



***THE SYSTEMIC INTERACTION BETWEEN CORPORATE
GOVERNANCE AND ESG: THE CASCADE EFFECT***

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Abstract

This chapter intends to structure the analysis, in different angles, on how corporate governance interacts with ESG (environment, social and governance) matters. Corporate governance relevance goes beyond being the “G” pillar of ESG, as one of the three criteria for responsible investment. The corporate governance system serves to prepare, adopt, execute, monitor, and enforce decisions in ESG matters. Therefore, the interaction between corporate governance and ESG is structural, reciprocal and multifaceted. Two main levels are to be taken into account: the investors’ level and the investee companies’ level.

One of the cornerstones of this analysis is the concept of the ESG cascade effect here described as the potential aptitude for companies to engage in ESG-based decisions and to systemically influence others to do so, including investors, investee companies and their respective supply chain and community.

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I. INTRODUCTION

In recent years a growing number of companies have adopted ESG (Environment, Social and Governance) objectives in their investment activities. Asset managers, banks¹, insurers and other financial institutions have taken the lead in this respect, showing concern about the social and environmental impact of their investments, and promoting their alignment with United Nations Sustainable Development Goals (UN-SDGs) and the Paris Agreement on climate change.

One important indicator relates to the signatories of the United Nations Principles of Responsible Investment (UNPRI), the pioneer ESG standard. The number of signatories to UNPRI has reached more than 3.800 organizations, with total of over 100 trillion USD assets represented. Large international fund managers (including the 'Big Three'²) have identically voiced their support to ESG³. Consequently, the number of ESG financial products (namely ESG investment funds and ESG pension funds) and their inflows rose considerably⁴. Moreover, there is a growing number of funds rebranding to ESG⁵.

In a stricter sense, ESG is the broad term that refers to the inclusion of environmental (E), social (S) and governance (G) criteria into investment decisions taken by companies as a manifestation of responsible or sustainable investment practices. While at its core ESG relates to investors' portfolio decisions, some extensions are to be considered to other financial decisions, namely investment advice decisions, lending decisions, and underwriting decisions⁶. In its turn, financial institutions' decisions are aimed at generating successive and lasting impact in

¹ MAZARS, *Responsible banking practices Benchmark study* (2021) shows that in 2020 74% of the banks adopted ESG measures, while in 2019 the percentage was of 49% (based on a sample of 37 banks based in Africa, the Americas, Asia-Pacific and Europe); MAFALDA DE SÁ, *ESG and banks*, Chapter 19 in this book.

² BlackRock, Vanguard, and State Street Global Advisors. See LUCIAN BEBCHUK/ SCOTT HIRST, *The Spectre of the Giant Three*, Boston University Law Review, Vol. 99, (2019), 721-741.

³ LARRY FINK, *Letter to CEOs*, (2018-2021). JOSÉ AZAR/ MIGUEL DURO/ IGOR KADACH/ GAIZKA ORMAZABAL, *The Big Three and Corporate Carbon Emissions Around the World*, ECGI – Finance Working Paper 715/2020 have shown that 'firms under the influence of the Big Three are more likely to reduce corporate carbon emissions'; JILL FISCH/ ASAF HAMDANI/ STEVEN DAVIDOFF SOLOMON, *The New Titans of Wall Street, A Theoretical Framework for Passive Investors*, 168 Penn. L. Rev. 17 (2019). Critically, arguing for the existence of a 'rational hypocrisy' from the Big Three, see ANNA CHRISTIE, *The Agency Costs of Sustainable Capitalism*, University of Cambridge Faculty of Law Research Paper No. 7/2021; LUCIAN BEBCHUK/ SCOTT HIRST, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 Colum. L. Rev. 2029 (2019).

⁴ MORNINGSTAR, *Sustainable Fund Flows Reach New Heights in 2021's First Quarter* (30 April 2021).

⁵ DANA BRAKMAN REISER/ ANNE M. TUCKER, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, Cardozo Law Review, Vol. 41, (2020), 1923; ATTRACTA MOONEY, *Greenwashing in finance: Europe's push to police ESG investing*, FT (10-mar.-2021), using Morningstar data.

⁶ See namely HAO LIANG/ LUC RENNEBOOG, *Corporate Social Responsibility: A review of the literature*, (2020), ECGI WP 701/2020, 4 ("incorporation of Environmental, Social and Governance considerations into corporate management and investor's portfolio decisions").

invested companies and in other organisations (*'cascade effect'*⁷). Therefore, ESG can also be viewed in a broader sense, where it relates to the influence of environmental, social and governance criteria in organisational decision-making at any level⁸.

ESG clearly marked a turning point of the evolution of the financial system, as it rapidly became an international movement of investors⁹. Hart/ Zingales call it a *"new mantra"*¹⁰, while Mark Carney admits that *'there is real momentum behind sustainable investing'*¹¹ and Rebecca Henderson¹² and Guido Ferrarini¹³ refer to ESG as *'a game changer'*.

Historically, the term ESG was coined at a United Nations 2004 joint initiative of financial institutions¹⁴ which were invited by United Nations Secretary-General Kofi Annan to develop guidelines and recommendations on how to better integrate environmental, social, and corporate governance issues in asset management, securities brokerage services and associated research functions. The topic was later developed in other United Nations initiatives¹⁵ – and most notably the Principles of Responsible Investment, that promotes ESG criteria in asset management. The main Principles address the need to incorporate ESG issues into investment analysis and decision-making processes, the promotion of active ownership and incorporation of ESG issues into ownership policies and practices and the push for appropriate disclosure on ESG issues by the invested entities¹⁶.

Therefore, at the essence of ESG lies the recognition of an inextricable link between environmental and social sustainability and corporate governance¹⁷. In other words, ESG expresses the connection between corporate governance and social and environmental sustainability. Badly governed companies cannot be sustainable.

⁷ Regarding ESG cascade effect, see further below, 4.4. and 9.

⁸ ALAN PALMITER, *Capitalism, beat thyself* (2021), available at SSRN 3950395. Regarding the influence of ESG in SOE and smart cities, see JOSÉ MIGUEL LUCAS, Chapter 21 in this book.

⁹ JOHN HALE, *A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights*, Morningstar, (21-jan.-2021) referring \$51 billion in 2020 of sustainable funds in the US in contrast to \$5.4 billion in 2018.

¹⁰ The *"new mantra"*, especially in Europe, is ESG: OLIVER HART / LUIGI ZINGALES, *Serving shareholders doesn't mean putting profit above all else*, Promarket.org, (oct.-2017).

¹¹ MARK CARNEY, *Value(s). Building a better world for all*, London (2021), 420.

¹² REBECCA HENDERSON, *Reimagining Capitalism. How business can save the world*, (2020), 141.

¹³ GUIDO FERRARINI, *Corporate Purpose and Sustainability*, ECGI - Law Working Paper #559/2020 (*'sustainability as a game changer'*), 58-61 and Chapter 2 in this book.

¹⁴ GLOBAL COMPACT, *Who Cares Wins Connecting Financial Markets to a Changing World Recommendations by the financial industry to better integrate environmental, social and governance issues in analysis, asset management and securities brokerage*, (2004).

¹⁵ See FRESHFIELDS, *A legal framework for the integration of environmental, social and corporate governance issues into institutional investment*, UNEP FINANCE INITIATIVE, (2005).

¹⁶ For further information, see unpri.org.

¹⁷ DOROTHY LUND/ ELISABETH POLLMAN, *The Corporate Governance Machine*, ECGI Working Paper n. 564 (2021), 35; BEATE SJÄFJELL / BENJAMIN J. RICHARDSON, *Company Law and Sustainability. Legal Barriers and Opportunities* (eds.), Cambridge, (2015), 313.

This movement erupted as a market-led initiative encouraged by the UN, but recently, this trend has also been amplified by regulatory pressure. The European Union began the route¹⁸ mainly¹⁹ through the European Commission Action Plan on Financing Sustainable Growth (2018), followed by the European Green Deal (2019), and the European Green Deal Investment Plan (2020). Then came a succession of important legislative interventions facilitating ESG activism, such as the Shareholder Rights Directive II²⁰ (that namely fosters shareholders' engagement), the Pension Funds Directive II/IORP II²¹ (allowing and encouraging pension funds to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors), the Benchmarking Regulation (concerning Paris-aligned Benchmarks)²², the Sustainable Finance Disclosure Regulation (SFDR) (imposing disclosure duties in respect to financial market participants)²³, the Taxonomy Regulation (establishing a taxonomy of sustainable objectives)²⁴ and the Corporate Sustainability Reporting Directive (CSRD) (that expands sustainability-related information duties)²⁵. Other legislative initiatives are expected to be approved soon²⁶. Some relevant measures have also been announced in the US, both by the Biden Presidency and by the SEC²⁷.

¹⁸ Signalling a 2018 shift in respect to previous legislative interventions, see LUCA ENRIQUES/ PAULO CÂMARA, *The Portuguese Securities Code at Twenty: Some Comments on the Expansion, Goals and Limits of EU Financial Market Law*, Caderno do Mercado de Valores Mobiliários, (2021). For further analysis, see ANTÓNIO GARCIA ROLO, *ESG and EU Law*, in Chapter 10 in this book.

¹⁹ The 2008 amendment to Article 11 of the Treaty on the functioning of the European Union also paved the way to a subsequent legislative policy re-direction (see BEATE SJÄFJELL / BENJAMIN J. RICHARDSON, *Company Law and Sustainability. Legal Barriers and Opportunities* (eds.), cit., 313).

²⁰ Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

²¹ Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs).

²² Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector. For further analysis, see JOANA FRADE/ JULIEN FROUMOUTH, *ESG Reporting*, in Chapter 12 in this book.

²³ Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks.

²⁴ Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment. For further analysis, see RUI DE OLIVEIRA NEVES, *The EU Taxonomy Regulation*, Chapter 13 in this book.

²⁵ Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022.

²⁶ Reference is made namely to Proposal on due diligence requirements to protect human rights and the environment in the supply chain (CSDDD) and to the level 2 measures related to SFDR and Taxonomy Regulation (regarding the latter, see Guido Ferrarini, Chapter 2 in this book).

²⁷ SECURITIES AND EXCHANGE COMMISSION, *Release No. 33-11042; 34-94478, The Enhancement and Standardization of Climate-Related Disclosures for Investors* (2022); WHITE HOUSE, *A Roadmap to Build A Climate-Resilient Economy* (October 14, 2021); SUZANNE SMETANA, *ESG and the Biden Presidency*, Harvard Law School Forum on Corporate Governance (19-feb.-2021); PAUL MAHONEY/ JULIA MAHONEY, *The New Separation of Ownership and Control: Institutional Investors and ESG*, Virginia Law and Economics Research Paper n. 2021-09.

This chapter intends to be setting the scene and to analyse, in different angles, how corporate governance interacts with ESG (environment, sustainability and governance) matters. A corporate governance system involves connectivity, complementarity, and interaction of all its elements²⁸. The inclusion of ESG objectives affects the whole governance system, as it impacts decision-making processes, ownership policies, product governance strategies, internal control procedures and disclosures. Therefore, the influence of ESG in corporate governance, and vice-versa, is not peripheral, but it is systemic. We therefore propose to briefly present the topics under discussion by addressing the systemic nature of the interference between corporate governance and ESG.

²⁸ CRISTINA MELE/ JAQUELINE PELS/ FRANCESCO POLESE, *A Brief Review of Systems Theories and Their Managerial Applications*, Service Science, Vol. 2, No. 1/2 (2010), 130-131.

II. CORPORATE GOVERNANCE AND ESG: LEVELS OF IMPACT

The sharp rise of ESG activity occurs at a time when some major trends have transformed the global corporate governance landscape.

On the one hand, climate change concerns have escalated at global level. Transition to a net zero economy appears as inevitable but the progress on meeting the 2015 Paris Agreement targets has been unsatisfactory so far. The COP 26 Glasgow meeting (2021) also confirmed some key States' difficulties in translating words into concrete action. This context reinforced the role of the private sector in addressing climate change and the need to clarify and to strengthen the role of companies in the mitigation and adaptation to the environmental crisis.

On the other hand, institutional investors have been more active and vocal in ESG matters. In the past decade, globally shareholder ownership of listed companies suffered a major shift towards the formation of shareholder blocks owned by large institutional investors ("reconcentration of equity ownership")²⁹. This trend³⁰ propelled a growing role to be played by institutional investors. The large scale of portfolios of these institutional investors (by some coined the 'universal owners'³¹), with diversification and investment in several countries, implied a priority in addressing systemic risks, such as climate change risks. Against this backdrop, the largest asset managers and banks have been widely supportive in ESG matters³².

In several jurisdictions such trend was amplified by a proliferation of stewardship codes, which encouraged a clarification of institutional investors' stewardship duties and paved the way for their further engagement with invested companies³³. The original driver for this trend was the influential UK Stewardship Code, whose 2020 version expanded the scope of stewardship by embracing ESG

²⁹ JAY CULLEN/ JUKKA MÄHÖNEN, *Taming unsustainable finance. The perils of modern risk management*, in BEATE SJÄFJELL / CHRISTOPHER M. BRUNER (EDS.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge, (2019), 103.

³⁰ RONALD J. GILSON/ JEFFREY GORDON, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights* (2013), ECGI – Law Working Paper n. 197; RONALD J. GILSON/ JEFFREY GORDON, *Agency Capitalism: Further Implications of Equity Intermediation* (2014), ECGI Working Paper n. 239/2014; RONALD J. GILSON, *Leo Strine's Third Way: Responding to Agency Capitalism*, *Journal of Corporation Law* vol. 33 (2007), 47-56.

³¹ FREDERICK ALEXANDER, *An Honorable Harvest: Universal Owners Must Take Responsibility for Their Portfolios*, *Journal of Applied Corporate Finance* Vol. 32, 2, (Spring 2020), 24-30.

³² WOLF-GEORG RINGE, *Investor-led Sustainability in Corporate Governance*, ECGI WP n. 615/2021, 13-16; JEFFREY GORDON, *Systematic stewardship*, ECGI WP n. 566/2021.

³³ DIONYSIA KATELOUZOU/ ALICE KLETTNER, *Sustainable Finance and Stewardship: Unlocking Stewardship's Sustainability Potential*, ECGI - Law Working Paper No. 521/2020.

concerns³⁴. Such Code states that *signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities*³⁵. The same pattern was followed by the 2020 version of the ICGN Global Stewardship Principles. This approach irradiated globally. In a recent account it is estimated that 84% of the stewardship codes refer to ESG topics³⁶.

Furthermore, following a longstanding debate on corporate social responsibility, an increased attention is given to the inclusion of environmental and social concerns in the purpose of the companies³⁷, taking into account not only shareholder interests, but also stakeholder interests, such as workers, clients, creditors, business partners and the community³⁸. This broader concept of corporate purpose is not contrary to profit-making. The gist of purposeful business implies that companies must be profitable, but profit is not in itself the purpose of companies³⁹. This vision of purpose beyond profit was namely embodied in a widely publicised US Business Roundtable 2019 Statement⁴⁰ subscribed by 183 US CEO's, and in Davos Manifesto (2020) as well as in several important interventions by the British Academy⁴¹.

This purposeful business movement implies a focus placed on the foundational reason why each company exists. As ALEX EDMANS states: '*a purpose defines who the enterprise is and why it exists*'. Professor COLIN MAYER and the British Academy further

³⁴ PAUL DAVIES, *The UK Stewardship Code 2010-2020 from Saving the Company to Saving the Planet?*, ECGI WP n. 506/2020.

³⁵ FRC, *The UK Stewardship Code*, (2020), Principle 7.

³⁶ DIONYSIA KATELOUZOU / DAN W. PUCHNIAK, *Global Shareholder Stewardship: Complexities, challenges, and possibilities*, ECGI WP 595/2021 9, 47.

³⁷ See BEATE SJÄFJELL, Chapter 3 in this book. See also COLIN MAYER, *Firm Commitment*, Oxford (2013); Id., *Prosperity. Better business makes the greater good*, Oxford (2018); COLIN MAYER/ BRUNO ROCHE (ed.), *Putting purpose into practice. The economics of mutuality*, Oxford, (2021); COLIN MAYER / RONALD GILSON/ MARTIN LIPTON, *Corporate Purpose and Governance*, *Journal of Applied Corporate Finance* vol 31 n. 3 (Summer 2019); JILL FISCH / STEVEN DAVIDOFF SOLOMON, *Should Corporations have a Purpose?* ECGI - Law Working Paper n.° 510/2020 (2020); MARTIN LIPTON/ STEVEN A. ROSENBLUM/ KARESSA L. CAIN/ SABASTIAN V. NILES/ AMANDA S. BLACKETT/ KATHLEEN C. IANNONE, *It's time to adopt The New Paradigm*, Harvard Law School Forum on Corporate Governance (2019); NUNO MOREIRA DA CRUZ/ FILIPA PIRES DE ALMEIDA/ MANON BLOM-EL NAYAL, *Responsible business leadership and the path towards purpose*, Católica Lisbon Center For Responsible Business & Leadership (abr.-2020).

³⁸ See GUIDO FERRARINI, *Sustainability as a game changer*, Chapter 2 in this book.

³⁹ COLIN MAYER/ BRUNO ROCHE (ed.), *Putting purpose into practice. The economics of mutuality*, Oxford, (2021)11-12.

⁴⁰ BUSINESS ROUNDTABLE, *Statement on the Purpose of the Corporation*, (2019). Regarding the relevance of this document, with contrasting views, see: (in a negative sense) LUCIAN BEBCHUK/ ROBERTO TALLARITA, *The Illusory Promise of Stakeholder Governance* (2020); Id., LUCIAN BEBCHUK/ KOBİ KASTIEL/ ROBERTO TALLARITA, *For Whom Corporate Leaders Bargain*, Southern California Law Review, Volume 93, (2021); LUCA ENRIQUES, *The Business Roundtable CEOs' Statement: Same old, same old*, Promarket, (9-sept.-2019); and (in a positive sense) MARGARET BLAIR, *Two Years After the Business Roundtable Statement: Pointing in the Right Direction*, ProMarket (13-sept.-2021); COLIN MAYER, *Shareholderism Versus Stakeholderism – a Misconceived Contradiction. A Comment on 'The Illusory Promise of Stakeholder Governance' by Lucian Bebchuk and Roberto Tallarita*, ECGI Law Working Paper No. 522/2020.

⁴¹ BRITISH ACADEMY, *Reforming Business for the 21st Century. A Framework for the Future of the Corporation* (2018); Id., *Principles for Purposeful Business. How to deliver the framework for the Future of the Corporation*, (2020); Id., *Policy & Practice for Purposeful Business. The final report of the Future of the Corporation programme*, (2021).

sustain that “*the purpose of the corporation is to do things that address the problems confronting us as customers and communities, suppliers and shareholders, employees and retirees*”⁴², while the Davos Manifesto stated that the purpose of a company is “*to engage all its stakeholders in shared and sustained value creation. In creating such value, a company serves not only its shareholders, but all its stakeholders – employees, customers, suppliers, local communities and society at large*”⁴³. Moreover, the COVID-19 pandemic crisis also forced a rethink from boards and investors in terms of the core corporate values and increased the attention to social and environmental priorities⁴⁴.

The evolution regarding corporate purpose is relevant under ESG because it places a wider range of interests (including climate, social and governance targets) at the forefront of the underlying objective of a company. Furthermore, it has a great potential to be explored both from investment companies and from invested companies. On the one hand, as a matter of internal and external coherence it is expected that the ESG strategy of financial institutions is aligned with their self-determined purpose⁴⁵. On the other hand, due to the pressure of investors, ESG decisions taken at invested companies’ level are expected to match their respective corporate purpose.

The interaction between corporate governance and ESG is therefore structural, reciprocal, and multifaceted. Two main levels are to be considered: the investors’ level and the invested companies’ level.

On the one hand, at investors’ level, corporate governance represents the pillar “G” under the acronym ESG (environment, social, and governance) and therefore corporate governance stands as one of the main criteria for responsible investment. A plethora of corporate governance indicators is therefore used by asset managers and other financial institutions in order to guide their investment strategy. The Corporate sustainability reporting Directive (CSRD) lists the following governance factors: *(i) the role of the undertaking’s administrative, management and supervisory bodies with regard to sustainability matters, and their composition, as well as their expertise and skills in relation to fulfilling that role or the access such bodies have to such expertise*

⁴² COLIN MAYER, *Prosperity. Better business makes the greater good*, cit., 40; Id., *Corporate Purpose and Governance*, *Journal of Applied Corporate Finance* vol 31 n. 3 (Summer 2019), 14; BRITISH ACADEMY, *Principles for Purposeful Business. How to deliver the framework for the Future of the Corporation*, (2020), 8.

⁴³ WORLD ECONOMIC FORUM, Davos Manifesto 2020.

⁴⁴ MARK CARNEY, *Value(s). Building a better world for all*, (2021), 211-260.

⁴⁵ See however below the analysis regarding product-specific strategies.

*and skills; (ii) the main features of the undertaking's internal control and risk management systems, in relation to the sustainability reporting and decision-making process; (iii) business ethics and corporate culture, including anti-corruption and anti-bribery, the protection of whistleblowers and animal welfare; (iv) activities and commitments of the undertaking related to exerting its political influence, including its lobbying activities; (v) the management and quality of relationships with customers, suppliers and communities affected by the activities of the undertaking, including payment practices, especially with regard to late payment to small and medium-sized undertakings*⁴⁶. Such catalogue should not be deemed as exhaustive. Other corporate governance indicators – such as remuneration and disclosure practices – are also to be considered.

The role and significance of governance in this context, however, goes beyond being the third ESG pillar. In effect, at the financial institutions' level, ESG also implies involvement of the whole system of governance of the institutional investors namely from the board, the investment function, compliance, HR, and the risk management functions. This is relevant in order to effectively channel ESG guidelines into investment decisions, dialogue with stakeholders, due diligence and risk management exercises and finally to provide accurate internal and external information regarding their execution.

On the other hand, financial firms usually manage and distribute financial products with different degrees of ESG involvement. In fact, each financial product may incorporate a distinct ESG strategy and relevant differences may be shown between each fund or portfolio managed. Non-ESG financial products differ substantially from ESG financial products, and the latter can also imply different levels of sustainability commitment, as we will see further below⁴⁷. Particularities may derive from the different nature of financial instruments, from diverse type of underlying management (eg. active vs. passive management) or from diverse investment policies. Therefore, the product-specific features also impact the relationship between corporate governance and ESG.

Finally, at invested firm level, the growing investor pressure in ESG matters will determine further scrutiny in respect to the ESG options taken by each invested

⁴⁶ Article 29b 2 c) CSRD.

⁴⁷ The EU Regulation SFDR provides for a classification of the ESG degree of involvement of financial products in terms of environmental objectives, as we will analyse below. See *infra*, 4.2.

company. Therefore, in its turn, this will impact the companies' policies, its culture, and its actions – in what is further below described as a part of a 'cascade effect' of ESG⁴⁸. This also leads for a need of accurate information regarding ESG, both for internal and external purposes.

In sum, corporate governance operates not only as a criterion of sound investment (under the 'G' pillar), but also as an enabler of ESG-related decisions. At both investor-level and invested-level, the corporate governance system serves to prepare, adopt, execute, monitor, and enforce decisions in ESG matters.

⁴⁸ See below, at 4.4 and 9.

III. ESG SCOPE AND MAIN COMPONENTS

As its scope tends to be increasingly wider, ESG encompasses different financial institutions and therefore investment decisions are impacted by distinct degrees of regulation. The central element of ESG deals with asset managers - including investment fund managers, pension fund managers, private equity managers, portfolio managers and insurance companies who manage insurance-based investment products. The common denominator is that these entities take investment decisions on behalf of their clients: they are empowered to buy and sell financial instruments and to exercise rights (including voting rights) attached to the financial instruments under management. Asset managers have therefore fiduciary duties in respect to the beneficiaries of the funds and portfolios managed. Asset management is precisely a financial service where fiduciary duties are more intense⁴⁹.

The EU Sustainable Finance Disclosure Regulation (SFDR) also includes in its scope investment advisory firms⁵⁰, due to their influence in investment decisions. Furthermore, ESG has also the potential of being a reference for banks and other financial institutions in terms of other financial products and services - namely green deposits, green loans, and sustainability-linked loans⁵¹.

The expansion of ESG scope of application does not follow a 'one size fits all' logic. In this respect ESG is a more pressing matter to asset managers than e.g. to investment consultants, because the former take investment decisions on behalf of their clients (decision-making role), while the consultants' activity is to render investment advice (decision-influencing role).

In respect to asset managers, the impact of ESG is central and decisive, because it shapes investment strategies, ownership guidelines and stewardship policies. In the words of Finance Professor REBECCA HENDERSON *'the widespread use of material, replicable, comparable ESG metrics is a game changer, potentially enabling investors to develop a much richer understanding of the relationship between a firm's investment in*

⁴⁹ Under MiFID II, suitability duties are more intense regarding asset management. See MAX MATHEW SCHANZENBACH/ ROBERT SITKOFF, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, Stanford Law Review vol. 72 (2020), 381-ff; TIAGO SANTOS MATIAS, *EU asset managers' run for green*, Chapter 20 in this book.

⁵⁰ Articles 2(11), 3, n. 2, 4 n. 5 and 6 n.2 of Regulation (EU) 2019/2088.

⁵¹ See MAFALDA DE SÁ, *ESG and banks*, Chapter 19 in this book; SÓFIA SANTOS/ TÂNIA DUARTE, *O Setor financeiro e o crescimento sustentável. A nova finança do século XXI*, (2019), 115-132.

*social and environmental performance and returns to the individual firm (...) and returns to the portfolio as a whole*⁵².

For asset managers, ESG presents itself as an integrated tool for investment assessment. According to the options and strategies of financial companies, investments are analysed not only in the financial dimension, but also in the dimensions of social and environmental sustainability and governance it presents, in a long-term perspective.

ESG also proposes a redefinition of the measure of value creation. In other word, the metrics of value and economic growth are seen at a wider matrix⁵³.

Finally, while it improves resource allocation/portfolio choice criteria, ESG leads also to the promotion of good practices. Financial institutions are sought to be promoters of environmental and social sustainability and to engage in improving the governance and sustainability standards of invested companies.

ESG impacts on different decisions, such as investment decisions, investment advice, risk management decisions and stewardship decisions (such as the exercise of voting rights). The areas of impact are wide and each of them deserves separate analysis.

Investment in shares accounts for the higher potential governance influence in ESG matters, because it combines voice and exit strategies altogether. The analysis on other financial assets is much scarcer⁵⁴. On the other extreme, the impact of ESG in sovereign bonds⁵⁵ or real estate assets are some examples of areas in which the “G” pillar suffers deeper adjustments. Even in these cases, however, the UNPRI has considered that governance-related topics are to be identically under scrutiny – namely in matters related to anti-bribery, money laundering, cybersecurity, and general compliance with the law⁵⁶.

⁵² REBECCA HENDERSON, *Reimagining Capitalism. How business can save the world*, (2020), 141; MARK CARNEY, *Value(s). Building a better world for all*, London (2021), 419.

⁵³ MARK CARNEY, *Value(s). Building a better world for all*, 418-453.

⁵⁴ PEDRO MATOS, *ESG and Responsible Institutional Investing Around the World. A Critical Review*, CFA Institute Research Foundation (2020), 53-54.

⁵⁵ RAPHAËL SEMET/ THIERRY RONCALLI/ LAUREN STAGNOL, *ESG and Sovereign Risk: What is Priced in by the Bond Market and Credit Rating Agencies?*, available at SSRN 3940945.

⁵⁶ Specific factors related to sovereign bonds are country’s political stability, government and regulatory effectiveness, institutional strength. Specific elements related to real estate funds are ESG clauses in leases. See UNPRI, *A Practical Guide To ESG Integration In Sovereign Debt*, (2019); Id., *ESG Engagement for Sovereign Debt Investors* (2020); UNEPFI, *Sustainable Real Estate Investment Implementing The Paris Climate Agreement: An Action Framework*, (February 2016); UNPRI, *An introduction to responsible investment: real estate*, at unprii.org; ISS, *Winning the Net Zero Arms Race – Commitment vs Action as Investors Seek Answers on Sovereign Climate Performance*, (29 April 2021).

IV. INVESTOR-LEVEL RELATIONSHIP OF ESG AND CORPORATE GOVERNANCE

The motives behind institutional investors' decisions to follow a ESG approach are multiple. Some firms adopt an ethics perspective, being committed to solving a civilizational problem (the 'doing well by doing good' approach) and thriving to contribute to the transformation process into a more sustainable economy. Other institutions use a financial foundation for ESG policies, seeking to take advantage of sustainable investments. As an example, in this context, LARRY FINK stated that "Environmental, Social and Governance (ESG) factors can provide essential insights into management effectiveness and thus a company's long-term prospects⁵⁷. Reputational concerns also come into play when adopting ESG investment criteria – namely because younger generation of investors take ESG more seriously⁵⁸.

Regardless of its motivation, a growing number of institutional investors find sufficient incentives to structure efficient governance instruments to execute its ESG policy.

Below we present and describe three main features of ESG at investor-level: i) ESG as a set of investment criteria; ii) ESG as a commitment; and iii) ESG as a method.

4.1. ESG AS A SET OF INVESTMENT CRITERIA

ESG refers to the set of responsible investment criteria, used by investors, according to environment, social and governance features of the invested companies.

The range of ESG factors to be considered is not harmonised, but at its core it includes: climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy; pollution prevention and control; the protection and restoration of biodiversity and ecosystems

⁵⁷ LARRY FINK, Letter to CEOs, (2017).

⁵⁸ AFDHEL AZIZ, *Playing for the Planet: How Playmob Helped the UN Conduct the Largest Climate Chance Survey Ever Using the Power of Gaming*, Forbes (Jan. 28, 2021); ALEX EDMANS, *Grow the Pie*, (2020), 35-36; SERGIO GRAMITTO RICCI / CHRISTINA M. SAUTTER, *Corporate Governance Gaming*, Nevada Law Journal, Vol. 22 (2021), 23-25; MICHAL BARZUZA / QUINN CURTIS/ DAVID WEBBER, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 Southern California Law Review (2020), ECGI Law Working Paper 545/2020 (2020) 1283-1312; ID., *The Millennial Corporation* (2021), SSRN 3918443.

(as E factors)⁵⁹, human rights; labour standards in the supply chain; child and slave labour; workplace health and safety; human capital management and employee relations; diversity; relations with local communities; health and access to medicine; consumer protection (as S factors) and board structure, size, diversity, skills and independence; executive remuneration; shareholder rights; disclosure of information; business ethics; bribery and corruption; internal controls and risk management (as G factors)⁶⁰.

Regarding the G factors, although they represent sound indications of corporate governance, they nevertheless may oversimplify the complexity of governance assessment and run the risk of involving purely mechanic box ticking exercises in their respective scrutiny. Important qualitative elements, albeit more difficult to measure and to compare, such as corporate culture or risk culture, should also integrate these G factors lists⁶¹. Furthermore, the list of relevant governance factors has expanded overtime: cybersecurity is an example of a new governance indicator, namely due to the increase of remote working following the pandemic.

The concept of ESG is very broadly designed, as an “umbrella term”⁶², so that it encompasses different choices of sustainability and governance indicators from companies. Some institutions may opt to give more granular description to the E pillar factors, the S pillar or to the G pillar.

The underlying objective of ESG is therefore to give the chosen degree of attention or prevalence to investment in sustainable and responsible companies, in order to maximize returns from sustainable economy and to avoid risks underlying non-sustainable and poorly governed companies. The aim is to redirect capital flows to sustainable investments.

⁵⁹ Article 9 of Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 (Taxonomy Regulation).

⁶⁰ EIOPA, *Opinion on the supervision of the management of environmental, social and governance risks faced by IORPs* (2019), 3; MARK CARNEY, *Value(s). Building a better world for all*, cit., 419.

⁶¹ ALEX EDMANS, *Response to the European Commission Study on Sustainable Corporate Governance*, (2020), 3.

⁶² JOHN HILL, *Environmental, Social, and Governance (ESG) Investing: A Balanced Analysis of the Theory and Practice of a Sustainable Portfolio*, (2020), 13; PETER MÜLBERT/ ALEXANDER SAJNOVITS, *The inside information regime of the MAR and the rise of the ESG era*, ECGI WP n. 548/2020, 7; PEDRO MATOS, *ESG and Responsible Institutional Investing Around the World. A Critical Review*, CFA Institute Research Foundation (2020), 1.

4.2. ESG AS A COMMITMENT; OPTIONALITY ARRANGEMENTS

Under client or peer pressure or regulatory influence, each financial company will ultimately have to take a stand in terms of the ESG approach to be taken.

The ESG commitment may have a voluntary or a mandatory nature⁶³. The promotion of ESG guidelines has been pushed from multiple sources in the last years – namely regulatory interventions (eg: EU Regulations), stewardship codes⁶⁴, international corporate standards⁶⁵ and voluntary initiatives adopted by financial firms. Other initiatives also deserve to be mentioned, such as the Net Zero Asset Managers Commitment, that commits asset managers to help deliver the goals of the Paris Agreement of net zero greenhouse gas emissions by 2050⁶⁶. ESG entails therefore a multi-actor and multi-level commitment⁶⁷.

The approach that each company takes in respect to ESG implies consistency and commitment in terms of the investment options.

The mentioned commitment does not exclude autonomy in choosing the ESG priorities that relate more to the purpose and sector of each company. Some investors may focus on climate-related criteria in their investments, while others may follow mainly social sustainability objectives. For instance, a pharmaceutical company may opt to give priority to ESG objectives related to health system, while an energy company may tend to fight climate change at the forefront of its ESG objectives. On the other hand, the scale of organizations may also be relevant. Smaller financial institutions may face difficulties in achieving very ambitious ESG goals.

This explains why optionality arrangements are important. In the UK, the Stewardship Code, originally approved in 2010 makes use of a set of ‘apply and explain’ Principles for asset managers and asset owners⁶⁸. As its preamble clarifies, *‘the Code does not prescribe a single approach to effective stewardship. Instead, it*

⁶³ As an illustration of mandatory ESG commitment, in Portugal pension fund managers are forced to incorporate ESG guidelines into their investment policies (article 53 n. 4 Law 27/2020).

⁶⁴ DIONYSIA KATELOUZOU, *Shareholder stewardship. A case of (re)embedding the institutional investors and the corporation?*, BEATE SJAFJELL / CHRISTOPHER M. BRUNER (EDS.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge, (2019), 585, 595; DIONYSIA KATELOUZOU / ALICE KLETTNER, *Unlocking stewardship sustainability potential*, ECGI Law Working Paper No. 521/2020.

⁶⁵ In this regard, see GUIDO FERRARINI, chapter 2 in this book.

⁶⁶ See www.netzeroassetmanagers.org.

⁶⁷ In respect to the multi-level, multi-actor and multi-instrumental of CSR narrative, see BIRGIT SPIESSHOFER, *Responsible Enterprise. The emergence of a global economic order*, München, (2018), 370, 498.

⁶⁸ BOBBY REDDY, *The Emperor's New Code? Time to Re-Evaluate the Nature of Stewardship Engagement Under the UK's Stewardship Code*, University of Cambridge Faculty of Law Research Paper No. 10/2021.

*allows organisations to meet the expectations in a manner that is aligned with their own business model and strategy*⁶⁹. Similarly, most stewardship codes in other jurisdictions also involve comply or explain approaches⁷⁰.

The EU Sustainable Finance Disclosure Regulation (SFDR) identically entails two types of comply or explain options. On the one hand, financial institutions may opt to consider principal adverse impacts of investment decisions on sustainability factors and disclose a statement on due diligence policies with respect to those impacts. Alternatively, such companies may opt to not consider adverse impacts of investment decisions on sustainability factors, if they disclose clear reasons for why they do not do so, including, where relevant, information as to whether and when they intend to consider such adverse impacts⁷¹.

From a pre-contractual disclosure point of view, the SFDR also allows for a comply or explain alternative. Financial institutions may opt for i) disclosing a description of the way sustainability risks are integrated into their investment decisions and the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available; or ii) disclosing a statement according to which they deem sustainability risks not to be relevant, with a clear and concise explanation of the reasons therefor⁷². However, this option is not available for larger institutions, herein defined as exceeding the average number of 500 employees.

Moreover, different financial products may entail different levels of ESG commitment. This is also clear under the EU classification of financial products according to its ESG involvement: such classification distinguishes between products with no particular ESG focus (the so-called ‘article 6 products’); financial products that promote, among other characteristics, environmental and/or social characteristics, provided that the companies in which the investments are made follow good governance practices (‘article 8 products’); and financial product with sustainable investment as its objective and an index has been designated as a reference benchmark (‘article 9 products’)⁷³.

⁶⁹ Financial Reporting Council, *The UK Stewardship Code* (2020), 4.

⁷⁰ DIONYSIA KATELOUZOU/ ALICE KLETTNER, *Unlocking stewardship sustainability potential*, cit., 25.

⁷¹ Article 4 (1) and (2) of Regulation (EU) 2019/2088. See SEBASTIAAN NIELS HOOGHIEMSTRA, *The ESG Disclosure Regulation – New Duties for Financial Market Participants & Financial Advisers* (March 2020), 4-5, available at SSRN.

⁷² Article 6 (1) and (2) of Regulation (EU) 2019/2088.

⁷³ See articles 6, 8 and 9 of Regulation (EU) 2019/2088.

Optionality arrangements and product-specific options are therefore central components of the current ESG landscape⁷⁴.

The binding facet of ESG has two other implications, to be addressed below: the importance of remuneration and the rules in force to prevent misleading information related to the ESG commitment⁷⁵.

4.3. ESG AS A GOVERNANCE METHOD

ESG implies a governance method with multiple tools, both general and specific. Firstly, general tools of investor engagement are common in ESG approaches – namely voting guidelines, exercise of voting rights, annual letters to CEO's and direct (both formal and informal) communication with boards⁷⁶.

Moreover, specific ESG tools have been developed, mainly under the influence of the UNPRI, and those include: removal from portfolio of companies that do not meet ESG criteria (negative screening); choosing companies that meet ESG factors (positive screening), either following a norm-based screening or opting for companies that are benchmark examples and can in turn serve as an inspiring example for others to follow ("best in class")⁷⁷; or adopting a strategy with a single objective - e.g. emissions reduction or gender diversity ('single-theme' funds).

As the UNPRI states, 'screening uses a set of filters to determine which companies, sectors or activities are eligible or ineligible to be included in a specific portfolio'⁷⁸.

Negative screening, however, deserves further analysis. This is an exclusionary approach as it involves leaving aside from the investment radar companies that are dedicated to activities or based on specific ESG criteria that are legal but unethical or unsustainable⁷⁹. Common examples of these usually excluded issuers' activities (originally coined in jargon as 'sin stocks') are alcohol, tobacco, gambling,

⁷⁴ Considering that it 'at least potentially impacts negatively the degree of harmonisation', see DANNY BUSCH, *Sustainability Disclosure in the EU Financial Sector*, European Banking Institute Working Paper Series 2021 - n. 70 (2021).

⁷⁵ See *infra*, 6a and 8.

⁷⁶ BENJAMIN J. RICHARDSON, *Aligning social investing with nature's timescales*, in BEATE SJÄFJELL / CHRISTOPHER M. BRUNER (EDS.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge, (2019), 573.

⁷⁷ HAO LIANG / LUC RENNEBOOG, *Corporate Social Responsibility and Sustainable Finance: A Review of the Literature*, ECGI – Finance Working Paper No. 701/2020, 13.

⁷⁸ TOBY BELSOM / CATIE WEARMOUTH, *Screening*, UNPRI, at unpri.org.

⁷⁹ JOHN HILL, *Environmental, Social, and Governance (ESG) Investing: A Balanced Analysis of the Theory and Practice of a Sustainable Portfolio*, London (2020), 14.

pornography, or military weapons. This exclusionary exercise is at times subject to criticism, because in some cases it runs the risk of leaving aside ESG-compliant companies (i.e. companies that in spite of operating in these sectors in other metrics score high in ESG terms) or conglomerates that predominantly operate in mainstream sectors and only residually in sensible areas⁸⁰. On the other hand, selling 'blacklisted stocks' is only viable because there is a market for such stocks. As Edmans reminded, "an investor can only sell shares if someone else buys, so divestment doesn't deprive a polluting company of capital"⁸¹. Finally, and most importantly, in governance terms, negative screening is a pure 'exit' approach while investment followed by engagement in black-listed companies has the potential of shareholder activism being a driver for change towards greener companies. This is why some investors (namely activist investor pressure group Carbon Action100+⁸²) prefer to focus on black-listed companies and try to engage with those companies in view of re-directing their activities to a more ESG-friendly pace. Other relevant illustration focused on emission-reduction rather than blacklisting is the Glasgow Financial Alliance for Net Zero (GFANZ), that assembles over 160 firms aimed at accelerating the transition to net zero emissions by 2050 at the latest.

4.4. THE 'CASCADE EFFECT'

ESG governance affects several types of entities and persons in successive waves of influence – in a manner that we label the 'cascade effect'. We define the ESG cascade effect as the potential aptitude for companies to engage in ESG-based decisions and to systemically influence others to do so, including investors, investee companies and their respective supply chain and community.

The ESG binding effect starts at the level of the asset manager, in which represents ESG first layer of impact. At this level, corporate governance is an important tool to enforce decisions at investors' sphere and its product governance policy, its investment policy, and its risk management approach. ESG does not serve merely to

⁸⁰ BIRGIT SPIESSHOFER, *Responsible Enterprise. The emergence of a global economic order*, München, (2018), 288-289; critically: JOHN HILL, *Environmental, Social, and Governance (ESG) Investing: A Balanced Analysis of the Theory and Practice of a Sustainable Portfolio*, cit., 16, 181.

⁸¹ ALEX EDMANS, *Is sustainable investing really a dangerous placebo?*, Medium (30-set.-2021).

⁸² CARBON ACTION 100+, *Progress Report* (2020).

refine screening methods, it mainly implies the involvement of governance methods and structures that lead to analysis, procedures, decisions, and initiatives taken in ESG matters.

Decisions taken by asset managers will in its turn pressure invested companies to act in a more sustainable manner. The decision-making structure of invested companies will inevitably be affected. ESG factors will be relevant to assess risks, impacts and the corporate purpose. Such is the second layer of impact.

Companies will also influence their supply chain (i.e. outsourced companies and other business partners) and other stakeholders affected by ESG decisions, in a third layer of impact.

Moreover, ESG decisions and reports have a wider audience and will be relevant not only to large investor and companies, but also to non-professional investors, to consumers and to the public⁸³. The workforce will also be paying attention to ESG factors, namely at recruitment processes. This is the fourth layer of impact derived from ESG.

On the one side, this 'cascade effect' reflects the potential effectiveness of ESG guidelines, decisions and initiatives. It represents a very relevant dimension of responsible investment in terms of its transformative potential.

On the other hand, this cascade effect also mirrors, mainly at third and fourth level, the influence based on social mechanisms and the importance of reputational incentives in this context. For this dynamic to operate properly it is very important to have clear, truthful, and objective information along each of the cascade levels.

Finally, taking into account the current funding gap for the achievement of SDGs⁸⁴, the ESG framework also presents a huge potential to be used in public funds' management⁸⁵. International finance institutions, central banks⁸⁶, development banks, public infrastructure funds, sovereign wealth funds⁸⁷ are starting to also use the ESG approach and method, as a direct way of pursuing their public purpose. That may be taken as another layer of impact of the 'cascade effect' described above.

⁸³ IRIS H-Y CHIU, *Corporate reporting and the accountability of banks and financial institutions*, in IRIS H-Y CHIU (ed.), *The Law on Corporate Governance in banks*, Cheltenham (2015) 198-199.

⁸⁴ EMILIOS AVGOULEAS, *Resolving the Sustainable Finance Conundrum: Activist Policies and Financial Technology*, 84 *Law and Contemporary Problems* 55-73 (2021).

⁸⁵ Regarding SOE's, see JOSÉ MIGUEL LUCAS, chapter 21 in this book.

⁸⁶ Regarding the potential expansion of the Taxonomy Regulation: LUNA ROMO, *Una taxonomía de actividades sostenibles para Europa*, (January 2021), Banco de España Occasional Paper No. 2101, 21-22.

⁸⁷ JOHN HILL, *Environmental, Social, and Governance (ESG) Investing: A Balanced Analysis of the Theory and Practice of a Sustainable Portfolio*, (2020), 227-246.

This presentation of the cascade effect does not mean we can take for granted that its consequences are always fully accomplished in each case. Intrinsic and extrinsic variables must be considered in this respect. On the one hand, as we have seen, the degree of ESG commitment varies from investor to investor and may vary within the same investor considering the type of financial product in question⁸⁸. Furthermore, each investor will choose and give prevalence to the stakeholder issues that are most material to its business model. The sector of activity of invested companies may also be very relevant in shaping ESG priorities. On the other hand, there are general external variables that also bear relevance. It has been studied that a stronger level of ESG investment incorporation is positively related to stronger environmental and social norms prevailing in the investor home country⁸⁹. ESG influence also manifests more clearly in more competitive markets⁹⁰. The quality of ESG data also plays a major influence in this regard: in case of defective disclosure from the financial firm the cascade effect might not even operate at first level. The cascade effect therefore points at the potential far-reaching ESG interactions but naturally does not preclude scrutiny on the extent to which its consequences are effectively achieved. Still, one can predict that as the flow of ESG investment continues to increase, the massive extension of the cascade effect will become more and more visible.

In the next sections we will analyse in more detail in what terms ESG impacts corporate governance and in which manners it contributes to redefine board duties and skills, disclosure, risk management and remuneration.

⁸⁸ See above 4.2.

⁸⁹ RAJNA GIBSON/ SIMON GLOSSNER/ PHILLIP KRUEGER/ PEDRO MATOS/ TOM STEFFEN, *Do Responsible Investors Invest Responsibly?* (May 25, 2021). Swiss Finance Institute Research Paper No. 20-13, European Corporate Governance Institute - Finance Working Paper 712/2020.

⁹⁰ THOMAS CHEMMANUR/ DIMITRIOS GOUNOPOULOS/ PANAGIOTIS KOUTROUMPIS/ YU ZHANG, *CSR and Firm Survival: Evidence from the Climate and Pandemic Crises*, SSRN 3928806.

V. REDEFINING BOARD DUTIES AND SKILLS; THE ‘KNOW YOUR STAKEHOLDER RULE’

Recent years have intensified the debate on whether and to what extent ESG factors determine an extension to board member duties. Focusing on the E pillar, the G7 namely referred to a *duty to safeguard the planet for future generations*⁹¹. Similarly, BEATE SJÄFJELL refers to a duty of environmental care⁹² while in this book JAAP WINTER proposes to introduce a duty of societal responsibility of the board⁹³.

The debate gravitates around two structural questions: on the one hand, on the extent to which existing board member duties (namely, duties of care) already include or imply ESG-related duties; on the other hand, there is a vivid and much divided discussion on the merit of having future legislative action to expressly expand the current set of board duties.

Regarding the first question, the OECD Corporate Governance principles clearly state that: *‘The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. Boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Observance of environmental and social standards is relevant in this context.’* But this is not a harmonised field of law and it is ultimately dependent upon each jurisdiction position in relation to expectations of board members conduct and to the balance between shareholder and stakeholders’ interests in that respect.

Nevertheless, there are additional factors that push for change at board level and that influence the current interpretation of board duties in climate, social and governance issues.

Firstly, ESG-related disclosure duties increase the pressure for recognizing that the spectre of board member duties is expanded in respect to ESG matters⁹⁴. As below addressed, the area of disclosure duties has rapidly developed in the EU and

⁹¹ CARBIS BAY G7 SUMMIT COMMUNIQUÉ, *Our Shared Agenda for Global Action to Build Back Better*, (June 2021).

⁹² BEATE SJÄFJELL / BENJAMIN J. RICHARDSON, *Company Law and Sustainability. Legal Barriers and Opportunities* (eds.), cit., 329.

⁹³ JAAP WINTER, *The Duty of Societal Responsibility and Learning Anxiety*, chapter 5 in this book.

⁹⁴ ELLIE MULLHOLLAND, *UK directors’ duties in a changing climate and the net zero transition*, in ANDREAS ENGERT / LUCA ENRIQUES / WOLF-GEORG RINGE / UMAKANTH VAROTTIL / THOM WETZER, *Business Law and the transition to a Net Zero Economy*, München (2022), 56-57.

in other countries, as well as the flow of voluntary ESG disclosure has expanded considerably. Both these trends bear implications in terms of the range of duties of the directors that are owed to the company in terms of scrutiny and assessment of the process regarding the preparation of ESG-related information. This impacts the board, that must ensure oversight of ESG risks and opportunities, ESG disclosures and of general compliance of ESG commitments.

Secondly, a consensus is emerging in respect to the board duties to identify, assess and manage ESG-related risks, and most notably climate risks⁹⁵. The World Economic Forum has namely recommended that *'the board should be accountable for the company's long-term resilience in respect to potential shifts in the business landscape that may result from climate change'*⁹⁶. We will examine this topic further below⁹⁷.

Thirdly, some recent cases of ESG-related litigation increased the pressure in terms of board effective commitment in ESG matters. Climate litigation is on the rise and a UN report found that in 2020 the number of climate-related cases reached at least 1,550 cases filed in 38 countries⁹⁸. Interestingly, two of the leading cases refer to Dutch court rulings: in 2019, the Supreme Court of the Netherlands required the state to take measures against climate change⁹⁹; in 2021 the District Court in The Hague issued a ruling that Royal Dutch Shell must reduce its global net carbon emissions by 45% by 2030 compared to 2019 levels (2021)¹⁰⁰. Other notable court cases have been presented globally in gender pay gap matters¹⁰¹.

Finally, the flow of shareholder proposals related to ESG also increased the importance of board members to live up to their ESG-related duties¹⁰². One preeminent example is Engine n. 1 success case in appointing three ESG-minded directors on the board of Exxon Mobil (2021).

⁹⁵ BRETT McDONNELL/ HARI OSOFSKY/ JACQUELINE PEEL/ ANITA FOERSTER, "Green Boardrooms?", *Connecticut Law Review* (2021), 517-518.

⁹⁶ WORLD ECONOMIC FORUM (with PWC), *How to set up effective climate governance on corporate boards. Guiding principles and questions* (2019), Principle 1.

⁹⁷ See *infra*, 7.

⁹⁸ UNEP, *Global Climate Litigation Report. 2020 Status Review*, (2020).

⁹⁹ Urgenda Foundation v. The State of the Netherlands C/09/456689 (2015).

¹⁰⁰ Milieudefensie et al v Royal Dutch Shell PLC C/09/571932 (2021). See BENOTT MAYER, *Milieudefensie et al v Royal Dutch Shell: do oil corporations hold a duty to mitigate climate change?*, in ANDREAS ENGERT / LUCA ENRIQUES/ WOLF-GEORG RINGE/ UMAKANTH VAROTTIL/ THOM WETZER, *Business Law and the transition to a Net Zero Economy*, 79-83.

¹⁰¹ ALEXIA FERNÁNDEZ CAMPBELL, *They did everything right — and still hit the glass ceiling. Now, these women are suing America's top companies for equal pay*, Vox (10-Dec.-2019).

¹⁰² BRETT McDONNELL/ HARI OSOFSKY/ JACQUELINE PEEL/ ANITA FOERSTER, *Green Boardrooms?*, *cit.*.

In order to take stock of ESG-related duties, both at investor-level and invested-level, boards should know who their relevant stakeholders are and how they are impacted by the company, in order to be able to understand their needs and approaches. This is what we call the 'know your stakeholder rule' and it stands as a prerequisite for any ESG strategy.

The literature distinguishes between primary stakeholders and secondary stakeholders¹⁰³. The first group comprises customers, employees, supply chain partners, and the communities. Secondary stakeholders include regulators, special-interest groups, consumer-advocate groups, NGO's, the media and the competitors. For ESG purpose, the core lies on primary stakeholders, because they are the ones connected to the value-creation process of the firm.

The selection of relevant stakeholders is closely related to the purpose of each company. In fact, evidence shows that companies with good ratings on *material* sustainability issues significantly outperform firms with poor ratings on these issues, while companies with good ratings on *immaterial* sustainability issues do not significantly outperform competitors with poor ratings on the same issues¹⁰⁴. This is one of the reasons why corporate purpose statements should be clearly articulated, disclosed, and monitored.

ESG criteria imply a long-term view of the investments. It therefore becomes part of what MARIANA MAZZUCATO describes as a 'mission-oriented approach'¹⁰⁵. Although most ESG funds reach excellent short-term performance¹⁰⁶, the full benefits they bring should also be viewed in a long-term perspective, as a component of an inter-generational sustainability strategy. The assessment of ESG board duties is more complex precisely by taking this long-term metric into consideration.

One of the topics that is still under development is the integration of ESG skills in selecting the board composition¹⁰⁷. The relevance of ESG-related risks, commitments, initiatives and disclosures clearly indicate that the board should have

¹⁰³ R. EDWARD FREEMAN/ JEFFREY S. HARRISON/ STELIOS ZYGLIDPOULOS, *Stakeholder Theory: Concepts and Strategies*, Cambridge (2018), 1.

¹⁰⁴ KHAN MOZAFFAR/ GEORGE SERAFEIM/ AARON YOON, *Corporate Sustainability: First Evidence on Materiality*, *The Accounting Review* (2016) 91 (6): 1697–1724.

¹⁰⁵ Missions require long-term thinking and patient finance: MARIANA MAZZUCATO, *Mission Economy: a moonshot guide to changing capitalism*, Dublin (2021), 181.

¹⁰⁶ QUINN CURTIS, JILL FISCH/ ADRIANA ROBERTSON, *Do ESG Mutual Funds Deliver on Their Promises?*, Michigan Law Review, ECGI WP n. 586/202.

¹⁰⁷ CERES, *Lead from the top: how corporate boards engage on sustainability performance*, (2015) (only 17% of Fortune 200 board members with ESG credentials); TENSIE WHELAN, *U.S. Corporate Boards suffer from inadequate expertise in financially material ESG matters*, NYU Stern Center for Sustainable Business, (January 2021) (29% of Fortune 100 with ESG credentials).

proper knowledge of these subject matters. Moreover, ESG is becoming increasingly technical and involves a granular analysis of data, which bears a necessary reflection in the board capabilities. Therefore, there is an increasing need for climate literacy and ESG literacy at board level. That should namely (but not exclusively) be reflected in the profile of non-executive directors.

In a recent public address, the fund manager VANGUARD underlined this point, by sustaining that *disclosures should provide enough information so that an investor can assess the climate competency of a company's board*¹⁰⁸. This statement should be read in a broader sense, as referring to the relevance of ESG competencies of the board, including social and governance matters.

Accordingly, the European authorities ESMA and EBA, in their 2021 redraft of suitability guidelines for management body have included within risk management skills the following: identifying, assessing, monitoring, controlling and mitigating the main types of risk of an institution including environmental, governance and social risks and risk factors. Moreover, environmental, governance and social risks are now included in the catalogue of the matters regarding which the management body collectively must have an appropriate understanding of and for which the members are collectively accountable¹⁰⁹.

ESG skills bears relevance both in the recruitment process and in subsequent training programmes for board members. Regarding the first component, it is relevant to note that the ICGN Corporate Governance Principles recommends that *there should be a formal induction for all new board directors to ensure they have a comprehensive understanding of the company's purpose*¹¹⁰.

In larger companies, this evolution may lead to some structural changes at board organisation level such as the appointment of ESG committees (internal or external¹¹¹), ESG working groups or a chief ESG officer¹¹². Each of these options has merits in terms of facilitating an integrated analysis and a fluid flow of information

¹⁰⁸ VANGUARD, *Letter to SEC. Public Input Welcomed on Climate Change Disclosures*, (11-june-2021).

¹⁰⁹ EBA/ ESMA, *Joint Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU*, ESMA 35-36-2319/ EBA/GL/2021/06, 63 (d), 70 (c).

¹¹⁰ ICGN, *Global Governance Principles*, (2021) 1.5.

¹¹¹ Regarding the merits of external ESG advisory committees: ALEX EDMANS, *Grow the Pie*, 233-234. Stating a 17% increase in the number of sustainability board committees across the 100 largest of the Forbes Global 2000 companies, see *The Sustainability Board Report 2020*, 2-3.

¹¹² MERVYN KING / JILL ATKINS, *Chief Value Officer: Accountants Can Save the Planet*, 72-114, *New York* (2016) (proposing a chief value officer); ANTÓNIO GOMES DA MOTA, *Corporate Governance in the new multi-stakeholder world: realities and challenges*, Prémio, 26 March 2021 (proposing a Chief Stakeholder Officer).

regarding ESG matters and its embedment in the governance structure and the company culture. Among these possibilities, the choice of the correct governance solution depends upon the specific features of each company and should be solidly anchored in the proportionality principle.

Finally, regarding board composition it has been noticed that the growth of ESG movement also impacted in the push for further gender balance at the boards, both at financial firms' level and at invested companies' level. In the UK, the FCA presented a proposal seeking to ensure that disclosure is provided, on a comply or explain basis, on whether at least 40% of board directors of each listed company are women¹¹³. In the EU, a Directive proposal on the subject has been under discussion since 2012¹¹⁴ and recently the European Commission has pledged to make a new push for that Directive to be finally approved, but there is uncertainty as to its outcome.

¹¹³ FINANCIAL CONDUCT AUTHORITY, *Diversity and inclusion on company boards and executive committees*, CP 21/24.

¹¹⁴ EUROPEAN COMMISSION, *Proposal for a Directive of the European Parliament and of the Council on improving the gender balance among non-executive directors of companies listed on stock exchanges and related measures*, COM(2012) 614 final.

VI. REDEFINING DISCLOSURE

One of the foundational documents of ESG, the United Nations Principles of Responsible Investment states, in its Principle 3, that signatories “will seek appropriate disclosure on ESG issues by the entities in which we invest”. Furthermore, one of the objectives of the European Commission’s Action Plan on Sustainable Finance (2018) is to “*foster transparency and long-termism in financial economic activity*”. Finally, the European Green Deal explicitly indicated that ‘*companies and financial institutions will need to increase their disclosure on climate and environmental data so that investors are fully informed about the sustainability of their investments*’¹¹⁵.

Disclosure is therefore at the heart of the relationship of corporate governance and ESG issues. In order to have an efficient ESG orientation and investment selection, the flow of information to the financial institutions is of critical relevance¹¹⁶. Moreover, the lack of a firm-level disclosure may lead to the potential mispricing of assets and financial instruments¹¹⁷. Finally, disclosure is also critical for the scrutiny of investor and invested companies.

The disclosure ecosystem as therefore been gradually changing to meet the expectations of institutional and non-institutional investors. In 2019, 90% of the S&P 500 Index have published a sustainability report - while in 2020 the rate was of 20%¹¹⁸.

The impetus for ESG disclosure has also been boosted by regulatory interventions¹¹⁹. In 2014, the European Union adopted a Non-Financial Reporting Directive (NFRD)¹²⁰, requiring all large public-interest companies to provide information about relating to environmental, social and employee matters, respect for

¹¹⁵ EUROPEAN COMMISSION, *Communication To The European Parliament, The European Council, The Council, The European Economic And Social Committee And The Committee Of The Regions The European Green Deal*, COM/2019/640 final, (2019), 2.2.1.

¹¹⁶ Some authors argue that the disclosure approach is insufficient: see namely JAY CULLEN/ JUKKA MÄHÖNEN, *Taming unsustainable finance. The perils of modern risk management*, in BEATE SJÄFJELL / CHRISTOPHER M. BRUNER (EDS.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge, (2019), 101, 105-107.

¹¹⁷ ZACHARIAS SAUTNER/ LAURENCE VAN LENT/ GREGORY VILKOV/ RUI SHEN ZHANG, *Firm-level Climate Change Exposure*, ECGI Finance Working Paper n. 686/2020, 2. For the opposite viewpoint see PAUL MAHONEY/ JULIA MAHONEY, *The New Separation of Ownership and Control: Institutional Investors and ESG*, cit., 5-8, 22-29.

¹¹⁸ See GOVERNANCE & ACCOUNTABILITY INSTITUTE, *Flash Report S&P 500 2020. Trends on the sustainability reporting practices of S&P 500 Index companies* (2020).

¹¹⁹ Regarding the SEC projects in the US, see DANA BRAKMAN REISER, *Progress is possible. Sustainability in US corporate law and corporate governance*, in BEATE SJÄFJELL / CHRISTOPHER M. BRUNER (EDS.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge, (2019), 143-145.

¹²⁰ Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

human rights, anti-corruption and bribery matter¹²¹. The NFRD is currently under revision, and it will be amended by the by the Corporate Sustainability Reporting Directive (CSRD). Moreover, the EU Prospectus Regulation dictates that *ESG circumstances can also constitute specific and material risks for the issuer and its securities and, in that case, should be disclosed in the prospectus*¹²². Finally, the European Commission published a Capital Markets Union New Action Plan namely comprising the establishment of a European Single Access Point for financial and non-financial information publicly disclosed by companies¹²³.

One of the key criteria for ESG disclosure under this EU regime is the 'double materiality perspective'. This means that the concerned companies will have to report not only about how ESG topics affect their business (outside-in perspective) but also about their own external impact on people, the society and the environment (inside-out perspective)¹²⁴. This approach has been further developed by the Corporate Sustainability Reporting Directive (CSRD), that requires the management report to include information necessary to understand the undertaking's impacts on sustainability matters, and information necessary to understand how sustainability matters affect the undertaking's development, performance, and position¹²⁵. The EU took the lead in this respect, and therefore it remains to be confirmed that this solution will be followed by other international standard-setters.

In relation to pension funds, according to EU Law the statement on Investment policy principles, to be publicly available, must include how the investment policy takes environmental, social and governance factors into account¹²⁶. Such information must also be disclosed to prospective members¹²⁷.

At present ESG disclosure also poses important challenges, which are namely: i) Defective disclosure; ii) Fragmentation of the information; iii) Excessive reliance on ESG ratings or other third-party service providers. These points are addressed below in further detail.

¹²¹ DAVID MONCIARDINI, *Conflicts and coalitions. The drivers for European corporate sustainability reforms*, in BEATE SJÄFJELL / CHRISTOPHER M. BRUNER (EDS.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge, (2019), 617; BIRGIT SPIESSHOFER, *Responsible Enterprise. The emergence of a global economic order*, München, (2018), 468-469.

¹²² Recital 54 of Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017.

¹²³ EUROPEAN COMMISSION, *A Capital Markets Union for people and businesses. New action plan*, COM/2020/590 final.

¹²⁴ EUROPEAN COMMISSION, *Guidelines on non-financial reporting: Supplement on reporting climate-related information* (2019/C 209/01), 4-5; EBA/ESMA/EIOPA, *Response to IFRS Foundation's consultation on Sustainability Reporting*, (16-dec.-2020).

¹²⁵ New article 19b of Directive 2013/34/EU.

¹²⁶ Article 30 Directive 2016/2341 (IORP II).

¹²⁷ Article 41 (1) c and (3) c Directive 2016/2341 (IORP II).

6.1. DEFECTIVE DISCLOSURE ('GREENWASHING')

ESG disclosure presents a risk of the information presented being defective - exaggerated, selective, deceptive or false.

There are two different basic forms of defective ESG disclosure: manipulative disclosure and selective disclosure. In both cases, we may distinguish entity-level and product-level defective disclosure¹²⁸.

There are important causes for defective information. On the one hand, defective disclosure is mainly rooted on the fact that ESG data is usually unaudited¹²⁹. At EU level, the new CSRD intends to change this, by imposing mandatory audit to non-financial information, although only for large companies. Moreover, the fragmentation of ESG metrics and disclosure frameworks – to be analysed below - also increases the risk of disclosing misleading ESG information. Finally, due to PR pressure, companies sometimes overestimate their respective accomplishments in ESG matters and/or embark in rhetoric exercises with no full adherence to effective action¹³⁰.

Defective ESG disclosure is generally labelled as *greenwashing*. While the use of this term is very popular among market institutions and regulators, it is clearly inaccurate as it solely points to environmental (the green – E - pillar) and not also to social and governance defective disclosure. The need for truthful, trustworthy, and objective disclosure covers all the three ESG pillars, and not just one of them.

The significance of the risk of misleading information may be confirmed by the screening exercise made in 2021 by the European Commission and national consumer authorities. This sweep exercise in online markets concluded that *“in 42% of cases the ESG claims were exaggerated, false or deceptive and could potentially qualify as unfair commercial practices under EU rules”*¹³¹.

¹²⁸ This classification adapts the three-types matrix presented in ELLEN PEI-YI YU/ BAC VAN LUU/ CATHERINE HUIRONG CHEN, [Greenwashing in environmental, social and governance disclosures](#), cit., 3.

¹²⁹ ELLEN PEI-YI YU/ BAC VAN LUU/ CATHERINE HUIRONG CHEN, [Greenwashing in environmental, social and governance disclosures](#), [Research in International Business and Finance](#), vol. 52(C), (2020), 3.

¹³⁰ ANNA CHRISTIE, *The Agency Costs of Sustainable Capitalism*, University of Cambridge Faculty of Law Research Paper No. 7/2021, 5 (arguing ‘a significant volume of rhetoric emanating from the Big Three in relation to climate change’); TARIQ FANCY, *Financial world greenwashing the public with deadly distraction in sustainable investing practices*, USA Today (march 2021): the former Blackrock CIO claims that ‘sustainable investing boils down to little more than marketing hype, PR spin and disingenuous promises from the investment community’.

¹³¹ EUROPEAN COMMISSION, *Screening of websites for ‘greenwashing’: half of green claims lack evidence* (28-jan.-2021).

Additional concerns in terms of disclosure are brought by ESG index funds, that in many cases have an opaque structure¹³².

In the EU, the articulation between the Sustainability Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation is precisely directed at ensuring reliable information in respect to ESG practices from financial institutions¹³³. The latter prescribes a much-needed taxonomy of environmentally sustainable economic activities¹³⁴. Under the SFDR, financial market participants will namely be requested to classify their financial products in one of three categories: general products, with no particular ESG focus (the so-called ‘article 6 products’); financial products that promote, among other characteristics, environmental and/or social characteristics, provided that the companies in which the investments are made follow good governance practices (‘article 8 products’); and financial product with sustainable investment as its objective¹³⁵ and an index has been designated as a reference benchmark (‘article 9 products’).

Article 8 and article 9 products are frequently labelled respectively as ‘light green’ and ‘dark green’ financial products. This terminology is incorrect as environmental factor is but one among three ESG factors and social and governance matters are also relevant for the SFDR.

Each of these financial products have distinct disclosure obligations. In respect to article 9 financial products, this namely implies the duty to disclose: i) information on how the designated index is aligned with that product objective; ii) an explanation as to why and how the designated index aligned with that objective differs from a broad market index; and iii) information regarding the methodology used for the calculation of the indices and the benchmarks used.

¹³² DANA BRAKMAN REISER/ ANNE M. TUCKER, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, *Cardozo Law Review*, Vol. 41, (2020), 2003; HESTER M. PEIRCE, *Statement on the Staff ESG Risk Alert* (April 2021); GARY GENSLER, *Remarks at the Asset Management Advisory Committee Meeting*, CLS Blue Sky Blog (8 July 2021).

¹³³ DANNY BUSCH, *Sustainability Disclosure in the EU Financial Sector*, European Banking Institute Working Paper Series 2021 - n. 70 (2021); SEBASTIAAN NIELS HOOGHIEMSTRA, *The ESG Disclosure Regulation – New Duties for Financial Market Participants & Financial Advisers* (March 2020), 10-12.

¹³⁴ Regarding the importance of taxonomy, in general, see OECD, *Developing Sustainable Finance Definitions and Taxonomies*, Paris, (2020).

¹³⁵ The SFDR defines ‘sustainable investment’ as ‘an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the invested companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance’. See article 2 (17) of Regulation (EU) 2019/2088.

The responsibility to prevent and deter defective ESG disclosure rests mainly within each company board, as a central component of its directors' fiduciary duties. As the UK Competition Market Authority stated: "*Businesses should be able to back up their claims with robust, credible and up to date evidence*"¹³⁶. Fact-based or data based ESG information will have to inevitably prevail. Companies that disclose incorrect ESG statements will face significant litigation and reputational risks. Therefore, greenwashing will growingly become more costly¹³⁷. Furthermore, the role of supervisory authorities will be decisive in terms of effective greenwashing prevention.

6.2. FRAGMENTATION OF INFORMATION

Sustainability is a global problem that requires global harmonization of legal responses¹³⁸. Nevertheless, the information regarding ESG factors is still fragmented and asymmetric, which makes it difficult for asset managers, investors and the public at large.

There in terms of ESG disclosure, there remains a big gap between EU and non-EU companies. On the one hand, there is a proliferation of disclosure templates – namely the Global Reporting Initiative, the SASB, the TFCB, the IFRS and IIRC¹³⁹. As the British Academy states: "*There is considerable confusion, inconsistency and cost associated with the variety of information being produced.*"¹⁴⁰ In the same vein, the OECD alerts that '*current market practices, from ratings to disclosures and individual metrics, present a fragmented and inconsistent view of ESG risks and performance*'¹⁴¹.

It is however noteworthy that some convergence initiatives are already in place. On the one hand, some of the leading standard setters on ESG reporting (including the Global Reporting Initiative ("GRI"), Climate Disclosure Standards Board ("CDSB"), Sustainability Accounting Standards Board ("SASB"), International Integrated Reporting Council ("IIRC") and CDP ("Carbon Disclosure Project")) have announced a commitment to the creation of a single reporting system. On the other

¹³⁶ COMPETITION MARKET AUTHORITY, '*Green' claims: CMA sets out the dos and don'ts for businesses*, (21-may-2021).

¹³⁷ ALESSIO PACCES, '*Will the EU Taxonomy Regulation Foster a Sustainable Corporate Governance?*', ECGI WP 611/2021, 7-8.

¹³⁸ DANA BRAKMAN REISER, '*Progress is possible. Sustainability in US corporate law and corporate governance*', in BEATE SJÄFJELL / CHRISTOPHER M. BRUNER (EDS.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge, (2019), 131.

¹³⁹ IRIS H-Y CHIU, '*Corporate reporting and the accountability of banks and financial institutions*', in IRIS H-Y CHIU (ed.), *The Law on Corporate Governance in banks*, Cheltenham (2015) 228-231.

¹⁴⁰ BRITISH ACADEMY, '*Principles for Purposeful Business. How to deliver the framework for the Future of the Corporation*', (2020), 25.

¹⁴¹ OECD, '*Business and Finance Outlook 2020: Sustainable and Resilient Finance*', (2020).

hand, the World Economic Forum, in collaboration with the international audit firms (Big Four) released its recommended system of universal metrics to measure ESG performance ("Stakeholder Capitalism Metrics"). Finally, the International Financial Reporting Standards (IFRS) Foundation announced the intention to create a new Sustainability Standards Board, a world standard-setter in the field.

Currently, at EU level, the Corporate Sustainability Reporting Directive was approved, aiming at a larger universe of companies and with a general EU-wide audit requirement for reported sustainability information. Moreover, the European Financial Reporting Advisory Group is preparing Level 2 rules of EU sustainability reporting standards¹⁴². It remains to be seen if the European regime, in spite of its complexity, will effectively pave the way for a global unified approach in terms of ESG reporting.

6.3. EXCESSIVE RELIANCE ON ESG EXTERNAL ADVICE

As noted, any ESG assessment involves the gathering and analysis of a large amount of data. For most middle and small sized asset managers, it is very hard or not possible to prepare proprietary models of ESG assessment. Financial institutions will have to rely on information provided by third parties – such as ESG ratings¹⁴³, ESG benchmarks and ESG indexes. The importance of proxy advisors also grows exponentially, in relation to ESG activism in voting matters. Moreover, in the EU, the Taxonomy Regulation will arguably dictate the increasing need for external labelling or certification providers¹⁴⁴. The importance of these service providers becomes therefore crucial.

However, there remain causes for concern regarding the disparate range of ESG ratings – namely different scope of categories, different measurement of categories,

¹⁴² EFRAG, *Final Report Proposals For A Relevant And Dynamic EU Sustainability Reporting Standardsetting* (February 2021).

¹⁴³ INGO WALTER, *Sense and Nonsense in ESG Ratings*, *Journal of Law, Finance, and Accounting*: Vol. 5: No. 2, (2020), pp 307-336.

¹⁴⁴ Article 19 of the EU Taxonomy Regulation indicates the need for future technical screening criteria regarding EU labelling and certification schemes, methodologies for assessing environmental footprint, and statistical classification systems (see CHRISTOS GORTSOS, *The Taxonomy Regulation: More Important Than Just as an Element of the Capital Markets Union*, European Banking Institute Working Paper Series n. 80 (2020), 21-22). Discussing assurance in the green bond context: STEPHEN KIM PARK, *Green bonds and beyond*, in BEATE SJAFJELL / CHRISTOPHER M. BRUNER (EDS.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge, (2019), 605.

and different weights of categories¹⁴⁵ -, which in part is due to the lack of uniformity of ESG reporting.

This context determines a concern on the potential lack of accuracy and on the overreliance in these providers¹⁴⁶. The discussion lies on the one hand, on the importance that each institutional investor is a true owner of its ESG strategy and monitors its execution (without blank cheques to third parties) and, on the other hand, on whether these service providers have the knowledge and the large resources required for ESG analysis of thousands to million companies worldwide. Proxy advisors are regulated both in Europe and in the US but other ESG service providers are not.

This also serves as a reminder that ESG involvement through these providers comes at a cost. The issue of costs has nevertheless to be weighed against the cost of non-disclosure¹⁴⁷. As mentioned above, currently the ESG global investment landscape suffers from lack of accessible, accurate and comparable information, and not from excessive information.

¹⁴⁵ FLORIAN BERG/ JULIAN KÖLBEL/ ROBERTO RIGOBON, *Aggregate Confusion: The Divergence of ESG Ratings* (May 17, 2020), available at SSRN.

¹⁴⁶ PEDRO MATOS, *ESG and Responsible Institutional Investing Around the World. A Critical Review*, CFA Institute Research Foundation (2020), 53. The same concern is reflected in the public consultation that preceded the US Fiduciary Duties Regarding Proxy Voting and Shareholder Rights (2021) whose final version was later suspended (U.S. Department Of Labor, *Statement Regarding Enforcement Of Its Final Rules On ESG Investments And Proxy Voting By Employee Benefit Plans*, (10 March 2021)).

¹⁴⁷ JOHN COATES, *ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets*, Harvard Law School Forum on Corporate Governance (13-mar.-2021).

VII. REDEFINING RISK

It is scientifically well documented that climate change and other environmental failures determine a wide myriad of risks¹⁴⁸. One of the conclusions of the Glasgow Climate Pact lies precisely on the recognition that ‘*climate change has already caused and will increasingly cause loss and damage and that, as temperatures rise, impacts from climate and weather extremes, as well as slow onset events, will pose an ever-greater social, economic and environmental threat*’¹⁴⁹.

The recommendations of the Financial Stability Board’s Task Force on Climate-Related Financial Disclosure also made very clear the potential financial impacts of climate-related events and a wide collection of scientific research is available to confirm it¹⁵⁰. Moreover, climate change is a ‘multiplier of threats’, as it increases exponentially, and over the long term, other sources of risk, such as the risk of conflicts, the risk of massive, disorganised immigration and the risk of national security¹⁵¹. These risks affect companies at a global scale.

Social crises and governance flaws are equally causal determinants to important risks. As namely the scandals at Enron (2001), Worldcom (2001), VW (2015), Deepwater Horizon (2010) and Shell (2021) show, ESG risks can be financially material and may lead to very significant losses¹⁵². Moreover, the pandemic resulting from COVID-19 also demonstrated the importance of adequately managing social risks¹⁵³.

In this context, following the pandemic period, the OECD recognized the need to companies to improve the management of environmental, social and governance (ESG) risk¹⁵⁴. Furthermore, it is being prepared an amendment to the EU banking prudential regime (CRD IV and CRR) to require banks to systematically identify, disclose and manage ESG short-, medium- and long-term risks as part of their risk management. Such risks are to be included in credit institutions’ strategies and

¹⁴⁸ STEFANO GIGLIO/ BRYAN KELLY/ JOANNES STROEBEL, *Annual Review of Financial Economics*, Vol. 13, 15-36, (2021); JONATHAN JONA/ NAOMI SODERSTROM, *Evolution of Climate-Related Disclosure Guidance and Application of Climate Risk Measurement in Research*, in Carol Adams (ed.), *Handbook of Accounting and Sustainability*, (2022).

¹⁴⁹ Glasgow Climate Pact (2021), VI.

¹⁵⁰ BEATE SJÄFJELL, *The Financial Risks of Unsustainability: A Research Agenda*, University of Oslo Faculty of Law Research Paper No. 2020-18, Nordic & European Company Law Working Paper No. 21-05.

¹⁵¹ MICHAEL E. MANN, *The new climate war. The fight to take back our planet*, London/ Victoria (2021), 180-181.

¹⁵² UNEP, *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing*, (2004).

¹⁵³ PAULO CÂMARA, *COVID-19, Administração e Governação de Sociedades*, in PAULO CÂMARA (coord.), *Administração e Governação de Sociedades* (2020); Id., *Coronavírus e Corporate Governance*, Ver (20-mar.-2020).

¹⁵⁴ OECD, *The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis*, (2021), 1.5.

processes for evaluating internal capital needs as well as adequate internal governance¹⁵⁵.

Other EU legislative measures have also been approved mandating UCITS and AIF fund managers to integrate sustainability risks in the management activity, taking into account the nature, scale and complexity of the business of the investment companies¹⁵⁶. Moreover, investment firms are required to review the investment products they offer or recommend and the services they provide on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market.

The risk management matrix should therefore integrate risks related to environmental, social sustainability and governance. This bears implications in terms of companies' duties, as they are forced to systematically identify, assess, manage, in the short, medium and long term, and to communicate ESG risks.

In order to be effective, ESG risk management also implies a method in gathering, assessing and reviewing information. It implies a flux of information to ensure access to complete, objective, accurate and timely non-financial information from invested companies. It also implies good stakeholder governance – and namely establishing a sound dialogue with stakeholders - as a way of mitigating social risks.

The types of risks are different in each of the ESG pillars. In a recent EU proposal¹⁵⁷, 'environmental risk' is defined as the risk of losses arising from any negative financial impact on the institution stemming from the current or prospective impacts of environmental factors on the institution's counterparties or invested assets, including factors related to the transition towards the following environmental objectives: (a) climate change mitigation ; (b) climate change adaptation; (c) the sustainable use and protection of water and marine resources; (d) the transition to a circular economy; (e) pollution prevention and control; (f) the protection and restoration of biodiversity and ecosystems. This presentation follows the Taxonomy Regulation structure.

¹⁵⁵ See EUROPEAN COMMISSION, *Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks*, COM(2021) 663 final (27.10.2021); EBA, *Report on management and supervision of ESG risks for credit institutions and investment firms*, (2021). See also MAFALDA DE SÁ, *ESG and banks*, chapter 19 in this book.

¹⁵⁶ See Delegated Regulation (EU) 2021/1255 (AIFMD) and Delegated Regulation (EU) 2021/1270 (UCITS).

¹⁵⁷ Article 4 (1), 52 e of Regulation (EU) No 575/2013, as amended by European Commission Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, 27.10.2021 COM(2021) 664 final.

Environmental risk includes physical risks, liability risks, transition risks, reputational risks, regulatory risks¹⁵⁸ and systemic risks¹⁵⁹. These risks can have long-term effects¹⁶⁰. For governance matters, risks may arise from any part of the governance system (e.g. ineffective financial controls, tunnelling, defective remuneration structures) and may represent the source of liability risks, regulatory risks and reputational risks.

A greater difficulty arises when mapping social risks. Social vulnerabilities are extremely dependent upon the context of each company, its dimension, its activity, and the community it affects. Therefore, the preparation of social vulnerability indexes must deal with firm-specific variations and spatial variations¹⁶¹. It is therefore disappointing that the EU has approved a Taxonomy Regulation that solely covers environmental issues and social minimum standards¹⁶². In other words, the EU still lacks a Social Taxonomy Regulation. This is a cause for concern as it implies a relevant asymmetry in identifying and managing social risks, and it is a matter to be inevitably addressed in the near future.

In general, ESG risks can be either short-term or long term. In particular, climate change is considered as a problem of extreme risk with both short-term and long-term impact, in the sense that it may have physical as well as systemic and irreversible effects¹⁶³.

ESG must also be embedded in the risk culture, both at investors' level and at invested company's level. Some institutional investors are faced with specific regulatory frameworks in this respect. The EU pension fund Directive forces the system of governance of such funds to include consideration of environmental, social and governance factors related to investment assets in investment decisions, and to be subject to regular internal review¹⁶⁴. Its risk management function also

¹⁵⁸ ZACHARIAS SAUTNER/ LAURENCE VAN LENT/ GREGORY VILKOV/ RUI SHEN ZHANG, *Firm-level Climate Change Exposure*, ECGI Finance Working Paper No. 686/2020, 2.

¹⁵⁹ EDITH GINGLINGER/ QUENTIN MOREAU, *Climate Risk and Capital Structure*, ECGI Finance Working Paper n. 737/2021 (2021); BARNALI CHOUDHURY, *Climate Change as Systemic Risk* (October 2020), SSRN; EVA MICHELER/ CORALINE JENNY, *Sustainability and Systemic Risk - A Conference Report*, ISE Law - Policy Briefing Paper No. 44 (2020).

¹⁶⁰ As LARRY FINK stated: 'Climate change is different. Even if only a fraction of the projected impacts is realized, this is a much more structural, long-term crisis' (*Annual Letter to CEO's*, (2020)).

¹⁶¹ For an example of strong spatial variation of social vulnerability, see IVAN FRIGERIO/ MATTIA DE AMICIS, *Mapping social vulnerability to natural hazards in Italy: A suitable tool for risk mitigation strategies*, Environmental Science & Policy, Vol. 63, (September 2016), 187-196.

¹⁶² MARLEEN OCH, *Sustainable Finance and the EU Taxonomy Regulation – Hype or Hope?*, Jan Ronse Institute for Company & Financial Law Working Paper No. 2020/05 (November 2020), 6.

¹⁶³ THE ECONOMIST INTELLIGENCE UNIT, *The cost of inaction: Recognising the value at risk from climate change*, (2015); FILIPE DUARTE SANTOS, *Alterações Climáticas*, Lisbon (2021), 49-50.

¹⁶⁴ Article 21 (1) Directive 2016/2341 (IORP II).

must assess environmental, social and governance risks relating to the investment portfolio and the management thereof¹⁶⁵.

Finally, in respect to banking, the Basle Committee has been active in publishing several documents regarding climate-related risk¹⁶⁶ and is preparing a set of Principles for the effective management and supervision of climate-related financial risks¹⁶⁷. Furthermore, banks are beginning to be faced with stress-testing exercises against sustainability risks, to assess their resilience against a catalogue of plausible climate-related events and to determine the impact of climate-related risk drivers on their risk profile¹⁶⁸.

In conclusion, the pressure to adequately identify, manage and report ESG risks is here to stay, both at the level of institutional investors and of invested companies.

¹⁶⁵ Articles 25 (2) g) and 28 (2) g) Directive 2016/2341 (IORP II).

¹⁶⁶ BASEL COMMITTEE ON BANKING SUPERVISION, *Climate-related financial risks: a survey on current initiatives*, (30 April 2020); Id., *Climate-related risk drivers and their transmission channels*, (14 April 2021); Id., *Climate-related financial risks – measurement methodologies*, (14 April 2021).

¹⁶⁷ BASEL COMMITTEE ON BANKING SUPERVISION, *Consultative Document Principles for the effective management and supervision of climate-related financial risks* (2021).

¹⁶⁸ MARK CARNEY, *Foreword*, in HERMAN BRIL / GEORG KELL / ANDREAS RASCHE (ed.), *Sustainable Investing. A path to a new horizon* (2021), xxxiii; PATRIZIA BAUDINO / JEAN-PHILIPPE SVORONOS, *Stress-testing banks for climate change – a comparison of practices*, FSI (2021).

VIII. REDEFINING REMUNERATION POLICIES

Remuneration practices have also been affected by ESG objectives¹⁶⁹. A WTW report documented that 51% of the S&P 500 companies already incorporate ESG metrics in their incentive plans¹⁷⁰. Deloitte also reported that almost 40% of the Fortune 100 companies incorporated ESG measures in their remuneration plans¹⁷¹ and signalled a prospect of increase in the next 1-2 years¹⁷². The most popular ESG metrics are GHG emissions, diversity and inclusion metrics, customer satisfaction and worker safety¹⁷³.

The European Commission Action Plan on *Financing Sustainable Growth* (2018) directly addressed this issue, by stating that ‘*The governance of public and private institutions, including (...) executive remuneration, plays a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process*’¹⁷⁴. Furthermore, the revised version of the EU Shareholders’ Rights Directive imposes the inclusion of financial and non-financial performance criteria in the remuneration policy, including, where appropriate, criteria relating to corporate social responsibility¹⁷⁵. In its first draft, the European Commission Proposal on Due Diligence also prescribed that climate action plans take into account, when setting variable remuneration, if variable remuneration is linked to the contribution of a director to the company’s business strategy and long-term interests and sustainability. A subsequent Council position, dated November 2022, however, deleted such provision.

The role of incentives is also recognized under Principle 6 of the Climate Governance Principles, that namely states that it could be considered to extend

¹⁶⁹ See INÈS SERRANO DE MATOS, Chapter 15 in this book. In general: PAULO CÂMARA, *Remunerações e Governo das Sociedades: uma nova agenda, em Instituto Português de Corporate Governance, Volume Comemorativo do XV Aniversário, (2018)*, 267-284.

¹⁷⁰ WILLIS TOWERS WATSON, *ESG Incentive Metrics S&P 500 Highlights* (March 2020), noting that only 4% include ESG metrics in long-term incentive programs. According to Bloomberg, 9 % of the 2,684 companies in the FTSE All World Index tracked by researcher Sustainalytics in a 2020 study had tied executive pay to ESG (Kevin Orland, Canadian banks tie CEO pay to ESG, setting them apart from the crowd, (18 March 2021).

¹⁷¹ KRISTEN SULLIVAN/ MAUREEN BUJNO, *Incorporating ESG measures into executive compensation plans* (April 2021).

¹⁷² DELOITTE, *Road to net zero... incentivising leadership* (September 2021), at 4.

¹⁷³ WEF, *Measuring Stakeholder Capitalism Towards Common Metrics and Consistent Reporting of Sustainable Value Creation* (2020), 9; SEMLER BROSSY, *ESG + Incentives 2021 Report* (2021), 4.

¹⁷⁴ EUROPEAN COMMISSION, *Action Plan on Financing Sustainable Growth*, COM(2018) 97 final (8-mar.-2018), at 1.

¹⁷⁵ Article 9a introduced by Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017.

variable incentives to non-executive directors¹⁷⁶. Some institutional investors¹⁷⁷ have also supported the inclusion of ESG measures in remuneration policies.

The remuneration policy is a central component of the corporate strategy and as such it is instrumental to the ESG strategy of each firm. Such policy is also a key pillar of the governance structure of a company and therefore must be consistent with the options taken in ESG policies, risk management policies and engagement/ stewardship policies. Full and coherent articulation between these policies becomes therefore of critical importance.

Both at institutional investors' level and at invested company level, the main concern is to ensure alignment between ESG objectives and the incentives that are in place. And, in fact, it is widely recognized that remuneration can be a very powerful tool to enforce ESG strategies¹⁷⁸. Furthermore, recent research has shown that the integration of corporate social responsibility (CSR) criteria into executive compensation is associated with greater firm innovation¹⁷⁹.

Remuneration policies are also important tools to promote sound and effective risk management of financial institutions¹⁸⁰. Therefore, KPI must be articulated with the risk management matrix, as discussed above. The preamble text of SFDR states that the '*structure of remuneration [must] not encourage excessive risk-taking with respect to sustainability risks and is linked to risk-adjusted performance*'. It is now clear must include risks related to environmental sustainability, social sustainability and governance.

Three main aspects of remuneration policy deserve particular attention: i) the structure of remuneration policy; ii) disclosure; and iii) the decision-making process. These will be dealt with below.

¹⁷⁶ WORLD ECONOMIC FORUM, *How to set up effective Climate Governance on Corporate Boards. Guiding principles and questions*, (January 2019).

¹⁷⁷ See namely BLACKROCK, *Incentives aligned with value creation* (2021); CEVIAN CAPITAL, *Cevian Capital requires ESG targets in management compensation plans*, (3-march-2021).

¹⁷⁸ LUCIAN A. BEBCHUK/ HOLGER SPAMANN, *Regulating Bankers' Pay*, GEO. L.J. vo. 98 (2010), 247; MARK J. ROE/ HOLGER SPAMANN/ JESSE FRIED/ CHARLES WANG, *The European Commission's Sustainable Corporate Governance Report: A Critique* (14-out-2020), 14.

¹⁷⁹ ALBERT TSANG/ KUN TRACY WANG/ SIMENG LIU/ LI YU, *Integrating Corporate Social Responsibility Criteria into Executive Compensation and Firm Innovation: International Evidence*, Journal of Corporate Finance, Vol. 70, (2021) (covering a sample of firms from 30 countries).

¹⁸⁰ IRIS CHIU, *Corporate Governance of Financial Institutions*, in HELMUT K. ANHEIER/ THEODOR BAUMS, *Advances in Corporate Governance. Comparative Perspectives*, Oxford (2020), 71.

The main ESG implications relate to the structure of variable component of the remuneration of the financial institutions (investor-companies) and listed companies (invested-companies)¹⁸¹.

The topic involves some degree of complexity¹⁸². Firstly, there is a debate on whether ESG-linked pay KPI might lead to short-term focus from the board¹⁸³. In response to this question, it is important to note that ESG-related metrics can affect short-term, medium-term, and long-term incentives. The European Directive on alternative fund managers, for instance, forces an assessment of remuneration indicators in a longer period ‘*appropriate to the fund life-cycle*’¹⁸⁴. In Germany, there is an explicit rule that mandates listed companies to have their remuneration policy aligned with their respective long-term development¹⁸⁵.

This serves as a caution in terms of the way ESG-linked KPI are drafted. On the one hand, ESG-linked KPI should be involved with long-term assessment in order to avoid a short-term focus from management¹⁸⁶. On the other hand, KPI should be not only quantitative but also qualitative. Moreover, there are tail events require adaptation and that may not be captured in standard KPI (eg. safety risk)¹⁸⁷. These indicators should also be drafted in a precise way and avoid vague and undetermined formulations, namely in terms that are too easy to achieve¹⁸⁸. Finally, ESG-linked KPI are part of a mix of performance indicators and should not be isolated (in order to avoid what ALEX EDMANS call the ‘*hit the target, miss the point*’ effect)¹⁸⁹. These observations, however, should not deter companies from using ESG metrics in their remuneration policies. In Europe and in the US, as an additional

¹⁸¹ Please bear in mind that in Europe financial institutions (investor-level) remuneration is subject to tighter regulation whereas listed companies may adapt a comply or explain approach.

¹⁸² PWC/ LBS/ CCG, *Paying well by paying for good*, (2021).

¹⁸³ See ALEX EDMANS/ LUCA ENRIQUES/ STEEN THOMSEN, *Call for Reflection on Sustainable Corporate Governance*, (2020), available at ecgi.org: ‘tying pay to stakeholder targets may lead to short-term behaviour to hit the targets’. In the same sense, see PWC/ LBS/ CCG, *Paying well by paying for good*, cit., 30.

¹⁸⁴ AIFMD, Annex II. See DIRK ZETZSCHE, *The Alternative Investment Fund Managers Directive* (ed.), 3rd edition, (2020), 149.

¹⁸⁵ § 87a Aktiengesetz. See CHRISTIAN ARNOLD/ JULIA HERZBERG/ RICARDA ZEH, *Das Vergütungssystem börsennotierter Gesellschaften nach § 87a AktG*, AG 9/2020, 313.

¹⁸⁶ ICGN, *Integrating ESG into Executive Compensation Plans*, (2020) (‘a move towards longer-term incentives is now needed’).

¹⁸⁷ PWC/ LBS/ CCG, *Paying well by paying for good*, (2021).

¹⁸⁸ The case of Honeywell inevitably comes to mind, whose KPI was merely to ‘drive a robust ESG programme’ (ANDREW HILL, *Executive pay and climate: can bonuses be used to reduce emissions?* FT (14-nov.2021)).

¹⁸⁹ ALEX EDMANS, *Response to the European Commission Study on Sustainable Corporate Governance*, (2020), 3; PWC/ LBS/ CCG, *Paying well by paying for good*, cit., 30; PWC/ PHILLIPPA O’CONNOR/ LAWRENCE HARRIS/ TOM GOSLING, *Linking executive pay to ESG goals* (2021).

argument, the say on pay regime serves as a tool for shareholder scrutiny in respect to the inclusion of ESG elements in remuneration policies¹⁹⁰.

The core underlying objective is to align key performance indicators with ESG targets. Companies are to adopt a clear strategy to identify ESG metrics that are relevant to its business and are compatible with its long-term business interest and vision, as well as with sustainable investment.

In respect to the 'E' pillar, the most frequent metrics relate to carbon emissions. A distinction is drawn here between Scope 1, Scope 2 and Scope 3 metrics. Scope 1 reports to direct emissions from owned and controlled companies, while Scope 2 concerns indirect emissions from sources of purchased electricity and Scope 3 includes all indirect emissions along the company's value chain, including suppliers, customers, and partners¹⁹¹. The latter is clearly more demanding and harder to implement and monitor.

On the other hand, these environment-related indicators will inevitably push for longer term indicators. Recent reports even give evidence for the existence of hyper-long-term incentive plans, that have effects long after board mandate termination¹⁹².

KPI in this context need to be meaningful, measurable and its structure should be subject to disclosure¹⁹³. In 2009, the European Commission already recommended to listed companies that *performance criteria should promote the long-term sustainability of the company and include non-financial criteria that are relevant to the company's long-term value creation*¹⁹⁴. In order to adapt their performance indicators, each financial institution must: i) identify ESG objectives; ii) set relevant measurement indicators; iii) measure and validate¹⁹⁵. In this exercise, when setting up objectives, the remuneration policy must be articulated with the company's

¹⁹⁰ ILLARIA CAPELLI, *La sostenibilità ambientale e sociale nelle politiche di remunerazione degli amministratori delle società quotate: la rilevanza degli interessi degli stakeholder dopo la SHRD II*, *Orizzonti del Diritto Commerciale*, 2|2020 (2020), 575-588

¹⁹¹ SHAI GANU, *Climate issues 'beat up' in boardrooms*, Willis Towers Watson, (2021), that states that '*Analysis by WTW shows that while around 11 per cent of top 350 European companies had tCO2e emission reduction targets in management goals and incentives, only 2% of the US S&P 500 companies did.*

¹⁹² SHAI GANU/ PHILIPP GEILER, *Combating climate change through executive compensation*, Willis Towers Watson, (2020).

¹⁹³ BEATE SJAFJELL, *The Role of Business Law in the Jigsaw Puzzle of Sustainability*, University of Oslo Faculty of Law Research Paper No. 2015-20, Nordic & European Company Law Working Paper No. 15-07 (2015); MARK J. ROE/ HOLGER SPAMANN/ JESSE FRIED/ CHARLES WANG, *The European Commission's Sustainable Corporate Governance Report: A Critique* (14-out.-2020), 14; ANDREW JOHNSTON/ JEROEN VELDMAN/ ROBERT G. ECCLES/ SIMON F. DEAKIN et al., *Corporate Governance for Sustainability Statement* (11-dec.-2019).

¹⁹⁴ EUROPEAN COMMISSION, Recommendation of 30 April 2009, 2009/385/EC, at 3.2.

¹⁹⁵ RUTH SIMSA/ OLIVIA RAUSCHER et.al., *Methodological Guideline For Impact Assessment*, TSI Working Paper Series No. 1, Brussels, (2014), 12.

purpose, both at investors' level and invested level. As previously said, ESG approach must be adapted to each firm. The challenge therefore is to transform Key Performance Indicators into Key Purpose Indicators.

On the other hand, the introduction of claw back and malus clauses related to ESG may be considered to enforce ESG objectives¹⁹⁶. Claw back clauses are apt to respond to longer term objectives¹⁹⁷ but in many cases may be poor substitutes for long-term deferral clauses and restricted stock, which are easier to enforce¹⁹⁸. Any of these remuneration techniques, however, avoid that ESG-linked KPI lead to short-term focus from the board.

In terms of disclosure, the EU Sustainability Finance Disclosure Regulation (SFDR) imposes financial institutions to include in their remuneration policies information on how those policies are consistent with the integration of sustainability risks¹⁹⁹. SFDR has a principles-based approach with a focus on disclosure. No details are imposed as to which elements of the remuneration policy must be adapted. The SFDR also mandated disclosure of such information on their websites²⁰⁰.

On the other hand, the revised EU Shareholders Rights Directive requires a remuneration report that namely includes information on how the remuneration policy contributes to the long-term performance of the company, and information on how the performance criteria were applied²⁰¹. Some sustainability metrics may be complex and therefore in some cases its disclosure should be supplemented with qualitative information²⁰².

Finally, remuneration committees will also have to adapt to the evolving ESG remuneration implications. One of the main topics relates to ESG qualifications of remuneration committee members, that are not mandatory by law, but will increasingly be important in practice.

¹⁹⁶ In this sense, PRI, *Integrating ESG issues into executive pay. An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact A Review Of Global Utility And Extractive Companies*, (2016), 6, 19-10.

¹⁹⁷ In general: IRIS CHIU, *Corporate Governance of Financial Institutions*, cit., 72-73.

¹⁹⁸ ALEX EDMANS, *Grow the Pie. How great companies deliver both purpose and profit*, Cambridge (2020), 126.

¹⁹⁹ Article 5 I of Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

²⁰⁰ Article 5 II of Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019. Further disclosures will be required by the level 2 EC Regulation.

²⁰¹ Article 6b introduced by Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017.

²⁰² ALEX EDMANS, *The dangers of sustainability metrics*, VOX (11 February 2021).

IX. CONCLUSION

Corporate governance has ever been considered as an organizational tool for a better future. In the ESG context, this can be manifested in a very tangible sense. Indeed, ESG is ultimately a vehicle for boosting climate, social and governance-based decisions.

As we have seen, the intersection of corporate governance and ESG is apt to produce a ‘cascade effect’. We have defined ESG cascade effect as the potential aptitude for companies to engage in ESG-based decisions and to systemically influence others to do so. Such is a metric, with effects and consequences that can be assessed at the investors’ level, at invested companies’ level, at supply chain level and at the community at large²⁰³. In any of these levels, ESG potential impact is systemic, and its degree of influence is variable and depends upon the ESG policies and upon product-specific arrangements in place.

The cascade effect bears cross-border implications, and that is particularly important in terms of climate change-related policies and behaviours. As climate change problems are global by nature, they require a global response. Therefore, the cross-border ‘cascade effect’ is also an important and necessary effect that stems from ESG.

The reciprocal influence of corporate governance and ESG determines a double and reciprocal empowerment. On one side, the governance reach is extended to ESG issues; and, on the other side, ESG decisions are adopted, implemented and enforced due to the governance structure. This double perspective also shows that the relevance of corporate governance for ESG goes beyond the financial sector and decisively impacts the whole economic landscape.

The analysis presented therefore confirms the need for a systemic analysis of corporate governance that places sustainability goals of financial institutions at its centre²⁰⁴. ESG namely shows that there can be an alignment between investor value and stakeholder value – what MARK CARNEY coins as the ‘divine coincidence’²⁰⁵. The core priority of the forthcoming ESG agenda lies precisely on boosting the chances for such alignment, namely in critical areas such as board duties and skills, disclosure, risk and remuneration.

²⁰³ See *supra*, 4.3.

²⁰⁴ Similarly, BEATE SJÄFJELL / CHRISTOPHER M. BRUNER, *Corporations and sustainability*, in *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge, (2019), 4.

²⁰⁵ MARK CARNEY, *Value(s). Building a better world for all*, cit., 426, 432, 453. See also LUCA ENRIQUES, Chapter 6 in this book. Regarding shareholder alignment paved through green financing, see also JULIAN NYARKO/ ERIC TALLEY, *Corporate Climate: A Machine Learning Assessment of Climate Risk Disclosures*, in ANDREAS ENGERT / LUCA ENRIQUES/ WOLF-GEORG RINGE/ UMAKANTH VAROTIL/ THOM WETZER, *Business Law and the transition to a Net Zero Economy*, (2022), 3-5.