THE ECONOMICS OF ESG GOVERNANCE AND DISCLOSURE

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I. INTRODUCTION

ESG has become an important feature of governance and capital-raising for both corporate managers and investment intermediaries. After a period of rapid, widespread adoption, ESG faces significant pushback.[1] Concerns have proliferated about the credibility and efficacy of ESG commitments, ever-expanding definitions of what counts as ESG, deleterious effects on firm governance, and whether various instantiations of ESG serve appropriate social interests. Difficulties arise, in part, from the various working definitions of ESG that have been utilized, some of which are inconsistent and which serve diverse and conflicting corporate, stakeholder, and social interests.[2] Further, ESG has been largely shoehorned into existing regimes that police internal corporate behavior and external disclosure, which may not be good fits for ESG reforms.

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1. *See* Chip Cutter & Emily Glazer, *The Latest Dirty Word in Corporate America: ESG*, WALL ST. J. (Jan. 9, 2024, 5:20 PM), https://www.wsj.com/business/the-latest-dirty-word-in-corporate-america-esg-9c776003 (stating that chief executives have stopped mentioning ESG in earnings calls and that interest in ESG funds has faded); WSJ Staff, *Why Corporate America Has Gone Quiet on ESG*, WALL ST. J. (Jan. 9, 2024, 6:39 PM), https://www.wsj.com/livecoverage/stock-market-today-dow-jones-01-09-2024/card/why-corporate-america-has-gone-quiet-on-esg-sH1fkwtWtZbieRzkviFy; Shane Shifflett, *Wall Street's ESG Craze is Fading*, WALL ST. J., (Nov. 19, 2023, 5:30 AM), https://www.wsj.com/finance/investing/esg-branding-wall-street-0a487105.

2. *E.g.*, Douglas K. Chia, *There is no "C" in "ESG": An Illustration of ESG's Biggest Risk*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 14, 2022), https://corpgov.law.harvard.edu/2022/10/14/no-c-in-esg/ (claiming that one of the biggest flaws of ESG is the subjectivity of what qualifies as E, S, or G); Kevin LaCroix, *Time to Say RIP to ESG?*, D&O DIARY (Oct. 29, 2023), https://www.dandodiary.com/2023/10/articles/esg/time-to-say-rip-to-esg/ (noting Aswath Damodaran's critique of ESG).

All this raises two existential questions about ESG. First, what is the purpose of ESG? Is it intended to maximize shareholder returns, or is it intended to encourage a tradeoff between shareholder returns and other pro-social outcomes? Second, how (if at all) will ESG achieve these aims? In particular, what role does governance and disclosure play in enforcing the aims of ESG?

In this article, we consider ESG from the perspective of economic incentives and the mechanisms that propel it. We propose four principal forms of ESG, based on the intended beneficiary and means of enforcing desired outcomes. Our taxonomy is as follows:

1. Shareholder returns ESG is aimed at benefitting shareholders[3] by focusing on maximizing long-term risk-adjusted returns. ESG raises the profile of long-term risks including future adverse regulation, potential reputational damage, and other, often inchoate, factors. Company and fund managers utilize these ESG metrics and disclosures to better manage these risks and thus better compete for investor dollars and, in some cases, votes.
2. Shareholder non-pecuniary (or "greenium")[4] ESG is also oriented at benefitting investors, but by providing non-monetary returns such as public goods (or avoiding public bads) that shareholders value. As in shareholder returns ESG, companies and funds aim to satisfy shareholders and compete for investment dollars, but based on the provision of both pecuniary and non-pecuniary benefits.
3. Stakeholder ESG is what is sometimes defined as stakeholder capitalism, with a goal to encourage (or force) companies to consider constituencies outside of the shareholder maximization paradigm, thus furthering the interests of the constituency, potentially at shareholders' expense. The mechanism through which this works is typically by providing the subject stakeholders a direct or indirect place in management, such that stakeholder interests are represented in corporate decision-making.

3. Throughout this paper, we focus on shareholders, as opposed to creditors, as the corporate governance and securities disclosure enforcement regimes, in their most robust forms, are largely (albeit not exclusively) aimed at benefitting shareholders.

4. We use the term "greenium" as a useful shorthand, but our analysis of this form of ESG pertains to any form of public goods-oriented investing, not just climate-related public goods.

4. Regulator-driven ESG arises from activist regulators charged with investor protection imposing new disclosure obligations onto corporate activity that aim to satisfy regulator preferences and may (or may not) also serve shareholder, constituency, or social interests. These obligations arise from regulatory fiat (as with SEC climate disclosure regulations), though, due to a lack of command-and-control authority, their ultimate effectiveness in affecting substantive corporate behavior typically relies on other enforcement mechanisms.

With this taxonomy in hand, we then analyze whether these various forms of ESG are economically workable under existing investor-oriented regimes of corporate governance and securities disclosure enforcement. In other words, will these enforcement regimes serve to implement the goals that these various forms of ESG are pursuing? We find that shareholder returns ESG is likely to be effective under these regimes for the intuitive reason that it targets factors that should already be of interest to shareholders—i.e., material information about expected future cash flows and risk. Greenium ESG, on the other hand, faces some difficulties, the first being a conceptual issue of whether non-pecuniary benefits from investments in green companies are excludible; if not, free riding occurs (although free riding does align with shareholder interests). Corporate governance works fairly well, as shareholder preferences drive the ESG goals, but disclosure enforcement, which depends upon price movements reflecting benefits to shareholders, is problematic. Stakeholder ESG is potentially well-served by existing corporate governance mechanisms, provided that stakeholder representatives are able to engage in Coasian bargaining on stakeholders' behalves; however, limitations on bargaining for some stakeholders may render joint-welfare maximizing bargains difficult to verify and enforce. The securities disclosure regime works poorly in the context of stakeholder ESG since shareholders may place little, no, or negative value on even genuine stakeholder ESG projects, leading to indeterminate share pricing signals. Finally, regulator-driven ESG may focus on areas which shareholders do not deem material; if so, regulator ESG mandates may have little effect on corporate behavior. However, it is possible that such a mandate may become material due to the regulatory spotlight motivating affected stakeholders, activists, and legislators; anticipating such effects, shareholders may treat such mandates as material, such that existing governance and disclosure enforcement regimes will function to align corporate behavior.

This article proceeds as follows. Part II provides an overview of the existing regimes of corporate governance and securities disclosure that serve to implement shareholder preferences and enforce the veracity of corporate disclosures. Part III defines and provides examples of shareholder-returns ESG and analyzes whether the existing governance and securities disclosure regimes will serve to enforce shareholder-returns ESG commitments. Part IV turns to "greenium" ESG, Part V to stakeholder ESG, and Part VI to regulator-driven ESG. Part VII concludes and sketches out potential avenues for reform.

II. AN OVERVIEW OF EXISTING ENFORCEMENT REGIMES

Corporate governance and the market for corporate control

In typical U.S. corporate governance, shareholders possess the right to elect the corporation's board of directors, which in turn appoints the firm's executives and sets its general policies.[5] The board is thus accountable to shareholder interests, and shareholders control the firm, albeit indirectly. Shareholder control is thought to be efficient because shareholders are (in a solvent firm) the residual claimants: they bear any marginal increase or decrease in firm value, and thus will prefer policies or activities that increase the overall enterprise value of the firm.[6] In contrast, non-residual claimants—creditors and other stakeholders—may prefer policies that do not maximize firm value; bondholders, for instance, may prefer safer, less volatile strategies, such as marshalling and conserving assets, that maximize their likelihood of repayment but which are not optimal from an overall firm value perspective. Corporate managers are held to fiduciary duties that are aimed at maximizing firm value, which, in a solvent corporation, typically implies maximizing shareholder value.[7] Further, to the extent that the firm is subject to appropriate guardrails—regulation and legal rules that internalize its costs—shareholder control is also consistent with maximizing overall social welfare.[8]

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5. WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 189–93 (6th ed. 2021).

6. *See id.* at 3–4 (noting that shareholders are the "residual claimants" because they do not get paid until everyone else is paid first).

7. *See id.* at 4 (describing fiduciary duties as intended to prevent self-interested opportunism by individuals within an enterprise).

8. *See* N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (holding that directors owe fiduciary duties to the corporation

To the extent the board does not represent shareholder interests well, it is subject to being voted out. In practice, this often takes the form of activism from larger investors, who may proactively engage management and, less cooperatively, undertake a proxy fight in which recalcitrant board members may be voted out.[9] Additionally, the market for corporate control provides a check on public company management: firms that are led inefficiently and suffer lower stock prices are subject to takeovers, in which the depressed share prices make the firm an attractive target for acquisition and replacement of underperforming management.[10]

Securities disclosure

For public companies, or companies offering their securities to the public for the first time, U.S. law imposes significant disclosure requirements and penalties for misstatements and fraud. The Securities Act of 1933 mandates extensive disclosure in public offerings, in which the issuer must disclose virtually all material information about itself, and imposes harsh liability for misstatements or omissions.[11] Public companies are also subject to periodic reporting under the Securities Exchange Act of 1934, which follows similar disclosure requirements.[12] Misstatements or omissions are subject to

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and its shareholders, even when "navigating in the zone of insolvency"); Larry Ribstein, *The Gheewalla Case: The Delaware Supreme Court Clarifies Directors' Duties in Bankruptcy*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 6, 2007), https://corpgov.law.harvard.edu/2007/06/06/the-gheewalla-case-the-delaware-supreme-court-clarifies-directors-d/.

9. ALLEN ET AL., *supra* note 5, at 192–98.

10. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 120 (1965) (noting the difficulty in distinguishing between mergers motivated by quests for monopoly and those attempting to establish management in poorly run companies); *see also* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981) (claiming that management's defensive tactics to a tender offer decrease the welfare of shareholders); ALLEN ET AL., *supra* note 5, at 579–82.

11. *See* 15 U.S.C. § 77e (forbidding most offers or sales absent filing a registration statement); *Form S-1: Registration Statement Under the Securities Act of 1933*, U.S. SEC. EXCH. COMM'N, https://www.sec.gov/files/forms-1.pdf (the basic disclosure form for registered offerings); *see also* 17 C.F.R. pt. 229 (2002) (setting forth particular disclosure line items).

12. *See* 15 U.S.C. §§ 78l, 78m (requiring registration of so-called public companies under the Securities Exchange Act of 1934); *see also Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, U.S. SEC. EXCH. COMM'N, https://www.sec.gov/files/form10-k.pdf (the form for a domestic public company's annual report).

anti-fraud liability.[13] Non-public companies raising capital through private offerings may not be subject to mandatory disclosure requirements (for instance, offers to accredited investors may have no required disclosure), but anti-fraud liability continues to apply.[14]

Most securities disclosure obligations and anti-fraud liability provisions are subject to a "materiality" standard, in which material information must be disclosed and misstatements or omissions trigger liability. Material information is defined to be that which a reasonable investor would care about. Courts apply basic financial theory to this standard to conclude that any information that impacts expectations of future corporate earnings, and the risks of those expectations not coming to pass, meets the materiality threshold.[15] Looking at markets as a whole, which are assumed to comprise reasonable investors, any information that actually moves markets must be material as well; courts regularly draw such an inference in securities fraud lawsuits.[16]

This system is thought to be efficient based on economic theory of how market traders utilize information about expected corporate earnings and risk. In liquidity discount models of securities trading, market participants compete against one another in a zero-sum game in which any informational edge may allow its possessor to conduct a profitable trade at the expense of its counterparty.[17] Informed traders spend resources on information (search costs) as they

13. 15 U.S.C. §§ 77k, 77i.

14. *See, e.g.*, 17 C.F.R. § 230.506 (2021) (providing an exemption for sales to accredited investors); *see also* 17 C.F.R. § 240.10b-5 (1992) (general antifraud liability under Rule 10b-5, applicable to public and private securities offerings).

15. *See* In re Adams Golf, Inc. Sec. Litig., 381 F.3d 267, 276 (3d Cir. 2004) ("[T]o the extent that information is not important to reasonable investors, it follows that its release will have a negligible effect on the stock price.") (quoting In re Burlington Coat Factory Sec. Litig., Inc., 114 F.3d 1410, 1425 (3d Cir. 1997)); James C. Spindler, *Why Shareholders Want Their CEOs to Lie More After Dura Pharmaceuticals*, 95 GEO. L. J. 653, 660–62 (2007).

16. *In re Adams Golf*, 381 F.3d at 276.

17. Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71, 72 (1985); Thomas E. Copeland & Dan Galai, *Information Effects on the Bid-Ask Spread*, 38 J. FIN. 1457, 1458 (1983); *see* James C. Spindler, *Integrity and Innovation in the Public Capital Markets: A Survey of the Securities Law Literature*, *in* HANDBOOK ON LAW, INNOVATION AND GROWTH 45, 45–50 (Robert E. Litan ed., 2011) (discussing the effects of informational asymmetry, including the costs on uninformed market players); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 642–43 (1992) (discussing information asymmetry in trading markets and incentives to engage in costly search).

seek to make profitable trades; these search costs are largely inefficient as they do not affect the real economy and, further, they are duplicative efforts among numerous traders.[18] Alternatively, investors may abstain from the market if they fear being expropriated in any trades that they might make (a form of precaution cost). The incentives to engage in such search and precaution costs increase with the degree of uncertainty about the security. It follows that compelling the issuer to disclose information about itself reduces uncertainty and duplicative search costs and encourages more investors to participate in markets. This, in turn, lowers the cost of capital and has positive effects on capital allocation.[19] This is the general justification for the existence of the mandatory disclosure regime in U.S. securities law and for the liability rules that attach, in various forms, to misstatements and omissions that make issuer disclosures more credible than they would otherwise be.[20]

III. SHAREHOLDER RISK-ADJUSTED RETURNS

A. Definition and examples

ESG is often defined in a way that is aligned with traditional corporate disclosures and the shareholder maximization paradigm.[21] For instance, MSCI, a leading ESG data provider, defines ESG as

18. There are potential indirect effects of greater pricing efficiency, such as better capital allocation and the reduction of managerial agency costs. For contrasting views on the importance of market efficiency and its market effects, see Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988), and Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L. J. 977 (1992).

19. Because traders will be able to sell their investments with lower liquidity costs in the secondary markets, they will be more willing to invest with issuers in the first place. In addition, a disclosure regime helps prevent low-quality companies from imitating or claiming to be high-quality companies—known as "pooling" in economics. This allows high-quality companies to raise capital more cheaply and leads to the efficient allocation of capital in the economy.

20. *See* Spindler, *supra* note 17, at 54 (discussing the disclosure-based rules in U.S. securities law).

21. *See* Amanda M. Rose, *A Hard Look at Portfolio-Focused Stewardship*, 2020 COLUM. BUS. L. REV. 313, 316 (2024) ("ESG disclosure advocates—which include many of the largest traditional asset managers—are often careful to cast their demands as in the interests of purely financially motivated investors, and the SEC has explicitly justified its proposed climate-related disclosure mandates in terms of their financial rather than social significance to investors.").

"[i]nvesting with a systematic and explicit inclusion of ESG risks and opportunities with the intention to enhance long-term risk-adjusted returns."[22] This is also apparent with financial rulemaking around climate change issues; the SEC[23] and the Federal Reserve,[24] in this context, view ESG as a lens for evaluating and managing emerging

22. *ESG 101: What is Environmental, Social and Governance?*, MSCI, https://www.msci.com/esg-101-what-is-esg/ (last visited Mar. 20, 2024).

23. As the SEC recently stated in its proposed climate disclosure rule:

> Investors need information about climate-related risks—and it is squarely within the Commission's authority to require such disclosure in the public interest and for the protection of investors—because climate-related risks have present financial consequences that investors in public companies consider in making investment and voting decisions. Investors have noted that climate-related inputs have many uses in the capital allocation decision-making process including, but not limited to, insight into governance and risks management practices, integration into various valuation models, and credit research and assessments. Further, we understand investors often employ diversified strategies, and therefore do not necessarily consider risk and return of a particular security in isolation but also in terms of the security's effect on the portfolio as a whole, which requires comparable data across registrants.

The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21335–36 (Apr. 11, 2022).

24. *See* Michael S. Gibson, *Climate-Related Financial Risks*, BD. GOVERNORS FED. RSRV. SYS. (July 18, 2023), https://www.federalreserve.gov/newsevents/testimony/gibson20230718a.htm (discussing the Federal Reserve's work relating to the financial risks of climate change); *Agencies Issue Principles for Climate-Related Financial Risk Management for Large Financial Institutions*, BD. GOVERNORS FED. RSRV. SYS. (Oct. 24, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20231024b.htm (discussing the regulatory principles introduced by federal bank agencies for the management of climate-related financial risks for large financial institutions); *Statement by Chair Jerome H. Powell on Principles for Climate-Related Financial Risk Management for Large Financial Institutions*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Oct. 24, 2023), https://www.federalreserve.gov/newsevents/pressreleases/powell-statement-20231024b.htm (stating that the Federal Reserve's responsibilities regarding the financial risks of climate change are linked to its responsibilities for bank supervision). In contrast to the Federal Reserve's approach of merely requiring banks to consider climate factors in their overall risk management programs, the European Central Bank has intervened to "shape bank behavior" toward decarbonization policies. Monica DiLeo et al., *Why the Fed and ECB Parted Ways on Climate Change: The Politics of Divergence in the Global Central Banking Community* 1 (Hutchins Ctr., Working Paper No. 88, 2023).

risks and opportunities that would impact returns, volatility, safety, and soundness. This view is also echoed by fund managers. In his 2022 annual letter to CEOs, Larry Fink—chairman of Blackrock, the world's largest asset manager—broadly equated capitalism, sustainability, and stakeholder welfare, arguing that ESG concerns are integral for companies and funds to deliver maximal returns to shareholders.[25]

In this framing, there is nothing new about ESG; it is just a means towards achieving the standard goal of shareholder maximization. The ESG framing may facilitate this goal if the factors it addresses were otherwise underappreciated by investors, companies, or both. Alternatively, ESG could be a convenient framing—akin to Generally Accepted Accounting Principles (GAAP)—that creates a consistent language for codifying and disclosing risks that otherwise lack a formal language or structure. For example, imagine a company whose current business model relies heavily on (legally) dumping mercury into a reservoir. Under an ESG regime, disclosures would reference the risks associated with the activity, such as legal liability, negative press resulting in reputational damage, or future adverse regulatory action. The company would be obligated to disclose its reliance on this dumping activity and the regulatory and reputational risks that attend to it. ESG score providers would rate it poorly. In contrast, a competitor company that chose an expensive alternative to dumping would have more positive ESG disclosures, score better on ESG indices, and overall would be viewed as having lower future risk, and potentially higher future profits. We would expect investors to use the information when determining the fair market price for the two companies. If the price implication of the potential risks of dumping were larger than the savings it generates, then the dumping company would suffer a lower trading price, the competitor would trade at a relative premium, and the dumping company would have an economic incentive to reform its environmentally destructive practices.

25. Larry Fink, *Larry Fink's 2022 Letter to CEOs: The Power of Capitalism*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (arguing that "[i]t is through effective stakeholder capitalism that capital is efficiently allocated, companies achieve durable profitability, and value is created and sustained over the long-term. . . . Stakeholder capitalism is all about delivering long-term, durable returns for shareholders. . . . Our conviction at BlackRock is that companies perform better when they are deliberate about their role in society and act in the interests of their employees, customers, communities, and their shareholders.").

Even though this example focuses on a company's environmental effect, the story fits neatly into the shareholder value maximization paradigm, so long as there is some mechanism to internalize the costs of the activity onto the offending company. Possible mechanisms include the potential for new laws, future regulatory action, or reputational concerns. So long as such a mechanism exists, some degree of accounting for the costs of the activity is simply good business. That said, the impact of the shareholder-returns version of ESG is necessarily narrow, at least with regards to its broader effect on society. Not all socially responsible activities are profit-maximizing. It would be implausible, for instance, that an oil and gas concern would maximize profits through a socially conscious strategy of completely shutting down operations. Instead, the benefits are limited to areas where shareholders, investors, or both, were either unable to assess the returns implications of ESG-related issues, or were doing so incorrectly, absent ESG-related disclosures.[26]

B. Enforcement issues

If ESG is merely a lens for maximizing risk-adjusted investor returns, then traditional financial enforcement mechanisms should work well in implementing ESG-promoting behaviors and maintaining the credibility of ESG disclosures and commitments. In fact, the U.S. system of corporate governance and securities disclosure is generally designed to maximize shareholder returns.

Shareholder-centric corporate governance provides the tools by which shareholders hold management accountable, including through voting, the market for corporate control, and managers' fiduciary duties to maximize firm value. A company that does not incorporate such ESG concerns into its strategy and operations will underperform. Shareholders will dislike this and will vote accordingly. Additionally, the price of the underperforming corporation's securities will trade lower, making them more subject to takeovers in the market for corporate control.

Similarly, securities disclosure and liability are likely to be effective in this context. Public firms are already under a duty to disclose material information, and if ESG factors impact future cash

26. It is worth noting that this version of ESG should also be non-controversial given the prevalence and mainstream acceptance of the shareholder maximization paradigm. We would posit that some of the current resistance to ESG, such as that evinced by some states such as Texas, is likely based on alternative views of ESG.

flows or risk, then those factors are material and arguably should have been disclosed already. Misrepresentations about material ESG factors will affect valuation, satisfying the practical requirement that a stock fraud suit is often premised upon some form of market movement to demonstrate materiality, causation, and damages. If a firm lies about the sustainability of its business model in a material fashion, revelation of the truth will result in a lower share price and investors will have a cause of action under current anti-fraud law. In all, it appears that the securities laws will function as well for this type of ESG information as they do for other material information.

However, there remains the meta-question of whether an announced ESG approach actually maximizes shareholder returns. Consider an oil company that claims its renewable energy investments are good business. One can see that verifying such a claim is difficult at best since ESG-focused business practices may rely, by construction, on engaging potential risks that may never actually come to fruition. While, over time, data should accumulate on ESG practices in general, evaluating risk-adjusted claims in real time is difficult; risk is typically measured ex post, looking at price fluctuations and correlations over time, and this is particularly difficult, if not impossible, for a single firm. In broad terms, as noted by Professors Max M. Schanzenbach and Robert H. Sitkoff, the empirical evidence on ESG returns is equivocal.[27] From a theoretical perspective, hard constraints—such as entirely divesting oil and gas assets—are unlikely to be first-best optimal. As others have pointed out, ESG may provide a backdoor for managers to maximize their own preferences or to benefit outside constituencies, ultimately exacerbating agency costs, frustrating good corporate governance, and causing inefficient firm operation.[28]

However, investors are likely to be able to assess the importance and salience of a firm's ESG claims as well as anyone. To the extent that the market values a particular ESG initiative, or reacts to corrective disclosures of false ESG claims, the current system should function as well as it does for other types of profit-oriented information.

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27. Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 433–47 (2020).

28. Rose, *supra* note 21, among others, notes this backdoor problem.

IV. SHAREHOLDER NON-PECUNIARY (GREENIUM) ESG

A. Definition and examples

It is possible that shareholders are not solely interested in pecuniary benefits. Rather, investors may value the non-monetary effects of a firm's activities, obtaining utility from activities that do not contribute to the firm's cash flows or investment returns—what we refer to as shareholder non-pecuniary ESG (sometimes using the term "greenium" as shorthand).[29] For example, investors might derive utility from an energy company's commitment to minimize its effect on the environment and preserve biodiversity in sensitive areas. Or, at the fund level, investors may choose a mutual fund based on an investment strategy that seeks to invest in socially conscious companies and/or avoids companies with a perceived negative social impact (such as producers of guns or tobacco products). Professors David H. Webber, Michal Barzuza and Quinn Curtis assert that index fund managers have engaged in competition to provide such ESG policies to attract a new generation of socially motivated investors.[30] A general characteristic of this form of ESG is that certain shareholders or other investors are willing to forego some purely financial returns in exchange for a non-pecuniary return.

One dividing question about this form of ESG is what, specifically, these "green" investors value: do they place a high value on public goods, or do they value holding investments that fund such projects? Much depends on this distinction. One recent and influential theoretical paper by Professor L'uboš Pástor et al. models green investors as deriving utility from holding investments that generate positive externalities, resulting in a price premium (though less than the non-pecuniary utility derived by investors), lower monetary returns, and a reduced cost of capital for green firms.[31]

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29. The term "greenium" comes from the financial economics literature, though the context is often that of debt securities. *See* S. MacAskill, E. Roca, B. Liu, R.A. Stewart & O. Sahin, *Is there a green premium in the green bond market? Systematic literature review revealing premium determinants*, 280 J. CLEANER PROD. 124491 (2021) https://doi.org/10.1016/j.jclepro.2020.124491.

30. David H. Webber, Michal Barzuza & Quinn Curtis, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 SO. CAL. L. REV. 1243, 1244 (2020).

31. *See* L'uboš Pástor, Robert F. Stambaugh & Lucian A. Taylor, *Sustainable Investing in Equilibrium*, 142 J. FIN. ECON. 550, 551 (2021) (noting the importance of positive externalities for green investors).

However, it is something of an internal contradiction that the Pástor model assumes that financial investments in public good providers are transformed into an excludible private good. One could imagine a plausible alternative in which somewhat altruistic investors value public goods rather than investments in public goods per se. This would result in free riding, as investors benefit from the public good regardless of their portfolio allocations, muting any price effects associated with green activities. This seems a more convincing interpretation of investor preferences, at least as applicable to the United States today.[32] Conceivably, if altruistic fund managers grow larger or become better able to coordinate with one another, such free riding may decline through a form of "portfolio-focused stewardship" that eliminates externalities, though this theory has its problems.[33] On the other hand, empirical studies tend to show a degree of underperformance of green investments, which is consistent with at least some amount of investment-oriented preference, as in Pástor et al.; underperformance is, however, also consistent with poor management.[34]

Further, while the Pástor et al. article took firm characteristics as given, in reality, firms adapt in response to investor preferences. We could just as easily ask how the presence of green investors affects the choices of value-maximizing firms, which must presumably find the optimal tradeoff between pecuniary and non-pecuniary objectives.

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32. Polls consistently show that a majority of Americans believe in global warming and support at least some policy response, but there is no widespread groundswell shareholder movement to shut or limit fossil fuels, and both clean energy stocks and traditional energy stocks remain highly responsive to financial performance. *See* Jennifer Marlin et al., *Yale Climate Opinion Maps 2023*, YALE PROGRAM ON CLIMATE COMMC'N. (Dec. 13, 2023), https://climatecommunication.yale.edu/ for a recent example of a survey of climate change opinions. Clean energy stocks significantly underperformed in 2023. *See* Krystal Hur, *Clean energy stocks have fallen out of favor. They face more challenges ahead*, CNN (Dec. 3, 2023), https://www.cnn.com/2023/12/03/investing/clean-energy-stocks-challenges-cop28/ (explaining that high interest rates and the world's slow transition to clean energy have contributed to the decline in clean energy stock returns despite billions in public and private investment).

33. Rose, *supra* note 21. Rose provides a critical examination of the claims of proponents of portfolio-focused stewardship; these claims effectively require that index funds (the portfolio stewards) be able to eliminate harmful competitive pressures among portfolio firms but retain the positive competitive pressures. Portfolio-focused stewardship is equivalent to a top-down planned economy, in which a central planner can outperform a disaggregated market responding to price signals—a dubious proposition.

34. *See* Pástor, *supra* note 31, at 552 (collecting studies).

This is similar to adjusting for risk aversion; a company should forgo a project with high expected payoffs if its risk characteristics result in a high enough discount rate. Similarly, the presence of green investors would mean that some "brown" projects may be unappealing despite favorable financial returns. In essence, the relative prominence of green investors (and the strength of their non-pecuniary preferences) will determine corporate activity.

B. Enforcement issues

Corporate governance and the market for corporate control

Because this form of ESG is driven by shareholder preferences, and because shareholders remain the residual claimants for both pecuniary and non-pecuniary benefits, the ordinary corporate governance mechanisms of shareholder control should work reasonably well. Shareholders will vote their interests, instituting policies that they desire. Some conflicts could arise as the firm becomes insolvent, as shareholders are no longer residual claimants and creditors become the new focus of fiduciary obligations, because the firm's creditors may differently value non-pecuniary benefits. In addition, there may be credibility or monitoring problems inherent in ESG-related representations or results, since they are less tangible than realized cash flows. This is reflected, for instance, in concerns about "greenwashing," in which ESG goals exacerbate agency costs by allowing managers more leeway to maximize their own self-interest. Further, the ability of investors to monitor and supervise managers by stock price (in which investors reward or punish managers based on stock price movements) will be reduced if price effects are less than complete.[35]

The market for corporate control should function properly, although the specifics may depend on the coordination capacities of the different types of investors. In principle, both green and non-green investors could coordinate amongst themselves; green activists may be willing to take-over or influence brown companies to make them greener, if optimal to do so, and vice-versa. In practice, it may be more plausible that the representative public market investor has some green preferences but faces high coordination costs. If true, companies may

35. *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1541 (2007) (outlining the relationship between stock prices and investor preferences).

find it optimal to sell certain assets (or relegate certain activities) to private enterprises run by deep-pocketed non-green investors (a form of greenwashing that caters to investor preferences). Examples include an energy company that eschews coal production only to have the foregone coal snapped up by dirty producers overseas, or a producer of humanely produced chicken eggs whose animal supply chain utilizes inhumane methods. This raises a conundrum for the Pástor et al. model of green investing: do green investors still enjoy utility from investments in companies that provide public benefits when those benefits are undone by others in the economy? Does Green Investor A garner utility from sequestering carbon if Brown Investor B invests in a company that puts as much carbon back in the atmosphere?

However, if investors value public goods rather than excludible investments in public goods, there will be little to be gained from such machinations, and in fact firms expending resources on public goods may be attractive takeover targets. This is not really a governance problem since it simply reflects shareholder preferences: while public goods will be underproduced due to free riding, with firms instead focusing on return maximization, this is owing to shareholders' rational choice to free ride.

Securities disclosure

Generally speaking, problems arise in the securities disclosure context because of variation in investor preferences. In a typical securities fraud investor class action, shareholders have a cause of action for the drop in stock price that occurs upon the revelation of the fraud.[36] Misstatements should be priced accurately in the firm's stock price, with the delta between the price at the time of the fraud and at the revelation of the fraud corresponding to the damage done to investors. However, when investors have different preferences, this statement only applies at the level of the representative investor. If only some investors are green, then a fraud related to ESG would have a muted price impact, vis-à-vis the harm done to those investors. Similarly, a fraud related to financial returns would have a muted price impact vis-à-vis non-green investors. In essence, green investors are underinsured against ESG fraud and over-insured against financial fraud; non-green investors are the reverse. While this does not necessarily alter the deterrence effect of disclosures for the company, it could increase the incentives for investors to engage in search costs associated with risks against which they are underinsured. This could

36. While there is more complexity than this, such stock price drops do provide a basis on which to establish materiality, causation, and damages.

argue for heightened disclosure requirements, for both ESG matters and financial matters.

In contrast, if investors instead value public goods, we reach the opposite conclusion. Because the externalities of a public good are (by definition) non-excludible, an ESG investor would enjoy the benefits or detriments of investment-created public goods regardless of whether she herself was financially invested in them, giving green investors an incentive to share information rather than secret it for themselves. This implies that the current system of mandatory disclosure, designed to save on duplicative search costs, is inapt for ESG concerns and imposes an excessive compliance burden on ESG-related issues. This is a sort of silver lining to the public goods free riding problem: while investors may have socially inadequate incentives to research and provide public goods, they do have reasonably good incentives to share what information they have with other investors.

Finally, typical company disclosure obligations extend only to the company itself, not to trading partners or other market participants; the impact of creating public goods or avoiding public bads may be overstated or even illusory. Scope 3 emissions disclosure, for instance, is an attempt at solving this problem in the carbon space (although it creates issues of its own). This suggests an innate limitation to what corporate ESG can do, as opposed to government regulation (such as regulatory-driven ESG, discussed below), in avoiding public bads. As a corollary, ESG investors may be ineffective until they reach government-like proportions. It also implies that current disclosure obligations, which typically only extend to the company's own internal activities, would need also to capture supply chains and other trading counterparties to be effective.

V. STAKEHOLDER ESG

A. Definition and examples

Stakeholder ESG is a form of firm governance designed to benefit some non-shareholder constituency through representation of that constituency in the management of the corporation. The motivation for stakeholder ESG is that, for some reason, the appropriate guardrails ensuring that corporate behavior is pro-social are lacking. For example, if the legislative and regulatory processes are slow or unresponsive, they may fail to force corporations to internalize their costs. Perhaps broadening the represented

stakeholders will accomplish indirectly what the first-best approach of regulation and shareholder maximization cannot.

The means for accomplishing this vary and include statutes requiring representation of certain constituencies (such as labor, women or minorities) on the corporate board, statements of corporate or fund purpose that explicitly reference non-shareholder constituencies, appointment of ideologically or socially motivated management personnel, and incentive packages that are tied to goals such as diversity, environmental stewardship, or social impact.[37]

In these framings, non-shareholder constituencies are intended to receive benefits from corporate activity. Accordingly, in stakeholder ESG, shareholders are not (fully) in the driver's seat: some amount of ownership and control over the corporation is granted to a non-shareholder constituency or its proxy. The mechanism for influence occurs through corporate management rather than shareholder choice: board appointees to represent constituent interests or managers who are incentivized to favor constituent interests. In some cases, these mechanisms may be imposed exogenously (as with the proposed Accountable Capitalism Act, which would place labor representatives on corporate boards). In other cases, they may be imposed by corporate founders or shareholder determinations to bind themselves to the mast, so to speak, in the future by establishing socially oriented goals, constraints, or benchmarks, perhaps enshrined in the corporate charter or other governing documents.[38] We could

37. *See* Merel Spierings, *Linking Executive Compensation to ESG Performance*, HARVARD L. SCH. F. ON CORP. GOVERNANCE (Nov. 27, 2022), https://corpgov.law.harvard.edu/2022/11/27/linking-executive-compensation-to-esg-performance/ ("The vast majority of S&P 500 companies are now tying executive compensation to some form of ESG performance."); Benjamin Broomfield, The 28 CEOs—Predominantly White Males—Who Earned $5 Million in DEI Bonuses Last Year, HR GRAPEVINE (Nov. 1, 2024), https://www.hrgrapevine.com/us/content/article/2024-11-01-meet-the-28-ceos-majority-white-men-who-earned-5million-in-dei-bonuses-last-year.

38. *See* Mark Segal, *"Going Purpose:" Patagonia Owner Donates Entire Company to Fight Climate Change*, ESG TODAY (Sept. 15, 2022), https://www.esgtoday.com/going-purpose-patagonia-owner-donates-entire-company-to-fight-climate-change/ ("Outdoor apparel company Patagonia announced Wednesday that its founder Yvon Chouinard and his family have transferred ownership of the entire company to a climate-focused non-profit and a newly created trust, with all future non-reinvested profits generated by the company dedicated to 'protect the planet.'"); Barbara Ortutay, *OpenAI's Unusual Nonprofit Structure Led to Dramatic Ouster of Sought-After CEO*, AP News (Nov. 21, 2023), https://apnews.com/article/openai-chatgpt-board-fired-sam-altman-dd6a15228fd11aa3b9bec2914c095271 ("Unlike Google, Facebook and other tech

also conceive of the appointment of ideological managers as another way of committing to certain socially oriented policies.[39]

Whatever the implementing mechanism, stakeholder ESG means that corporate management does not seek to maximize shareholder welfare (at least not ex post), but, rather, balances in some way payoffs to shareholders and non-shareholders. [40] This likely reduces shareholder value: shareholders relinquish at least some control, and a hitherto unrecognized constituency asserts claims on corporate productivity.[41]

B. Enforcement issues

Corporate governance

Because stakeholder ESG is no longer serving shareholder interests, the shareholder franchise is by itself insufficient to instantiate stakeholder-oriented corporate objectives. Rather, stakeholder ESG places the constituency or its proxy somewhere within corporate management, whether at the board or executive levels, with some levers of influence or control over corporate activities.

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giants, the company behind ChatGPT was not created to be a business. It was set up as a nonprofit by founders who hoped that it wouldn't be beholden to commercial interests."); Theo Francis, Berber Jin & Tom Dotan, *OpenAI's Complex Path to Becoming a For-Profit Company*, WALL ST. J. (Sept. 29, 2024, 12:01 AM), https://www.wsj.com/tech/ai/openais-complex-path-to-becoming-a-for-profit-company-bad21a42.

39. *See* Muireann Bolger, *Coco-Cola GC Threatens Attorney Fee Cuts Over D&I*, WORLD IP REV., (Feb. 3, 2021), https://www.worldipreview.com/diversity/coca-cola-gc-threatens-attorney-fee-cuts-over-d-i-21003 ("Coca-Cola will withhold a nonrefundable 30% of fees from law firms that fail to meet its new diversity requirements."); Nathan Lewin, *Will Lawyers Comply With Coca-Cola's Racial Quota*, NEWSWEEK (Mar. 18, 2021, 7:30 AM), https://www.newsweek.com/will-lawyers-comply-coca-colas-racial-quota-opinion-1576962.

40. Stakeholder ESG is often conflated with shareholder returns ESG. For instance, Larry Fink's 2022 Letter to CEOs states that stakeholder capitalism is equivalent to maximizing shareholder returns. Fink, *supra* note 25. This is not, in general, true.

41. Conceivably, joint welfare maximization has the potential to make shareholders better off than they otherwise would have been, but this will depend on the ability to bargain to efficient outcomes as well as the split of surplus between shareholders and other constituents. In other words, while stakeholder ESG can conceivably result in a larger pie, the shareholders' piece of that pie may not be larger.

Possibly, such an arrangement has the potential to enhance social welfare. Instead of maximizing merely shareholder welfare, the firm now seeks to maximize the joint welfare of shareholders and the constituency. This improves social welfare if the corporation's activity imposes a cost on that constituency that is not otherwise internalized in the corporation (i.e., through the normal channels). We expect this joint maximization if Coasian bargaining takes place within the firm. Even if shareholder and constituent interests are largely opposed, a Coasian solution allows them to maximize their joint self-interest, with some resulting split of the surplus paid to each. As a hypothetical: if a representative of sea-ice loving polar bears is injected into an oil exploration company, there is still a joint-welfare-maximizing bargain that can be struck even if we assume oil extraction is antithetical to the preservation of sea ice. If the sea ice is more valuable to the bears than oil extraction is to the shareholders, the joint-welfare-maximizing solution is to stop drilling. If not, then keep drilling. In the Coasian bubble of the firm, the bears (or their representatives) and shareholders can determine the optimal course of action and agree to follow it. Of course, if one or the other party has the upper hand in corporate management, we might expect that corporate activity will track that party's preference, rather than the social optimal. To aid the bargaining process, however, in a Coasian environment the parties can make side-payments. If the sea ice is more valuable, then a side-payment can be made from the bears to the shareholders. If drilling is more valuable, then a side payment is made from shareholders to the bears. Corporate governance in this instance works because, even though neither the bears nor the shareholders are individually the residual claimants, they are together the joint residual claimants, and they can act together to maximize joint welfare. In what could be termed the "Larry Fink[] version of stakeholder capitalism,"[42] there is at least the potential that shareholders can be made better off in the presence of actual joint welfare maximization since the collective surplus will be bigger; conceivably, such a constraint could serve as a check on the subset of bogus ESG plans that do not actually maximize social welfare and which make shareholders worse off.[43]

42. *Larry Fink's Shell Game*, BOARDROOM MAGAZINE, INSTITUTE OF DIRECTORS (Autumn 2022), at 64, 64.

43. Under the Larry Fink version of the world, shareholders could feel good about the social impact of their corporation whenever the stock price goes up. This would, were it not for the likely problems that follow, make managing by stock price, a la Gordon, an efficient way to enforce management's ESG commitments.

Of course, the above hypothetical raises a problem: how do stakeholders such as polar bears make or receive side payments? Even if the bears' poor bargaining skills are made up for through a human proxy, it would be difficult to determine how they could recompense the oil company's shareholders for foregoing drilling (or vice versa). Without side payments, problems of inefficient corporate activity (viz., is it really better not to drill, and how do we prove this?) and managerial agency costs (is ESG just a cover for something managers wanted to do anyway?) re-emerge. Another way of viewing the problem is that the polar bears are no longer residual claimants, and they or their proxy do not have incentives to maximize corporate value or social welfare, even though they may now have control of the levers of corporate management. Such problems may be lessened when the stakeholder constituents are commercial parties, such as labor. Labor representatives not only have a history of able bargaining, but they have the ability to make monetary side-payments, such as reducing wages in return for better working conditions or job security. Still, problems of non-residual claimancy remain: labor may not, for instance, suffer in the way shareholders do in a corporate reorganization (German codetermination does not, by way of example, extinguish labor board representation upon insolvency, nor would Warren's Accountable Capitalism Act),[44] and thus have little skin in the game with regard to certain detrimental activities and corporate risk-taking.[45] Labor may benefit from tunneling, where corporate surplus is shoveled out the door to them through higher wages and benefits, none of which is subject to clawback or forfeiture in the event of insolvency or discovery of bad activity. Such things call into doubt incentives of labor in particular, and stakeholders more generally, to manage in a social welfare-maximizing fashion.

Securities disclosure

There is reason to doubt that the securities disclosure regime will render credible firms' claims that they efficiently serve stakeholder interests. Stakeholder interests are not directly reflected in stock prices. Unlike greenium ESG, in which shareholders value non-monetary benefits, shareholders in stakeholder ESG place no intrinsic

44. Jens Dammann & Horst Eidenmueller, *Codetermination and the Democratic State* 41 (European Corp. Governance Inst., Working Paper No. 536/2020, 2020); Jeffrey Meli & James C. Spindler, *The Promise of Diversity, Inclusion, and Punishment in Corporate Governance*, 99 TEXAS L. REV. 1387, 1419 (2021).

45. Arguably, this was the case with the Volkswagen diesel scandal, which involved employees at all levels. Meli & Spindler, *supra* note 44, at 1419.

value on benefits given to other stakeholders. If management announces a (socially efficient) stakeholder ESG program that is costly to shareholders, the reaction to the announcement is likely to be negative. Share price reaction, then, will be insufficient to distinguish an efficient stakeholder ESG program from an inefficient one. Conversely, if a stakeholder ESG program disclosure is found to be materially inaccurate, the price reaction could well be positive, if shareholders infer that management is, in fact, only working for them.

Because the securities disclosure regime relies principally on price movements to establish materiality, causation, and damages, it appears unlikely that securities fraud litigation would deter misstatements about undertaking stakeholder ESG programs.[46] It would conceivably discipline statements about having ended them: shareholders may welcome the cessation of such programs.

VI. REGULATOR-DRIVEN

A. Definition and examples

Finally, we consider the concept of regulator-driven ESG. In this framing, a regulator charged with investor protection attempts to impose her own preferences on companies, influencing their behavior in a way that the regulator believes is pro-social, typically through disclosure rules. In order to distinguish this from the other forms of ESG, we assume here that any such change in corporate behavior comes at a cost to shareholders; i.e., left to their own devices, even armed with a full understanding of the implications of the activity, shareholders prefer the status quo. An example would be if the SEC's carbon emissions disclosure rule was intended to reduce overall emissions, rather than better inform investors about the risks of said activity, but that emitting carbon is otherwise both legal and profitable.

Like with stakeholder ESG, the motivation for regulator-driven ESG could be a failure of the legislative and regulatory process to appropriately address the externalities of corporate activity. For example, securities regulators could believe that the rules governing carbon emissions imposed by other regulators are insufficient to address climate change and design ESG disclosures to address this

46. Laura Wamsley, *Exxon Wins New York Climate Change Fraud Case*, NPR (Dec. 10, 2019, 12:15 PM), https://www.npr.org/2019/12/10/780317799/exxon-wins-new-york-climate-change-case.

gap. While the SEC is our principal example, other regulators have enacted ESG-oriented investor protection mandates, such as NASDAQ's diversity comply-or-disclose requirement, as well as foreign regulators.[47]

That regulator preferences influence their rule-making seems uncontroversial. We can look to any change in Presidential administration to find myriad examples of rules that are reversed or changed without any accompanying change to federal law.[48] In fact, the expansive discretion afforded to regulators has attracted significant criticism, including the successful challenge to the *Chevron* doctrine last term.[49] However, the statutes that govern the regulators charged with investor protections are quite specific. The SEC, for example, has a limited statutory mandate, and cannot propose regulations simply because a majority of the commissioners believe they would be good for society. Any preference-satisfying proposals must be carefully framed so as to fit squarely within statutory mandate. Despite this careful framing, many commentators have alleged that the SEC is exceeding its authority and imposing a values-based rulemaking.[50]

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47. *Order Approving Proposed Rule Changes, as Modified by Amendments No. 1, to Adopt Listing Rules Related to Board Diversity and to Offer Certain Listed Companies Access to a Complimentary Board Recruiting Service*, U.S. SEC. EXCH. COMM'N (Aug. 6, 2021), https://www.sec.gov/files/rules/sro/nasdaq/2021/34-92590.pdf (adopting requirement that companies either have at least two diverse board members or explain the company's reasons for not meeting this diversity objective).

48. For example, the Biden administration reversed (or is in the process of reversing) many regulatory changes made by the Trump administration. To cite just two examples, Obama-era rules governing offshore drilling were reinstated and the administration is proposing to largely reinstate Obama-era rules associated with Title IX and campus sexual assault that were changed under the Trump administration. Kevin McGill, *Biden Reinstates Stricter Offshore Safety Rules, Reverses Trump era Policies*, PBS NEWSHOUR (Aug. 22, 2023, 5:16 PM), https://www.pbs.org/newshour/politics/biden-reinstates-stricter-offshore-safety-rules-reverses-trump-era-policies; Katherine Knott, *New Title IX Rules Are Out. Here's What You Need to Know*, INSIDE HIGHER ED (April 19, 2024), https://www.insidehighered.com/news/government/2024/04/19/biden-administration-finalizes-title-ix-overhaul.

49. Amy Howe, *Supreme Court strikes down* Chevron, *curtailing power of federal agencies*, SCOTUSBLOG, (June 28, 2024, 12:37 AM), https://www.scotusblog.com/2024/06/supreme-court-strikes-down-chevron-curtailing-power-of-federal-agencies/.

50. *See* Jay Clayton, Patrick McHenry, *The SEC's Climate-Change Overreach*, WALL ST. J. (Mar. 20, 2022, 4:37 PM), https://www.wsj.com/articles/the-secs-climate-change-overreach-global-warming-risks-lawmakers-invertors-market-data-11647801469. The authors (a former SEC Chairman and a Republican Congressman

The SEC has been its own critic on this issue. In commenting on the recent (begrudging) approval of bitcoin exchange traded products ("ETPs"), Commissioner Hester Piece claims that personal views about the validity of bitcoin as an investment or asset contaminated the review process of the proposed new products[51]:

> If we had applied the standard we use for other commodity-based ETPs, we could have approved these products years ago . . . .
> . . . .
> . . . we have abused administrative procedures to withhold investments that we do not like from the public.
> . . . .
> . . . Our unreasonable approach to these applications has signaled that regulatory prejudice against new products and services can lead us to sidestep the law and unreasonably delay product launches.

B. Enforcement

Given the limited authority of securities regulators, they cannot simply mandate the behavior that they desire. This raises an important and obvious question: why would disclosure mandates that are ex-ante immaterial to shareholders affect corporate behavior?[52] If

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from North Carolina, respectively) argue that the SEC climate disclosure proposal exceeds its authority, which rightly lies with Congress, and predict that the proposal will be subject to judicial challenge. *See also* Richard Shinder, *Mission Creep at the SEC*, CITY J. (Apr. 5, 2022), https://www.city-journal.org/article/mission-creep-at-the-sec (characterizing the move as "mission creep" on the part of the SEC).

51. Hester M. Pierce, *Out, Damned Spot! Out, I Say! Statement on Omnibus Approval Order for List and Trade Bitcoin-Based Commodity-Based Trust Shares and Trust Units*, U.S. SEC. EXCH. COMM'N (Jan. 10, 2024), https://www.sec.gov/news/statement/peirce-statement-spot-bitcoin-011023. The approval process for bitcoin ETFs lasted over a decade, and eventual approval was catalyzed by a legal challenge to the SEC. Grayscale Invs., LLC v. Sec. and Exch. Comm'n, 82 F.4th 1239 (D.C. Cir. 2023).

52. Here we abstract from the cost of complying with the mandates themselves. Some critics of the SEC climate disclosures claim that the costs of compliance are themselves burdensome. *See* Letter from Cass Sanford to Securities and Exchange Commission, Re: File No. S7-10-22: The Enhancement and Standardization of Climate-Related Disclosures for Investors, (Dec. 22, 2020), https://www.sec.gov/comments/s7-10-22/s71022-20153387-320794.pdf (offering such a critique).

shareholders prefer the status quo, and if action to address any gaps exposed by the disclosures is costly, shareholders will, left to themselves, simply ignore the disclosure.[53] It will not affect corporate governance, and misstatements or inaccurate disclosures are unlikely to have an effect on equity valuations, removing any discipline provided by potential shareholder action. In other words, regulator ESG requires an enforcement channel through which (supposedly) pro-social disclosure rules influence company behavior.

We would argue that there is a channel from mandated disclosure into corporate governance, whereby disclosure shines a spotlight on companies, making them visible and potential targets for sympathetic activists, stakeholders, and legislators. Negative publicity, reputational damage, and adverse legislative or further regulatory action can lead to significant costs. In light of such a result, or fearing such a result might occur, the disclosure mandate then compels shareholders to demand change because the cost associated with activity changes with disclosure. This strategy harnesses shareholder value maximization; in so doing, it also provides an end-run around the regulator's limited statutory authority. Even a disclosure that ex-ante has no relevance for shareholders can become relevant by the very the act of disclosure.

Other researchers have identified the role disclosure can play in catalyzing pressure on companies from other (non-shareholder) stakeholders.[54] These stakeholders can include "market actors" such as customers, suppliers, and employees.[55] They can also include activists and special interests, who can more easily mobilize public opinion once armed with disclosures, and even regulators and policy makers, who may find it easier to address societal ills once presented with the information contained in disclosures.

There is significant evidence that pressure of this kind is routinely applied, that this pressure is often catalyzed by disclosure of

53. Although true in theory, reality could be more complex. *See* George Loewenstein, Cass R. Sunstein & Russell Golman, *Disclosure: Psychology Changes Everything*, 6 ANN. REV. ECON., 391, 403 (2014) (noting that disclosure may result in a change in behavior even absent any economic incentives to do so in a phenomenon termed the "tell-tale heart").

54. Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. ON REGUL. 499, 511–516 (2020). Lipton identifies community activism and customer boycotts as two channels that can influence company behavior, and she cites several examples where such activism has succeeded.

55. The term "market actors" is taken from Amanda M. Rose, *supra* note 21, at 33.

information, and that it can affect company behavior. For example, Google (owned by Alphabet) declined to renew an AI contract with the U.S. military in response to pressure from employees.[56] Bank of America committed to ending its financing of for-profit prisons, in part due to pressure from activists, who confronted the CEO at the company's annual shareholder meeting.[57] These tactics work (when they do) largely because of their effect on shareholders. Loss of reputation, bad press, customer boycotts, and employee turnover are all concerns for shareholders. An issue that is immaterial to a shareholder ex-ante can become material ex-post once it is in the news.

In other words, disclosure can effect change by creating materiality where none naturally existed. It harnesses shareholder maximization for "good," at least as conceived of by the regulator and like-minded activists, by using public pressure to force shareholders to internalize (real or perceived) externalities associated with their activity.

This form of ESG enforcement appears to work in at least some instances. As evidenced by the above examples, pressure from non-shareholder stakeholders can influence corporate activity. Disclosure requirements aid this process by both increasing the information these stakeholders have regarding corporate activity and by creating a uniform reporting standard, which facilitates effective cross-company comparisons. This eases the coordination process; activists can better identify the worst offenders and concentrate their efforts accordingly. It also eases the remediation process for corporations. Any progress that results from change will be easily identified and thus mitigate the pressure tactics and their attendant costs. Shareholders can be assured that costly action will have the expected results.

That said, there are several weaknesses of this strategy. One is that the ability to impose costs on corporations does not necessarily scale with the gravity of the malfeasance, rendering this mode of ESG activism imprecise. A simple example illustrates the point. Imagine a corporation (legally) dumps wastewater, saving $100 in water treatment costs, but that the societal costs (e.g., from future

56. Daisuke Wakabayashi & Scott Shane, *Google will not renew Pentagon contract that upset employees*, BUS. AND HUM. RTS. CTR. (June 1, 2018), https://www.business-humanrights.org/en/latest-news/google-will-not-renew-pentagon-contract-that-upset-employees/.

57. Imani Moise, *Bank of America to stop financing operators of private prisons, detention centers*, REUTERS (June 26, 2019, 3:04 PM), https://www.reuters.com/article/usa-immigration/bank-of-america-to-stop-financing-operators-of-private-prisons-detention-centers-idUSL2N23X1JL/.

remediation, health consequences, etc.) total $200. The first-best solution is for the company to incur the $100 treatment costs. A disclosure mandate about wastewater treatment could mobilize activists, community representatives, and other stakeholders to impose pressure, generate negative press, protest at company headquarters, and so on. To be effective, the total reputational costs of these tactics must exceed $100. Costs below that threshold would not force the company to incur the treatment cost. Note that the hurdle is not linked to the full societal costs, but rather to the private benefits enjoyed by the company. Nonetheless, the costs associated with protests and bad press are unlikely to scale proportionately with the costs of the activity, implying that the effectiveness of regulator ESG is likely to be limited to smaller-scale issues.

Consider the example of private prisons mentioned above, where activists have had success. The negative press around private prisons caused eight banks representing over 80% of the financing commitments to the largest operators to commit to withdrawing financing, resulting in an increase in the cost of capital to the industry.[58] However, this required little economic sacrifice from banks; the private prison industry is small. The two largest operators together generated just over $4 billion in revenue in 2023.[59]

Contrast this with the fossil fuel industry, which is large; ExxonMobil alone generates over 100 times as much revenue as the entire private prison industry.[60] There is no shortage of pressure on banks to reduce their financing commitment to this industry.[61]

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58. *See* Gin Armstrong, *Private Prisons Now Face 87.4% Financing Gap as Banks Continue to Flee Industry,* LITTLESIS.ORG (Aug. 14, 2019), https://news.littlesis.org/2019/08/14/private-prisons-now-face-87-4-financing-gap-as-banks-continue-to-flee-industry/ (noting the CEO of CoreCivic commented directly on the resulting increased cost of capital, and GEO group mentioned the increased financing risk in its quarterly reporting).

59. Peter Wagner and Bernadette Rabuy, *Follow the money of mass incarceration,* PRISON POL'Y INITIATIVE (Jan. 25, 2017), https://www.prisonpolicy.org/reports/money.html (estimating the revenue of the two largest operators of private prisons (CoreCivic and GEO Group), which "dominate" the industry, at $3.62 billion as of 2015).

60. *See* Exxon Mobil Corporation, Annual Report (Form 10-K) (Feb. 22, 2023).

61. Some recent examples include coordinated protests at large US banks. *See, e.g.*, Michael Copley & Paola Moura, *Climate activists target nation's big banks, urging divestment from fossil fuels,* NPR (Mar. 22, 2023, 6:38 AM), https://www.npr.org/2023/03/22/1165127291/climate-change-activists-target-big-banks-divest-from-fossil-fuels (describing efforts by protestors to urge banks including JPMorgan Chase, Bank of America, and Citi to stop funding fossil fuel

However, given the size of the industry, this change would be much more costly. As a result, U.S. banks have not only continued to finance the industry, they have at times made public commitments to do so.[62] In fact, the state of Texas produces a list of banks that boycott the industry, as part of a state law that prohibits state agencies from entering contracts over $100,000 with such entities.[63] It is notable that the list contains no U.S. banks (all of the banks on the list are European).[64]

The Texas law is also a good example of the second, more interesting weakness of regulator ESG. Disclosure can cut both ways; the SEC is not the only game in town. Several states have passed laws that link state business to corporate policies on ESG issues. For example, Florida House Bill 3 prohibits state pension funds from considering "non-pecuniary" factors (specifically, "social, political, or ideological interests") when making investments.[65] The aforementioned Texas law prohibits agencies from doing business with banks and other financial services providers that boycott fossil

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projects); Erum Salam, *Climate protesters call out US banks for funding fossil fuel projects,* THE GUARDIAN, (Apr. 25, 2023, 11:02 AM), https://www.theguardian.com/environment/2023/apr/25/climate-protest-citibank-banks-fossil-fuel-funding (reporting on climate activist protests outside Citibank headquarters).

62. For example, Goldman Sachs CEO David Solomon defended Goldman's support of the fossil-fuel industry and dismissed calls from activists to reduce financing of the sector. Sridhar Natarajan, *Goldman CEO Dismisses Calls to End Ties to Fossil-Fuel Firms*, BLOOMBERG NEWS (Sept. 25, 2023), https://www.bloomberg.com/news/articles/2023-09-25/goldman-ceo-dismisses-calls-for-ending-ties-to-fossil-fuel-firms.

63. *See* Comptroller of Public Accounts, *List of Financial Companies that Boycott Energy Companies: Frequently Asked Questions*, TEX. COMPTROLLER (October 2023), https://comptroller.texas.gov/purchasing/docs/divest-energy.pdf (providing an FAQ on the review process and the consequences of being included on the list).

64. The list includes (along with the country of domicile) BNP Paribas (France), Credit Agricole (France), Danske Bank (Denmark), HSBC (UK), Nordea Bank (Finland), Société Générale (France), Svenska Handelsbanken (Sweden), Swedbank (Sweden), and UBS (Switzerland). The list also contains asset managers, including one US institution (Blackrock). For lists of the companies identified by Texas, *see List of Financial Companies that Boycott Energy Companies*, TEX. COMPTROLLER (last visited Sept. 25, 2024), https://comptroller.texas.gov/purchasing/docs/divest-energy.xlsx

65. Martine E. Cicconi, Mark R. Herring, Stacey H. Mitchell, Brian Arthur Pomper, Ryan C. Anderson & Christopher A. Treanor, *Florida Enacts Anti-ESG Legislation—House Bill 3 Explained*, AKIN GUMP STRAUSS HAUER & FELD LLP (May 19, 2023), https://www.akingump.com/en/insights/alerts/florida-enacts-anti-esg-legislation-house-bill-3-explained (providing a summary of the Florida law).

fuels, refuse to finance gun manufacturers, or boycott Israel.[66] Of note, the classification scheme used by Texas to identify companies that boycott fossil fuels makes explicit use of both ESG scores and company disclosures on ESG related issues.[67]

These laws can act as a counterweight to ESG related activism; in fact, they could even be viewed as an alternative form of (anti) ESG activism. They increase the costs associated with bowing to activist pressure. Shareholders will respond to the net cost of any adjustment. These include both direct costs, such as the lost revenue from not doing business with Texas and Florida, as well as any indirect costs associated with the reputational and political consequences of being singled out by these states. The current zeitgeist around ESG, and the revised approach and framing undertaken from some early adopters of ESG, challenges the efficacy of regulator ESG.

Finally, the anti-ESG policies of Texas and Florida highlight another problem with regulator ESG, which is that there is no guarantee that any particular activist regulator is correct. The SEC stands at odds with Texas and Florida, and, to paraphrase Lincoln, they cannot all be correct. Regulatory fiat is not subject to nearly the same degree of market discipline as are individual companies and funds. If regulator demands are generally perceived as material because, for one reason or another, there are significant hazards to crossing the regulator and ending up in the crosshairs, then corporate governance and securities disclosure will generally bend to regulatory will, viewing compliance as positive and non-compliance as detrimental.

VII. CONCLUSION

The lack of consensus on the definition of ESG presents a significant hurdle to understanding the effectiveness of ESG disclosures. We propose four principal definitions of ESG, differentiated by their intended effect and the underlying mechanisms through which ESG-related disclosures influence the decisions of corporations and investors.

Two of these definitions are centered around shareholders. The least controversial is that in which ESG is seen as a means towards more effective maximization of shareholder value, premised on the

66. *List of Financial Companies that Boycott Energy Companies: Frequently Asked Questions*, *supra* note 64.

67. Texas used ESG scores compiled by MSCI and public pledges and/or commitments to third party organizations related to "net zero" targets. *Id.* at 2.

view that ESG issues are important inputs into shareholders' standard assessments of risk and return, but that the existing disclosure rules inadequately motivate disclosure about these factors. The "greenium" view of ESG is similar, in that ESG is considered an input into maximizing shareholder value, but that shareholder value contains both a pecuniary and a non-pecuniary, or "green," component, at least at the level of the representative investor. In both cases, ESG disclosures are likely to function as expected in the existing enforcement framework. Shareholders care about the information, use it to evaluate securities prices, and can use the typical framework to seek redress for fraudulent or inaccurate disclosures.

One difference, however, is the efficacy and necessity of mandatory disclosure. For shareholder returns ESG, the standard motivation applies; ESG disclosures will be effective (although new requirements are arguably unnecessary since the information likely ought to be disclosed under existing requirements). In the second, the need for disclosure requirements depends on what, exactly, investors value: investments in "green" companies versus "green" outputs. In the former, investors are either over- or under-insured against both financial and ESG risks, depending on their preferences, which argues for more robust disclosure requirements to avoid inefficient search costs. In the latter, disclosures may be unnecessary, as investors have strong incentives to pool information. There are further nuances regarding market control, which could encourage a separating equilibrium, whereby investors self-segregate into investments that more closely fit their specific preferences. Understanding if, and how, investor preferences have actually changed is an important step in determining the necessity and optimal scope of ESG disclosures.

The last two definitions are centered on improving social welfare, either through operating directly upon the corporation through the inclusion of stakeholders, or indirectly through the preferences of activist regulators. In either case, the intention is to close a gap between the status quo and a first-best outcome, on the premise that the existing regulatory regime is somehow ill-suited to force companies to internalize the costs of their activities. These are more controversial and more likely the source of the emerging resistance to ESG. If the presumption that the existing regime is inadequate at addressing externalities is correct, both of these types of ESG have promise; it is theoretically possible for either to effect change. However, they also both face significant challenges. First, the existing enforcement regime is centered around shareholders, who may be ambivalent or even opposed to the reforms these types of ESG

are intended to engender. They both face implementation hurdles. Stakeholder ESG requires identifying the right stakeholders and finding a mechanism to include them alongside shareholders as residual claimants. Regulator ESG is subject to anti-ESG backlash; the information in ESG disclosures can be used to inveigh against reforms as easily as to support reforms and of course requires that regulators be "right" when they choose the optimal behaviors they want to encourage. This latter view, in particular, is a philosophical departure for a regulator like the SEC, which has traditionally relied heavily on the market to assess information and determine the appropriate response. We conclude that simply mandating ESG disclosures, unaccompanied by significant other changes to the enforcement regime, is unlikely to achieve the goals of these forms of ESG.