COMMENT

EXTERNALITIES AND THE COMMON OWNER: VIEW FROM A SHAREOWNER

by James Andrus and Anne Simpson

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California Public Employees' Retirement System (CalPERS) is the largest-defined benefit public pension fund in the United States, with about $450 billion in global assets under management. CalPERS actively protects its rights as an investor and the Board Governance and Sustainability program sits at the center of this effort. Collectively, we have more than 40 years-experience in corporate governance and have been very close to CalPERS' work on engagement, advocacy and integration of climate change risk and opportunity, as well as the conduct of this work through partnerships. We appreciate Madison Condon's focus on the great work of Climate Action 100+ in her article *Externalities and the Common Owner* (the Article).[1] As the convener and co-founder of Climate Action 100+, we are delighted to provide background on CalPERS' focus on climate change, our work with Climate Action 100+, and some of our thoughts on the Article given our knowledge of the common ownership debate.

In 2020, CalPERS completed a Taskforce on Climate-Related Financial Disclosure (TCFD) report titled, "CalPERS' Investment Strategy on Climate Change."[2] In that report, we highlighted our work with various entities to address climate change. Such groups include the Principles for Responsible Investment (PRI), Ceres, the United Nations Global Investors for Sustainable Development, and the Vatican Dialogue on the Energy Transition and Care for Our Common Home. Likewise, we touched on our approach to leverage positions on the advisory boards of regulators to advocate for mandatory climate risk reporting. Such boards include the Investor Advisory Committee to the Securities and Exchange Commission, the Investor Advisory Group to the Public Company Accounting Oversight Board (PCAOB), the Financial Accounting Standards Advisory Committee (FASAC), the Commodities and Futures Trading Commission (CFTC) special committee on climate change, and the International Financial Reporting Standards (IFRS) Advisory Council, on which we represent the Council of Institutional Investors (CII). Partnering with organizations allows CalPERS to share insights and pool resources with fellow investors with shared objectives.

The origins of Climate Action 100+ lie in CalPERS' commitment to mapping its carbon footprint. In 2014, CalPERS became the first U.S. signatory to the PRI Montréal Pledge, thereby agreeing to measure and publicly disclose the carbon footprint of our global equity investment portfolio. After analyzing more than 10,000 companies within our portfolio, we found approximately 80 companies were responsible for 50% of the portfolio's scope 1 and 2 greenhouse gas emissions. The emissions trajectory of these systemically important carbon emitters is critical in determining whether the global economy will meet the goal of the Paris Agreement to keep global warming to 1.5 degrees Celsius. CalPERS recognized that other global investors were likely to have similar holdings in their portfolios, so we convened a series of meetings hosted by the French mission to the United Nations. The result was a new partnership among regional and global investor networks (North America, Europe, Australia, and Asia) to launch Climate Action 100+. The list of companies in Climate Action 100+ cover a wide range of sectors including oil and gas, utilities, transportation, metals and mining, construction materials, industrials, chemicals, and food, beverages, and forestry. Climate Action 100+ was officially launched at the One Planet Summit in December 2018.

The initiative has since been recognized by the United Nations as one that will drive progress toward meeting the ambition of holding global warming to 1.5 degrees Celsius. CalPERS plays a leading role in Climate Action 100+ as

1. Madison Condon, *Externalities and the Common Owner*, 95 Wash. L. Rev. 1 (2020), https://digitalcommons.law.uw.edu/wlr/vol95/iss1/4.
2. CalPERS' Investment Strategy on Climate Change, CalPERS (June 2020), https://www.calpers.ca.gov/docs/board-agendas/202006/invest/item08c-01_a.pdf.

the inaugural chair and a member of the Steering Committee, which sets the strategy for the initiative. Our Corporate Governance team assumed the lead role for 22 of the companies identified for engagement. The responsibilities include meeting in-person with the company's leadership, senior management, and board members to communicate and engage on the Climate Action 100+ goals of governance, targets, and transparency. Those goals are:

- **Governance:** Implement a strong governance framework for each company that clearly articulates the board's accountability for oversight of climate change risk and opportunities. This includes ensuring that corporate lobbying and executive compensation are aligned with the Paris Agreement to facilitate a low-carbon transition.

- **Targets:** Act to reduce greenhouse gas emissions across the company's value chain, consistent with the goal of limiting global average temperature increase to 1.5 degrees Celsius above pre-industrial levels.

- **Transparency:** Provide enhanced corporate disclosure in line with the TCFD recommendations to enable investors to assess the robustness of a company's strategy against a range of climate change scenarios.

CalPERS will continue to be a leader on climate change. For example, we recently committed to the United Nations' Net-Zero Asset Owner Alliance that reaffirms the same goal we are setting for the largest emitters in our portfolio. We will continue to innovate through research and integration by building climate resilience into our portfolio and seeking investment opportunities in the low-carbon economy. In all this work, our partnership with fellow investors, policymakers, the business sector, and civil society will continue to be of vital importance. Tackling the climate crisis is urgent work that requires a cohesive effort to meet the goals of limiting global warming to 1.5 degrees Celsius.

Four years ago, we reviewed common ownership research and concluded that such research did not support the conjecture that common owners controlled the pricing of products or services. On the contrary, research rejected such an argument.[3] Professor Condon's Article provides high-value insights, such as the economic arguments for (1) internalizing carbon emission externalities because of their impact on a broader portfolio, and (2) why universal owners are appropriately interested in the larger social issues given that they invest in the entire market.

The Article highlights extensively the successes of Climate Action 100+, the world's largest investment engagement initiative that engages with the world's largest greenhouse gas emitters, to argue that the coordinated efforts to produce those successes are similar to coordinating efforts to control product pricing. This comparison is both unfortunate and inaccurate.

Part I of the Article argues that diversified investors seek to maximize profits at the portfolio, rather than firm, level and further argues that investors seek to internalize harmful climate-change externalities. Part II then extends the argument to the common owner debate and contends that there is clear evidence of shareowner power to influence managerial motives at the product level. Part III then contends that diversified investors inappropriately step into the shoes of regulators and act as if they understand the underlying businesses better than the industry experts.

Upon scrutiny, we found the argument to be lacking. Professor Condon's argument that internalization of externalities explains institutional investors' incentives to encourage carbon emitters to reduce emissions is novel. It is even a great after-the-fact explanation; however, she does not discuss any of institutional investors' actual motivations for reducing carbon emissions, such as their belief that a company can improve performance by improving its ability to adapt to the current transition to a lower-carbon-intensive economy. Professor Condon does not appear to believe that policy and market forces are causing a carbon transition. For instance, she contends that "it would be reasonable for a well-informed industry manager to conclude that the risks of imminent federal climate policy are low, even after Donald Trump leaves office."[4] That assumption appears to have been ill-informed and ill-advised as the Joseph Biden Administration is pursuing an aggressive agenda to reduce carbon emissions, and the U.S. Congress is following suit with its legislative proposals.

Professor Condon also does not adequately acknowledge that addressing climate change risk is a global issue and the companies engaged by Climate Action 100+ are global companies. Therefore, institutional investors in global companies need to examine what is happening with worldwide carbon emissions policy to determine the proper strategies for most large companies.

We are most concerned by the arguments laid out in Part III. Part III is problematic because it casts the common ownership debate as one-sided, failing to acknowledge substantial disagreement among researchers. For example, Edward Rock and Daniel Rubinfeld convincingly refute the foundations of Einer Elhauge's work[5] by showing that common owners do not commonly own the same percentage of each company. Therefore, shifting incentives for corporate profits in favor of the weighted average of holdings in an industry[6] does not reasonably hold when the investors would have differing mid-points. Rock and Rubinfeld also undermine arguments that common owners have the incentive and ability to control product price. According to

3. *See, e.g.*, Menesh S. Patel, *Common Ownership, Institutional Investors, and Antitrust*, 82 Antitrust L.J. 279 (2018) http://dx.doi.org/10.2139/ssrn.2941031; Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance*, NYU Law and Economics Research Paper No. 17-05, (Mar. 1, 2017) http://dx.doi.org/10.2139/ssrn.2925855.

4. Condon, *supra* note 1, at 28.
5. *See* Einer R. Elhauge, *Horizontal Shareholding*, 109 Harv. L. Rev. 1267 (2016) http://dx.doi.org/10.2139/ssrn.2632024.
6. Rock & Rubinfeld, *supra* note 3, at 4-6.

their work, there is "no evidence that shareholders vote on competitive strategy and no evidence that directors run on a platform that is directed toward a competitive strategy."[7] Rock and Rubinfeld argue that none of the tools available to institutional investors provide "for the degree of micromanagement necessary to implement the kind of alignment with the portfolio interests of actual shareholders."[8] Seeing no general case, Rock and Rubinfeld examined the airline industry and found the whole idea to be "implausible theoretically."[9] In examining airport-to-airport routes, they found that proponents of the common ownership theory did not adequately consider city-to-city competition posed by Southwest, and changes at Southwest may have been the actual reason why prices increased.[10]

The Article argues that because Climate Action100+ is successful, common owners can also place anti-competitive pressure on companies at the product level. Professor Condon, however, provides no examples that have not already been soundly debunked. Further, it is important to highlight that page 59 of the Article states that "Blackrock, Vanguard and State Street are not members of Climate Action 100+."[11] Interestingly, the largest asset owners were the targets in the initial common ownership debates, but it is clear that they played a significantly lesser role in Climate Action 100+, yet there is no analysis of this change in composition or its impact on the debate.

Finally, Professor Condon argues that passive investment requires no equity analysis at all,[12] which is incorrect. Index-based investors have an adequate interest in engaging companies on climate risk and related topics because such investors actually own larger economic stakes, even if the percentage ownership appears small because companies are much larger now. Thus, it is economically feasible and even necessary to engage. Additionally, she argues in one place that engagement is too costly given small investment,[13] but later argues that investors have "enormous stakes" in companies targeted.[14] In 2021, investors have adequate monetary stakes in companies to show concern about carbon emissions. Moreover, pension funds like CalPERS have a fiduciary obligation to act if the government fails to act after being made aware of the economic risks posed by carbon emissions, so the Article's contentions do not align with these fiduciary duties.

Although flawed, the Article provides interesting food for thought. It underscores that market observers need more input from asset owners and asset managers to improve their understanding of the incentives and motivations driving coordinated corporate governance actions.

7. *Id.* at 9.
8. *Id.* at 10.
9. *Id.* at 11.
10. *Id.* at 13.
11. Condon, *supra* note 1, at 59.
12. *Id.* at 33.
13. *Id.* at 3.
14. *Id.* at 5.