Pensions and ESG: An Institutional and Historical Perspective

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Abstract

Sustainable investing is growing into its moment. Funded pensions, which were among the first institutions to respond to sustainability concerns, are showing renewed interest in better ways to reflect responsible investing objectives, along with regulators, asset managers and shareholder groups. Looking back, the principal elements of sustainability—environmental, social and governance (ESG)—all have different origins and took different pathways. Looking across, sustainable investing developed differently depending on region and country. Viewing it today, we see the trend toward E, S & G convergence—of definition, process and organization—toward a more integrated investment perspective and process. With growing asset size, funded pensions, sovereign wealth funds and other large institutional investors became "universal owners" and, along with thought leaders and regulators, drove the evolution of sustainable investing toward the more systematic set of tools and policies we see today. Looking forward, questions remain, such as who will be most influential in determining the future of sustainable investing—pensions and other institutional investors, governments, shareholders and companies-- as well as what it will look like. As such, sustainability remains a work in progress and pensions are in a strong position to shape its evolution.

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Whether labeled sustainable, responsible, or ESG investing, sustainable investing is growing into its moment, with pensions and other institutional investors playing important roles. Although once quite separate, environmental, social and governance concerns are converging as pensions and other investors increasingly treat these strands as three parts of a whole. In addition, once quite separate, sustainability considerations are also being increasingly integrated into institutions' overall investment processes.

In other words, convergence and integration are apparently irreversible trends as pensions and institutional investors around the world expand their sustainable investing capabilities or require their managers to do so. Several suggestive indicators include the following:

- In 2006, 63 asset owners, managers and service providers around the world, representing about US$6.5 trillion, signed on to the U.N.'s first Principles of Responsible Investing (PRI). In 2020, the U.N. PRI had over 3000 signatories, of which over 300 are asset owners or managers representing about US$100 trillion (UN PRI 2021). Another estimate puts actual sustainably managed global assets at about US$40 trillion (Opima 2020).[1]
- In 1995, U.S. institutions managed about $2 billion using a variety of E, S and G criteria, whereas by 2020, ESG AUM in the U.S. had grown to over $17 trillion, a compound annual growth rate of about 14% (US SIF 2020).
- Japan's GPIF, with over US$1.5 trillion AUM, is now requiring its fund managers to integrate environmental and social concerns into security selection.
- The European Union has been engaged in a multiyear program to increase ESG disclosure by public companies and to require institutional investors to incorporate sustainable investing principles and practices into their investment programs.

- In the U.S. CalPRS defined benefit plan has long been a leader in ESG convergence and integration and TIAA, an early innovator among defined contribution plans with separate social choice funds and a strong governance program, is considering how to bring sustainable investing criteria to bear on its entire investment portfolio.
- Among asset managers, Blackrock announced in 2020 that it is in the process of reorienting its entire $7 billion plus investment portfolio to incorporate sustainable investment criteria, while Capital Group has integrated ESG-based securities analysis into its investments. Many other asset managers preceded those actions or are following suit.
- Stats on ESG voting…

In what follows, we identify four forces behind these trends towards convergence and integration in sustainable investing.

Economic transformation, movements and organizations. Social movements and government programs intended to ameliorate the worst of the effects of industrialization are well-known and long recognized. In the last few decades, reemergence of wealth and income inequality, increasing industrial concentration and globalization, identification of climate change and other environmental and social effects, have stimulated regional and global movements and independent organizations to advocate and pressure government regulators and companies to address negative consequences.

Information and analysis. Better data and research on environmental and social issues, including increased disclosure by companies, has enabled governments, independent organizations and shareholders to understand the case for companies to act on ESG considerations. This has also enabled the creation of multiple measurement systems for evaluating companies according to ESG criteria.

Institutional ownership. Pension and mutual fund ownership of public securities grew several-fold over the last several decades so that by 2020, pensions accounted for over 60% of the US$ 20 trillion in AUM among the world's top 100 asset owners (Hall et al. 2020). Sovereign wealth funds accounted for most of the rest. Recognizing the growing size of institutional holdings, pension participants, mutual fund investors and governments began increasingly to pressure those institutions to engage with the companies they own.

Stakeholder not just shareholder orientation. While the legitimacy of a stakeholder view of corporate responsibility varies by country and region, wider acceptance of a broad definition of stakeholders to include all of those affected by company actions has been growing. This is true both in the U.S., where by the late 20th Century a narrow shareholder view dominated, and in Europe, where employees in many EU countries have long been recognized as legitimate stakeholders.

These forces have contributed to a more comprehensive approach by institutions to ESG investing across the developed world and, in turn, to changes in the way many companies behave and report, but complete convergence among environmental, social and governance considerations and full integration into the investment process by pensions and other investors are both incomplete. If the trend toward convergence and integration is to continue, it will depend on several issues that are still being addressed and debated.

Goals and objectives. There has been a sea change regarding two basic issues: pensions' fiduciary responsibility with respect to sustainability versus investment returns and companies' responsibility to shareholders versus broader stakeholders. However, neither is fully resolved while debate and analysis continue.

Analytics. As other papers at this conference show, there is far from universal agreement on how to define environmental, social and governance factors. This is important both for what companies disclose regarding their activities, practices and impacts and for investment analysis of companies along ESG dimensions. While a variety of disclosure standards and measurement systems have been developed over the past several decades, they do not always agree on what factors to consider, how to define those factors precisely and what weight should be given to each factor.

The investment toolbox. Investors develop their own preferred mix from a variety of ESG investment tools or approaches, including negative screening to exclude certain companies, industries or countries, positive screening to include companies, or both; best-in-class investing within industries; impact investing intended to further specific ESG goals; engagement and voting on ESG matters; and integration of ESG factors into the securities analysis and portfolio construction process. The fastest growing of all approaches is ESG integration into the investment process (Sustainability 2020)

Global standards and practices. Pensions and other institutions operate within regional and global systems that include a variety of other powerful public and non-government organizations that regulate or advocate for sustainability policies and practices, all of which still vary across countries and regions.

Although the trends toward ESG convergence and integration are unmistakable, pensions and other institutions cannot simply adopt universal goals and standards, common valuation metrics and off-the-shelf engagement programs. For example, even with general agreement on reducing carbon emissions, institutions are still faced with determining by how much and by when; which companies can or will contribute to reductions; and which companies will do so efficiently (i.e., provide superior returns). In other words, investors must identify and prioritize their ESG objectives, define specific metrics and apply them to security selection and create and manage sustainability programs.

This paper traces the evolution of ESG investing as it has evolved to today's more, but not completely integrated framework. It begins by laying out a conceptual framework based on the concept of the 'universal owner,' a long-term, global investor in a position to benefit from evaluating and acting on ESG principles through improvements in corporate governance and by reducing harmful externalities. It then documents the development of practical approaches to achieving sustainability ends that now represent a formidable set of tools for pensions and other investors to evaluate companies and influence their behavior. It also examines the critical public policy issues affecting sustainable investing, for example the way alternative definitions of fiduciary duty with respect to sustainable investing affect pensions based in different countries and regions. The paper also shows how frameworks, definitions, tool usage and public policies have begun to converge and concludes by considering sustainable investing challenges pensions and other investors will continue to face in the years ahead.

Framework

While ESG, sustainable, responsible and impact investing each have somewhat different connotations, they all reflect the United Nations Principles for Responsible Investing's 'strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership' (PRI 2021). The seeming simplicity of this definition raises important questions, such as what exactly are the ESG factors that need to be incorporated, who is responsible for investment decisions, to whom is the investment decision maker responsible?

Universal Owner

The PRI definition of ESG investing considers environment, social and governance to be three parts of a whole, but they haven't always been treated that way. What brings them closer together is the concept of the 'universal owner,' a pension or another institution that by intention or requirement invests long-term in widely diversified holdings throughout the global economy (Urwin 2011). These institutions must manage total market exposure, for example recognizing that environmental and social costs are unavoidable since they affect the portfolio through insurance premiums, taxes, inflated input prices, unrest and instability, which in turn create costs that reduce returns for some investments. Examples include environmental degradation, poverty, pandemics and many others. Looming over all of this, poor company governance can lead to short-termism, insufficient attention to pertinent environmental and social issues and suboptimal decisions that reduce long-term performance. As we will see, universal owners have played a major role in patterns and policies for sustainable investing today, acting both individually and in consortia, such as the UN PRI and with independent and industry groups.

Besides universal owners, other stakeholders have an interest in sustainable and responsible corporate practices. The most influential of these are governments, which, even more than universal owners have a long-term stewardship interest in the effects of corporate actions on society and tools such as legislation and regulation, to direct and affect corporate behavior. While governments and universal owners cannot afford to avoid sustainability issues, individual shareholders may also see an interest, although their influence will be less than that of governments and universal owners. Finally, corporations can assess their own stance and take actions to embrace or avoid sustainability and responsibility (Urwin 2019).

Externalities and Agency

How can we understand the interests of all of these actors in ESG investing? It is helpful to turn to two well-known but fundamental economic concepts: externalities and agency theory. Simply, an externality is a cost or benefit that accrues to third parties—society, organizations or individuals that did not directly agree to incur them. The externality may also affect the firm (and its shareholders) that produces it, but a significant portion of the cost or benefit accrues to third parties. One the one hand, a plant's stationary source air pollution could result in higher health insurance costs and reduced productivity among its workers, thus affecting profits, but most of the impact will be felt by many others through air particulates or climate change. On the other hand, a plant that scrubs its emissions will benefit many others who don't pay directly for the costs of doing so.

More generally, an externality is when a product or service's private price equilibrium does not reflect the true costs or benefits of that product or service for society as a whole. From the society's perspective, because resources are suboptimally allocated the externality cannot pass the Pareto optimality test and results in a market failure.

While it may be in society's interest to reduce or eliminate externalities, the dilemma is that when the cost of doing so is born by one or more firms they are unlikely to be able to fully capture related positive benefits (e.g., cleaner air and climate stability). The firm might still spend the money, hoping that ESG-minded customers and investors will reward it by their willingness either to pay higher prices for the firm's goods and services or to purchase its securities. For example, Patagonia's customers are willing to pay more for its highly publicized environmentally friendly cotton-based clothing. In many cases, however, a firm acting alone is unlikely to get a return on its actions.

Another approach is for a group of competitors to all agree on reducing specific negative externalities. While they may not be able to capture all of the positive effects, they presumably incur similar extra costs so their relative competitive positions remain the same. In these cases, trade associations or standard setting groups (SAE, LEED, UN PRI) play a central role.

A third approach is for third parties to step in and pressure firms to act. These can include regulators charged with stewardship over public goods, consumers able to direct their purchasing dollars (e.g., boycotts) or pensions and other investors who can pressure company managements using a variety of tools—carrots and sticks—at shareholders' disposal.

This is where agency theory comes into play. A conflict or moral hazard arises between a principal—the shareholder—and the agent—company management—when the two parties have different interests and asymmetric information, i.e., management knows more about the business than the shareholder (Berle and Means 1967). In this case, shareholders cannot directly ensure that management is always acting in their best interest, particularly when activities that benefit the principal prefers are costly to the agent and where what the agent does is costly for the principal to observe. In these cases, there may be suboptimal outcomes—agency costs—that lower societal welfare. The agency problem can get worse when company management acts on behalf of multiple principals or shareholders, some of whom may not want to share in the cost of monitoring and enforcing certain company policies and practices or who may not agree on what those policies and practices should be.

These agency problems affect pensions and other institutional universal owners. Among other things, institutional shareholders may be reluctant to act because they receive a fraction of the benefits resulting from stewardship activities while having to handle all the costs.

It might seem that the problems of externalities and agency theory are closely related and that responsible investing efforts should easily recognize the connection. Those using the externality lens and those using the agency lens could both recognize incentives, such as shareholder and customer preferences or regulation, to internalize certain negative externalities. More likely, a narrower view of agency that focuses on shareholders interested primarily in short-term profits to the exclusion of externalities will conflict with a broader conception that includes a wider set of stakeholders interested in addressing externalities. For example, efforts to align manager and shareholder interests that produce policies that ignore or amplify negative externalities (e.g., reducing costs by moving jobs to countries that allow sweatshop labor) are aligned on the profit question but not in ways that produce sustainable, responsible outcomes.

Stakeholders vs Shareholders

As a U.S. example of this issue, CalPRS, the California Public Employees Pension System, defines corporate governance as "the relationship among various participants in determining the direction and performance of corporations." It is interesting that this statement uses the term "various participants" rather than "shareholders" and "management." In contrast, in a 1970 essay, Milton Friedman laid out the case for a definition of corporate governance confined almost entirely to return on investment to a firm's owners:

> In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to their

> basic rules of the society, both those embodied in law and those embodied in ethical custom. (Friedman 1970)

To Friedman, corporate governance should be evaluated by how it transmits and enforces actions that maximize monetary returns to shareholders, tempered only by the need to conform to the 'basic rules of the society.'

There is, however, an alternative and more expansive definition hinted at in the CalPRS formulation, one that is exemplified by the Johnson & Johnson Company's Credo, penned by Robert Wood Johnson in 1943, which recognizes that the companies' activities touch employees, customers, and communities, as well as shareholders (J&J Credo 1943). In other words, the J&J Credo understands the company creates externalities, which must be acknowledged and managed. Governance, according to this definition, should be evaluated by how it serves the needs of all of these entities, not just by improvements in returns to stockholders. It also allows for the introduction a consideration of externalities, i.e., effects on stakeholders that don't accrue to shareholders or management.

This tension between shareholder vs. stakeholder conception of corporate governance is present everywhere limited liability corporations exist, but it had and has a different flavor across countries and regions in terms of the roles, responsibilities and influence of company management, shareholders, stakeholders and governments. It continues to challenge pensions, other institutions, and other shareholders in efforts to improve corporate governance around the globe.

Recognizing that a focus on externalities and the narrower view of governance can conflict, it is also possible to treat externality and agency issues separately. Those primarily interested in improving societal and environmental outcomes might choose to focus on mechanisms, such as regulation or proxy votes, that work directly toward those ends and not directly address agency issues. Those interested in better aligning shareholder and management incentives—perhaps in search of higher profits—might focus on governance policies, such as board independence and firm takeover policies, to the exclusion of concerns about externalities.

In this vein, a comprehensive way to define the challenge for proponents of responsible investing is the effort to gain agreement on a broader definition of principals in the agency problem to include stakeholders affected by a company's externalities and then how to align management, shareholders and stakeholders so they agree on policies to reduce negative externalities and to capture positive externalities. This challenge is a formidable one, but even if we could agree on a broader definition of whose interests a company should serve, there is no universal agreement on to weight those interests, i.e., how to prioritize externalities and how to address them.

These are the challenges that have colored the evolution of ESG investing and that remain today. In the next section we will see that the modern origins of responsible investing were grounded in this dilemma and essentially led to separate tracks for efforts to improve governance and environmental and social outcomes. For pensions and some other institutional investors, improving governance, i.e., programs and policies to better align management with shareholder interests, emerged early on in what might be called the modern era of sustainable investing. As it did so, better governance proponents did not at first recognize that the relevance of environmental and social concerns to their project. What brought the three tracks closer together was recognition of a broader, more encompassing longer-term focused definition of shareholder interests that includes negative and positive externalities.

Strands and Spheres: 'Pre-Modern' to 'Modern'

We are primarily interested in understanding the place of pensions and other institutions in modern ESG investing, but it is impossible to do so without recognizing the developments that brought both pensions and ESG to where they are today. We refer specifically to three observations about what we might call the 'pre-modern' era (roughly prior to the 1980s) as opposed to the 'modern' era of ESG policies. First was, the absence of pensions in sustainable investing until the late 20th Century, largely because funded pensions were small compared to other institutional and some individual investors. Then, with rapid asset growth and a large base of participants, pensions began to recognize their emerging status as universal investors with an interest in long-term issues of sustainability. Second, due to government policies, sustainable investing evolved quite differently across countries and regions. Then, as governments, pensions and others recognized that ESG raises issues that are global in nature, policies and practices that vary between countries began to be reexamined. Third, was the minimal attention paid to the environment (E) strand of ESG, later followed by attempts to treat G separately from S and E. With a growing recognition that agency and externality issues are highly intertwined, public policies, pensions and other investors began to bring the E, S and G strands together. In effect the transition from the pre-modern to the modern ESG era is one of evolution and convergence.

The Pre-Modern Era

Some observers group countries with respect to ESG investing exclusively by type of corporate legal system. However, while legal systems differ, two simple but powerful drivers of the evolution of sustainability practices in the private sector have been patterns of (1) stock market ownership and (2) government involvement in social reform and corporate regulation across countries and regions.

Prior to the turn of the 20th Century, early social reforms benefiting employees and then consumers began to emerge in developed countries, but they were more often the result of pressure from workers, voters and advocacy groups on governments with little investor involvement. (See Appendix A for details on premodern ESG developments in selected countries.)

What investor interest there was centered on what we now call corporate governance, as corporate control in industrial economies was concentrated in three ways: in monopolistic or oligopolistic industries, and/or control by wealthy families or by financial institutions. For example, in some countries, families used pyramidal ownership structures[2] and/or banks used special share classes and proxy voting to give them effective control. This began to change, but not always in the direction of greater protections for other shareholders and with differences among countries, notably in the role of government control. The U.S., for example, used antitrust policy and regulation to virtually eliminate family and financial institution control of public companies by the 1940s, but tended to favor the interests of company management over that of shareholders. In contrast, in most European countries, family and financial institution control was tolerated for far longer. In addition, in the name of worker and consumer protection and to preserve declining industries after World War II some European governments took direct ownership of companies in certain industries and/or a stronger role in capital allocation. We would also note that environmental issues played a back seat to governance and social concerns or were completely nonexistent until the 1960s and 70s.

At the dawn of the modern era of ESG investing, the landscape looked as follows:

Exhibit 1: ESG investing landscape at the dawn of the "Modern" Era

			U.S.	U.K.	Netherlands	Germany	France	Italy	Sweden	Japan
Corporate Governance	Policies and Tools	2-Tier Board Structure (+ worker participation)			X	X	X			
		Limit instituitonal ownershp	X	X						
		Separate commercial & investment banking	X							
		Government ownership/direction of certain industries		X			X	X		
		Formal/legal regcognition of stakeholders			X	X				
		Strong anti-monopoly enforcement	X	X						
		Higher degree of uniform accounting, reporting & disclosure rules	X	X		X				
		Small shareholder activism								
	Continuing Issues	High degree of manager control/low degree of shareholder control	X	X	X					X
		Relatively higher use of voting caps, multiple share classes, etc.			X				X	
		Interlocking directorates			X					X
		Family or bank control common*				X	X	X	X	
		Takeover defenses	X		X					
Social & Environmental		Environmental regulation and activism	H	L	L	L	L	L	L	L
		Consumer and worker protections	M	M	H	H	H	H	H	H
		Family and individual protections**	L	M	H	H	H	H	H	M
		Union activism: negotiation, lobbying	L	M	H	H	H	H	H	L
Pensions		Growth of funded pension assets (DB and DC)	H	H	H	L	L	L	L	H
		Social & environmental investments	L	L						

Sources: Morck (2005);

Notes: *Family control often exercised through pyramid ownership structures; bank control often exercised by proxy voting or direct ownership

**Health insurance, child support, other family support

In this table, we can see that several of the tools and approaches used to promote good corporate governance in the modern era are already in use, but not all widespread by this time, including the 2-tier board structure, a degree of uniform accounting and disclosure, limits on institutional and family ownership, anti-monopoly enforcement and formal recognition of stakeholders. Note that others, such as shareholder initiatives, prohibition of interlocking directorates, independent board members and… are scarce or missing.

For social and environmental issues, while there was a long history of employee and consumer protections in many countries, the impetus was rarely from shareholders and most often from union activism and other interest groups leading to government regulation and/or ownership of industry. For example, the U.S. government created a wave of regulatory agencies at the start of the 20th Century. In particular, pensions were not in a position to exercise much influence in these developments, since in many countries pensions were unfunded public entities or, as in the

U.K. and the U.S., were funded but did not accumulate significant ownership shares for several decades.

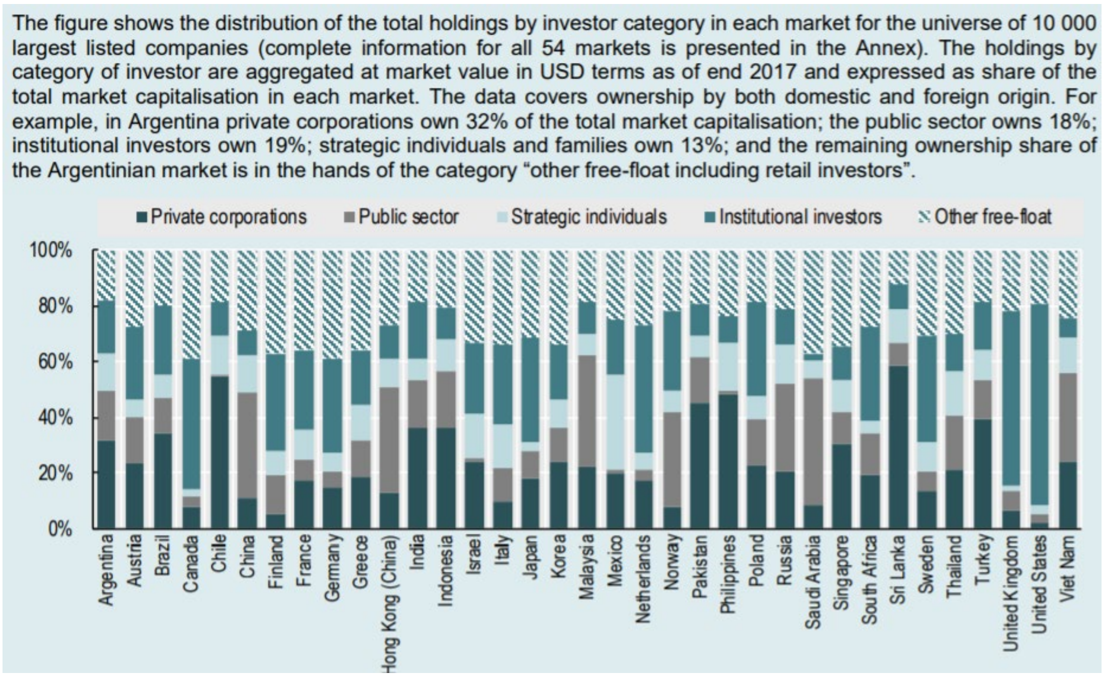
The Modern Era

What we can call the modern era of ESG investing began in the late 1970s and early 1980s, marked by (1) the rise of pension ownership and (2) the retreat of direct government ownership of companies and (3) separate movements to promote corporate governance and environmental reforms. For example, in 1969, creation of the U.S. Environmental Protection Agency exemplified a new era of government regulation in response to environmental activism and was followed later by similar programs in other countries.

The establishment of funded pensions earlier in the 20th Century, particularly in the U.S., the U.K. the Netherlands and later in Australia, meant that by the 1980s they had become substantial asset owners along with sovereign wealth funds. In addition, a small number of asset managers joined asset owners in controlling a growing percentage of public company shares. While these trends were far from identical in all industrial countries and the assets under management appear from today's vantage point to be small, the largest institutions could even then be considered universal owners who had no choice but to purchase shares in most public companies in search of capital appreciation and income for their beneficiaries.

Today, we can observe the legacy of these shifts in stock ownership patterns. Institutional investors, which includes pensions, other asset owners and asset managers who work, in part, for asset owners, now own over 7O% of outstanding shares in the U.S., with similar percentages in the Netherlands, the U.K. and Canada. In contrast, in other European countries institutional investors own less than 40% of public shares, about a third in Japan and less than 10% in China. Corporate cross holdings, which are high in Asia, are quite low in Europe and the U.S.

Exhibit 2: Total stock market holdings by investor categories across countries, 2017



Source: De La Cruz et al. (2019) based on OECD Capital Markets Data Set, Thompson Reuters and Bloomberg.

In addition, in some countries, such as Norway and Japan, government agencies invest pension savings in the stock market, while in others, such as China, governments take direct ownership of companies. This table also does not reflect the legacy and continuation of pyramidal ownership and share class structures in Asia and Europe.

Nevertheless, these figures suggest that it isn't surprising that interest among pensions in ESG investing issues emerged, though not all at once and not simultaneously, but rather evolving with different patterns across institutions, countries and the three strands of sustainability: environmental, social and governance.

Governance

Pensions. Several leading U.S. pensions, such as TIAA and CalPRS, and other institutional investors were instrumental in the corporate government movement that arose in the 1980s and 1990s. Contextually, in addition to their growing asset base, these institutions were operating with the legacy of pre-WW II reforms that favored company management over other stakeholders, a rising stock market and an accompanying wave of mergers. For example, management-controlled boards, limited disclosure, opaque shareholder initiative process and other measures, all enabled managers to operate with little scrutiny. Although there was a dearth of concrete evidence available, institutional investors began to respond to the view that it was in their interest to propose and/or support policies that would shift the balance of power toward shareholders and away from management.

No two pensions (and other institutional investors) pioneered identical approaches to corporate governance programs. For example, CalPRS was more likely to employ public statements aimed at changing corporate behavior while TIAA more often, but not always, used direct and relatively more private communications with company management. Nevertheless, these and other programs largely shared four elements: a legal orientation, similar though not identical reform proposals, cross fertilization with investment managers and separation from environmental and social concerns. Conceptually, corporate governance reform was for the most part viewed through a legal rather than a financial or economic lens, meaning that problems and solutions were more likely to be evaluated by whether they conformed to a set of preferred principles, such as a definition of board independence, or a process, such as a streamlined shareholder initiative process. Economic impacts, such as increased shareholder returns, were mostly ignored or they were assumed to follow from the implementation of corporate governance initiatives. Organizationally, new corporate governance units were, for the most part, housed in the legal departments of institutional investors. For pensions as well as corporate governance service providers, these units were led by experts with a legal background.

Exhibit 3: ESG in the 1970s

"ESG as a principle"

- Investors align around key social concerns (e.g., South Africa, Vietnam War, poverty)
- Forerunning ESG research, and shareholder advocacy, and community development institutions are founded

Key Institutions

- Council on Economic Priorities / CEP (1969)
- Pax World Fund (1971)
- Dreyfus Third Century Fund (1972)
- Interfaith Center for Corporate Responsibility / ICCR (1972)
- Investor Responsibility Research Center / IRRC (1972 (became IRRC Institute after 2005 sale of IRRC to ISS)
- South Shore Bank / Shorebank (1973)
- National Federation of Community Development Credit Unions (1974)
- Calvert Social Investment (1976)

In keeping with this focus on principles and process, pensions could agree on the need for assistance. TIAA, CalPRS, CalSTRS and others were co-founders of the Institutional Investor Responsibility Center (IRRC) in 1972 to aid investors in understanding corporate governance issues. They, as well as international pensions, were also among the founders of the Council of Institutional Investors (CII), which assisted with proxy voting, regulatory advocacy and other activities. These and other research, service and advocacy programs, helped pensions and other institutional investors further the following policies: greater independence of board members, separate audit and compensation committees, changes in executive compensation, removal of poison pill provisions, support for the shareholder initiative process, regular proxy voting and various forms of engagement.

In terms of cross fertilization, although corporate governance programs were not generally housed in investment departments, within organizations that directly managed assets corporate governance staff could learn from investment analysts and managers knowledgeable about the management, governance structure and process of the companies they covered and could as well recommend companies that might benefit from certain reforms. In turn, investment analysts and managers could potentially incorporate into their investment decisions information about initiatives being proposed by corporate governance staff.

Exhibit 3: ESG in the 1980s and 1990s

"ESG as a product"

- Dedicated industry networks are formed in the USA (Ceres, USSIF)
- Triggered by corporate takeovers and environmental disasters—Exxon Valdez spill, Bhopal India (Union Carbide) chemical leak—investors increase their focus on corporate governance and the environment
- First social indices launched and universe of Socially Responsible Investing (SRI) funds expands
- Advanced business case for sustainability and reporting (Global Reporting Initiative—GRI)
- DOL issued guidance that plan fiduciaries are permitted to consider social benefits

Key Institutional Developments

- CalPRS, CalSTRS
- US Social Investment Forum / USSIF (1984)
- Franklin Research & Development (1982)
  later renamed Trillium in 1999
- Grameen Bank (1983)
- Self-Help Credit Union (1984)
- Working Assets founded (1985)
- Social Venture Network (1987)
- CERES & the Valdez Principles (1989)
  initially a project of the USSIF
- TIAA Social Choice Account (1990)

Finally, until the 2010s, corporate governance programs did not consider environmental and social issues to be part of their universe. The legal orientation of corporate governance programs may have made it difficult to incorporate these relatively more outcome-oriented issues. In addition, some activists might have considered corporate governance reform to be fundamental and these other issues to be derivative. In other words, it might be thought that establishing good governance practices would then lead any company to evaluate and treat all externalities properly.

Corporate Governance Organizations. It is impossible to understand TIAA, CalPRS and other institutional investors without including the work of independent corporate governance service organizations. Investors and companies in the U.S. had for many years been able to turn to business groups such as the Chamber of Commerce, the Business Roundtable and, for fund companies, the Investment Company Institute, for views on corporate structure and process, which often supported company management over shareholders. Beginning in the 1970s, new service organizations were established that played various advisory and advocacy roles that were oriented to the interests of institutional investors.

The non-profit Investor Responsibility Research Center (IRRC) was founded in 1972 to provide independent, impartial research on proxy voting, corporate governance, and corporate social responsibility issues (Weinberg Center 2021).[3] Another independent organization, the National Association of Corporate Directors (NACD), was organized in 1977 to train and set standards for board directors.

Exhibit 5: Major corporate governance research, service and advocacy organizations

Organization		Est.	Primary Focus	Non-Profit?	Membership/Support	Notes
Investor Responsibility Research Center	IRRC	1972	Research, Proxy Voting	Yes	Subscription	2005 sale to ISS funded the U Delaware Weinberg Center's IRRCi
National Assn of Corporate Directors	NACD	1977	Board member practices and education	Yes	Corporate directors	
Council of Institutional Investors	CII	1985	Proxy voting, shareholder resolutions, regulatory advocacy, engagement, litigation	Yes	U.S. and non-U.S. pensions, endowments /foundations, asset managers	
Institutional Shareholders Services	ISS	1985	Proxy voting	No	Fee for advisory service	Acquired by MSCI
International Corporate Governance Network	ICGN	1995	Governance and stewardship standards and practices	Yes	Pensions, asset managers, public companies, advisory services	Primarily North America and Europe
Weinberg Center for Corporate Governance		2000	Discussion forum, teaching, research	Yes	Law firms, asset managers, companies	
Harvard Law School Program on Corporate Governance		2003	Research, teaching	Yes	Law firms, companies	
Harvard Law School Forum on Corporate Governance		2006	Discusison forum	Yes	Law firms, companies	
Ira Millstein Center for Global Markets and Corporate Ownership		2012	Teaching, research, discussion forum	Yes	Law firms, companies	Columbia U. law school
Arthur and Toni Rembe Rock Center for Corporate Governance		2006	Teaching, research, discussion forum	Yes	Law firms, companies	Stanford U Law and Business Schools

Sources: https://www.weinberg.udel.edu/; https://www.nacdonline.org/; https://www.cii.org/about; https://www.issgovernance.com/; https://www.icgn.org/; https://www.weinberg.udel.edu/; https://pcg.law.harvard.edu/; https://corpgov.law.harvard.edu/; https://millstein.law.columbia.edu/; https://law.stanford.edu/arthur-and-toni-rembe-rock-center-for-corporate-governance/.

In 1985 during a period of heightened corporate mergers, the Council of Institutional Investors (CII) was formed by 21 members, mostly from public pension plans, to pool resources in exercising shareholder oversight through proxy voting, shareowner resolutions, pressure on regulators, discussions with companies and litigation. Today membership includes 140 U.S. public, union and corporate employee benefit plans, endowments and foundations with combined assets under management of approximately $4 trillion. Associate members include non-U.S. asset owners with more than $4 trillion and U.S. and non-U.S. asset managers with more than $35 trillion in AUM (CII 2021).

Also founded in 1985, Institutional Shareholders Services (ISS) began to advise institutional shareholders (including mutual and hedge funds) on proxy voting and, when requested, to vote their shares. It later acquired the IRRC and was in turn sold to MSCI.

On the international front, the International Corporate Governance Network (ICGN), which was started in 1995, promotes dialogue and education regarding governance and stewardship practices. Its members are drawn from over 45 countries, primarily in North American and Europe, including pensions, asset managers, public companies and advisory firms (ICGN 2021).

Institutional investors varied in how they used these developing corporate governance resources. Some relied on organizations such as ISS to form positions and vote their shares. Others, such as many mutual fund companies, refrained from active or intense participation in corporate governance issues and shareholder voting. Still others relied on external research from the IRRC, CII and other organizations, but developed their own corporate governance positions and programs.

While the world of corporate governance remained quite separate from the worlds of environmental and social issues until ????, the latter two strands of sustainable investing also began to develop in the modern era.

Environmental and Social

As with governance, investor concerns for social and environmental topics evolved over time into what is now often treated under the banner of SRI or socially responsible investing. Essentially, the stakeholder orientation provided the foundation for social and environmental investing, on the basis that companies' activities affect, in addition to shareholder returns, communities, employees, customers and the environment, so that these latter interests should have a voice in company activities. At first, environmental and social initiatives focused three avenues: shareholder activism, community investing and guideline investing. Of the three avenues, social investing emphasized shareholder activism and community investing, while environmental investing emphasized both shareholder activism and guideline investing. Nevertheless, as time went on, all three were important for both E & S.

Shareholder activism. For pensions required to consider fiduciary duty, the initial investor tool was to exert influence on companies who were identified as "doing harm" with their products or where they were doing business (e.g., South Africa). This took the form of informal and formal engagement with companies, including communications and, in some cases, formal shareholder initiatives. In the U.S. and in other countries, a recurring theme was the role of government vis a vis stakeholders and companies. Governments can spend to improve social and environmental conditions as well as direct companies to do so. Stakeholders can pressure government, public and private pensions and other asset owners to, in turn, pressure companies to act. In that vein, SEC rule 14(a)8, no action relief (granted or not), and shifting guidance on what constituted fiduciary duty, all helped to shape pension activism.

South Africa apartheid was an early defining social issue. In 1977 the Sullivan Principles became a voluntary code of conduct for companies operating in the country. In this spirit, in 1978 TIAA issued its own statement on companies doing business in South Africa, following by full divestment in 1983. Other investors around the globe did so, too. Other instances of global activism included, in the 1980s, actions against Procter & Gamble and Philip Morris for their involvement El Salvador in the 1980s and, beginning in the 1990s, wages, working conditions and child labor in companies with factories outside the U.S.

These initiatives led to expansion of a formal corporate social responsibility (CSR) movement that helped to alter the expectations of companies' responsibility to internalize the effects (externalities) of their supply chains. The CSR movement resulted in greater demand by direct investors and other stakeholders for improved reporting, including both S and E. For example, CERES (Coalition for Environmentally Responsible Economies), which was a reporting response to the Exxon Valdez disaster in 1989, took a more comprehensive view of sustainability reporting and led to the Global Reporting Initiative (GRI) program in 1997 (with Tellus Institute and the UN Environment Programme). The GRI would eventually become an independent organization in 2001, with headquarters in Amsterdam (see https://www.globalreporting.org/about-gri/mission-history/.) Beginning with the Valdez disaster, state pensions, such as New York, CalPRS and CalSTRS, were active in designing and supporting these organizations.

Within their portfolios, during the 1990s pensions recognized the need to apply additional lenses to their portfolios, mainly through proxy voting and engaging with companies of concern, but also growing pressure from participants and other constituencies to use more E&S information to exclude portfolio holdings. [*Include historical data from USSIF Trends Report in exclusionary criteria over time? USA vs ROW – point being that pension funds in other countries more comfortable with this approach than most in the States*]. To that end, pensions began to develop their ability to create and manage ESG portfolios.

Guideline investing, begun in the 1970s by Calvert, Dreyfus and Pax World, was used by investors to exclude tobacco, alcohol, weapons, and other products or activities as investors sought better alignment of portfolios with ethical or faith values. Later, guideline investing expanded to more systematic negative screening, positive screening, and best-within-a-sector (best-in-class) security selection. Pensions as well as asset managers were active in these developments, including TIAA, CalPRS, CalSTRS and others.

As it evolved, there was a tension between the use of segregated funds versus applying ESG criteria to security selection and portfolio construction throughout the pension portfolio. For example, TIAA, which created the TIAA-CREF Social Choice Account as one among many investment options for participants in 1990, faced continuing participant pressure to eliminate tobacco and other products from all funds, not just the Social Choice Account. Moreover, across institutional investors there was also no general agreement on how to select securities. Should companies be selected on an absolute basis or on the best companies within an industry or sector?

In addition, while there might be agreement on certain issues, such as tobacco, there was much less agreement on what exactly constituted ESG objectives as well as a paucity of data and analysis to provide a foundation for investment decisions. For example, in 1986 when the EPA required the first toxic release reports, that system focused on facilities rather than companies so that it was difficult for investors to use the information for investment analysis. In many cases the early research providers that served institutional investors did not provide 'raw' data but interpreted data (ratings, assessments) – in retrospect this might have harmed the cause more than it helped, because institutions first had to get behind 'black box' methodologies and then determine how the information should inform investment decisions. Examples like this one led to initiatives, such as the GRI, to develop better reporting and measurement systems as well as efforts to define and reach agreement among investors and others on ESG objectives. While establishment of the Intergovernmental Panel on Climate Change (IPCC) in 1988 was not primarily investor driven, its periodic assessment reports helped to shape investor understanding of the role of industry and company actions regarding climate degradation and accompanying investment risk.

Community investing or economically targeted investments (ETI) was the precursor to today's impact investing, done to pursue specific social outcomes alongside financial return. This was based on the belief that "the plight of the homelessness and joblessness cannot be 'fixed' through conventional Wall Street investments," but instead required involvement by credit unions, foundations, community-based revolving funds, worker cooperatives and other entities (Domini et al. 1992). A specific impetus was the federal Community Reinvestment Act of 1977, which required the Federal Reserve and other federal banking regulators to "encourage" financial institutions to help meet the credit needs, including loans and direct investments, of the communities in which they do business. Organizations such as the Local Initiatives Support Corporation (LISC) were formed to work with financial institutions to channel funds into local projects and pensions and other institutional investors were also encouraged to participate.

For pensions, community investing challenges included developing appropriate investment vehicles, gaining scale, return expectations and, for ERISA pensions, shifting DOL guidance on fiduciary duty and more generally, what constitutes responsible lending practices. Alliances with Shorebank and other community banks as well as the Local Initiatives Support Corporation (LISC, founded in 1977) and the launch of Impact Community Capital (year?), founded by TIAA and 7 other insurance companies, all provided solutions, particularly for low-income housing initiatives. In addition, activism played a role as shareholders pressured banks regarding practices that indebted vulnerable customers via predatory lending and redlining practices.

Pension and other institutional involvement in community investing took a more global turn in the 1990s and 2000s with microfinance and the broader concept of financial inclusion. The term 'impact investing' was first coined in 2007 and gained traction through the launch and field building work of the Global Impact Investing Network, which included foundations and pensions in different countries. The initial focus was on private equity, with a concern for specific goals and outcomes that depended for credibility on advances in ESG-related measurement. Impact investing has more recently gained traction in other classes.

Bringing the Three Strands Together

[More to come …]

Exhibit 6: ESG in the 2000s

"ESG as a process"

- Investor further convergence on climate reporting issues
- New global investor networks begin to unite investor approaches from different regions
- In 2008, the US DOL narrows 1994 guidance: fiduciaries should only rarely consider non-economic factors when picking investment options for retirement plans.

Key Institutional Developments

- Carbon Disclosure Project / CDP (2000)
- UN Global Compact (2000)
- UN Principles for Responsible Investment (2006)
- Global Impact Investing Network / GIIN (2009)

-Recognition that E and S won't be successful unless G reforms supports them and that G reforms lead to a discussion of E & S.

-South Africa, Bhopal, Exxon Valdez, Enron

-changing listing standards,

-Uber, Facebook illustrate continuing probs w/shareholder rights and social issues, e.g., employees, customers

-European integration, EU and convergence

-connect corp gov units with E & S investing in pensions and other institutions

-integrate ESG into "regular" investment analysis and portfolio construction

- UNPRI is launched in 2006, begins to bring different parts of E, S & G together…biggest impact of UINPRI is how asset managers began to put pressure on their managers. Initially UNPRI progress reporting was not that stringent and the organization made some significant changes in 2011/2012

Exhibit 7: ESG in the 2010s

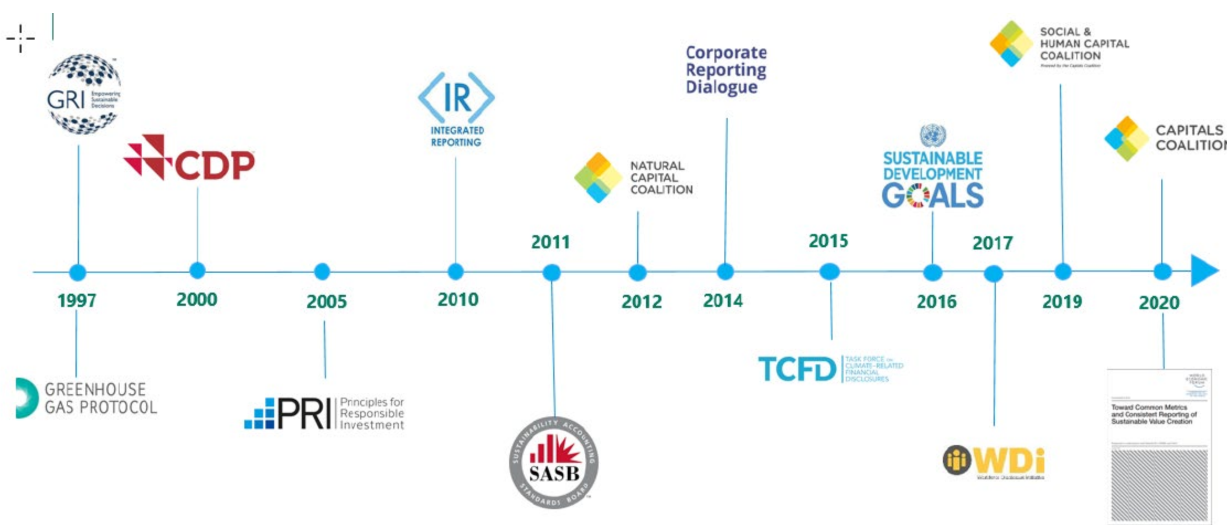
"ESG as an outcome"

- ESG investing expands across asset classes
- Expansion of ESG data and reporting to better quantify ESG factors
- Greater focus on "intentional" outcomes and impact measurement
- In 2015, DOL reversed its 2008 guidance, which "unduly discouraged fiduciaries from considering [economically targeted investments] and ESG factors".
- Heightened investor urgency around climate change as COP 21 establishes the Paris Agreement, aiming to limit global warming
- E.U. issues a series of sustainable investing guidelines and regulations

Key Institutional Developments

- UK Stewardship Code launched (2010)
- Global Initiative for Sustainability Ratings / GISR (2011)
- Sustainability Accounting Standards Board (2011)
- Investment Leaders Group / ILG (2013)
- Japan Stewardship Code launched (2014)
- Taskforce on Climate Related Financial Disclosure / TCFD (2015)
- UN Sustainable Development Goals / SDGs (2015/2016)
- Investor Stewardship Group / ISG (2017)
- International Finance Corporation (IFC) Operating Principles for Impact Mgt (2019)
- Impact Management Project (2017)

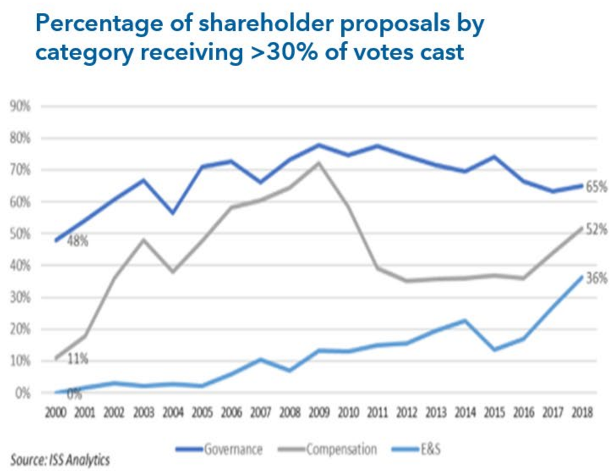
Exhibit 8: Evolution of International ESG Frameworks, Guidelines and Standards, 1997-2020



Source: Sustainability 2020

Most important, current conditions continue to reflect historical expectations regarding company consideration of stakeholder interests such that … [MORE].

Exhibit 9: E & S Issues join the mainstream among shareholders



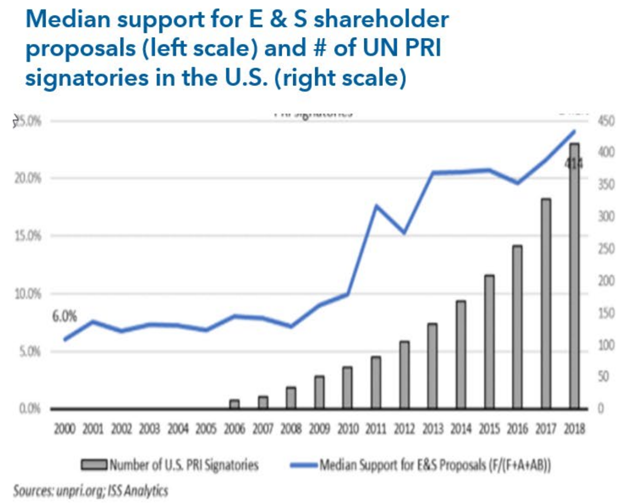


Exhibit 10: ESG in the 2020s

"ESG as a system"

- Expansion of ESG data and reporting to better quantify ESG factors
- Greater focus on "intentional" outcomes and impact measurement
- COVID-19 and racial equity issues spur renewed emphasis on "S"
- Increased scrutiny and global regulation to combat "greenwashing"

Key Institutional Developments

- Capital Group, TIAA, Blackrock and other asset managers go "all ESG" (2020)
- U.S. DOL rules that fiduciaries may only consider financial factors in investing (2020)
- U.S. DOL announces it will not enforce the rule for the time being (2021)
- E.U.

Looking Ahead: Challenges for Pensions

Driven by at least four forces—economic transformation and accompanying social movements; the emergence of universal owners; stakeholders and small shareholders; and improved information and analysis—the modern era of sustainable investing for pensions and other institutions has been characterized by convergence of E, S and G and integration of sustainable considerations into asset owners' and asset managers' investment processes. While these trends are unmistakable, convergence and integration will remain incomplete for several reasons that highlight challenges and directions for pensions and other institutions.

Goals and objectives. As we have seen, pension sponsors and their asset managers have increasingly recognized their role as representing participants in universal ownership of public companies. There is less agreement on specific goals and objectives, often summarized as fiduciary responsibility. One remaining question regards the extent to which *sustainability conflicts with returns,* i.e., how does sustainability conform to regulations requiring pensions to invest prudently on behalf of participants? Reflecting continuing confusion on this issue, the late 2020 DoL requirement that pensions focus on returns and, by implication, that ESG considerations reduce returns, was rescinded by a new Administration in early 2021. It is likely that the U.S. will eventually follow the European view that sustainability affects investment risk and that proper fiduciary responsibility focuses on balancing sustainability risks with return.

Even with such a resolution, other questions remain. A second is the time dimension, or how much to *sacrifice short-term return to achieve long-term benefits.* For example, an institutional investor may assess that a company with good short-term profit potential is undervalued but that its long-term prospects are less attractive because of the nature of its business (e.g., tobacco or fossil fuels). Which is the better strategy: to avoid the company altogether or own the company in the short run and determine when to sell it?

A third issue is *participant heterogeneity*. Pensions and other institutions act for all participants and shareholders, but not all agree on all issues. One participant's negatives, such as owning alcohol distributors or military suppliers, is another's positives, and these differences may reflect both emotional responses as well as assessments of negative and positive externalities. In either case, they pose challenges for investment institutions in setting responsive policies. One interim approach is to focus on ESG issues that gain wide approval among participants and shareholders, such as we saw in South Africa divestiture and now in long-term policies to reduce exposure to fossil fuels.

A fourth issue is other *organizational constraints*, including regulatory and other stakeholder concerns that affect pension and other institutional ownership. On the regulatory side, an example is the series of E.U. regulations issued over the past 10 years under the sustainability banner. On the stakeholder side, unions, advocacy groups and others using ownership stakes, shareholder meetings, and other mechanisms to pressure asset owners and managers will continue to encourage investment institutions to focus on their preferred goals and objectives. However, constraints can also work in the other direction. Notably, in Japan, while the GPIF has established environment-oriented investment programs and criteria, it has not done the same with respect to governance and social issues and we can speculate that this could be connected to the interests and views of some of the largest domestic public companies.

Analytical tools. There is far from universal agreement on how to evaluate environmental, social and governance factors important to both company disclosure practices, performance standards and investment evaluation. For disclosure, governments such as the E.U. and independent organizations such as SASB are calling for more and better standardized company disclosure. Others are focusing on performance standards to determine which activities can be considered sustainable versus those that aren't (Eccles… https://www.forbes.com/sites/bobeccles/2021/02/28/the-us-struggle-over-climate-change-disclosure-is-coming-to-a-hopefully-successful-head/). In addition, drawing on the findings of other papers at this conference that directly address and evaluate the ESG definitional and measurement challenges, we would note that while a variety of measurement systems have been developed over the past several decades, they do not always agree on what factors to consider, how to define those factors precisely and what weight should be given to each factor. On the one hand, a lack of agreement provides opportunities for one investor with superior resources and skill to do a better job of securities analysis. On the other hand, analytical heterogeneity can limit or provide conflicting signals to companies as to what is expected of them regarding sustainable practices. Moreover, the design and choice of a measurement systems reflects the sponsor's sustainability goals and objectives, which, as we have seen, vary by institution. It is possible to imagine that information users—institutional owners, government overseers, activists and others—eventually will be able to agree on disclosure standards. It is also likely that, for investment analysis, the largest universal owners will continue to refer to one or more widely available ESG measurement systems, but will also rely on their own proprietary approaches to identifying and incorporating ESG considerations in securities analysis and portfolio construction.

Institutional shareholder initiatives. Beyond security selection and portfolio construction, there is also general agreement on the benefits of and necessity for universal owners to give voice to sustainability improvements in the companies they own. However, there is less agreement on how and how much, ranging from proxy voting, private communications and initiating shareholder resolutions to public campaigns, lobbying and lawsuits. TIAA and other institutions have pioneered programs that operate on all these levels and it could be anticipated that more universal owners will use these models as templates for their own engagement activities.

Global standards and practices. As we have seen, pensions and other institutions operate within regional and global systems that include a variety of other powerful government and non-government actors. Regional and national regulators, both public (e.g., EU or U.S. DoL) and private (e.g., SASB, FASB), are encouraging or requiring a consistent approach to accounting, disclosure and other practices that promise to affect sustainable behavior, both by companies and pensions. Other quasi-government (e.g., UN PRI) and non-governmental organizations will also continue to be active in promoting sustainability. However, policies, practices and levels of activism still vary across countries and regions. While international treaties and organizational initiatives (UN PRI) have made substantial contributions to increased consistency, policies and practices are unlikely to completely converge without additional international-level enforcement, either through peer pressure or actual regulation. Moreover, who should be the final arbiter of international standards, practices and behavior? There is a strong case that investors should not be the final arbiter of corporate behavior. (cite Bob Eccles recent articles on this, role of new institutions)

Implications for Pensions

In sum, while we can see movement toward convergence and integration among pensions and other institutional investors, there are forces, or reasons, why these developments are not yet and may not be soon be complete.

Does further ESG progress require all investors to be on the same page? While pension investing is increasingly global, pensions serve participants in specific countries and in some cases sectors. While many, if not most, can agree on the importance of ESG, specific objectives and motivations are diverse. For example, while most appreciate the implications of global climate change, even for that issue, impacts, concerns and programs vary across regions and among populations. This is likely true for almost all ESG issues. Therefore, complete convergence may be impossible or not desirable.

Similarly, complete integration of ESG into all investments may be a goal for some investors, but not others. The TIAA experience, for example, suggests that some participants would like 100% of their investments to be driven by ESG criteria, while others might prefer less weighting on ESG.

Further progress can be achieved in a world with many actors—governments, pensions, other institutional investors, advocacy groups, etc.—and many tools for advancing ESG. In fact, such a world can encourage innovation and adaptation, if not always complete coordination. In addition, there does seem to be wide agreement on the need for further progress on ESG.

Who will make decisions? Who is the appropriate entity to prioritize among stakeholder interests and set beneficial real-world outcomes; decide what additional ESG data companies should be required to disclose; how that data should be evaluated (e.g., what makes a company an ESG leader or laggard); and investment and engagement decisions? Pensions operate in a multilayered system where multiple public actors at the international, national and local levels can claim authority for ESG policies affecting investments. Further, pension participants, other shareholders and other stakeholders in the nonprofit and profit arenas also can claim an interest in investment decisions. We saw the ground shift as pension asset grew in the latter half of the 20th Century. There is no reason to think that changes will not continue. It would be possible to imagine that as pension assets continue to grow, particularly in China, the rest of Asia and Latin America, those pensions will increasingly express their views and take action.

Who 'owns' the big picture? As we know, there is no global ESG regulator. Public (e.g., governments) and independent (e.g., SASB, rating agencies, etc.) entities at the regional, country and international levels all have a voice and cooperate as well as compete to set the ESG framework and guide action. This includes international pension consortia and even the very largest asset managers (e.g., Blackrock). Is the creation of an effective global investment industry ESG ecosystem necessary for continued evolution? Who and how would such an ecosystem be directed? Which market investors and stakeholders win and which lose in that future state?

What's the next unifying issue after climate change? Climate change is arguably the issue that, in the modern ESG era, has generated the most interest and agreement among asset owners, managers and other investors. Given that addressing climate change requires committing resources to analysis and large and sustained public and private action, it will continue to be the most visible ESG issue for the foreseeable future.

Nevertheless, what other ESG issues are candidates for unifying action? One issue, that has worn several labels in ESG history, is what is now called equality (or inequality). The economic aspect of the equality issue goes back to the 19th Century with concerns about workers, families and consumers along with regulation and social programs to address them. Interest in economic equality has waxed and waned, but has reemerged with proposals to improve working conditions, raise children out of poverty and reduce the nearly unprecedented gap between the rich and the poor, the high and low income populations. Increasing economic equality is not exclusively a challenge for government and nonprofit organizations; companies play a role through wages and benefits, working conditions, supply chain design, environmental and investment policies. Therefore, it is possible to imagine that if equality continues to attract attention, proposals and programs to address it will include actions companies can take.

In any case, while these challenges remain, pensions and other asset owners can benefit from knowledge and experience gained from the evolution of ESG, deeper analytical and organizational resources, a more robust set of tools and initiatives, support (and constraints) from government and non-governmental organizations, and considerably more agreement among investors on goals and objectives. Pensions can draw on these resources to address ESG concerns, both existing and emerging.

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Endnotes

[1] According to these estimates, ESG AUM consists almost entirely of assets where managers incorporate ESG considerations into the “regular” investment process. A few are in separate funds and accounts dedicated to ESG.

[2] A pyramid ownership structure separates rights to a firm’s cash flows from voting rights. In this case a family uses a firm where it has controlling interest to set up one or more firm controlled by the first company, but with dispersed stock ownership as well. The first firm can capture a large percentage of the new firms’ revenues but leave any losses at the level of the new firms. In this way the family can access the entire amount of the retained earnings of the first company, which can include the captured firms’ revenues.

[3] In 2005 the IRRC was sold to Institutional Shareholder Services and the IRRCi, a research center now housed at the University of Delware, was created with the proceeds.

Appendix A: "Pre-Modern" Era in Selected Countries [More to come…]

United States

The Progressive and Depression Eras' reaction to concentrated wealth and the negative externalities of industrialization not only resulted in new government social, economic and health protections for consumers, small-businesses and employees, such as strong regulatory agencies and support for strong unions and emergence of pensions. Later, government acted to require companies to provide pensions and to pay for publicly managed unemployment insurance. Notably, this period also produced protections for small shareholders including major anti-monopoly policies and court decisions that largely eliminated family pyramidal ownership structures, separated commercial from investment banking and limited the ability of banks, insurance companies, pensions and mutual funds to take controlling interest in other companies (Becht & DeLong 2005). It did not, however, solve the agency problem, as hired managers directed company activities, with oversight by a board whose members were effectively chosen by management and approved through votes by dispersed shareholders. By the latter half of the 20th Century, most public companies featured a relatively high degree of managerial control and a relatively low degree of shareholder influence.

Germany

Worker and shareholder protections as well as social programs began in the late 19th Century in Germany, with Bismarckian legislation establishing the first health insurance, publicly sponsored pensions and unemployment insurance, and union protections. These developments helped reduce negative externalities born by workers and their families and they enabled workers to band together to negotiate with corporate management. Nevertheless, as in the U.K., France and other countries, these initiatives were not driven by investor actions, but rather by workers themselves pressuring government and, through unions, companies.

In contrast, investors were more influential in German corporate governance, as Germany mandated a form of uniform accounting and reporting rules and a dual corporate board structure that prohibited overlapping members, features that exist today. However, German banks could still collect and vote proxies of shareholders of companies underwritten by those banks and companies themselves issued additional share classes favoring family control. Consequently, the larger banks and prominent families controlled an increasing percentage of the German stock market. Notably and perhaps remarkably, in 1938 a Nazi law was the first in the world to explicitly assign corporate responsibility to all stakeholders, not just shareholders. However, family owners responded by shifting away from special share classes to a pyramidal ownership structure (Fohlin 2005). Today, while diminished, German corporate governance continues to reflect bank and family control of companies.

United Kingdom

In the U.K. early social programs were also the result of worker pressure on government and, again through unions, on corporations, after the voting franchise was expanded several times in the 19th Century. The original U.K. corporate structure was through grants of monopoly from the central government. In the late 19th Century, not long after the first shareholder protections in Germany, U.K. legislation requiring greater company disclosure and making company directors liable for prospectus statements were both thought to have influenced a decline in family ownership of firms while supporting shareholder rights (Franks et al. 2005). Importantly, in the name of employee and consumer protection, after WW II government ownership of prominent industries advanced and then reversed in the 1980s with the Thatcher government's emphasis on shareholder rather than governmental control. By the late 20th Century U.K. corporate governance came to resemble more closely the U.S. version, with strong management, a somewhat weaker board, dispersed ownership and regulatory oversight.

The Netherlands

The Netherlands has the oldest stock market in the world, but by the 19th Century its development lagged due to hangover from a series of bubbles and crises and French-influenced aversion to bank financing. As in France, family-owned firms predominated with financing from retained earnings. In the 20th Century, the use of public shares and long-term bank loans grew as family dominance gave way to management control. Although Dutch firms are required to have a two-tier board structure, shareholders had little say in board membership. Moreover, interlocking directorates, super- and preference-voting shares, income trusts and other measures reinforced management control. While workers were not as influential in the Netherlands as in in Germany, they did have a voice, both in corporate policies and through government worker protections. For example, industry-based funded pensions proliferated after WW II.

France

With a long history of financial market crises, France relied relatively little on banks and the stock market as it industrialized.[4] Instead, firms tended to finance new investment largely out of earnings, thus favoring family control, which was further encouraged through inheritance laws as well as close government connections with family members. Like the U.K., following WW II the French government took controlling interest of major industries, such as transport, energy and others, in order to promote employee and consumer interests. It also established a dual board structure with worker representation on the supervisory board. As in the U.K. the French government later divested some of its industrial holdings, but maintains some of the strongest worker protections of any industrial country (Murphy 2005).

Italy

Italy's major banks collapsed in the early 1930s after which the central government assumed ownership and separated investment from commercial banking. Similar to the U.K. and France, after WW II the government owned and directed investment in capital intensive industries, propped up failing firms and used industrial policy to support development in Southern Italy. It also supported the rise of family-controlled firms through provision of capital and lack of regulatory objections. Many family firms remained privately owned while publicly traded companies were family-owned pyramids. By the 1990s, rising debt loads and poor performance among government-owned firms forced a round of privatization and more dispersed shareholding, giving rise to demands for better shareholder protections (Aganin & Volpin 2005).

Sweden

Canada

Japan

After emerging from self-imposed isolation from the international economic system in the late 19th Century, Japan's government worked to catch up by funding development of major firms, which were then consolidated into large family-controlled conglomerates. In the 1930s, the military took effective control of these firms, but after WW II, the U.S. wrested control away from government and families to create widespread ownership. However, in response to takeover fears, Japan's large public firms developed the system of persistent interlocking cross corporate holdings.

Social benefit program began for the military at the turn of century and over the years expanded to other employment sectors so that by the 1970s health insurance was universal and retirement was supported by a combination of public and private insurance. Unions were not a strong force in this period.

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[4] Both France and Italy followed the pattern in Germany and the U.K., where investors were not instrumental in demanding social reforms.