THE ecgi BLOG

RESPONSIBLE CAPITALISM

THE ECGI BLOG REVIEW | VOL. 1

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About the Blog

Launched in February 2022, the ECGI Blog is a global voice on corporate governance, stewardship and corporate responsibility. It facilitates more timely scholarly reflection without the often long lead-in time and caveated restrictions associated with the publication of academic research.

It complements the already successful ECGI Working Paper Series which is a reliable source of knowledge pertaining to the ecosystem and governance of the corporation, relating to law, finance and economics. Through comment and analysis from the ECGI network and beyond, the Blog aims to enhance the wider understanding of related research, igniting and influencing global debate.

The ECGI Blog focuses on selected themes with global interest throughout the year. The first focus theme. 'Responsible Capitalism', collected 46 articles from the ECGI network, showcasing some of the many global perspectives from academics, practitioners and policymakers on broad or narrow subjects relating to the theme. A selection of these articles is included in this Review for your enjoyment. To continue reading and to access hyperlinks and article references, please visit the Blog section of the ECGI website: https://ecgi.global/blog

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The theme

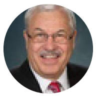
As part of a broader initiative, ECGI is calling for a research debate that seeks to explore the tension between the beneficial outcomes of capitalism, and the unequal consequences which are not aligned with democratic societies and the future of the planet. Responsible Capitalism is an economic system that accommodates private ownership and the pursuit of market opportunities while achieving societal goals. As a pluralist research organisation, ECGI does not have an institutional view. However, the articles collected in the Blog advanced both nuanced and quite strong opinions which makes for thought-provoking reading.

The views

Herman Daems
Stimulating capitalism to act more responsibly is an effective way to make markets, companies and governments respond to today's ESG challenges while safeguarding creativity, innovation, and climate-compatible growth.

Jennifer Hill
Growing calls for 'responsible capitalism' serve as a reminder that corporate governance is not static; nor is it exclusively a private law problem about misalignment of interests between shareholders and managers.

Ronald J. Gilson
For 'distributional decisions', corporations are accountable to the political system, rather than to a board of directors elected increasingly by large institutional investors.



René Stulz
An economy with a well-functioning price system with the right kind of taxes and restrictions and where managers follow Friedman's dictum that firms should maximize shareholder wealth will likely achieve a more responsible outcome than one where some investors and managers (but not others) try to achieve responsible outcomes.

Mark Roe
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Michele Cristostomo
The 'interest of the group' and its corporate purpose can be challenging to pin down for a complex international group, with multiple companies in jurisdictions where different laws and codes apply and contrast.

Dan Puchniak
Fink's proclamation should be cabined within US borders – where empirical evidence suggests it will likely, in any event, amount to nothing.

Vivien Chen
Shareholders' voting rights and accountability within the confines of a corporate entity afford little protection to the citizenry when vast amounts of public funds are used and abused in relative secrecy behind a corporate veil.

Takeo Hoshi
It is not obvious that Japan really suffers from the ill effects that are often associated with shareholder capitalism.


Luis Garicano and Lukasz Rachel
Those who fear an economic collapse precipitated by the oil and gas ban generally think that it is hard to substitute Russian gas. But the marvel of market economy is its adaptability.

Roza Nurgozhaveva
The effect of sanctions can be undermined by several important features of Russia's state ownership system and its governance.

Umakanth Varottil
Proponents of stakeholder capitalism might find some utility in the history and legislative design of Indian corporate law.

Curtis Milhaupt
It is time to acknowledge that deep capitalist engagement with China has not only failed to bring about change in Beijing, it has significantly reduced the leverage of Western governments and the private sector to encourage regime softening in China.

Tom Gosling
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Luca Garavoglia
Who should ultimately decide to trade the value created for shareholders for incremental benefits in favour of stakeholders?

Erik Lidman
Key parts of The European Commission's CSDDD proposal are counterproductive.


Yuriy Gorodnichenko and Florian Berg
Russia's invasion of Ukraine, a massive shock to Russia's human rights profile, exposes some limitations of the current ESG rating systems.

Joon Hyug Chung
An influx of retail investors into the Korean stock market is effectively raising public attention to corporate governance concerns.

Anne Lafarre
There is urgency for the introduction of a harmonized mandatory CSDD as proposed by the European Commission, but to ensure positive impact throughout the entire global value chain, including remediation of adverse impacts, some important improvements are required.

Aurelio Gurrea-Martinez
Despite the shareholder-oriented corporate governance model that prevails in Latin America, the regulatory framework for businesses in most Latin American countries includes many stakeholder-oriented provisions.

Sir Ronald Cohen
The solution to our financing gap now looks obvious: a change in values, leaps in technology, and the measurement of impact are converging to shift capitalism from risk-return to risk-return-impact and bring solutions to the great challenges we face.

J S. Liptrap
Profit-seeking investors may be attracted to the form [of benefit companies] because it is not difficult to externally signal a commitment to social good and simultaneously operate the firm internally like a traditional corporation.

Marta Viegas & Christopher Burt
The mobilization of sustainable capital in poorer regions is one route to a more responsible form of capitalism.

Francisco Reyes Villamizar
The evident benefit that arises from BIC companies consists of the possibility of acting legitimately in lucrative and non-profit spheres.

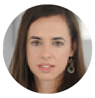
Katja Langenbucher
[For Wirecard and Volkswagen] the portion of the system that failed, the actors that helped bring misbehavior to light, their interdependencies and struggles would have looked very similar in most jurisdictions.

Alan K. Koh
Doing good and making money may be attractive in theory, but the irreducible tension between profit maximization and non-profit motivations may prove difficult to balance in small business practice.

European Company Law Experts Group (ECLE)
The European legislator should not introduce rules that are hard or impossible to apply in order to force Member States to take action on gender balance.

Laura Field
A principles-based approach potentially mitigates some of the costs of complying with rules-based approaches, while still achieving the same broad objective — in this case, increased female representation in boards.

Philipp Krueger
We can try to gauge the potential effects of disclosure requirements by learning from the experiences of countries that have already introduced such requirements in the past.



Kathryn Judge
The growth of today's long and complex supply chains has often helped lead to lower prices and seemingly more efficient modes of production. But it has also introduced new sources of fragility—leaving firms both exposed to more risks and less able to see those risks.

Paul Davies
The British Academy team may not like the purposes boards currently choose, but the law neither mandates that choice nor prevents the board from making a different set of choices.

Brian Cheffins
UK reform of a more radical character should be on the agenda, such as abolition of the UK Corporate Governance Code.

Carlos Portugal Gouvêa
The survey identified that 0.00% of the positions on the boards of directors [in Brazil] surveyed were held by Black people and that only 1.05% of them were held by Brown people.

Giovanni Strampelli
The recent battle for elections to the board at Generali has revitalized the debate on the role and the functioning of slate voting and, perhaps more importantly, has brought the spotlight on how outdated some conventional beliefs on Italian corporate governance are.

Colin Mayer
How precisely purpose should be defined, determined, implemented, measured, and rewarded and how it relates to the ownership, governance and financing of firms are still questions that, nearly thirty years after Bartlett and Ghoshal wrote about it, remain to be adequately researched and resolved.

Jordi Canals
Purpose becomes relevant when it is not only authentic, but also connected with a corporate strategy that generates a sustainable competitive advantage.

Tom Gosling
ESG activism has a bright future, but the Sainsbury's case contains important lessons.

Gaizka Ormazabal
Beyond performance measurement considerations, ESG pay could be one way to signal to the market that the firm is committed to ESG.

Colin Mayer
The issue is not about shareholder versus stakeholder interests but what is meant by the success of the company.

European Company Law Experts Group (ECLE)

Article 25 [of the proposed Due Diligence Directive] is likely to be a major source of confusion and uncertainty, as a result of its vagueness and lack of precision.

Theo Vermaelen
When the first group underperforms and the second group (consisting of coal stocks and oil and gas companies) outperforms as happened in 2022 investors in ESG funds will give up returns for a non-existing benefit (saving the planet).

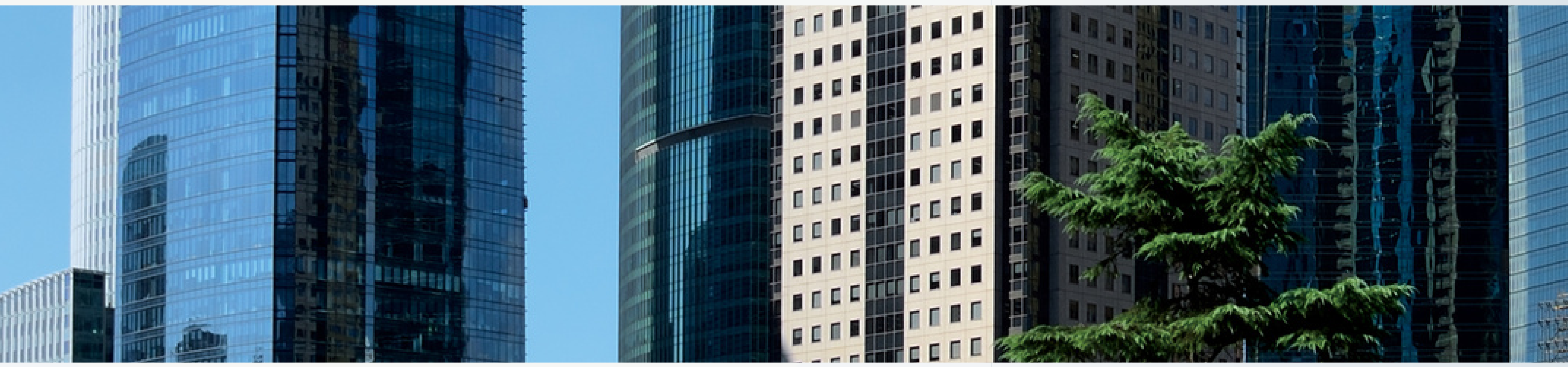
Natania Locke
The South African Code for Responsible Investing, places the ultimate responsibility for stewardship at the door of the asset owner and places no independent stewardship responsibility on the asset manager.

Dionysia Katelouzou
For an ever-growing number of investors, investor stewardship stands at the heart of their investment practices. What it precisely means, however, to be an effective steward of capital is hardly a settled matter.

John Gaffney
Radical revisions to company law may be required to reflect radical visions of stakeholder capitalism.

European Company Law Experts Group (ECLE)

Art. 15 CSDD marks a fundamental policy shift in combating climate change, moving from the reliance on market forces, to reliance not only on conduct regulation, but on punctual and possibly disproportionate governmental intervention.



Capitalism's shortcomings

Herman Daems
ECGI and BNP Paribas Fortis

Introduction and welcome

I am proud to introduce ECGI's new blog which has as its first theme: Responsible Capitalism. This will be an important theme for ECGI research in the years ahead. The issues of sustainability, inequality and exclusion create new challenges for capitalism and corporate governance. Stimulating capitalism to act more responsibly is an effective way to make markets, companies and governments respond to today's ESG challenges while safeguarding creativity, innovation, and climate-compatible growth. ECGI's global network of top-level academics, influential policymakers and concerned business leaders is ideally composed and exceptionally capable of discussing the fundamental challenges facing global capitalism today and tomorrow. A collection of blog submissions are an ideal format to begin to diagnose these fundamental issues and to suggest avenues of research along with remedies and policies to design governance systems that make capitalism behave more responsibly.

Capitalism is a system for the creation and distribution of wealth. Like any human product, capitalism certainly does not work perfectly. It has many shortcomings. But economic history suggests that per capita income levels in countries were capitalism is the dominant system are higher and grow faster over a longer period than in countries that have tried other systems. Other systems, certainly large ones, have not fared better on ecological measures. Our aim should be to acknowledge the shortcomings and failures of capitalism and to look for ways to improve it.

Capitalism has at least four major shortcomings.

First, capitalism leads to inequalities. Although it is probably the case that capitalism improves economic growth and raises average income levels it is certainly not clear that under capitalism income inequality declines and that every citizen benefits from increased growth.
Second, the capitalist system can be unstable. The many financial crises over the past two centuries illustrate this instability.
Third, left on its own, capitalism handles ecological issues and sustainability imperfectly. It is not a surprise that short-termism has become a characteristic of modern capitalism and that there are many appeals for sustainability.
Fourth, many individuals, families and communities do not participate in the capitalist system and are consequently excluded from the wealth creation process. This exclusion happens within countries, as poverty and unemployment levels show, and between countries, as demonstrated by the huge levels of global economic inequality. I believe such exclusion does not take place by design but is, rather, the consequence of how the capitalist system works. The call for measures to make capitalism more inclusive is therefore more than justified.
Making capitalism more responsible means that the capitalistic system must take responsibility for its shortcomings and must develop practices, policies and regulations that correct them. Much of this will be the topics of blog articles and research papers written by scholars, policymakers and business people in the coming months and years. I cannot try to speculate about the ideas that will come forward. But personally, I see two big tracks for capitalism to take greater responsibility for its shortcomings. Other contributions will advocate different tracks.

1. **Business must act more responsibly**

Business is probably the largest participant of the capitalistic system. It must assume greater responsibility for the shortcomings of capitalism. Business cannot correct all shortcomings. But by changing its behavior it can do a lot for making capitalism more sustainable and improving its inclusiveness. Over the last decades business has started to change its behavior from a reckless profit motive to being concerned about its effect on sustainability and inclusiveness. It has done so by changing products, processes and value chains and by providing training such that more people can participate in the economic process and are no longer excluded. I strongly believe that business can take us a long way towards responsible capitalism if it changes its behavior. Those corporations that have developed a purpose, that are working on the United Nations Strategic Development Goals and that have implemented programs to be ESG-compliant demonstrate that corporate behavioral change is possible. Fortunately, corporations have found support from the many asset managers who have created ESG-compliant funds . This is a first track to make capitalism more responsible.

1. **Smart regulation and taxation.**

It would be naïve to solely rely on changes in corporate behavior for making capitalism more responsible. There are too many prisoner dilemmas involved. Further regulation will be necessary in all fields. Regulations are seldom perfect, and they often carry a high cost. But they will be unavoidable because changes in behavior alone will not be enough to make capitalism responsible. The big challenge is to make regulations smart. Smart means that regulations must be effective, i.e., they must reach their goals, and must create value, i.e., the benefits obtained must be larger than the costs they create. Regulation will be necessary to deal with the systemic instability of capitalism and sustainability. To deal with inequality a fair tax code will be necessary.
By underlining this critical research theme with the support of a new blog platform, ECGI is acknowledging that responsible capitalism is feasible and needed. It is taking important steps to move the concept forward for meaningful change.

Herman Daems is Chair of ECGI and Chair of the board of directors of BNP Paribas Fortis. For similar thoughts see his contribution to Inclusive Capitalism. The Pathway to Action. London June 26, 2015, Coalition for Inclusive Capitalism.

Regulation will be necessary to deal with the systemic instability of capitalism and sustainability.

The journey from corporate rights to corporate responsibilities

Jennifer G. Hill
Monash University and ECGI

The term, 'responsible capitalism', inevitably signifies different things to different people. To some, it is an oxymoron. Karl Marx, for example, viewed worker exploitation as an indelible feature of capitalism. For others, 'responsible capitalism' means profit-making without breaching society's rules. Milton Friedman came close to this interpretation, when he famously stated that 'There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud'.

A burgeoning understanding of the meaning of 'responsible capitalism', however, considers that it involves something more than the mere avoidance of deception or fraud in the pursuit of profit-making. Just over 30 years ago, Professor Phillip I. Blumberg noted that much of the historical debate surrounding corporate personality in the United States had centred on the issue of the rights accorded to corporations, particularly constitutional rights. Questions of this kind have by no means disappeared—one only needs to think of the well-known 2014 Hobby Lobby decision, in which the U.S. Supreme Court determined that business corporations constitute 'persons' with a right to claim a statutory religious exemption. Nonetheless, according to Professor Blumberg, the new frontier of modern corporate law and governance would not be about rights, but rather about corporate responsibilities and about how to ensure accountability for corporate actions.

It seems that we have now reached that envisaged frontier and it is reflected in the concept of 'responsible capitalism'. 'Responsible capitalism' is, of course, not the only epithet to express this shift from corporate rights to responsibilities. It intersects and overlaps with a range of other terms, such as 'corporate social responsibility (CSR)'; 'environmental, social and governance (ESG)'; 'corporate culture'; 'corporate purpose'; 'stakeholderism'; and 'corporate reputation', to name just a few that can be readily found in today's corporate governance ether. These terms ('responsible capitalism' included) suggest a different conception of the corporation to the paradigm which inspired Milton Friedman's famous edict and which has underpinned U.S. corporate law over the last four decades. Rather than, à la Friedman doctrine, viewing the corporation as a private enterprise with responsibilities primarily to its shareholders, these epithets present the corporation as a social actor with responsibilities to the community. Nowhere is this theoretical u-turn more apparent than in the 2021 Final Report of the British Academy's Future of the Corporation project. Indeed, the project itself constituted a review of the role of business 'in society'. The Final Report envisages a greater public role for business (and, by implication, corporations), by defining the purpose of business as 'creating profitable solutions for problems of people and planet, and not profiting from creating problems'.

This is by no means the first time in legal history that corporations have been perceived as playing a significant public role. After all, from at least the 17th century, U.K. royal chartered corporations, which provided the foundation for U.S. corporate law, had quasi-public roots and were seen as bodies approved by the State to act in the national interest. By the time that Berle and Means published their classic corporate law treatise in 1932, the authors regarded the corporation as a profoundly ambiguous body, which could be interpreted as falling under public or private law.

And during the early 1970s, a period of great political upheaval and environmental concern, members of the Rockefeller Foundation's board of trustees considered that American corporations 'must assert an unprecedented order of leadership in helping to solve the social problems of our time'.

Yet, from the 1980s onward, the dominant legal paradigm of the corporation has been the 'nexus of contracts' model. This paradigm, which depicts the corporation as a complex network of voluntary bargains between resource holders, placed the corporation firmly within the realm of private law. Under this theory, shareholder interests and corporate performance took centre stage, and the central problem of corporate law was perceived to be the misalignment of interests between shareholders and corporate managers. Acceptance of this paradigm resulted in an outpouring of academic literature, designed to address this fundamental misalignment of interest, in diverse areas, such as takeovers, boards of directors and executive compensation.

> Incentives designed to address problems of corporate performance can exacerbate harm to stakeholders or society as a whole

Growing calls for 'responsible capitalism' serve as a reminder that corporate governance is not static; nor is it exclusively a private law problem about misalignment of interests between shareholders and managers. A second problem is the danger that corporate conduct may result in negative externalities that harm society. As a number of recent scandals, including those examined by a high profile 2019 Royal Commission in my own country, Australia, have demonstrated, incentives designed to address problems of corporate performance can exacerbate harm to stakeholders or society as a whole, by creating perverse incentives for corporate misconduct or unethical behaviour.

'Responsible capitalism' represents a significant shift in the direction of modern corporate governance. It will involve an increased focus on society's expectations of corporations, particularly in an era marked by a cascading series of global financial, environment and health crises. It will also entail recalibration of incentives and regulatory techniques to ensure corporate accountability. There may be broad agreement that capitalism needs to become more 'responsible'. However, the devil will be in the detail and the feasibility of establishing credible incentives and credible metrics. The dangers of 'greenwashing' and malleable environmental metrics in executive pay represent significant hurdles to achieving the goals of 'responsible capitalism'.

Jennifer G. Hill is an ECGI research member and the Bob Baxt AO Chair in Corporate and Commercial Law, Monash Law School, Australia

Can capitalism be responsible?

René Stulz
The Ohio State University and ECGI

There is a wide consensus that some actions in a capitalistic economy can have damaging effects for society and are not responsible in the sense that such actions are inconsistent with sustainability. For brevity, I will focus here on actions that have negative externalities – they impose costs on other economic agents for which these agents are not compensated. An example is pollution. Pollution can be beneficial for a firm, but it hurts economic agents who are not compensated for the damage caused to them. The existence of actions with negative externalities is not intrinsic to capitalism. There are many ways that such actions can be made less likely in a capitalistic economy, but not all approaches are equally efficient. When choosing among approaches to reduce negative externalities, the approaches that have the least cost in terms of economic growth should be chosen and care should be exercised to avoid approaches that could end up in making it less likely that common goals will be achieved.

Though literally capitalism means that capital is owned by the private sector rather than the state, the more useful definition is that capitalism is a system where individuals can pursue market opportunities freely. Capitalism is an economic system and economic agents take actions within that system. Capitalism as such is indifferent as to whether actions are responsible or not. However, a capitalistic economy can make irresponsible actions less likely. In such an economy, individuals respond to price signals. If something has a high price, they will typically buy less of it. The role of price signals is crucial for the allocation of labor and capital to be efficient. When price signals are distorted, the economy grows more slowly or not at all. It is well-established among economists that such a system will deliver optimal outcomes if there are no negative externalities.

> To push economic agents to take responsible actions, the focus should be on selecting the most efficient ways to achieve responsible outcomes.

Externalities are problematic when the actions that lead to costs imposed on other agents do not have a price; if they did have a price, firms would be less likely to take such actions. For instance, if there is no price on pollution, firms will pollute more than if they have to pay for pollution. The obvious response to this problem is to impose costs for negative externalities. Such costs can be imposed through the legal system, in the form of prices, or in the form of restrictions on behavior.

Investors have preferences. They are free to pursue goals that are inconsistent with wealth maximization for a given level of risk. They can decide not to invest in firms that are responsible for particularly onerous negative externalities. By exerting their preferences, investors can influence prices. For instance, in the stock market, investors can affect the cost of capital for firms that are high carbon emitters. By exerting their preferences, investors can impact the direction of the economy and the choices made by firms. If investors prefer lower profits but cleaner air, they can invest accordingly and doing so will change the price signals to which corporations respond as long as enough investors behave that way.

When institutional investors or managers use other people's money, they should only pursue responsible outcomes that those who provide the money – the capital – want. Otherwise, the door would be opened for agency distortions that would hurt capital providers and decrease trust in the investment management industry. If management decides to increase wages beyond the market level to reduce inequality, it does so at the expense of the providers of capital. Effectively, management is stealing from them if they did not sign on for this course of action. Similarly, institutional investors who decide to invest in a way that pursues their preferences for responsibility when their mandate does not give them this goal are failing in their fiduciary duty. They are effectively expropriating the providers of capital by delivering lower pecuniary performance to extract from firms non-pecuniary benefits in the form of achieving outcomes that they find socially preferable. The use of other people's money should not be a way for institutional investors and firms to pursue preferences that shareholders do not have.

Institutional investors can push responsible policies on management of firms through engagement. Success of such policies at the level of a firm or a number of firms may not make the economy more responsible. Such policies could just lead to an inefficient outcome. For instance, if the goal is to reduce carbon emissions, what is relevant is the ultimate reduction in emissions and not what a particular firm does. Firms trying to achieve some outcome concerning emissions on an individual level may lead to a highly inefficient reduction in emissions. It is economics 101 that emissions should be reduced more where the cost of doing so is lower. To achieve an efficient outcome, the price system has to be used or activities have to be restricted. Solutions that do not involve the price system often lead to distortions and inefficiencies. An economy with a well-functioning price system with the right kind of taxes and restrictions and where managers follow Friedman's dictum that firms should maximize shareholder wealth will likely achieve a more responsible outcome than one where some investors and managers (but not others) try to achieve responsible outcomes.
Institutional investors should not try to be successful central planners for our economy by telling firms what projects they can and cannot take with the intent to achieve societal goals. There is no reason for them to think that doing so will be successful in achieving these goals in an efficient manner. They could end up just creating demand and supply imbalances that impose costs on the economy instead of achieving societal goals.

René Stulz is an ECGI Fellow and the Everett D. Reese Chair of Banking and Monetary Economics and the Director of the Dice Center for Research in Financial Economics at the Ohio State University.

Does stock market short-termism make capitalism irresponsible?

Mark Roe
Harvard Law School and ECGI

Stock market short-termism is said to drive ESG and CSR shortfalls, worsening environmental quality and global warming in particular, making the corporation less responsible. A stock market of rapid traders is not a stock market, in the conventional view, that can think about sustainability and climate catastrophe. The recent EU initiative on sustainable capitalism (such as via this study) strongly asserts this proposition, and it is one that is widely believed on both sides of the Atlantic. "The short-term payback periods of financial markets take precedent over the long-term time horizons of ecological and social systems," says one analysis. "The finance world's short-termism will destroy our communities, economies and the planet," the World Economic Forum was told in Davos.

The policy implication of this linkage between short-termism and climate change is quite important since in this view, which seems to be conventional in public policy circles, stock-market-driven short-termism perniciously affects public firms, making them pollute and warm the planet. Thus, the commonly-discussed remedies for stock market short-termism are even more important to implement. To (help) save the planet, we should tax stock trading, enact higher capital gains taxes on short-term holdings than on long-term holdings, reduce shareholder activists' power, and diminish stock markets' capacity to influence firms.

This thinking can give hope to climate activists that solutions (or at least mitigations) through corporate governance reform are at hand. With governments too passive in the face of relentless global warming, climate activists can imagine that corporate governance changes that lengthen corporate horizons, which are more plausibly attainable than, say, a wide and seriously effective carbon tax, can make a major difference and maybe even save the planet from climate catastrophe.

This thinking is conceptually incorrect for the most part and, if policymakers are persuaded by it and act on it, they will not do much good for the environment or for stakeholders, nor will they do much to arrest climate change. The primary stock market characteristic driving climate issues is not a truncated time horizon. It's the corporation's capacity to externalize environmental and climate harms. The two are often conflated but are quite different.

Here's what I mean. Posit a corporation that is exceedingly long-term in its focus, highly valuing the profits it expects to reap decades hence. Will its incentives to pollute and contribute to global warming reverse, as compared to its short-term cousin? In general, no. The pollution problem is that neither the short-term nor the long-term firm internalizes the costs from the corporation's pollution. A corporation that's strongly oriented toward shareholder value over social value will look more closely at the bottom line profit and worry less about the costs society bears from its pollution—those costs are externalized and do not hit the corporation's bottom line. Others suffer from the corporation's pollution, not the corporation itself—and not its stockholders as investors.

It's not that the selfish short-term corporation will pollute while a long-term one will not. Both will pollute across time.

True, time horizons are not absolutely and in all ways absent. Executives may worry about profits on their watch more than long-term profits. But even here, the operative mechanism is that the firm that pollutes does not pay for its pollution. The problem is still primarily one of externalities, not primarily one of truncated time horizons. To deal with the short-term executive, the solution is not so much to lengthen his or her time horizons as to make the firm (or the executive) pay for its pollution, whether that pollution is now, or in the future. Fix the externality problem and one fixes the ESG/CSR problem. Fix the perceived time horizon problem and the polluting firm still pollutes.

The difference between corporate time horizons and externalities can be readily illuminated by comparing corporate overproduction and excessive burning of hydrocarbons to our personal burning of hydrocarbons—when driving our cars, for example. Corporate hydrocarbon burning (and hydrocarbon sales, and other petroleum use) risks climate catastrophe for the planet decades from now. And personal hydrocarbon burning, such as when I drive my car and when you drive yours, has us individually contributing to global warming and to the risk of climate catastrophe decades hence as well.

But our personal shortened time horizons when driving our cars to work are not the principal motivations inducing us to risk climate catastrophe. The primary mechanism here is that neither the polluting corporation nor the gasoline-burning car driver, such as myself and maybe you, absorbs the full costs of their own pollution. These costs are spread over society. So my driving harms the environment, but it does so (1) only to a small degree and (2) with almost no impact to me.

And when the corporation, even the megacorporation, burns hydrocarbons, or finds them, refines them and sells them, it harms the environment, but with almost no negative impact to the corporation. The harms are spread over society generally and not borne primarily by the firm's stockholders, its executives, or its employees.

The costs of the pollution are externalized, but not the profits. The convenience of my driving to work today is nice for me, but the resulting pollution and the car's contribution to environmental degradation are not good and something we car-drivers often regret. However, the costs are borne by society overall. My time horizon is not what counts; my capacity to externalize the costs is what counts.

Why is understanding this incentive—and the difference between time horizon problems and externalization problems—important? Because, as said above, if we overly weight shortened time horizons as the impetus for pollution—thinking that short-term firms pollute while long-term firms do not—policymakers will favor standard policies to reduce stock market short-termism. But they will not reduce pollution and global warming much, or at all. A considerable portion of the public thinking on the subject goes in this erroneous direction.

Thinking that the climate problem is in large measure a stock market time horizon problem makes it easier for policymakers, because that thinking diminishes the pressure they would otherwise feel to pursue effective but politically stressful action. Fulminating against stock market short-termism as causing climate change—and even taxing the corporation or the stock or the trading of the stock—will not motivate anti-government populism but will satisfy it. Unpopular government actions—like enacting an effective carbon tax or taxing us more at the gas pump—will, in contrast, damage a governing party's popularity.

Mark J. Roe is an inaugural ECGI Fellow, and the David Berg Professor at Harvard Law School. The issue considered here—distinguishing externalities from time horizons—is more extensively analyzed in chapter 3 of his book, Missing the Target: Why Stock Market Short-Termism Is Not the Problem (forthcoming, Oxford University Press).

No need for Asia to be woke: Responsible capitalism through an Asian lens

Dan Puchniak
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Larry Fink's 2018 proclamation that every company must show 'how it makes a positive contribution to society' ostensibly woke American CEOs to the need for companies to fulfil a societal purpose beyond profit maximization. The American Business Roundtable's 2019 commitment that business should no longer be run purely for profit is cited as another woke moment for American CEOs to the new reality that corporate purpose matters. However, just as the sun rises first in Asia, there was no need for Asia's CEOs to be woke to the reality that corporate purpose matters.

Two decades ago, in Asia's largest economy, the inaugural 2002 Chinese Corporate Governance Code (CCGC) encouraged listed companies to 'be concerned with the welfare, environmental protection, and public interests of the community' and to 'pay attention to the company's social responsibilities'. Article 5 of the 2006 Chinese Company Law required companies to 'undertake social responsibility'. The 2018 CCGC goes even further by encouraging listed companies to 'actively implement the concept of green development, integrate ecological and environmental protection requirements into the development strategy and corporate governance process, actively participate in the construction of ecological civilization, and play an exemplary role in pollution prevention, resource conservation, and ecological protection'.

As if that was not purposeful enough, it encourages listed companies to assist 'poverty-stricken counties or villages, and actively connect with and earnestly support poverty-stricken areas to develop local industries, train talents, and promote employment'. The newly issued draft of the revised PRC Company Law is also all about purpose; Article 19 states that 'companies should fully consider the interests of the company's employees, consumers and other stakeholders, as well as ecological and environmental protection and other social public interests, to assume social responsibility. The State encourages companies to participate in social welfare activities and publish social responsibility reports.'

China was clearly awake to corporate purpose long before Fink's proclamation; on paper, it is as purposeful as can be. What is less clear, is whether Chinese companies can fulfil these lofty purposes. Another question that looms large is: Can Chinese companies stay on their world changing trajectory in an economy where the Chinese Communist Party appears to be ratcheting-up its control over which purposes companies may serve? Fewer purposes and a narrower focus on maximizing shareholder value may be exactly what is required in China at this moment – the opposite of what America's awakening prescribes.

The story of Japanese corporate governance also makes America's woke moment appear like bad medicine. Japan is (in)famous for its 'company community' corporate governance model in which lifetime employees, not shareholders, define corporate purpose. As Asia's second largest economy, the world watched as former Prime Minister Abe Shinzo launched an arrow which aimed to make shareholder primacy the target for corporate Japan. This never fully materialized and now his successor, Prime Minster Kishida Fumio, under the slogan of 'new capitalism', 'talks about the importance of other stakeholders in businesses, such as workers and customers, evoking the Edo-era merchant philosophy of sanpo-yoshi, or "three-way good" for buyers, sellers and society'. Again, many believe that Japan should be moving away from its stakeholder-centred approach towards having a more shareholder primacy focus – the opposite of what America's awakening prescribes.

Corporate governance in India, Asia's third largest economy, seems to repeat this story yet again. It has historically adopted a stakeholder approach and doubled down on stakeholderism in the India Companies Act 2013. The Companies Act requires directors to 'act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment'.[9] More strikingly, it mandates large companies to spend 2% of average net profit on Corporate Social Responsibility. This hardly seems like a corporate governance system that needed to be woke by Fink.

Throughout Asia, listed state-owned enterprises define a new form of capitalism which combines the state as the controlling shareholder with the private investors as minority shareholders in 'mixed-ownership companies'. Singapore arguably provides the most successful example of 'mixed-ownership' where the state is indirectly the country's largest shareholder and it has developed an economy with a GDP per person higher than every G7 country.

The Singapore mixed-ownership system has been successful because the state has developed an institutional architecture to ensure that profit maximization – and not politics – drives how its mixed-ownership listed companies are governed. However, as the government benefits from the success of these companies and Singapore citizens in turn benefit from the government's social programs, Singapore's model may ultimately be the most purposeful of all. That its success lies in the unique institutional architecture that ensures state control companies focus on profit maximization runs against Fink's proclamation.

This is where the idea of 'responsible capitalism' may have some intellectual and practical leverage – provided it is framed properly. Asia demonstrates that different jurisdictions have different understandings of the purpose that corporations should serve and there is no one model that fits all. But: corporations must be governed, within the context of their environment, in a way that benefits the public good. This much is certain. How this is achieved will vary from jurisdiction to jurisdiction and within each jurisdiction over time. Being responsible means ensuring that the purpose that corporations (should) serve is aligned with maximizing the public good in each jurisdiction at any given time. What is also certain is that the existential threat of climate change can only be successfully addressed through intervention on a global scale. Global action will require accepting diversity in approaches, allowing each system to achieve climate change goals in their own way. As such, outcomes should be the focus of responsible capitalism, not prescribed methods of achieving those outcomes. In short, Fink's proclamation should be cabined within US borders – where empirical evidence suggests it will likely, in any event, amount to nothing

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Kishida's New Form of Capitalism

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In many parts of the world, capitalism is under attack. Capitalism, especially its recent neo-liberal form, is alleged to have widened inequality, destroyed the middle class, and exacerbated if not caused climate change. Japan is not an exception. If anything, the discussion has been more active in Japan because the movement toward a new and better form of capitalism has now gained a powerful advocate: Prime Minister Fumio Kishida.

Mr. Kishida, who became the Prime Minister in October last year, put forward the "new form of capitalism" as the main theme for his economic policy. At the beginning, the concept of and the policy package that would lead to the "new form of capitalism" were not entirely clear. Through the discussion in the Committees to Implement the New Form of Capitalism that the Kishida Administration has established and through various speeches that Kishida delivered, the concept and the contents of the new form of capitalism have become clearer. The idea of Kishida's new form of capitalism is expressed most clearly in an article written by Mr. Kishida himself and published in the February 2022 issue of Bungei Shunju (a monthly magazine roughly comparable to the Atlantic and the New Yorker in the U.S.).

I start by briefly summarizing this Bungei Shunju article to clarify what the new form of capitalism is. I then discuss how much Kishida's policy is different from his immediate predecessors' policies. Finally, I ask whether the new form of capitalism, if pursued seriously, is a right prescription for the current Japan.

Kishida points out that neoliberal capitalism became the mainstream for advanced economies since the 1980s but its harmful effects including expansion of income inequality and increased burden on the natural environment are now clear. Japanese corporations used to care about various stakeholders including employees, customers, suppliers, and communities, in addition to shareholders, but now the shareholders dominate and everything is determined by the market and competition. Kishida argues that Japan now needs to reverse the course and lead the world in the efforts to establish the new form of capitalism "that overcomes the global challenges of division and disparity."

Kishida lists three keywords for his policy toward the new form of capitalism: human capital investment, public-private partnership, and local communities. First, investing in "people" should be the hallmark of new capitalism: a corporation should measure the value of human capital and disclose that on the balance sheet. Second, rather than leaving it to the market and competition, public and private sectors should cooperate to create industries with high value-added components. Startups will play an especially important role and the government should foster them. Third, the new form of capitalism should promote local economies. To do that, the government will invest in the digital infrastructure such as high speed communication networks under the banner of "digital garden city concept."

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Thus, Kishida's new form of capitalism is very much similar to other concepts of improved and sustainable capitalism, such as "responsible capitalism." It tries to reduce the influence of shareholders and market competition on corporate management, encourage corporate social responsibility, and emphasize the role of government involvement/partnership with private business. This concept of the new form of capitalism appears quite a contrast to the economic policies of Kishida's predecessors. Prime Minister Shinzo Abe, for example, placed corporate governance reform as one of the most important parts of the agenda in his Abenomics reforms and tried to make the management of Japanese companies more responsive to the interests of shareholders and investors. Kishida now argues that the corporations are swayed too much by shareholders and markets at the expense of social welfare.

The actual policies that Kishida suggests so far, however, are not much different from the economic policies of Abe and Yoshihide Suga. It was Abe who introduced the tax incentive for corporations that raise wages and salaries. Kishida is just expanding that to realize the "virtuous cycle of growth and distribution," which is exactly the same slogan that Abe used.

The public-private partnership to increase productivity and profitability was another approach that was emphasized in Abenomics. So was the promotion of startups. Increasing human capital investment and promoting local economies were also important parts of Abenomics. Digital transformation, green transformation, and economic security emerged as important policy areas toward the end of the Abe administration and became central parts of the economic policy of the Suga administration.

Thus, Kishida's "new" form of capitalism is more rhetoric than an actual policy change. It does not represent a major departure from his predecessors' policies. But, we do not have to be disappointed, because reversing the direction of corporate governance reform in Japan does not seem to be the right prescription for Japan.

First, it is not obvious that Japan really suffers from the ill effects that are often associated with shareholder capitalism. The income inequality measured by Gini coefficient (after redistribution), for example, has not increased after Japan allegedly embarked on neoliberal reforms under the Koizumi administration in 2000. The Gini coefficient actually fell slightly from 0.38 in 1999 to 0.37 in 2017. The proportion of Japanese people who consider themselves belonging to the middle class has also stayed high. It actually increased from 89.3% in 1980 to 92.7% in 2018.

Second, the shift toward shareholder capitalism in Japan, to the extent that it has happened, is not responsible for major economic problems. For example, the stagnation of wages is not a result of more emphasis on market competition and shareholder governance. On the contrary, the wage stagnation in Japan has a lot to do with the lack of flexibility in the labor market. An easy way to tell this is to look at wages of full-time workers, whose employment is shielded from market forces, and those of part-time workers separately.

The stagnation of wages turns out to be a result of stagnant full-time wages. As I showed in a paper with Anil Kashyap ("The Great Disconnect: The Decoupling of Wage and Price Inflation in Japan"), the average wage for full-time workers has been almost the same in nominal term since the late 1990s. In contrast, the average wage for part-time workers has increased steadily although the level is still lower than that for full-time workers. We also find that the full-time wages have been less responsive to market conditions (measured by the unemployment rate or the job offers to applicants ratio) than part-time wages. Thus, what Japan needs is more market forces, not less, at least in this aspect.

Finally, we can list additional problems of the new form of capitalism for the current Japan. By focusing on harmful effects of market competition, the call for a new form of capitalism gives an excuse to the firms that do not make efforts to raise productivity and profitability. The pressure to pay attention to the environment and/or social impact of corporations may also end up hurting the endeavor by more serious managers to improve productivity and profitability. Perhaps even more importantly, the new form of capitalism, by forcing the responsibility to address environmental issues to corporations, allows the government to avoid more effective but politically difficult solutions such as introducing a carbon tax.

Kishida's "new" form of capitalism is more rhetoric than an actual policy change

In summary, Kishida's new form of capitalism is roughly the same as other concepts of improved and sustainable capitalism such as "responsible capitalism." The contents of Kishida's policy, however, do not represent much of a departure from his predecessors' policies that allegedly moved Japanese corporate governance too much in the direction towards shareholder capitalism. It may be fortunate for Japan that the Kishida administration has not seriously embarked on changing the course (back) to the "new" form of capitalism, because it does not seem to be the right strategy currently for Japan.

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Supply Chain Liability in the Corporate Sustainability Due Diligence Directive Proposal

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The proposal of Corporate Sustainability Due Diligence Directive (CSDDD) establishes 'due diligence' obligations, to be implemented by Member States, requiring companies to identify, prevent or at least mitigate, and ultimately terminate adverse impacts on human rights and environmental protection by them, their subsidiaries, and their supply chain partners. Failure to do so may expose the parent company to administrative sanctions and civil liability. Focusing on the latter, I will explain that establishing a supply chain liability, the EU could counter the strategic use of limited liability to avoid damage compensation for human and environmental degradation. However, the current proposal is ineffective and possibly counterproductive as it fails to address the crucial issue of the burden of proof.

In economics, adverse impacts on human rights and environmental protection are negative externalities. Because individuals and corporations do not bear the full social cost of human and environmental degradation, they produce too much of it. Although this may sound cynical, economics helps clarify the meaning of sustainability as correcting negative externalities of this kind. This, in turn, means making individuals and corporations internalize the social cost of their actions, which governments have been trying to do via taxes, regulation, and liability rules. Governments have been struggling with making corporations internalize externalities.

The recent emphasis on corporate and investors' responsibility for sustainable development, for instance – as I explain here – in the EU Taxonomy Regulation, acknowledges government limitations in correcting corporate externalities. The CSDDD's expanding corporate liability goes in the same direction.

Corporations can escape government regulation because, to a large extent, they can choose the jurisdiction governing them through the decision where and what lines of business to incorporate. Part of the problem is that different jurisdictions cope with externalities differently, depending on the relative influence of lobbies on taxation and regulation. A bigger problem is that corporations anywhere enjoy limited liability allowing them to externalize social cost even when, ex-post, they would be liable for the harm done. When the liability is higher than the company's equity, the company is judgment proof. Ex-ante, such a company has incentive to engage in human and environmental degradation because, if caught, it will not be able to pay damages. More important, undercapitalized companies can be created precisely with the purpose to externalize social cost. In principle, the supply chain liability established by the CSDDD deals with this problem.

> Making parent companies unlimitedly liable for damages by subsidiaries would seem the obvious solution.

Article 22 of the CSDDD proposal makes all companies in scope liable for failure to comply with due diligence obligations. The innovation here is that companies are liable for the damages caused by their subsidiaries and supply chain partners, wherever in the world they are. This aims to stop companies from evading tort liability by concentrating potentially harmful activities in judgment-proof subsidiaries. Overcoming limited liability in this context has been long advocated by the law & economics literature to make corporations internalize negative externalities (Hansmann & Kraakman 1991). The fact that corporate groups use limited liability strategically is borne out by the empirical evidence. A recent finance study found that the introduction of parent liability protection in environmental liability cases by the U.S. Supreme Court resulted in a 5% to 9% increase in pollutant emissions by subsidiaries.

Making parent companies unlimitedly liable for damages by subsidiaries would seem the obvious solution. The CSDDD proposal is functionally equivalent as it imposes directly on the parent failing to exercise due diligence liability for the damages by subsidiaries (and supply chain partners, as discussed below). Regulatory arbitrage undermines both approaches. First, liability for damages by subsidiaries depends on some definition of subsidiary control, such as the CSDDD reference to 'controlled undertakings' based on the Transparency Directive. Corporate groups can get around this definition. Second, the CSDDD aims to cover also non-EU companies having sufficiently large turnover in the EU. However, non-EU parents can escape liability operating in the EU territory through subsidiaries, whose liability does not carry on to the non-EU parent. To avoid regulatory arbitrage, Hansmann and Kraakman advocated a simpler rule: unlimited shareholder liability towards tort victims with extraterritorial reach. Although the CSDDD falls short of this approach, it addresses another loophole.

Even if unlimitedly liable, shareholders could enjoy limited liability by outsourcing potentially harmful activities to formally independent corporations and share in the benefit of cost externalization by paying a lower price for inputs or receiving a higher price for outputs. A recent job market paper uncovers evidence of supply chain's strategic disaggregation. The CSDDD tackles supply chain's strategic disaggregation by expanding liability to the operation of suppliers or customers, also indirect, in 'established business relationships.' However, companies can escape supply chain liability too. Firstly, liability depends on vague standards such as failure to take 'appropriate' measures, though some required actions are identified more precisely. Moreover, companies are not liable for damages by indirect partners if they have requested from the direct partners contractual assurance that due diligence obligations will be passed on, and set up a system to verify compliance, unless it is 'unreasonable' to expect that these measures are effective. Not only does this approach call for box ticking, but it also makes the effectiveness of supply chain liability dependent on who has the burden of proof. Liability will not bite if victims must prove that due diligence measures were unreasonable. Surprisingly, in Recital 58, the CSDDD proposal leaves this matter to Member States.

Failing to legislate on the burden of proof seems to be a fatal mistake of the CSDDD proposal. Whereas placing the burden of proof on the victims would undermine liability's effectiveness, leaving the choice to national law is worse. Varying national rules call for regulatory arbitrage. Companies will rearrange their supply chains to minimize liability exposure, frustrating the purpose of supply chain liability. On the one hand, liability will not help internalise externalities as corporations can evade it. On the other hand, rearranging supply chain partners to evade liability creates additional inefficiency as it increases the transaction cost of make-or-buy decisions.

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What does stakeholder capitalism mean for investors?

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The widespread loss of trust in shareholder value and calls for a move to a more stakeholder-oriented model are undeniable. Expectations of investors to address societal problems are growing. However, the only source of legitimacy for investor action comes from client mandates and fiduciary duty. Sometimes addressing stakeholder issues will be consistent with long-term shareholder value creation. But not always. Pursuing stakeholder interests at a cost to clients without their consent is a misappropriation of property rights.

Yet the way in which stakeholder issues make their way into the decision-making process can seem chaotic at times. The client mandate or fund prospectus is often a technical document that doesn't explain how clients should expect investors to act on stakeholder issues. The risk then is that the asset manager's own priorities take over, perhaps motivated by marketing considerations. Interest groups take advantage of societal concerns to push a particular agenda, and the loudest and most effective campaigners win. Investor governance departments then promote a range of issues that appear to companies on the receiving end to be uninformed and disconnected from business priorities or the investment thesis. So investors need to get much better at prioritising, and articulating why they are prioritising, stakeholder issues.

The following three-part test was developed as part of a year-long collaboration during 2021 between The Investor Forum and the Centre for Corporate Governance at London Business School, titled: What does stakeholder capitalism mean for investors? Investors have legitimacy to act on a stakeholder issue when all three parts of the test are met.

1. **Materiality**

In order for investors to have a mandate for action on a stakeholder issue, the stakeholder should be material. Investors are used to thinking about stakeholders that have a material impact on a company's financial performance. But materiality operates in two directions: a company that has a large negative impact on a stakeholder may well find that at some point the same stakeholder becomes financially material to the company. Carbon emissions are a great example of where companies have had a material impact on the environment for a long time, but only recently has this impact translated into a material financial issue for the companies themselves as a result of a combination of increased scientific knowledge, changing consumer attitudes and evolving economic and regulatory pathways towards net zero.
Another reason for action is intrinsic materiality: clients have non-financial goals and preferences for how their portfolio is managed regardless of whether that reduces returns, or the issue may reflect a desirable minimum standard on a societal basis – for example human rights standards.

2. **Efficacy**

There should be a realistic prospect of investor action bringing about change in the real world. Investors only have indirect impact, through the influence they have on investee company actions. For this reason, the influence investors can have on real-world outcomes is often less than claimed.
Claiming credit for real-world impact that cannot be justified by the evidence is simply green-washing. Integrity relating to claims for real-world impacts will be an important part of trustworthy stakeholder-oriented behaviour by the investment industry.

3. Comparative advantage

Investors should act where they are well-placed to address the issue, either individually or collectively, and when compared with other actors, for example government or stakeholders themselves.

Just because an issue is important does not mean that everyone should act upon it. The list of "systemic issues" on which investors are urged to act has grown to include climate change, inequality, human rights, diversity, deforestation, biodiversity, antimicrobial resistance, artificial intelligence, and fair distribution of COVID-19 vaccines.

While these issues are all important, not all of them have systemic valuation impacts across the market that can usefully be addressed by investors. We either need to admit that some of these objectives are being pursued for non-financial reasons, and get the clear mandate from clients to do that, or recognise that there may be other parties than investors better placed to pursue them, in particular government.

This links to the topic of political legitimacy. In a number of stakeholder areas there is significant risk of investors being drawn into promoting activity that is fundamentally political in nature. Everybody wants their issue to be prioritised. But one person's essential priority is another person's grave error. Although investors' clients are drawn from across society, on a vote-weighted basis they are not politically representative. There is risk of investor action on stakeholder issues decreasing, rather than increasing, trust if it is seen to be a way that an elite, formed of investors' most valuable client segments, can use their financial firepower to bypass the political process.

So investors need to be thoughtful about getting too far ahead of political consensus on the stakeholder issues they act on. Of course, the role of investor (and broader business) leadership is relevant here. Business can play a role in influencing societal attitudes, as well as responding to them. This has arguably happened in relation to climate change where investor and corporate action on the issue has made it easier for government itself to act. But it is a delicate balance.

An underemphasised area is the role investors can play to support and maintain the robust institutions and regulation essential to the functioning of capitalism, through influencing responsible corporate lobbying activity, tax policies and so on. This is less politically fraught, although even here one person's enabling regulation is another's overweening interference of the state.

The investor community has a legitimate role in addressing stakeholder issues. However, investors need to be extremely clear on their mandate for pursuing such issues and on the likely overall effectiveness of their actions. Only on this foundation can investors reconcile responsiveness to stakeholder issues with adherence to fiduciary duty. And through that process create the circumstances for shareholder value to be seen as part of the solution rather than part of the problem.

This is what stakeholder capitalism means for investors.

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Why do sanctions against Russia miss the target? A corporate governance perspective

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Vladimir Putin's decision to invade Ukraine has created a new reality for Russia's isolation. As the result of "unprecedented" and "devastating" sanctions against Moscow, Russia's economy faces rising inflation, unemployment, and the worst economic recession in decades. Experts predict that the Russian economy could shrink by 8% this year – a record low since 1994. It might appear that sanctions have successfully reached their goal by putting Russia's economy and Putin's regime on their knees. But do they? Are these sanctions efficient as they seem or are claimed to be? How do the introduced penalties impact the prospects of green development?

Are anti-Russia sanctions as efficient as they seem to be?

The history of sanctions against Russia can be traced back to 2014, when Russia violated international law and annexed the Crimea Peninsula. Back then, the West introduced coordinated sanctions that, among the rest, restricted access to Western financial markets and services for selected Russian state-owned enterprises and placed embargos on exports of specific high-tech and military equipment to Russia. Over the years, the sanctions list grew with the same narrative that sanctions "hit the bullseye of the Putin regime" and successfully prevent escalation in Ukraine. Obviously, it was a false assumption that exposed a weak link between the sanctions and Russia's actual economic, political, and social conditions.

Growing economic pressure from the West has already expedited two major trends of Russia's economy: The lack of economic growth and the state sector's expansion. According to the World Bank data, Russia's GDP growth was less than half of the global average for the past decade. In 2020, it shrunk to -3%, the lowest since the financial crisis of 2008. At the same time, the state's dominance in Russia's economy became more profound.

The Federal Antimonopoly Service of the Russian Federation revealed that the combined contribution of state-owned enterprises (SOEs) to Russia's GDP in 2018 reached 60 percent. The current sanctions will uphold this expansion putting Russian SOEs in the spotlight. However, the effect of those sanctions can be undermined by several important features of Russia's state ownership system and its governance.

First, SOEs in Russia are decentralized and heterogeneous. The key federal property owners are state corporations. They control a broad portfolio of companies resembling a classic holding company structure that governs subsidiaries and affiliated organizations based on direct, indirect, or cross-shareholding. Their portfolio companies have a commercial focus and are very diverse in terms of industries, supply chains, markets, and organizational forms. Despite the term 'corporation' in their title, state corporations are unincorporated non-profit entities that have a clear non-financial focus – the interests of the Russian state. This means that: (1) state corporations' incentives are not driven by financial results; and, (2) they are not the main sources of revenues, but their portfolio companies are. In other words, the sanctions focused on state corporations might miss the real target – portfolio companies that fall outside the category of SOEs and, as a result, are hardly spotted by the sanctions.

Second, the state is a minority shareholder in half of incorporated SOEs in Russia. Notwithstanding a minority share, the state still utilizes several governance tools to pursue its interests, including board and audit commission nominations, cumulative and qualified majority voting, access to financial and other corporate documents, 'golden shares,' and legislative provisions that protect the state's share from any dilution. Minority shareholding allows the state to exercise actual control over a much larger number of profitable companies, which again are not covered by the sanctions.

Third, Russia's state assets management lacks a correlation between management remuneration and the companies' financial performance. There is no solid link between profit and management incentives in many SOEs, including the largest exporters Gazprom and Rosneft. Therefore, financial losses resulting from the sanctions would not substantially affect incentive structures of management existing in these SOEs.

Finally, as of December 2021, China was among Russia's top trading partners, with 13.2% of Russia's total exports. Along with other BRIC countries, China has not been rushing to join the sanctions. European countries aggregately accounted for another large trading portion – almost 38% of Russia's total exports in 2020. The same year, 26% of the EU's oil imports and 40% of the gas imports were delivered by Russia. The explicit dependence on Russia's mineral resources explains why Western countries have been avoiding targeting Russia's commodity exporters directly until recently. Only after Russia's invasion, multinational oil companies have openly started distancing themselves from their Russian partners amid public pressure. Germany announced that it froze the Nord Stream 2 pipeline project, and the US declared a ban on Russian oil imports.

It is still unlikely that the EU will follow the US's example by introducing an embargo on Russia's oil and gas in the near future since Europe is in a much more vulnerable energy position compared to the US.

However, even if the EU decides to ban Russian oil and gas, population and economic growth will inevitably boost global energy consumption, particularly in developing Asian countries. According to the US Energy Information Administration (EIA) experts, this consumption will increase by nearly 50% in the next 30 years, with petroleum and other liquid fuels remaining the world's largest energy source. This means that despite the US and even perhaps the EU decisions, there will be a strong demand for Russian energy globally, especially in Asia.

The prospects of green development

Russia is the largest country in the world that spans nine time zones. It is also one of the richest countries for natural resources, including oil, gas, and minerals. Even before the current sanctions were imposed, Russia's economy had already suffered from low energy efficiency, unsustainable use of resources, obsolete production processes, and, as a result, deep ecological problems.

More than 20% of the world's forests are in Russia. In 2018, Russia ranked first in the world in terms of the rate of loss of wild, most ecologically valuable forests. In Russia, the climate warms about 2.5 times faster than the global average. Therefore, Russia's ecological stagnation impacts not only Russia but the entire continent and beyond.

It is worth mentioning that due to international market integration, Russian companies and financial institutions have achieved a certain amount of progress in incorporating ESG policies in their operations. In 2019, the Moscow Stock Exchange joined the international initiative 'Exchanges for Sustainable Development' and launched a special section for sustainable development securities that included 'green' and social bonds. Large commercial banks started offering green and responsible financial instruments and limited loans to companies with unacceptably high ESG-associated risks. Companies increasingly issued non-financial reports following the GRI (Global reporting initiative) standards. The Social Charter of Russian Business united 270 organizations that share responsible business principles. Finally, the Central Bank of Russia introduced the Recommendations on implementing the principles of responsible investment.

However, the sanctions might put this progress on hold. The introduced restrictions will accelerate Russia's economic and technological decline while transitioning to a green economy and decarbonization requires cutting-edge technologies, capital, and effective institutions. Russia's further isolation from crucial markets and technologies will have a far-reaching and detrimental impact on the global ecology and climate. The sanctions on Russia will deprive "Russia's industry from the technologies desperately needed today to build a future", as EU President Ursula von der Leyen put it. However, the international community should understand that it is not only Russia's future, but that of the world, which could be at stake – another unfortunate victim of the invasion of Ukraine.

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ESG ratings and the case of extreme human rights violations

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ESG investment offers an opportunity to align investment decisions with values. The idea is simple and noble. An independent rater examines how a corporation performs along three key dimensions: environmental, social, governance (hence, ESG). Using these ratings, investors can put their money in responsible businesses. This idea has been wildly successful: more than 3,000 investors with a combined $100 trillion in assets under management have signed a commitment to use ESG information for their investments. Of course, reaching a verdict on a complex business is never easy, and hence ratings are only imprecise signals about a commitment to ESG. But these signals have the potential to be valuable. A high ESG score can open access to vast funding provided by pension funds, insurance companies, and other investors interested in supporting responsible businesses. Unsurprisingly, firms cherish their ESG scores.

Russia's invasion of Ukraine, a massive shock to Russia's human rights profile, exposes some limitations of the current ESG rating systems. The West responded with unprecedented sanctions to punish the aggressor and prevent the latter from supporting its army with new weapons. To reduce reputation risk, some firms such as McDonald's and Coca-Cola halted sales either temporarily or indefinitely in the case of Starbucks. Others, such as Société Générale and Metro, decided to stay.

The reaction of MSCI, a major provider of ESG ratings, came almost immediately for Russian firms: most of them seem to be downgraded to a rating that makes it theoretically impossible to appear in an ESG portfolio.

But what happened to firms domiciled in countries respecting the rule of law that did not stop their business ties with Russia? Put differently, how do we rate firms that are exposed to extreme human rights violations with only parts of their revenue stream? MSCI's choices seem clear, as Société Générale stays stable at the highest possible rating AAA and Metro at AA. This inaction suggests several crucial problems with the current system of ESG ratings.

First, firms can substitute bad behavior with good behavior as most ESG ratings are linear weighted averages within sectors. For instance, Nestlé is a leader regarding Water Stress and Corporate Governance for MSCI. Hence, Water Stress can compensate for an abysmal human rights track record. And although Nestlé has taken stronger action in recent days, this substitution quandary for ratings providers remains.

Second, the measurement methodologies are not transparent. Users of ESG ratings have no ability to determine how the human rights record of a company is judged and potential exposure to risks. For example, products may end up in nefarious uses. Germany's Bosch, a major truck parts supplier, discovered that these parts were found in Russian military vehicles. Upon learning this information, Bosch halted deliveries, but the damage had been done. Without knowing how the raters assess Bosch, we cannot know in advance how such cases are treated. We also cannot productively scrutinize the raters' methodologies.

Russia's invasion of Ukraine exposes some limitations of the current ESG rating systems.

Third, extreme human rights violations by a country are difficult to separate entirely from a firm. A firm that operates in such a country supports the regime through taxes. Similarly, a firm that operates in a regime where corruption is widespread might not be able to do business without engaging in corruption.

How can we address these problems?

First and most importantly, ESG raters should be more transparent. Some form of government regulation may be necessary. The European Commission plans to seek stakeholder views on the use of ESG ratings by market participants and the functioning and dynamics of the market, while the SEC listed ESG rating practices as a key examination focus.

Second, MSCI and other ESG raters can provide more warnings about potential risks associated with specific businesses. For example, KLD, a provider of ESG scores acquired by MSCI and discontinued, issued flags for firms operating in questionable regimes (e.g., firms doing business with the apartheid regime in South Africa received those flags; similar flags were issued for firms connected to Sudan). These flags or similar warnings would give portfolio managers the ability to make an informed choice regarding their investments. This would also prompt quicker reactions when human rights records deteriorate.

Third, some issues are so significant, such as extreme human rights violations, that they should maybe not be able to be compensated by other issues. Indeed, some indicators could be capped by the sovereign score of the country where the firm operates. For instance, credit risk ratings agencies do not allow firms to have a much better rating than the sovereign and effectively cap these ratings. A mechanism like that does not exist for ESG ratings.

But what about ESG portfolio managers facing the difficult choice to override ratings today? Portfolio managers need to assess what firms are exposed to Russia in their portfolios. They can use financial services data to figure out how much the firms in question are exposed to business in or with Russia by looking at the revenue streams. Then, it is just the act of downgrading the rating themselves. Furthermore, they could engage with ratings agencies, to discuss how ESG ratings methodologies should evolve.

In summary, the Russian war in Ukraine exposes important limitations in current ESG rating methodologies. ESG investors are facing difficult choices and might be forced to overrule ESG ratings to realign portfolios with their values. Undoubtedly, regulators and ratings agencies have improvements in their sights, however the current situation and powerful public sentiment has just made them considerably more urgent.

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Democracy as a Stakeholder

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Today, there is a growing demand for companies to be responsible to the planet and society. This is justified given the harm they are inflicting and the potential contribution they can make. It is also pleasing to see many companies responding to such demand proactively. However, we know that this is not the only channel available to make capitalism responsible. Historically, stakeholder-oriented policy reforms were given precedence over shareholder-oriented capitalism to achieve this goal. Such measures include labor laws, workplace safety laws, consumer protection laws, and environmental laws (just to name a few).

However, for this policy reform channel to work properly, we need a system that can translate public will into legislative action. We call this democracy. Yet, the legislative process is often gridlocked, delaying the enactment of important stakeholder-oriented reform measures. To make matters worse, the pre-existing laws are not strictly enforced. Who is responsible for this? Powerful capitalists are most certainly amongst the lot. Refusing to remain passive rule-takers, they often choose to become rule-setters or even rule-busters. They use their might to distort the legislative process and weaken law enforcement by lobbying politicians, policymakers, prosecutors, and judges. This blocks the introduction of new reform measures and weakens the existing ones. Democracy is thus put at stake.

There is no need to go back into history to illustrate this point. Many countries are experiencing it today. Let me present the case of Korea, where people in decision-making positions often succumb to pressures from capitalists running big businesses (family-controlled business groups, also known as chaebols and, more recently, large platform companies).

The first to be mentioned are the Korean presidents and the ruling party leaders. During elections, they promise to reform big businesses. Once in power, however, they embrace the capitalists that run these big businesses as their partners. Big businesses pledge to increase investment and employment that help with the presidents' approval rating. Presidents and ruling party leaders, in return, jettison the promised reform measures or worse, grant explicit favors, such as special pardons to convicted capitalists. A clear example of the rule of law breaking apart!

Second in the line are the Korean bureaucrats. It is a well-established norm for them to be hired by large law or accounting firms upon their retirement. Their new role then is to lobby former colleagues for the benefit of their clients – big businesses. In return, they get rewarded handsomely. Sometimes, they are even offered to become outside directors of major public corporations, only to act as lobbyists. What is more concerning is the way this changes the behavior of the bureaucrats currently in office. Foreseeing such lucrative future job opportunities, they seldom take actions against big businesses.

Third, we come to Korean prosecutors and judges. Like Korean bureaucrats, they also receive lucrative job offers upon retirement. Capitalists hire them as criminal defense lawyers and pay them exorbitant fees as compensation. The expectation is that their tight connections with their former colleagues who are still in office will help with reducing sentences. Historically, this has proven to be true. Typically, the maximum sentence capitalists running big businesses received was a three-year imprisonment, suspended for five-years. In Korea, they are too big to be jailed.

The fourth to be held accountable are the Korean journalists. In the past, by unveiling truth, they played an important role in fighting against dictatorships and winning political democracy. Today, they are called upon to do the same against big businesses, but they fail. Media companies, whose major advertisement revenue comes from big businesses, seldom let their journalists expose corporate wrongdoings. Sometimes, the journalists go even as far as taking a proactive stance and advocating pro-capitalist policies or propagating fake news to thwart reform.

The fifth to be mentioned are the Korean academics. They are also silenced by the power of capital. Corporate donations and revenues from corporate executive programs are important financial sources for many Korean universities. Furthermore, testifying in court in favor of big businesses is an important source of income for professors. They are also offered outside director positions in corporations, which further increases their financial reliance on and thus, their loyalties to, big businesses. It is worth noting that a whopping 35 percent of the outside directors of Korean firms are such academics. Together with former bureaucrats, prosecutors, and judges, this percentage rises to 70 percent. In Korea, the outside director system is manipulated to reinforce plutocracy.

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The consequence of such plutocracy is costly. We lose one of the two main channels that can make capitalism responsible. With the stakeholder-oriented policy reform no longer being viable, we are left with stakeholder-oriented management alone. Would even this channel work under plutocracy? Probably not. It is inconceivable that a capitalist, who is lobbying hard to block stakeholder-oriented policy reforms, would voluntarily manage companies in a responsible way.

Without true democracy, we will have no planet, nor social justice.

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Did the German stakeholder model fail in Wirecard and Volkswagen?

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When asked recently why "the German stakeholder model failed so spectacularly in Wirecard and Volkswagen", my immediate reaction was "it was not the German stakeholder model that failed". What we are looking at in Wirecard and Volkswagen are familiar governance shortcomings, seen in corporate scandals such as Enron, Theranos or Greensill. In a policy briefing for the European Parliament we highlighted for Wirecard how each traditional corporate governance actor failed in ways we have seen in similar scandals. This goes to the company's internal control system, its supervisory board, its external audit, the oversight bodies for financial reporting and auditing and, last but not least, the market supervisor BaFin. Another feature Wirecard shares with Enron, for instance, is the role of less traditional outside actors. Whistleblowers and the press were key in uncovering both scandals (compare Dyck/Morse/Zingales JoF 65 (2010) 2213). The portion of the system that failed, the actors that helped bring misbehavior to light, their interdependencies and struggles would have looked very similar in most jurisdictions.

My second reaction to the question was "maybe we have to talk about what we would call the German stakeholder model?". As a more general term, it denotes a form of management discretion. Along with, and in addition to shareholder value, boards may consider stakeholder concerns. Much of this broad understanding of the stakeholder model is today reflected in discussions on corporate purpose, sustainability and ESG. More specifically, we might understand the German model as addressing employees as a core group of stakeholders. We would then be asking about the role of co-determination on boards. It entails employee representatives on (supervisory) boards – in addition to representation through trade unions and work councils.

It is probably safe to say that the more general version of the German stakeholder value model has little to do with a corporate scandal along the lines of Wirecard or Volkswagen. This is not to deny a familiar critique of a stakeholder, rather than a shareholder focus. There is a certain risk that management might use its discretion to disguise opportunistic tunnelling as doing good things for stakeholders. However, neither Wirecard nor Volkswagen fall into that category. Volkswagen is a story of aggressive market expansion at all costs combined with a hierarchical corporate culture and a tightly knit shareholder base of family members and state ownership. Wirecard was a fraudulent venture very early on, involving large-scale accounting manipulations. Its playbook was focused on a convincing equity story and its meteoric rise fueled by the rapid growth of its market capitalization. Neither scandal involves a focus on stakeholder interests.

A more interesting question is whether we can frame co-determination on boards as an instrument in the toolbox of corporate governance. Historically, it was not conceived as such. Its proponents advertised co-determination as a form of extending democracy and inclusion from the political process to spaces of value-creation in the corporate world. Co-determination, so they suggested, provides an institutional framework for settling conflicts between employees and management. By contrast, the modern focus on principal-agent conflicts between shareholders and management was not the reason to introduce co-determination. Empirical work today suggests that co-determined companies fare better on corporate disclosure and accounting, but endogeneity issues make this a complex endeavor.

Conceptually, employee representatives can be just as entrenched as management. Their human capital is invested in one company, not a portfolio. Hence, their incentives will not necessarily align with shareholders, especially if management promises to keep their jobs secure. Behavioral work on corporate scandals suggests a possible coalition along these lines: Fraudulent managers can be motivated by a feeling of duty towards "their" employees. In Wirecard, co-determination played no role for a simple reason. The corporation successfully circumvented co-determination. Its board members were appointed by shareholders only. Volkswagen, by contrast, is of course fully co-determined. However, given the company's shareholder base, an (informal) coalition between executive board members, family and state majority shareholders, their representatives on the board and, lastly, employee representatives seems likely. Dispersed and small-stake shareholders were the ones on the losing end.

A lesson both corporate scandals hold is the role of non-traditional actors which have so far not been a focus of corporate governance research.

Summing up, it is not the German stakeholder model which failed in Wirecard and Volkswagen. It was never intended as a monitoring tool for principal-agent conflicts. A lesson both corporate scandals hold is the role of non-traditional actors which have so far not been a focus of corporate governance research. This goes to whistleblowers and the press (in Wirecard) as well as non-financial supervisory agencies (in Volkswagen). Future research will have to explore their incentives. Future lawmakers will have to enable their actions, bringing together areas of the law as diverse as corporate, employment, press and privacy.

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The impossible case of EU gender legislation

The European Company Law Experts Group (ECLE)

The proposal to improve the gender balance on the boards of listed companies in Europe dates to 2012 and was discussed in the European Council until the Maltese Presidency in 2017. After that, negotiations got stuck and were only revived by an initiative of the French Presidency in 2022. On 14 March 2022, the Council reached a General Approach on the proposal. This means that, in all likelihood, the project will become law via a fast-track procedure without any in-depth discussion in recent times. That by itself is deplorable. Even worse, a legislative process without further public discussion may lead to a flawed law.

The proposal aims to achieve a more balanced representation of men and women among directors of EU companies, whose shares are admitted to trading on a regulated market, by requiring member states to set quotas either for non-executive directors (40%) or for all directors, including executives (33%). That is a sensible proposal and the text could stop here.

However, article 4a goes on to stipulate procedural rules by which Member States shall ensure that listed companies meet these objectives: The selection of candidates for the board must be carried out based on a comparative analysis of the qualifications of each candidate. If candidates are equally qualified, preference must be given to the candidate of the under-represented sex, i.e., typically the female one. Upon request of a candidate the company is obliged to inform them of the objective comparative assessment of the candidates and the considerations tilting the balance in favour of a candidate of the other sex.

Finally, if a candidate of the under-represented sex establishes that he or she was equally qualified as compared with the candidate of the other sex selected for the position, it shall be for the listed company to prove that it did not breach the Directive's requirements.

Looking at these requirements from a company law perspective, one cannot help wondering how the provisions are supposed to operate in practice, given that, typically, company boards are elected by the shareholders' meeting. In listed companies there are typically many thousands of (domestic and foreign, private and institutional) shareholders. Most of them exercise their voting rights electronically or by proxy. Of course, it is possible to request the company to prepare a comparative analysis of the qualifications of each candidate as the basis for the shareholder vote. But requiring these shareholders to adhere to certain criteria when casting their votes seems a farfetched idea. Who should establish the criteria and monitor their application? Who is responsible if the vote does not follow the objective assessment?

Even more obscure is the requirement that the company should inform unsuccessful candidates upon request of the objective comparative assessment, etc. This is simply not applicable to an election where thousands of shareholders cast votes, in most cases anonymously, and where there are no justifications given for a vote. Furthermore, different shareholders might very well have different reasons for voting in favour (or against) a certain candidate. There is, in practice, no way the general meeting as such can inform the company about the rationale for the election of a certain director. Did the Commission draftsmen think that boards are self-perpetuating bodies?

Hence, it is not surprising that Member States have not introduced comparable systems in their national rulebooks. Of course, this is not meant to imply that Member States have not introduced systems designed to improve the representation of women on boards. Some such systems operate with mandatory quotas, whereby any appointment violating the quota is void; under this more rigid approach, companies know precisely which rules to adhere to. Other countries encourage companies to set a policy, often pursuing broader aims of diversity apart from gender equality, but do not prescribe its contents; under this more flexible approach, each company can set the rules most appropriate for its situation. We do not want to argue which of these approaches is superior – but we are certain that either is superior to the one chosen in the General Approach.

Its proponents do not seem to be sure of the effectiveness of these rules either. Otherwise, it would be hard to explain why the text empowers the Member States to deviate from these rules if equally effective measures have already been taken. Hence, Member States can opt out of the system and given the proposal's weaknesses they should probably do so.

Is this a good way of legislating? We do not think so. The European legislator should not introduce rules that are hard or impossible to apply in order to force Member States to take action on gender balance. This will not lead to meaningful harmonisation. Rather, one could understand the proposal's real aim as giving incentives to some Member States, the laggards, to act on the issue of gender balance, while others, where such measures are already in place, will not need to introduce new legislation.

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Summing up, it is not the German stakeholder model which failed in Wirecard and Volkswagen. It was never intended as a monitoring tool for principal-agent conflicts. A lesson both corporate scandals hold is the role of non-traditional actors which have so far not been a focus of corporate governance research. This goes to whistleblowers and the press (in Wirecard) as well as non-financial supervisory agencies (in Volkswagen). Future research will have to explore their incentives. Future lawmakers will have to enable their actions, bringing together areas of the law as diverse as corporate, employment, press and privacy.

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MORE: A detailed critique by the ECLE group of the Proposal can be read on the ECGI Blog "Gender Balance Broom Wagon – The resurrection of the Commission Proposal on improving the gender balance among board members".

Should climate disclosures be more like financial disclosures?

Philipp Krueger
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Financial market efficiency relies on the disclosure of timely and accurate information regarding firms' risk exposures. However, research suggests that many institutional investors believe that publicly listed firms currently provide insufficient information regarding an increasingly relevant risk: climate risk. For instance, in a co-authored paper in which we surveyed institutional investors worldwide, we found that the large majority of responding institutions believed that current management discussions of climate risks were insufficient and that the available quantitative information regarding firms' exposure to climate risks was also lacking. Furthermore, about three quarters of the surveyed institutions held the belief that more information regarding firms' climate risk exposure was required and that standardization and mandatory reporting was a necessary step forward.

Perhaps as a result of the recognition that current firm-level climate disclosures are provided in inadequate quantity, are of insufficient quality, and also lack much needed standardization, several proposals have been made recently to improve the state of climate-related disclosures. For instance, the Securities and Exchange Commission has released a draft proposal that would mandate and standardize climate disclosures for publicly listed firms in the United States. In parallel, the European Financial Reporting Advisory Group (EFRAG) issued the first draft of the European Sustainability Reporting Standards, which--if adopted--would introduce requirements for many firms to disclose climate-related information in a standardized way.

In a similar spirit, the International Sustainability Standards Board (ISSB), the body of the IFRS Foundation tasked with the development of sustainability-related financial reporting standards, has also proposed a set of climate-related disclosure standards.

While the abovementioned proposals differ in many respects, they also share a common element in that they aim to improve and standardize firms' disclosures of climate-related information by means of prescription. An important concern surrounding any change to existing reporting requirements is a proper understanding of the potential effects that these changes could entail. It is difficult to predict the exact effects of introducing mandatory, prescriptive, and standardized climate disclosure requirements. However, we can try to gauge the potential effects of such requirements by learning from the experiences of countries that have already introduced such disclosure requirements in the past.

A point in case is the United Kingdom, which--through the Companies Act 2006 Regulations 2013--made the standardized disclosure of greenhouse gas (GHG) emissions a mandatory requirement for UK firms listed on the Main Market of the London Stock Exchange. Because of the uniqueness of the regulation, the UK experience has been widely studied in both accounting and finance. Using slightly different approaches, samples, and settings the research generally suggests that the law caused a stronger reduction of GHG emissions among UK firms relative to firms that were not affected by the disclosure requirement. The research also suggests that the disclosure regulation facilitated across firm comparisons through standardization, thereby leading to emissions reductions.

Specifically, standardized disclosures allow firms to better assess their own GHG emissions relative to that of their peers, pushing firms to reduce GHG emissions. The role of 'benchmarking' and peer effects in driving GHG emissions reductions is confirmed by other research focusing more on mandatory GHG requirements at the plant-level.

When it comes to the financial effects of the UK regulation, the conclusions differ across studies. Some research suggests that the mandatory disclosure requirement did not lead to changes in the operating performance of the concerned firms. However, other research points to a regulation induced reduction in operating performance for the most highly emitting firms. The latter is consistent with the view that the most GHG emitting UK firms reduced emissions through costly operational adjustments after mandatory disclosure requirements were introduced. The differences in the conclusions regarding the financial implications of the regulation could be--at least partially--due to the slightly different study designs.

While most of the research studying the financial effects of the regulation have focused on accounting based measures of financial performance, other research has evaluated possible capital markets implications. These studies also generally document beneficial effects such as higher liquidity and lower bid-ask spreads as well as lower volatility for the firms most affected by the regulation.

So what can be concluded regarding the initial question of whether introducing mandatory climate-related disclosure requirements for firms was a good idea or not? In a sense, such regulation aims to apply principles that typically govern financial disclosures to the realm of non-financial disclosures. In general, financial disclosures of publicly listed firms meet several requirements: they are mandatory, standardized, available in regulated disclosure documents, and audited. Nobody would disagree that these requirements are critical for the functioning of efficient capital markets. In contrast, when it comes to climate-related information, firm-level disclosures rarely meet these requirements. Studying a unique legal change in the United Kingdom that essentially introduced mandatory, standardized, and prescriptive carbon disclosure for listed firms, several research papers document beneficial effects such as reductions in firm-level GHG emissions or lower volatility, suggesting that introducing mandatory carbon disclosure for firms is probably a good idea. The alternative would simply leave us with a soup of selective and questionable voluntary disclosures, on which we could determine very little from future research regarding its efficacy in combatting climate change.

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Corporate purpose: A concept in search of clarification, data and evidence

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While an old topic, corporate purpose has risen to prominence over the last few years. The reason is a growing disquiet in many quarters about the single-minded focus of business on profit and financial value as the predominant objective of firms.

The renowned business school professor, Sumantra Ghoshal led the revival of interest in corporate purpose when, in 1994, together with Christopher Bartlett, he wrote that:

"Purpose is the embodiment of an organization's recognition that its relationships with its diverse stakeholders are interdependent. In short, purpose is the statement of a company's moral response to its broadly defined responsibilities, not an amoral plan for exploiting commercial opportunity…..If corporate ambition begins to focus on the company's narrow self-interest, it eventually loses the excitement, support, and commitment that emerge when objectives are linked to broader human aspirations. When organizational values become merely self-serving, companies quickly lose the sense of identification and pride that makes them attractive not only to employees but also to customers and others. And when management's respect for and attention to its employees' ideas and inputs is diluted, motivation and commitment fade. Purpose – not strategy – is the reason an organization exists. Its definition and articulation must be top management's first responsibility."

Corporate purpose has therefore featured prominently in business and management studies literature in relation to such topics as organizational behaviour, strategy, and business ethics. It is central to debates in corporate law around questions of corporate personhood, the fiduciary responsibilities of directors, the accountability of boards to stakeholders as well as shareholders, and the regulation of companies. It is closely related to issues about corporate ownership, governance, and the financing of firms. And it bears directly on the role of the financial sector; environmental, social and governance factors; activism; and engagement.

Purpose is therefore at the heart of many of the debates that are currently in progress in ECGI and academies around the world. However, there are divergent views on what is or should be the purpose of business and, while there is growing recognition of mounting problems in relation to environmental, human, and social impacts of companies, there is little consensus about their causes and even less about their appropriate remedies.

To some, these problems reflect a deficiency of the design and enforcement of traditional tools of anti-trust, regulation, and taxation, and a need for more effective anti-trust policy, tougher regulation, and more effective use of tax to address market failures. To others, conventional tools are not adequate, sufficient, or efficient means of dealing with the problems. Instead, the failures stem from fundamental defects of the way in which corporate and financial sectors operate. This is where questions about corporate purpose, and its traditional focus on the success of business for the benefit of its shareholders, come in.

Whatever one might think of the merits or otherwise of contending views on corporate purpose, one thing is clear. There is a pressing need for better understanding of the issue and more evidence to evaluate contending hypotheses. Until recently a major limitation on empirical research on corporate purpose has been the paucity of available data. But this is changing and, as the interest of financial and business communities as well as academics, policymakers and regulators in corporate purpose and non-financial indicators of performance grows, the availability of alternative sources of data is expanding.

There are three areas in which there is a particular need for more academic analysis. The first is in relation to the role of business purpose in promoting business performance. It is frequently asserted that corporate purpose is associated with enhanced corporate performance but there are few studies providing rigorous empirical evidence. Furthermore, to the extent that they do exist, most studies evaluate performance in traditional, predominantly short-term, financial terms and do not establish the degree to which purposeful companies confer benefits on other parties in the long-term.

The second area relates to corporate law and purpose. There is much discussion on whether effective implementation of corporate purpose requires changes in corporate law or whether existing law is sufficiently flexible and permissive to allow companies to adopt and enact their chosen purposes. Related to this are questions about the accountability of boards of directors to external parties, in particular employees and other stakeholders as well as shareholders, for delivery of and deviations from corporate purpose.

The third area concerns the relation of corporate purpose and responsible investment. There has been an explosion of analyses of environmental, social and governance (ESG) factors and attempts to provide international standardization of reporting on sustainability. However, the relation between these and measures of corporate purpose are often unclear and confused. This gives rise to concerns about "greenwashing" and a lack of authenticity regarding the degree to which companies are really committed to deliver on outcomes that reflect a broader range of interests than short-term financial performance.

Underpinning all three areas are questions about precisely what is meant by corporate purpose. Christopher Bartlett and Sumantra Ghoshal correctly stated in the above quote that corporate purpose is the reason why a company exists and is fundamental to its strategy. But how precisely it should be defined, determined, implemented, measured, and rewarded and how it relates to the ownership, governance and financing of firms are still questions that, nearly thirty years after Bartlett and Ghoshal wrote about it, remain to be adequately researched and resolved.

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There's more to corporate purpose than ESG

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The explosive growth of ESG investment in recent years has moved to a new phase. With increased geopolitical risks, energy transition in trouble and inflation spiraling out of control, some large institutional investors are now changing tack, supporting new investment in oil and gas infrastructure, and suggesting that the effort on decarbonization should slow down. In addition, the rather critical views on ESG that some asset managers' senior executives have recently expressed are raising concerns about how green ESG investment is. It is no surprise that regulators are stepping in and adopting tougher scrutiny of ESG funds.

Free markets and entrepreneurship bring great benefits to society, but companies' activities also have negative effects on the environment and communities. Neither greenwashing nor higher energy costs due to a disrupted energy transition will wipe these negative externalities away. Companies must come up with effective solutions.

The fight against climate change should involve not only regulators and investors; it badly needs the alignment of companies themselves. Some experts assume that a growing number of investors pushing for ESG goals or stricter regulation would be enough to turn the corporate world around and make it more environmentally and socially responsible. Companies have a key role to play: they are polluters, but also have the capacity to innovate and create new products that can meet society expectations. Corporate governance needs to embrace ESG and build on the notion of purpose.

ESG factors were formally born in 2004 as a joint-effort by the UN Global Compact and some large financial institutions with the goal to define investment principles that would take into account the environmental and social negative effects of companies' activities. Financial investment and asset management have since been and remain the drivers of ESG growth.

But the notion of purpose has a much longer tradition than ESG in the corporate world. In management theory, 'purpose' or 'mission' - has been used for decades (Barnard, 1938; Selznick, 1957; Mayer, 2018).

Purpose adds an important governance and management perspective, helping to prioritise customer needs and long-term value objectives. It goes beyond ESG considerations to simultaneously consider customer needs, innovation and competitive advantage.

The divergences are also significant. ESG policies work by controlling and eventually reducing some corporate risks regarding the environment, social effects and governance. Purpose works through a different channel. It signals the firm's willingness to be an effective organization that creates value by serving customers in a unique way, engaging employees and caring about other key stakeholders. In this way, purpose is a source of innovation. Purpose operates through engaging and motivating employees (Edmans, 2011), by offering them a sense of meaning (Gartenberg, Prat and Serafeim, 2019) and a relation based on trust (Henderson and Van den Steen, 2015). It can also appeal to customers by offering products that are better or environmentally friendly. Purpose can become a driver of sustainable competitive advantage, which is the engine of superior economic performance.

Some criticisms of purpose suggest that the goal of maximizing shareholder value offers a more direct and simple objective for boards and CEOs and the introduction of an integrated purpose raises the possibility that decision-making could become less effective. As Simon (1976) suggested, maximizing profits may not be possible in the real world of management with bounded rationality and uncertainty. However, in management theory, the hypothesis that general managers should tackle a broader view of goals and policies and manage trade-offs to govern companies has been the rule, not the exception. It is part of a senior manager's job. Some CEOs will do it well and others will fail.

The empirical evidence emerging from many companies that have adopted a notion of purpose varies. When purpose is integrated into corporate strategy and business model, it becomes a source of competitive advantage. This is what we observed on European companies such as Henkel, Ikea, Nestlé, Puig, Schindler, Schneider Electric, Unilever, among others, is the necessary condition for sustainable long-term value creation (Canals, 2023).

Schneider Electric offers a useful reference. Its energy goals in 2006 embodied a strategic option that the board and the senior management selected, introduced in its mission, articulated in a long-term strategy to foster innovation in product development in coherence with that goal, obtained shareholders' support and eventually delivered on performance. Sustainability has unsurprisingly become well-ingrained in the firm's strategy and business model and it is at the root of a very strong competitive advantage. As this case and many others point out, purpose becomes relevant when it is not only authentic, but also connected with a corporate strategy that generates a sustainable competitive advantage. Purpose – not only ESG factors - becomes a driver of positive change while ensuring that companies continue to create economic value.

There is also evidence of the opposite. In recent years, companies such as Danone, GE, Johnson& Johnson or PepsiCo that also adopted a certain notion of purpose, were not able to deliver the value that they promised. It was not that their purpose was mediocre or that their ESG goals were not well-defined. The main problem was the lack of consistency between purpose and the firm's strategy and business model.

When embedded strongly in strategy, purpose can unquestionably help to create value for shareholders and stakeholders in a sustainable way and make companies more respected institutions in our society.

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The role of corporate law in corporate purpose: the British Academy Report

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In 2018, in his book Prosperity, Colin Mayer promoted "an embarrassingly simple policy" aimed at inducing companies to pursue purposes defined more broadly than the shareholders' interests. To be sure, shareholders would benefit from these broader purposes, but that benefit would flow from the attainment of the broader purposes, and not be the direct goal of corporate action. The book led to the establishment of a Future of the Corporation programme at the British Academy (BA), designed to analyse ways of taking this policy forward. Its final report, Policy & Practice for Purposeful Business, appeared in September 2021. The role proposed for corporate law was put as follows: "Corporate law should place purpose at the heart of the corporation and require directors to state their purposes and demonstrate commitment to them." This policy is spelled out in a little more detail. "More specifically it is proposed that:

• Company law emphasises duties of directors to determine and implement company purposes.
• Governments publish guidance on how companies can incorporate purpose in their legal form, for example in their articles of association."

What is this likely to amount to for UK company law and other legal systems persuaded to go down the same path? The answer is probably "not very much", though that "not much" is likely to be positive. Let's look at the directors' duties and company's constitution proposals in turn.

Directors' Duties

As is clear from the opening pages of Prosperity Colin Mayer was reacting against the view of Milton Friedman, which Mayer characterises as being that "the purpose of business is exclusively to make money for the owners of the business" (p 3). Whether this is actually what he said is contested by some. In any event, for a corporate lawyer, this seems a questionable starting point, since it is impossible to identify a corporate law system in any developed system of law which casts the duties of directors in such blunt and unqualified terms.

UK company law, as the BA Report states, "requires directors to promote the success of the company for the benefit of its shareholders, having due regard to the long term and the interests of other stakeholders." This is surely clear enough: the directors are not under a duty to promote the interests of the shareholders directly but only by means of setting policies which promote the company's success. When one adds in the words, which the Report omits, that the director "must act in the way he considers in good faith would be most likely" to promote the success of the company, it becomes clear that the section gives directors a wide range of discretion over the setting of company policies. Only policies which would confer no substantial benefit on the shareholders over any reasonable time-frame are ruled out – and Prosperity appears to rule them out also.

One might cavil at the fact that the section gives shareholders' interests priority over those of other stakeholders. In formal terms, this is so.

In practice, it is doubtful whether this is a significant restriction on directors' policy setting. The duty is subjective (and so it's difficult to get a court to review a board's decisions) and no time-frame is stipulated for the benefit to the members to emerge, except some encouragement to take a long-term view. So, giving stakeholder interests greater weight than is currently done is not likely to be problem for the well-advised board. If the directors of UK companies do in fact prioritise the interests of the shareholders and prioritise them over the short-term (also a contested proposition), then the cause is more likely to lie in capital market pressures (limited protection of directors against removal, hostile takeovers and activist shareholders) than in the law of directors' duties. If one wants to change company law to reduce the shareholder pressure on managers, then Law of directors' duties is not the most useful place to begin.

In short, the current formulation of the core duty of directors in UK law does put the formulation of company purposes at the heart of directors' duties. And those strategic choices and a whole raft of material relevant to ESG matters must then be revealed publicly in the company's Strategic Report (if its shares are publicly traded). The BA Team may not like the purposes boards currently choose, but the law neither mandates that choice nor prevents the board from making a different set of choices. Perhaps some dim realisation of these points explains the ambiguity of the word "emphasises": the use of the indicative rather than the subjunctive tense leaves it unclear whether reform of the law is suggested.

If the above analysis of UK law is correct, it is likely to be even more applicable to legal systems (probably the majority) which dodge the issue by stipulating that the directors promote the "interests of the company" and omit any formal reference to the shareholders, thus leaving the directors with even greater freedom of action.

Incorporating purposes into the company's constitution

This is to be a voluntary matter, it appears. The government is to provide guidance on how to incorporate purpose commitments into the company's constitution, but it is not proposed that companies be required to do this. This is a softening of what was proposed in Prosperity, where purpose statements in the articles were proposed to be mandatory. The voluntary approach follows that of the recent French reforms.

This is a wise decision. We have been here before, of course – in the nineteenth century. The mandatory purpose statement was circumvented then and its modern-day counterpart is likely to be equally avoidable.

In the middle of the nineteenth century, fearing the consequences of the introduction of this new business organisation with limited liability, the legislature required companies to state the areas of business in which they were to operate and the powers they were to have. The courts in the UK (and other common law countries) then applied the "ultra vires" doctrine to this statement: transactions outside the declared purposes were of no legal effect and directors were potentially personally liable to the company for failing to conduct its affairs in accordance with the company's constitution. Naturally, directors did not relish the prospect of personal liability, but neither did shareholders nor third parties contracting with the company like the ultra vires doctrine. The company might lose valuable business opportunities arising in adjacent areas of activity. (Originally, the statement of purpose was unalterable, so that a new company with fresh capital was needed to exploit non-covered activities, even though the company was well placed to exploit them itself.) Third parties did not welcome the risk of losing a transaction because the company, ex post, sought to argue opportunistically that the contract was beyond its powers, whilst companies lacked effective means to bond themselves in relation to this risk. As usual, only the lawyers benefitted, since an obvious response was to have the lawyers pore over the company's constitution to see if the proposed transaction was within the company's objects.

A better response, however, which boards began to adopt was to take advantage of their drafting freedom and insert in the constitution prolix objects clauses, covering any future activity in which the company might conceivably wish to engage. In its fully developed form, the list would have final clauses which included anything "incidental or conducive" to the achievement of specified activities or even "any other trade or business whatever which in the opinion of the board of directors can be advantageously carried on by the company" in connection with the specified objects. Although this drafting effectively defeated the legislature's objectives, the courts came to accept it, probably because of the doctrine's disadvantages mention above. Today, commercial companies are not required to specify their objectives and, more important, the ultra vires rule has been removed.

What does this little piece of legal history tell us about the likely take-up of the facility to include purpose statements in the articles (or for boards to adopt purpose resolutions)? I suggest two things. First, both directors and shareholders will be reluctant to adopt purpose statements which significantly constrain the company's commercial freedom. Second, both directors and shareholders will be reluctant to avail themselves of constraints which threaten stringent monetary sanctions against either the directors personally or the company.

One way to achieve both objectives would be again to use the lawyers' drafting skills to produce purpose statements which have a high level of generality and imprecision. Breaches of such statements are difficult to establish. A quick look at the optional statements produced by companies under the recent French reforms suggests this is a likely pattern.

Shareholders and directors might feel less incentivised to take this avoidance approach if the enforcement mechanism were constrained. Under conditions where breach of the purpose statement did not threaten the validity of corporate transactions, where enforcement lay exclusively in the hands of the shareholders (no third party and especially no civil society enforcement or public authority enforcement, the latter being hinted at in the "Regulation" section of the BA Report) and where the remedy was confined, at least as a first step, to a court order to the directors to observe the purpose statement, shareholders and directors might be willing to take up the option on a significant scale.

Indeed, this facility might prove an interesting test of shareholders' ESG commitment. We are told that investors are increasingly willing to invest according to ESG criteria, but the breadth and depth of the shareholder taste for this style of investing is unclear, especially if there is a risk that the company's financial performance will suffer from its ESG commitments. This proposal might provide an interesting event study.

Conclusion

The directors' duty proposal arguably calls for no reform of current company law, and the proposal for inclusion of purpose statements in the constitution is avowedly to be implemented through guidance. Does this mean there are no new angles for corporate law in relation to corporate purposes? This would be too negative a conclusion. One might explore ways of making companies' (voluntary) purpose commitments credible, whether or not they are embedded in the articles or ways of using corporate law to secure better levels of compliance with external regulation. These look like fruitful lines of enquiry, but, unfortunately, not simple ones.

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The Role of Corporate Law Reconsidered: A Brief Response to Paul Davies' Blog

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In his ECGI blog "The role of corporate law in corporate purpose: the British Academy Report" (Responsible Capitalism blog series, 5 July 2022), Paul Davies contends that the case for corporate reform put forward in my 2018 book Prosperity and the 2021 British Academy report on the Future of the Corporation is misconceived. He suggests that the argument for reform is based on a misconception that the duty of directors under corporate law is directed towards shareholder interests when it is in fact to the success of the company for the benefit of shareholders under UK Company Law and simply to the success of the company in some other jurisdictions. Directors therefore have considerable latitude in terms of how they formulate their corporate purposes and "only policies which would confer no substantial benefit on the shareholders over any reasonable time-frame are ruled out".

Davies sees the mistake of both my book and the British Academy report as deriving from an incorrect attribution of directors' duties to shareholder interests when in fact they are to corporate success. He therefore believes that the argument rests on a false presumption of the law constraining corporate purposes to those promoting shareholder interests.

That, however, is not the case at all. The argument for reform that the British Academy and I have put forward applies equally to corporate laws which are framed in terms of the success of the company without any reference to shareholders. The issue is not about shareholder versus stakeholder interests but what is meant by the success of the company, be it restricted to benefits of shareholders in terms of their wealth or welfare or more broadly construed to include those of, for example, employees.

At present, corporate law does not impose any limitation on the notion of corporate success. A company must operate in the confines of private and public laws, and it is subject to the pressures of the markets within which it operates but so long as "it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud", as Milton Friedman's Doctrine (1970) states, it is at liberty to promote whatever forms of success it wishes.

The difficulty with this is that what a company sees as success, others, who are affected by or dependent on the firm, may not. They may be the individuals, local or global communities who suffer the environmental or social consequences of its activities. These "externalities" are viewed in conventional terms as falling outside the domain of director duties in so far as they do not pertain to a notion of the success of the company narrowly defined.

That is precisely the issue that is the concern of both my book and the British Academy programme. What are the appropriate boundaries of the firm? The conventional view would have it that the boundaries of the firm are defined by the property owned by the firm and its contractual claims and liabilities resulting from public and private law in the form of, for example, regulation and contracts. However, the effects of the firm are felt well beyond those boundaries and are determined by the changes that it brings about and the effects that it has on the wellbeing and flourishing of individuals, communities, and the natural world.

In this regard, the determinants of the "success" of the company extend beyond either its shareholders' and creditors' wealth or wellbeing, or indeed those of its employees as well as its investors.

This notion of success is captured in the proposed definition of corporate purpose in the Future of the Corporation programme as "producing profitable solutions to the problems of people and planet, not profiting from producing problems for either". The significance of this is not only in extending the boundaries of the firm to the impact it has on others but in determining what is meant by success, namely where benefits accrue for some, and detriments are inflicted on none. That accords with the origins of the word profit in the Latin "proficere" and "profectus", meaning to advance and progress, namely wealth and welfare creation not wealth or welfare diversion or transfer.

The significance of this is that the purpose of business then aligns private inducements of financial profit with environmental and social benefits of problem solving without problem creation. Without that, the influence of the law is moot in so far as its good intentions will be overrun by the reality of capital and product markets in driving individuals and organizations to promote outcomes that are detrimental as well as beneficial for others.

Why should a firm be concerned about such matters and, still more pertinently for these purposes, why should corporate law? Is it feasible and practical? Is it measurable? Who should determine the parties affected and impacted by the firm? To whom is the firm accountable for this? Does this lie beyond the legitimate sphere of influence of directors and managers of firms who are not appointed by publicly democratic processes of election?
In fact, it may not be nearly as complex to achieve as may be imagined and might not require new legislation. Instead, it may be effected by changes in judicial interpretations of existing statutes.

Take, for example, the case of s.172 of the UK Companies Act 2006 which states that "the director of a company must act in the way that he considers, in good faith, most likely to promote the success of the company for the benefit of its members and in so doing, have regard to (amongst other matters) the likely consequence of any decision in the long-term" and the interests of other stakeholders (and it then lists several stakeholders, including customers and employees)."

While the statement "and in so doing, have regard to ……" is conventionally viewed as a right conferred on directors in promoting the success of the company for the benefit of its members, it could equally be interpreted as a requirement. Namely, it could imply that in promoting the success of the company, a director must, not just may, uphold the interests of other parties in the long-term. That in turn would suggest that the success of the company should not derive from inflicting detriments on others. Protection of their interests is intrinsic and the success of the firm derivative of it, not extrinsic in depending on its contribution to the success of the firm. The definition of a corporate purpose in the British Academy programme of producing profitable solutions without profitable problems would then have a natural interpretation within existing company law.
Would this give more bite to corporate purpose than the meaningless statements that came to be associated with the object clauses and ultra vires conditions that were introduced around the time of freedom of incorporation in the 19th century? The answer is quite possibly in so far as such a revision would allow companies to commit to their purposes in ways in which it is not credible for them to do so at present. It would thereby create a level playing field between companies, and it would correct the current competitive market incentives to run to the bottom rather than the top in the pursuit of corporate success.
In sum, much might be gained from modest reforms rather than radical revisions to existing company law.

Why are firms adopting ESG Pay?

Gaizka Ormazabal
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A growing number of firms are incorporating ESG criteria in executive compensation contracts (henceforth, I will refer to this compensation practice as "ESG pay"). Based on data on thousands of firms across the world, a recent ECGI Working Paper finds that the percentage of listed firms linking executive pay to ESG performance has grown from 1% in 2011 to 38% in 2021. In some industries, this percentage is as high as 70%.

These statistics raise a natural question: Why are firms adopting ESG Pay? The answer is not obvious. To begin, one could argue that caring about the planet and social justice is a "must", and thus should not be subject to variable remuneration. A related argument is that executives already have powerful non-monetary incentives to improve ESG performance in the form of social pressure, reputation, and the like. One could reply to the previous objections that monetary incentives are necessary because the current ESG ambitions of our society entail a dramatic transformation of the economy, which requires that executives go the extra mile. But even if we accept this perspective, it is not completely obvious that we need ESG pay. Let me elaborate.

Top executives frequently make a business case for ESG. For example, it is commonly argued that improving ESG performance has beneficial effects on the product markets (consumers care about ESG), on the labor market (ESG helps retain and attract talent), and on the financial market (investors increasingly demand ESG performance). Not only that, the effort to improve ESG could result in mitigation of critical risks such as those related to climate change and social unrest. And there is yet another potential benefit: higher ESG performance could prevent regulatory scrutiny and activism.

If we buy into the above arguments, we should expect that ESG efforts translate into financial performance. So why do we need to introduce ESG metrics in compensation contracts? Doesn't the previous argument suggest that ESG performance will eventually show up in financial metrics? Moreover, do we trust ESG metrics? Keep in mind that measuring ESG performance is an extremely difficult task. ESG is a multidimensional concept with many aspects that are hard to quantify. In fact, there is an ongoing debate about how to design sustainability reporting rules, and commercial ESG ratings are subject to substantial criticism. Let's face it – we still have a lot to learn in terms of measuring ESG performance. The metrics we currently use suffer from important limitations.

The problem is that, when it comes to measuring ESG performance, financial metrics also suffer from significant constraints. First, performance measures such as ROA, EBITDA and EPS are based on accounting information. It is well known that financial statements have a limited ability to incorporate forward-looking and intangible information (among other things, due to accounting conservatism). For example, it is unlikely that accounting earnings fully capture the beneficial effects of ESG on shareholder returns, as some of these effects are hard to measure and too uncertain to be recognized in financial statements.

When it comes to measuring ESG performance, financial metrics also suffer from significant constraints.

What about basing compensation on the stock price of the firm? True, the stock price is forward looking and does incorporate intangibles. However, it relies on market efficiency, which has its limits. For example, do stock prices capture the potential future consequences of climate risk and social unrest? Even the strongest advocates of market efficiency would doubt that the market can quantify future events that have a high degree of uncertainty.

Does this mean that there is a case for using ESG metrics in executive compensation schemes? Probably yes. These metrics could be valuable for contracting purposes to the extent that they can tell us something about future financial performance that financial metrics are not able to tell us due to the limitations of accounting earnings and stock prices. While important, the previously mentioned measurement issues do not necessarily mean that all ESG metrics are uninformative. Beyond performance measurement considerations, ESG pay could also be one way to signal to the market that the firm is committed to ESG.

But the previous discussion also suggests that the need for ESG pay varies across companies. Accordingly, a successful implementation of this practice requires a careful and tailored design of the compensation arrangement – especially of the ESG metrics – consistent with the characteristics and the strategy of the company. Firms should also keep in mind that incentive schemes should be clear and relatively simple; overcomplicated contracts could generate confusion and perhaps even unintended behavior.

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Investor stewardship in an uncertain world: complexities and surprises

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For an ever-growing number of investors, investor stewardship – the responsible allocation of capital and purposeful engagement – stands at the heart of their investment practices. What it precisely means, however, to be an effective steward of capital is hardly a settled matter. Recent years have seen soft-law principles of investor stewardship continue to develop in the UK and abroad and the introduction of an increasing number of regulatory initiatives (often without specifically using the term stewardship) that aim to foster the efficient inclusion of sustainability in investment management and corporate governance.

By 2020 a total of 35 stewardship codes have been issued across 20 jurisdictions on six continents. Today, three more stewardship codes (in the broad sense) have been released in Brazil, Russia and Taiwan and stewardship initiatives have been introduced in Germany and are currently negotiated in other jurisdictions. In addition, stewardship principles have been developed at international and regional levels. Investor stewardship has, therefore, become truly global. Whether it is index funds in the US, active and passive asset managers in the UK, retail investors in France, local pension funds in South Africa or the National Pension Service in South Korea, stewardship is becoming the global mantra and measure of long-term value. But, at the same time, breeding and exercising investor stewardship effectively is becoming very complex.

At the beginning of the stewardship policy movement, stewardship codes and principles had a simple aim: to encourage shareholder engagement with investee companies and turn passive institutional shareholders into active stewards. Investor stewardship was originally about "shareholder stewardship", that is the stewardship responsibilities of institutional investors (mainly asset managers and asset owners but sometimes service providers too) as shareholders of public companies. The UK was the first country to introduce a Stewardship Code in 2010 (revised in 2012) with the aim to promote the so-called "micro-level" shareholder stewardship and integrate shareholder monitoring and engagement into investment management. This very simple idea of an "engaged steward" travelled very successfully around the world in the 2010s and the Stewardship Codes seen around the world are strikingly similar to the UK "gold standard" of stewardship. This global diffusion of the UK model of shareholder stewardship came as the first surprise to comparative law scholars. Outside the UK, the problem the UK Code 2012 aimed to solve does not exist and the "gold standard" of shareholder stewardship is inherently unattainable due to differences in local legal infrastructures, ownership structures, and cultural barriers.

A second surprise, at least for some, came with the recognition that that the model of micro-level shareholder stewardship was unachievable on a large scale due to the incompatibility of existing business models with firm-specific engagement. In the UK, this weakness was translated into the revised 2020 Stewardship Code which expands stewardship both in terms of aims and targets. First, stewardship is not viewed anymore monolithically as a corporate governance tool to awake passive investors.

Rather investor stewardship is becoming relevant for both active and passive strategies and has a role to play in "greening" investment management externally and enhancing the accountability across the investment chain (from asset managers to asset owners and from asset owners to beneficiaries and members). Secondly, stewardship is not only about public equity and firm-level engagement. Rather investor stewardship is taking place at different levels and across different assets (including fixed income and real estate) and even includes engagement with policymakers and other standard setters. To the surprise of many market participants, instead of discarding stewardship in the trash bin of policy history, investor stewardship became more complex in terms of both aims and targets.

For a comparative law scholar, a critical question to be asked is whether a diffusion 2.0 of the "expanded" stewardship model likely to take place? The newer iterations of stewardship codes in Japan and Singapore and the draft South Africa code offer perhaps some room for optimism for the diffusion of sustainability-related principles as the 2020 UK Code aligns better with investment models. Yet a diffusion 2.0 may not be needed as investor stewardship has started to become embedded in local markets and business models.

Rolling out flexible and local-conscious policies and codes is one thing; how the envisaged stewards (ranging from asset managers to asset owners, and from service providers to controlling shareholders or even retail investors) is another. And, current systemic risks pose significant challenges for stewards-to-be investors. When the "stewardship movement" took shape, few could have predicted the uncertainties to come in the following years. Society at large has faced significant challenges including the Covid-19 pandemic and other health risks, climate change and environmental risks (including biodiversity and deforestation), supply chain disruptions, tech risks, geopolitics (including the armed conflict in Ukraine) and the ever-increasing demand to tackle economic and social inequalities. All these uncertainties entail a variety of risks, from environmental geo- and socio-political, a common trait is the systemic nature of the risk they present.

As the investment industry continues to grapple with these risks and challenges in the background of the much broader debate about climate change, stewardship by all providers of capital is becoming fundamental to reconcile finance with a sustainable and socially fairer economy. It is here that we may find another surprise awaiting us. Investor stewardship was developed in the Anglo-American context to be the solution to a problem that is not shared globally; but it may reveal itself as the solution – at least in part – to truly global problems of climate change and sustainability.

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