so that potential clients/ investors can choose in an informed way according to their preferences. The supervision of disclosure should reduce the risk of greenwashing and the transactions costs relative to the selection of investments. However, supervision does not eliminate the risk of misrepresentation so that investor protection also depends on national rules concerning civil liability for false or misleading disclosure.

Overall, the legal framework concerning ESG stewardship is no doubt complex but also consistent with securities regulation and other parts of financial regulation such as insurance law. Sustainability is dealt with in ways that are not too different from those traditionally employed with respect to financial performance of investments and financial products in general. Indeed, recent reforms of fiduciary duties amend existing provisions simply integrating sustainability factors and risks into them. In all cases, the focus is on end-clients and their sustainability preferences. However, parts of the regulation do not strictly depend on those preferences but respond to prudential criteria which are applicable in all cases, such as the need for financial market participants to integrate sustainability risks into portfolio selection and risk management.

Regulatory policy serves not only the interests of end-investors and users of financial services, but also the economic and financial systems at large. The integration of sustainability in financial management should increase the resilience of the financial system and therefore reduce the risks to financial stability. Moreover, it should help the economy to reduce sustainability risks not only for enterprises but also for humanity by contributing, for instance, to reduce carbon emissions and therefore the impact of climate change. This justifies the choice of regulation made by the EU legislator given the public interest to enhance sustainability and the need to get both financial institutions and their clients involved in this extraordinary challenge. Nonetheless, the function of stewardship codes does not appear to be totally excluded by the rise of stewardship regulation in the EU. Rather, a rethink of the codes' function may be appropriate to the extent that they have ceased to be a substitute for regulation but could still be a complement of the latter, contributing to specify the regulatory principles and norms and to identify best practices in the relevant area of financial services.

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