Bryce C. Tingle QC
N. Murray Edwards Chair in Business Law
Faculty of Law, University of Calgary
2500 University Dr. NW
Calgary, AB T2N 1N4

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Alberta Securities Commission
Autorite des marches financiers
British Columbia Securities Commission
Financial and Consumer Services Commission, New Brunswick
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Office of the Superintendent of Securities, Newfoundland and Labrador
Ontario Securities Commission
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Superintendent of Securities, Department of Justice and Public Safety, PEI

c/o The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor, Box 55
Toronto, ON
M5H 3S8
comment@osc.gov.on.ca

Me Phillippe Lebel
Corporate Secretary and Executive Director, Legal Affairs
Autorite des marches financiers
Place de la Cite, tour Cominar
2640, boulevard Laurier, bureau 400
Quebec (Quebec) G1V 5C1
Consultation-en-cours@lautorite.qc.ca

Via email

Dear Sirs/Mesdames:

Re: CSA Request for Comment – Proposed National Instrument 51-107 Disclosure of Climate-related Matters (the "Instrument")

Thank you for the opportunity to provide comments on the Instrument. I am the N. Murray Edwards Chair in Business Law in the Faculty of Law at the University of Calgary and, until recently, I was the Director of the Financial Markets Regulation Programme at the School of Public Policy.

My research interest over the past ten years has been the declining public markets in the United States, Canada and the United Kingdom. I have published a number of articles in peer-reviewed journals on this and related subjects. I recently reviewed the empirical literature around ESG investing (both by corporations and institutional investors) and I hope this work may be useful to the Canadian Securities Administrators ("CSA") as they evaluate the merits of the Instrument.

To respect your time, I am merely summarizing my research in this letter. There are several papers (some in the pre-publication stage) that enter into these arguments in much greater detail, canvassing the empirical evidence more exhaustively. Don't hesitate to ask for copies of these papers if you believe that they would be useful to your deliberations.

In this letter I acknowledge that global warming is a serious and critical issue demanding effective regulatory initiatives in response. Ineffective intervention is worse than no intervention, as ineffective regulatory policy crowds the public sphere and consumes finite resources without achieving any meaningful outcomes. It can also give rise to cynicism about our institutions if they don't produce the hoped-for effects.

Throughout this letter I develop the argument that the Instrument, as currently formulated, is unlikely to achieve its underlying objectives. This conclusion is based on a comprehensive review of the extensive pool of relevant empirical research into corporate and shareholder behaviour published over the past couple of decades. I also argue the Instrument may impair emission reduction efforts based on similar disclosure regimes targeted at changing firm behaviour.

I hope that you will consider the arguments set out in this letter, along with the extensive empirical evidence cited throughout, in your ongoing review of the Instrument. Ultimately, my goal in collating these arguments and submitting them for your consideration is to encourage further deliberation that will lead to more effective regulatory policy, offering better prospects of leading to meaningful change in actual behaviours in the climate change sphere.

1. Why the Probable Impact of the Instrument Matters

Global warming and its likely consequences, including exacerbating global inequality, creating substantial hardship for many people, and its impact on various delicate natural ecosystems, is a serious problem. Nothing in this comment letter is intended to suggest otherwise. It is important, however, that attempts to reduce greenhouse gas emissions are actually effective.

My first concern is that, if disclosure and its related corporate governance channels inherently lack the power to effect meaningful environmental reforms, then all the time and energy reformers are putting into this effort is wasted. The resources of those who are working for a better world would be better invested in other methods of accomplishing it.

Second, if the Instrument is ineffective in producing meaningful improvements in corporate emissions, failures will breed cynicism and anger. If we believe that corporate governance

(including shareholder pressure) is sufficient to accomplish certain ends, then any failures will be attributed to bad faith, corruption, or dishonesty. At this point in our history, do we need more cynicism about the trustworthiness of our institutions?[1]

Third, the disclosure mandated by the Instrument is not without cost. It absorbs considerable corporate resources to report on these matters and it would take considerable effort by investors to evaluate the disclosure, even if they were so minded. This is fine if some social good is being secured, but if the Instrument is ineffective, the costs in time, resources and attention represent a dead loss to society.[2] Empirical studies demonstrate that senior Canadian business leaders already believe public firms are over-regulated.[3]

Fourth, by increasing the penalties of going public, the Instrument will likely further reduce the attractiveness of Canada's public markets, which are roughly half the size (looking at operating companies) as they were twenty years ago. I have argued elsewhere that ineffective, but costly, reforms to the governance of public companies of the sort proposed by the Instrument are the most likely reason fewer and fewer companies are choosing to go public, a grave problem for a country like Canada which struggles to scale up its businesses in many industries.[4]

Much of the empirical literature looks at environmental issues or "ESG" more broadly, rather than emissions specifically. As ESG is, in practice, mostly about securing environmental and social ends (as opposed to maximizing shareholder returns) I will use this literature in places to illustrate the difficulties with the proposed Instrument. Where I have found research that specifically looks at corporate carbon emissions, I have included it.

2. Shareholders are Unlikely to Use Climate-related Disclosure

In theory, there are many possible constituencies for the disclosure proposed by the Instrument. However, in practice, the only plausible constituency for a disclosure regime like the one proposed by the Instrument is investors.[5] In the case, for example, of employees as an audience for the disclosure, they lack the power under the corporate contract to have much impact, and their

[1] "Edelman Trust Barometer 2020" (2020), online (pdf): *Edelman* <https://www .edelman.ca/sites/g/files/aatuss376/files/2020-02/2020%20Edelman%20Trust%20Barometer%20Canada%20-%20FINAL.pdf> (finding low and declining levels of social trust in Canada, particularly with respect to various institutions including business).

[2] Bradford Cornell & Aswath Damodaran, "Valuing ESG: Doing Good or Sounding Good?" (20 March 2020), online: *SSRN* <https://ssrn.com/abstract=3557432> (concluding a review of the empirical literature on CSR: "when all is said and done, a lot of money will have been spent, a few people (consultants, ESG experts, ESG measurers) will have benefitted, but companies will not be any more socially responsible than they were before ESG was invented" at 23).

[3] L. Daniel Wilson, "Can Regulatory Reform Reverse the Decline of Public Markets in Canada? Assessing the Factors Impacting Decisions by Corporate Leaders to Avoid Canadian Public Listings" (2020). Electronic Thesis and Dissertation Repository. 6869.

[4] Bryce C Tingle, J Ari Pandes & Michael J Robinson, "The IPO Market in Canada: What a Comparison with the United States Tells Us About a Global Problem" (2013) 54:3 Can Bus LJ 321; Bryce C Tingle & J Ari Pandes, "Reversing the Decline of Canadian Public Markets" (2021) 14:13 School of Public Policy Publications.

[5] Though I will point out later in the letter that competitors and other third parties may use this disclosure in ways that impair emission reduction efforts.

incentives tend to be aligned with maintaining the corporate status quo.[6] In the case of consumers, boycotts require considerable effort, they are rare, their success is not assured, and many of Canada's public firms are not consumer-facing.[7]

Shareholders, in contrast, have considerable power over companies, are easier to mobilize than thousands of dispersed consumers, and have the sophistication to evaluate complex disclosure on climate change issues. Unfortunately, there are many reasons to expect shareholders will not make use of the disclosure proposed by the Instrument. These reasons relate to the institutional and market constraints under which they operate, and have little to do with investors' generally sincere interest in doing their part to reduce the risks of climate change.

The issues impacting shareholder use of climate change disclosure may be summarized:

a. Institutional investors face powerful incentives to maximize relative portfolio returns. This is a fiduciary obligation they owe their clients as well as a matter of self-interest. In the market for investment advice, money flows to managers who generate the best relative returns.[8] These incentives operate even on those managing captive funds in the public sphere.[9] Institutional investors thus face strong market pressure to improve their financial performance relative to other funds or market benchmarks.

b. ESG investments are not associated with better risk-adjusted returns. In theory, it takes a relatively small group of investors to spot a way companies are systematically being over-valued

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[6] The most convincing evidence of the lack of employee power is the research from Europe that shows that even when placed on the board of directors they are unable to use this uniquely powerful corporate governance channel to realize better wages or job security: Christine Blandhol, "Do Employees Benefit from Worker Representation on Corporate Boards?" (December 2020) NBER Working Paper No 28269; Gary Gorton & Frank A Schmid, "Capital, Labor, and the Firm: A Study of German Codetermination" (2004) 2:5 J European Economic Assoc 863; Simon Jager, Benjamin Schoefer & Jorg Heining, "Labor in the Boardroom" (2021) 136:2 QJ Economics 669.

[7] Philippe Delacote, "On the Sources of Consumer Boycotts Ineffectiveness" (2009) 18:3 J Envtl & Dev 306; Dirk Engelmann & Jean-Robert Tyran, "To Buy or Not to Buy? An Experimental Study of Consumer Boycotts in Retail Markets" (2005) 72:1 Economica 1.

[8] For the most exhaustive treatment of these incentives, see Roger M Barker & Iris HY Chiu, *Corporate Governance and Investment Management: The Promises and Limitations of the New Financial Economy* (Edward Elgar, 2017) [Barker & Chiu, "Investment Management"]. See also, Jack B Jacobs, "'Patient Capital': Can Delaware Corporate Law Help Revive It?" (2011) 68 Wash & Lee L Rev 1645 (noting "institutional investors are managed by persons or firms whose compensation depends on generating short-term returns from the portfolio company shares under fund management" at 1650); Lynne L Dallas, "Short-Termism, the Financial Crisis, and Corporate Governance" (2011) 37 J Corp L 264 at 272; Andrei Shleifer & Robert Vishny, "Equilibrium Short Horizons of Investors and Firms" (1990) 80 American Economic Review 148; Jonathon B Berk & Richard C Green, "Mutual Fund Flows and Performance in Rational Markets" (2004), 112:6 J Pol Econ 1269 (finding fund managers are incentivized to increase the size of their funds until diseconomies of scale risk an outflow of investor funds); Michael K Berkowitz & Yehuda Kotowitz, "Incentives and Efficiency in the Market for Management Services: A Study of Canadian Mutual Funds" (1993) 26:4 Canadian Journal of Economics 850 (discussing the prevalence of asset-based compensation in Canadian funds relative to performance- based compensation); Ronald J Gilson & Jeffery N Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights" (2013) 113:4 Colum L Rev 863 (discussing the business model of investment intermediaries focuses on increasing assets under management through relative performance).

[9] The best recent example of this is the fallout from the losses experienced by Alberta Investment Management Corporation (AIMCo) in the spring of 2020 that resulted in the resignation of the CEO and at least five other senior managers, proposals to shake up the board of directors, and the withdrawal of large amounts of money from AIMCo by public pension plans such as that representing university faculty.

(or under-valued) to sell (or buy) the shares of those companies until the pricing error is corrected.[10] In other words, the opportunity for ESG investing to generate abnormal returns lasts just as long as it takes for market prices to adjust to new understandings about the importance of ESG factors.

The empirical literature generally supports finance theory on this point. For example, researchers find that bad environmental performers trade at prices that more or less exactly reflect the economic losses imposed by regulators.[11] Looking at ESG risk specifically, researchers have found "the risk/retun trade-off is such that no clear utility gain or loss can be realized by investing in firms characterized by different levels of social and environmental performance."[12]

Since the turn of the century, three-quarters of all academic papers on ESG investing have dealt with the financial performance issue.[13] Most of this work is deeply flawed because it either relies on the self-identification of institutional investors claiming to pursue an ESG strategy (as we will see below this is an unreliable guide to what the investor is actually doing), or it relies on third-party ESG ratings of firms (as we will see these are invalid).

The most useful studies are the ones that look at objective measurements of ESG behaviour. These generally find ESG investment strategies lead to portfolio underperformance or no improvement. For example, a recent empirical study concludes, "stocks of companies with high levels and growth rates of emissions have higher returns than those…with low levels and growth rates of emissions."[14] (A different study completed last year merely found no connection between greenhouse gas emissions and stock and bond returns.)[15]

c. Institutional investors lack the resources to effectively understand and monitor issuers. There are powerful market disincentives for most institutional investors to engage in firm-specific governance activities. Even if the investor succeeds in an intervention (which is by no means assured), the benefit of the investor's work will be reflected in the relative returns of rival funds and the market benchmarks against which the investor's performance is measured. They will thus fail to reap any of the relative advantage that is so important to investment funds.

For this reason, investment funds do not usually hire asset managers who have corporate operational, technical, or managerial experience.[16] They hire finance professionals who are good stock pickers and traders. Even those investors who claim expertise in firm-specific governance

[10] Eugene F Fama & Kenneth R French, "Disagreement, Tastes, and Asset Prices" (2007) 83:3 J Fin Econ 667; Henri Servaes & Ane Tamayo, "The Role of Social Capital: A Review" (2017) 33:2 Oxford Rev Economic Policy 201 (in relation to social issues, "there is sufficient arbitrage capital available to correct any mispricing" at 222).
[11] Jonathan M Karpoff et al, "The Reputational Penalties for Environmental Violations: Empirical Evidence" (2015) 48:2 J L & Econ 653.
[12] Ioannis Oikonomou, Chris Brooks & Stephen Pavelin, "The Impact of Corporate Social Performance on Financial Risk and Utility: A Longitudinal Analysis" (2012) 41:2 Financial Management 483 at 512.
[13] Gunther Capelle-Blancard & Stephanie Monjon, "Trends in the Literature on Socially Responsible Investment: Looking for the Keys Under the Lamppost" (2012) 21:3 Bus Ethics: A European Rev 239 at 241
[14] Patrick Bolton & Marcin Kacperczyk, "Do Investors Care About Carbon Risk?" (April 2020) NBER Working Paper 26968.
[15] Wei Dai & Philipp Meyer-Brauns, "Greenhouse Gas Emissions and Expected Returns" (17 March 2021), online: *SSRN* <https://ssrn.com/abstract=3714874>.
[16] Alon Brav et al, "Hedge Fund Activism, Corporate Governance, and Firm Performance" (2008) 63 J Fin 1729 at 1755.

interventions, such as activist investors, are generally poorly equipped to contribute to the management of a business. For example, once activist nominees join a board of directors, the average targeted company underperforms matched peer firms unless it is sold.[17]

The problem of resources dedicated to firm-specific governance is exacerbated by the rapid growth of the ETF segment, which competes primarily on their very low fees, which leave them with few resources for ESG activities.[18] Even in the segment occupied by ESG-branded funds, "vastly more" money flows to lower-priced products.[19] Competition over the past few years has driven fee levels down for ESG funds, even though this means fewer resources available for investigating and intervening in corporate activities.[20]

3. The Empirical Evidence Suggests Shareholders Do Not Engage in Meaningful ESG Activities

Thus far, I have argued that the market incentives operating on nearly all investment funds are to maximize the return of their portfolios regardless of their ESG character, generate returns superior to those of competitors or market benchmarks, and minimize the amount of time spent on individual firm ESG analysis and interventions. What does the empirical evidence suggest?

a. Evidence on Institutional Investor Motivations

• A recent survey of institutional fund managers found that "the use of ESG information is driven primarily by financial rather than ethical motives."[21]

• ESG funds do not provide public guidance on how the funds' social and environmental value creation is to be measured by their clients, nor do the funds allocate a meaningful amount of their managers' pay to their environmental achievements. Generally, managers running ESG funds are paid in the same ways as their peers in non-ESG funds: almost exclusively on financial performance.[22]

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[17] Ed deHaan, David Larcker & Charles McClure, "Long-Term Economic Consequences of Hedge Fund Activist Interventions" (2018) European Corporate Governance Institute Finance Working Paper No 577/2018 at 6, online (pdf): <ecgi.global/sites/default/files/ working_papers/documents/finaldehaanlarckermcclure.pdf> ("[t]he biggest improvements in productivity are concentrated among plants that were sold after the activist intervention"); Bratton, "Hedge Funds", *supra* note 58 (finding financial underperformance particularly notable where hedge funds entered the board room); Jonathan Macey & Elaine Buckberg, "Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation" (17 August 2009), online (pdf): *National Economic Research Associates* <https://www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf > (noting that there are "[s]everal...studies [that] establish that when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contest" at 9).

[18] Lucian Bebchuk & Scott Hirst, "Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy" (2019) 118:8 Colum L Rev 2029.

[19] Michael Wursthorn, "Tidal Wave of ESG Funds Brings Profit to Wall Street" *Wall Street Journal* (16 March 2021), online: <https://www.wsj.com/articles/tidal-wave-of-esg-funds-brings-profit-to-wall-street-11615887004> .

[20] *Ibid.*

[21] Amir Amel-Zadeh & George Serafeim, "Why and How Investors Use ESG Information: Evidence from a Global Survey" (2018) 74:3 Financial Analysts J 87 at 94.

[22] Paul Brest, Ronald J Gilson & Mark A Wolfson, "How Investors Can (and Can't) Create Social Value" (March 2018) ECGI Working Paper No 394/2018.

• Blackrock employs only 45 “stewardship personnel” to oversee ESG matters for an estimated 11,246 portfolio companies. Vanguard and State Street employ less than half this number for even bigger portfolios.[23]

• Scholars estimate the average stewardship budget is “less than one-fifth of 1% -- only 0.2% -- of the estimated fees that each of the [three largest index funds] charge for managing equity assets.”[24]

• Investment fund managers report they do not actually read companies’ ESG disclosure and do not wish to spend additional resources on ESG matters.[25]

• A recent study testing the willingness of investors in real market conditions to sacrifice returns for environmental benefits finds that, “the greenium, or the premium that green assets trade to otherwise identical non-green securities is precisely equal to zero.”[26]

b. Evidence About Institutional Investor Portfolio Behaviour

• Most empirical studies have found that ESG-branded investment funds do not, on average, hold positions in more environmentally and socially responsible companies than conventional funds.[27]

• Some researchers find ESG funds hold portfolio companies with *worse* track records for compliance with environmental and labour laws, relative to non-ESG funds.[28]

• Specifically with regard to carbon emissions, scholars have found ESG funds’ investments “exhibit worse performance with respect to carbon emissions, in both raw emissions output and

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[23] Lucian Bebchuk & Scott Hirst, “Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy” (2019) 118:8 Colum L Rev 2029.
[24] *Ibid.*
[25] Emiel van Duuren, “ESG Integration and the Investment Management Process: Fundamental Investing Reinvented” (2016) 138:1 J Bus Ethics 525 at 528-9.
[26] David F Larcker & Edward M Watts, “Where’s the Greenium?” (2020) 69:2-3 J Accounting & Economics 1 at 2.
[27] Sebastian Utz & Maximillian Wimmer, “Are they any good at all? A financial and ethical analysis of socially responsible mutual funds” (2014) 15:1 J Asset Management 72; Hao Liang, Lin Sun & Melvyn Teo, “Greenwashing: Evidence from Hedge Funds” (2021), online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3610627> (finding many hedge funds that sign UN PRI have low levels of ESG investments); Aneesh Raghunadan & Shivram Rajgopal, “Do Socially Responsible Firms Walk the Talk?” (2020), online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3609056> (finding the largest ESG ETF and mutual fund demonstrate no correlation between their stock ownership and trading and ESG quality); Soohun Kim & Aaron Yoon, “Analyzing Active Managers’ Commitment to ESG: Evidence from United Nations Principles for Responsible Investment” (2021), online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3555984> (PRI signatories do not improve the weighted-average ESG scores in their portfolios); Aneesh Raghunandan & Shiva Rajgopal, “Do the Socially Responsible Walk the Talk?” (24 May 2020), online: *SSRN* <https://ssrn.com/abstract=3609056> (“we find no evidence that firms’ fundamental records with respect to ‘E’ [environmental] and ‘S’ [social] predict their inclusion in key mutual funds that purport to be ESG-oriented” at 37).
[28] Aneesh Raghunandan & Shivram Rajgopal, “Do ESG Funds Make Stakeholder-Friendly Investments?” (2021), online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3826357> ; Rajna Gibson et al, “Do Responsible Investors Invest Responsibly?” (2020) Swiss Finance Institute Research Paper No 20-13, online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3525530>; Kim & Yoon, *supra* note 26 (finding active managers that sign the PRI experience an increase in environmental controversies among the companies in their portfolios).

emissions intensity."[29] Other scholars have found that with respect to carbon intensity and the rate of carbon emissions growth, "there is no significant effect of the level of emissions on institutional investor portfolios."[30]

• A recent survey of investment managers who claim to actively integrate environmental factors into their investment process showed that many of them did not buy or sell a single share in a given year due to ESG-related information.[31]

• Strongly suggesting that ESG considerations are eventually subsumed by the market imperatives to maximize relative fund returns, researchers have found that new ESG funds start by owning highly-rated companies for the first two years, but once the funds are established, there is a steep decline in the environmental and social quality of portfolio companies in subsequent years.[32]

c. Evidence About Institutional Fund ESG Interactions with Portfolio Companies

• In 2019, investor support for shareholder proposals on ESG matters reached a new record, but it was on average only 29% of the votes cast at the meeting.[33]

• Over a three-year period, of the 633 ESG proposals brought to vote in the companies making up the Russell 3000, just 2.5% received enough votes to pass.[34]

• Active investment managers who sign the UN's Principles of Responsible Investment "vote less on environment-related issues after signing."[35]

• The number of ESG shareholder proposals have actually been declining over the period that ESG marketing language from investment funds has been increasing.[36]

• The quality of shareholder proposals relating to global warming is very low. In 2020, only 16 climate-change proposals were brought before shareholders in the United States. Fifteen asked for

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[29] *Ibid* at 3

[30] Patrick Bolton & Marcin Kacperczyk, "Do Investors Care About Carbon Risk?" (April 2020) NBER Working Paper 26968 at 7.

[31] Emiel van Duuren, "ESG Integration and the Investment Management Process: Fundamental Investing Reinvented" (2016) 138:1 J Bus Ethics 525 at 528-9.

[32] Maximillian Wimmer, "ESG-persistence in Socially Responsible Mutual Funds" (2013) 3:1 J Management & Sustainability 9.

[33] Cydney Posner, "How do the largest fund families vote on shareholder proposals related to ESG?" (2 March 2020), online (blog): *JD Supra* <https://www.jdsupra.com/legalnews/blog-how-do-the-largest-fund-families-90960/>.

[34] Oliver Hart & Luigi Zingales, "Companies Should Maximize Shareholder Welfare Not Market Value" (2017) 2 J L Finance & Accounting 247.

[35] Soohun Kim & Aaron Yoon, "Analyzing Active Managers' Commitment to ESG: Evidence from United Nations Principles for Responsible Investment" (2021), online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3555984>. See also: Gita R Rao, "A Surprise About Some ESG Funds – They Actually Vote Against Environmental and Socially Conscious Resolutions" (18 December 2020), online: *Market Watch* <https://www.marketwatch.com/story/a- surprise-about-some-esg-funds-they-actually-vote-against-environmental-and-socially-conscious-resolutions- 11608306020>.

[36] Gibson Dunn, "Shareholder Proposal Developments During the 2020 Proxy Season" (4 August 2020) at 1, online: *Gibson Dunn* <https://www.gibsondunn.com/wp-content/uploads/2020/08/shareholder-proposal- developments-during-the-2020-proxy-season.pdf>.

more corporate disclosure and one asked for the creation of a climate-risk board committee.[37] These proposals can't be understood as meaningful attempts to drive change in the miniscule number of firms impacted.

• For their part, corporate managers appear to believe that shareholder engagement is mostly about financial performance. Using "close call" votes, a recent paper found that companies where a shareholder proposal does pass, "experience significantly slower growth in goodness [ESG] scores than firms in which the proposals narrowly fail."[38] Managers cutting back on ESG investments could be wrong about what will improve their relationship with their shareholders, but it seems unlikely.

• Most ESG-branded funds explain their relative lack of formal engagement with companies by emphasizing their informal communications with portfolio companies. A very recent study allows us to measure the effectiveness of this informal engagement by looking at how corporate behaviour changes following an influx of ESG capital.[39] The study looked at concrete outcomes in a variety of ESG areas, including pollution outcomes using data from the American Environmental Protection Agency. They conclude: "following an exogenous increase in [ESG] capital allocated to a stock, we find no change in air, land, or water pollution, nor do we find any change in workplace safety, employee satisfaction, or gender or racial diversity on corporate boards."[40]

For all these reasons, it is understandable that the former Chief Investment Officer for Sustainable Investing at Blackrock has recently observed that when it comes to climate change, Blackrock's activities "actually amounts to little more than marketing."[41]

4. Evidence Shareholders Do Not Draw Accurate Conclusions from ESG Disclosures

This letter argues market imperatives pressure investors to reduce the time and other resources devoted to evaluating the ESG performance of portfolio companies. We have seen that as far as we can tell, investors dedicate few resources to sustainability matters. Probably the best evidence, however, for the lack of investor engagement with ESG disclosure, is the existence of the ESG ratings industry.

The ESG ratings industry is comprised of more than 125 different firms and has become a very big business.[42] The industry exists because: "Most investors are unable to assess the sustainability

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[37] *Ibid*

[38] Ing-Haw Cheng, Harrison Hong & Kelly Shue, "Do Managers Do Good With Other People's Money" (September 2013) NBER Working Paper 19432 at 5.

[39] Davidson Heath et al, "Does Socially Responsible Investing Change Firm Behavior?" ECGI Finance Working Paper 762/2021 .

[40] *Ibid* at 3.

[41] Gabriel Friedman "Here's Why the Former Head of Sustainable Investing at BlackRock Says Don't Believe the ESG Marketing Hype", *Financial Post* (7 May 2021), online: <https://financialpost.com/investing/heres-why-the-former-head-of-sustainable-investing-at-blackrock-says-dont-believe-the-esg-marketing-hype>.

[42] "The ESG Data Challenge" (March 2019), online (pdf): *State Street Global Advisors* <https://www.ssga.com/investment-topics/environmental-social-governance/2019/03/esg-data-challenge.pdf> ["The ESG Data Challenge"]. But see Feifei Li & Ari Polychronopoulos, "What a Difference an ESG Ratings Provider Makes!" (January 2020), online: *Research Affiliates* < https://www.researchaffiliates.com/documents/770-what-a-difference-an-esg-ratings-provider-makes.pdf> at 3 (suggesting there are 70 firms); Sakis Kotsantonis, Chris Pinney

of companies on their own, and therefore rely heavily on the ESG scores provided by sustainability rating agencies…”.[43]

The most important fact about these ratings is that they are invalid. Over a dozen different empirical studies have compared ESG ratings from different providers and found wide variation in the way the same company is rated.[44] For comparisons sake, the correlations among credit ratings agencies is 99% (meaning they rate the same company identically 99% of the time); the correlations among ESG rating firms are usually below 50%.[45] The environmental assessments ratings provided by the ESG ratings industry also do a poor job of predicting things like future pollution and compliance violations.[46]

& George Serafeim, “ESG Integration in Investment Management: Myths and Realities” (2016) 28:2 J Applied Corporate Finance 10 (suggesting there are more than 80 entities active in producing and selling ESG data).

[43] Samuel Drempetic, Christian Klein & Bernhard Zwergel, “The Influence of Firm Size on the ESG Score: Corporate Sustainability Ratings Under Review” (2017) 167:2 J Bus Ethics 333 at 334

[44] See e.g. Li & Polychronopoulos, *supra* note 160 (constructing two portfolios, each on the basis of a different ESG data providers’ rankings and finding very low correlation of returns); Florian Berg, Julian F Kolbel & Roberto Rigobon, “Aggregate Confusion: The Divergence of ESG Ratings” (2020), online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533> (looking at the ratings provided by six different ratings providers and finding correlations as low as 0.38 with an average of 0.54) [Berg, “Aggregate Confusion”]; Gerhard Halbritter & Gregor Dorfleitner, “The Wages of Social Responsibility – Where Are They? A Critical Review of ESG Investing” (2015) 26 Rev Financial Economics 25; Gregor Dorfleitner, Gerhard Halbritter & Mai Nguyen, “Measuring the Level and Risk of Corporate Responsibility – An Empirical Comparison of Different ESG Rating Approaches” (2014) 16:7 J Asset Mgmt 450 (finding significant differences in various ESG ratings concepts); “The ESG Data Challenge”, *supra* note 33 (two researchers from State Street Global Advisors’ ESG team compares four of the largest ESG data providers and finds a correlation of only 0.53 among their scores); Arthur Hughes, Michael A Urban & Dariusz Wojcik, “Alternative ESG Ratings: How Technological Innovation Is Reshaping Sustainable Investment” (2021) 13:6 Sustainability (finding low commensurability between different styles of creating ESG ratings); Doron Avramov et al, “Sustainable Investing with ESG Rating Uncertainty” (2021), online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3711218> (finding “substantial variations across different rating providers” that are “quite persistent throughout the entire 18 year sample period,” with an average rating correlation of 0.48 at 2); Rajna Gibson, Philipp Krueger & Peter S Schmidt, “ESG Rating Disagreement and Stock Returns” (2019) European Corporate Governance Institute Working Paper No 651/2020 (looking at six rating firms and finding the average correlations is 0.46); Lies Bouten et al, “CSR Performance Proxies in Large-Sample Studies: ‘Umbrella Advocates’, Construct Clarity and the ‘Validity Police’” (2018), online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3107182> (comparing two prominent ESG data providers and finding low correlations and even that in environmental scores the two are *negatively* related to one another); Dane Christensen, George Serafeim & Anywhere Sikochi, “Why is Corporate Virtue in the Eye of the Beholder? The Case of ESG Ratings” (2019) Harvard Business School Working Paper No 20-084 (“rating agencies tend to have strikingly different views on a given firms’ ESG performance” at 20) [Christensen, “Why is Corporate Virtue in the Eye of the Beholder?”]; Gregor Dorfleitner, Gerhard Halbritter & Mai Nguyen, “Measuring the Level and Risk of Corporate Responsibility – An Empirical Comparison of Different ESG Rating Approaches” (2015) 16:7 J Asset Management 450 (finding “hardly any correlation” between ratings of firms or appraisals of their ESG risk).

[45] Berg, “Aggregate Confusion”, *supra* note 35. See note 35, *supra*, setting out the range of correlations in the academic literature.

[46] Aaron K Chatterji, David I Levine & Michael W Toffel, “How Well Do Social Ratings Actually Measure Corporate Social Responsibility” (2009) 18:1 J Economics & Management Strategy 125 (finding measurements of “environmental strengths” do a poor job of predicting future pollution and compliance violations); Aneesh Raghunadan & Shivram Rajgopal, “Do Socially Responsible Firms Walk the Talk?” (2020), online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3609056> (finding a negative association between high ESG companies and environmental violations).

This is not a problem the industry is getting closer to solving. The range of disagreement among ESG rating firms over the performance of a given company has actually been increasing over time.[47] The problem is not a matter of inadequate or disingenuous disclosure on the part of the corporations themselves, as the rating agencies that come to wildly varying conclusions are generally working from the same information. Rather, the problem arises because environmental disclosure is complex, requires a great deal additional information to evaluate, and involves weighing incommensurable qualities and trade-offs.[48]

The fact that these ratings are relied upon by institutional investors tells us all we need to know about the quality of information at those investors' disposal. As well, the failures of environmental and social ratings schemes are well known. They are widely reported in the financial press,[49] by securities regulators,[50] and even in communications by ESG asset managers themselves.[51] Institutional investors' ongoing reliance on these ratings tells us something important about the paucity of internal resources available to those investors to independently evaluate the kind of disclosure proposed by the Instrument.

5. Evidence Securities Disclosure is Poorly Suited to the Task of Reducing Emissions

ESG data providers and the institutional investors that rely on them are sincere in wanting to contribute to climate change solutions. Their failures to generate accurate assessments tells us as much about the weakness of securities disclosure as it does about the market incentives affecting investment intermediaries.

a. Background: The General Problems with Our Current Disclosure Regime

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[47] Christensen, "Why is Corporate Virtue in the Eye of the Beholder?", *supra* note 35 at 121.

[48] Aaron K Chatterji, "Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers" (2016) 37:8 Strategic Management J 1597 (the ratings diverge because the raters "not only do not agree on one definition of responsibility (their "theorizations" of CSR differ), but also that raters may measure the same construct in different ways (the "commensurability" of CSR is low)"at 1598).

[49] See example, James Mackintosh "Is Tesla or Exxon More Sustainable? It Depends Whom You Ask", *Wall Street Journal* (17 September 2018), online: <https://www.wsj.com/articles/is-tesla-or-exxon-more-sustainable-it-depends-whom-you-ask-1537199931>; Robin Wigglesworth "Rating agencies using green criteria suffer from 'inherent biases'", *Financial Times* (20 July 2018), online: <https://www.ft.com/content/a5e02050-8ac6-11e8-bf9e-8771d5404543>; John Sindreu & Sarah Kent "Why It's So Hard to be an 'Ethical' Investor", *Wall Street Journal* (1 September 2018), online: <https://www.wsj.com/articles/why-its-so-hard-to-be-an-ethical-investor-1535799601>; Kate Allen "Lies, damned lies and ESG rating methodologies" *Financial Times* (5 December 2018), online: <https://www .ft.com/content/2e49171b-a018-3c3b-b66b-81fd7a170ab5>.

[50] Commissioner Hester M Peirce, Speech (Scarlet Letters: Remarks before the American Enterprise Institute, Washington DC, 18 June 2019), online: *US Securities and Exchange Commission* <https://www.sec.gov/news/speech/speech-peirce-061819>.

[51] "The ESG Data Challenge", *supra* note 33.

• The current disclosure regime already generates so much information that most market actors don't benefit from much of it.[52] Securities commissions in Canada and the United States have periodically questioned the volume of current corporate disclosure.[53]

• The Instrument is clear that the information it will require from issuers is non-material from a financial point of view. (Otherwise, production of the information would be compelled under existing securities rules). This type of non-material, non-financial information is particularly ignored by the market. For example, researchers who have investigated the market effect of the "explanations" provided by companies in "comply or explain" disclosure regimes find little evidence of market reaction to those explanations, suggesting "investors may ignore or not understand the content."[54]

• More concerning is that empirical research has convincingly demonstrated that the quality of people's decisions is *inversely* related to the quantity of information available to them.[55] This means the massive expansion of corporate disclosure in the past few decades is actually making markets less efficient.[56] Introducing another sphere of non-material information, as the Instrument proposes, will exacerbate this problem.

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[52] Barbara Black, "Behavioral Economics and Investor Protection: Reasonable Investors, Efficient Markets" (2013) 44:5 Loy U Chicago LJ 1493 (given its length and complexity reading current disclosure "would be a waste of investors' time"at 1506); Henry T C Hu, "Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class" (1996) 84 Geo LJ 2319 (reviewing data showing most people don't read prospectuses or understand them sufficiently to make good decisions at 2376-77); Tamar Frankel, "The Failure of Investor Protection by Disclosure" (2013) 81:2 U Cin L Rev 421.

[53] Canadian Securities Administrators, Staff Notice 51-353, "Update on CSA CP 51-404: Considerations for Reducing Regulatory Burden for Non-Investment Fund Reporting Issuers" (27 March 2018), online (pdf): <https://www.osc.ca/sites/default/files/pdfs/irps/csa_20180327_51-353_fund-reporting-issuers.pdf >; Ontario Securities Commission, Staff Notice 11-784, "Burden Reduction" (24 January 2019), online (pdf): <https://www.osc.ca/sites/default/files/pdfs/irps/sn_20190114_11-784_burden-reduction.pdf > . Securities regulators in the United States have expressed similar concerns: US, Securities and Exchange Commission, "Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts: The Wheat Report" (New York: Commerce Clearhousing, 1969) (concluding prospectuses are too long or complex and cannot be easily understood); US, Securities and Exchange Commission, "Report of the Task Force on Disclosure Simplification" (5 March 1996), online: <https://www.sec.gov/news/studies/smpl.htm> (making a number of recommendations to simplify disclosure).

[54] Brandon D Stewart, "Shining Some Sunlight on Mandatory Corporate Climate-Related Disclosure" (September 2020), online: *SSRN* <https://ssrn.com/abstract=3684525> at 13. The studies finding this lack of market reaction: Arcot, Corporate Governance in the UK: Is the comply or approach working? (2010) 30:2 Int'l Rev L & Econ 193; Yan Luo & Steven E Salterio, "Governance Quality in Comply or Explain Governance Disclosure Regime" (2014) 22:6 Corporate Governance: An Int'l Rev 460.

[55] Omri Ben-Shahar & Carl Schneider, "More than You Wanted to Know: The Failure of Mandated Disclosure" (Princeton: Princeton University Press, 2014) [Ben-Shahar & Schneider, "More than You Wanted"]; Troy Paredes, "Blinded by the Light: Information Overload and its Consequences for Securities Regulation" (2003) 81:2 Wash U LQ 417; Susanna Kim Ripken, "The Dangers and Drawbacks of the Disclosure Antidote: Towards a More Substantive Approach to Securities Regulation" (2006) 58:1 Baylor L Rev 139.

[56] Ravindranath Madhavan & John E Prescott, "Market Value Impact of Joint Ventures: The Effect of Industry Information-Processing Load" (1995) 38:3 Academy Management J 900 (measuring the market value impact of announcements as a function of the quantity of information provided); Morris H Stocks & Adrian Harrell, "The Impact of an Increase in Accounting Information Level on the Judgment of Individuals and Groups" (1995) 20:7 Accounting, Organization & Society 685 (summarizing studies on the adverse impact of too much information);

b. The Specific Problems with Disclosure of the Type Reflected in the Instrument

• The preparation and disclosure of non-material information will never be the preoccupation of senior business leaders. As anyone who has participated in the management of a large business in competitive markets can attest, it is almost impossible to stay on top of just the *material* information. For this reason, sustainability reporting is generally prepared by specialized staff who do not occupy senior positions or have significant authority over the actual business operations of the company.[57]

• The lack of a guiding criteria (like the "materiality" standard) for information inclusion means empirical studies find the informational quality of sustainability reporting to be low.[58]

• The absence of hard criteria to evaluate the strategies being disclosed in environmental reports means that it is also very difficult for outsiders to make use of this information. So, for example, multiple studies find that corporate environmental scores are not related to greenhouse gas emission intensity, but to the resources invested in disclosure documents.[59] "When provocatively formulated, we could propose that it may be better for companies to invest in sustainability reporting, rather than sustainability activities or impact."[60]

• The problems with investors properly digesting and applying non-material, non-financial information cannot be cured by simply requiring more information be disclosed. Greater amounts of ESG disclosure are associated with larger disagreements between outside evaluators of corporate performance.[61]

• Business strategy, including decisions that have an impact on greenhouse gas emissions, involve trade-offs between various constituencies and potential outcomes. It is simply impossible for outsiders to accurately evaluate these decisions without the entire informational matrix possessed

Steven M Davidoff & Claire A Hill, "Limits of Disclosure" (2013) 36:2 Seattle U L Rev 599 (noting the problem in the 2008 financial crisis was not insufficient disclosure of risks, but an inability of investors to understand and price those risks at 609-623); Troy A Paredes, "Blinded by the Light: Information Overload and its Consequences for Securities Regulation" (2003) 81:2 Wash U LQ 417 at 440-443 (summarizing an extensive literature on information overload in the context of financial markets).

[57] Brett McDonnell et al, "Green Boardrooms" (2020), online: *SSRN* <https://ssrn.com/abstract=3569303>at 35 (under the current voluntary system in the United States, "the collection and processing of [environmental] information may be done within a sustainability office that is isolated from other operating divisions" at 35); Robert G Eccles et al, "The Board's Role in Sustainability" (2020), online: *Harvard Business Review* <https://hbr.org/2020/09/the-boards-role-in-sustainability> (reporting that more than half of surveyed directors in 2019 thought boards were "spending *too much* time on sustainability").

[58] Jean-Noel Chauvey et al, "The Normativity and Legitimacy of CSR Disclosure: Evidence from France" (2015) 130:4 J Bus Ethics 789; Carlos Larringa et al, "Accountability and Accounting Regulation: The Case of the Spanish Environmental Disclosure Standard" (2002) 11:4 European Accounting Rev 723.

[59] Samuel Drempetic, Christian Klein & Bernhard Zwergel, "The Influence of Firm Size on the ESG Score: Corporate Sustainability Ratings Under Review" (2020) 167:2 J Bus Ethics 333; Aneesh Raghunandan & Shivaram Rajgopal, "Do ESG Funds Make Stakeholder Investments" (3 May 2021), online: *SSRN* <https://ssrn.com/abstract=3826357> at 3; Sameul Dremptetic, Christaim Klein & Bernhard Zwergel, "The Influence of Firm Size on the ESG Score: Corporate Sustainability Ratings Under Review" (2019) 167:2 J Bus Ethics 1; Florencio Lopez de Silanes, Paul Pudschedl & Joseph McChery, "ESG Performance and Disclosure: A Cross-Country Analysis" (2020) 2020:1 Singapore J Legal Studies 217.

[60] Drempetic et al, *ibid* at 335.

[61] Christensen, "Why is Corporate Virtue in the Eye of the Beholder?", *supra* note 35 at 5.

only by corporate managers. As a result, shareholders demonstrate little engagement with corporate strategy and instead deploy crude “screens” to carry out their ESG mandate, such as refusing to invest in oil and gas companies.[62]

• The inability of shareholders to engage with corporate strategy as it impacts environmental matters leads to odd results:

> i. There is little evidence shareholders deal with the question of whether it is the absolute environmental externalities generated by a company that matter, or its relative production of externalities. Large companies generally receive better ESG scores than smaller companies, notwithstanding shareholder engagement with a larger company is likely to produce greater total reductions in emissions.[63]
>
> ii. There is little evidence shareholders deal with the question of whether they should focus on the environmental performance of the company in question, or include the emissions of its customers or suppliers. For example, the food production industry scores very well on emissions if we look only at the industry itself; if we look at emissions from third parties who supply the food production industry with materials, or who buy the food and waste from the industry, then it becomes one of the worst emitters in the economy.[64]
>
> iii. The inevitable failure of outsiders to understand corporate strategy means that entire areas of environmentally-relevant corporate operations do not factor into their decisions. For example, a recent study looked at what kinds of companies are generating the most useful technological innovations to reduce various environmental harms.[65] They found that these “green patents” (and in particular “blockbuster” green patents that are cited by many other patents) are largely generated by resource extraction firms of the type “explicitly excluded from ESG funds investment” and “targeted by divestiture campaigns.”[66]

• Ultimately, of course, strategic decisions bearing on environmental matters, including emissions, depends on taking into account the cost and viability of various alternative strategies, but securities disclosure is almost always about what the company is doing, not about hypothetical possibilities. For this reason, investors and third-party agencies do not have the firm-specific, market-specific, or technology-specific information to properly understand the alternative strategies open to an issuer, much less to evaluate their risks and returns, and weigh those impacts against the needs of

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[62] Pieter Jan Trinks & Bert Scholtens, “The Opportunity Cost of Negative Screening in Socially Responsible Investing” (2017) 140 J Bus Ethics 193 at 193 (negative screening is most common ESG investment strategy); Patrick Bolton & Marcin Kacperczyk, “Do Investors Care About Carbon Risk?” (April 2020) NBER Working Paper 26968.

[63] Dorfleitner, Halbritter & Nguyen, *supra* note 35 at 460; Drempetic, Klein & Zwergel, *supra* note 50; Bolton & Kacperczyk, *supra* note 12.

[64] Bolton & Kacperczyk, *supra* note 12 at 13. See also, Elena Escrig-Olmedo, “Ratings the Raters; Evaluating how ESG Rating Agencies Integrate Sustainability Principles” (2019) 11:3 Sustainability 915 at 13.

[65] Lauren Cohen, Umit G Gurun, & Quoc H Nguyen, “The ESG-Innovation Disconnect: Evidence from Green Patenting” (2020), online: SSRN <https://ssrn.com/abstract=3718902>.

[66] *Ibid.*

other constituencies to the corporate contract such as employees, communities, taxing authorities, customers, suppliers, etc.

In summary, ESG factors are often subjective, non-quantifiable, incommensurate among themselves, poorly suited to disclosure regimes, and require in-depth firm-specific knowledge that is neither possessed by outsiders nor likely to be provided by companies. It is for these reasons that ESG rating agencies in possession of the same information come to wildly varying assessments of environmental quality.

6. Shareholders Lack the Tools Necessary to Effect Changes on Corporate Behaviour

Even if we assumed that securities disclosure was up to the task of communicating useful information, and that investors were incentivized and able to act on this disclosure, the proposed Instrument would still be unlikely to achieve its objects. Directors and officers of a corporation have the ability to engage in operational fine-tuning and small-scale experiments. In contrast, shareholders have only very blunt mechanisms for making corporate changes: interventions (such as shareholder proposals and proxy fights) or dropping a firm from their portfolio.

These are binary decisions. For these kinds of decisions shareholders only need a straightforward metric telling them which companies merit an intervention or a refusal to purchase their shares. In other words, the corporate governance tools of shareholders also drive the need for deeply-flawed and overly-simplistic ESG ratings. As well, these limited tools provide another explanation why investors correctly see little return on deeply engaging with environmental disclosure and firm-specific strategies.

a. Negative Screening or Divestiture

Selling or refusing to purchase the shares of companies with poor ESG ratings is – by far – the most common ESG investing strategy.[67] It is popular because it is easy, and compared with other types of shareholder engagement, it is cheap. In practice, there are many problems:

• Negative screening depends on knowing who the bad ESG performers are, and as we have seen, shareholders do not really know this.[68]

• To get some idea of how coarse negative screening is in practice, researchers have found investors generally applied negative screening to companies in only three industries: oil and gas, utilities, and automobiles.[69] This means negative screening was not used in relation to companies in all other industries, regardless of those companies' total emissions or relative emission intensity.

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[67] Pieter Jan Trinks & Bert Scholtens, "The Opportunity Cost of Negative Screening in Socially Responsible Investing" (2017) 140 J Bus Ethics 193 at 194.

[68] One example of this is provided by the prominent corporate law scholar, Daniel Fischel , who observes that the lists of the "worst polluters" targeted by two different divestment groups contain very little overlap: Daniel R Fischel, "Fossil Fuel Divestment: A Costly and Ineffective Investment Strategy", online: *Divestment Facts* <http://divestmentfacts.com/pdf/Fischel_Report.pdf> at 13-14.

[69] Patrick Bolton & Marcin Kacperczyk, "Do Investors Care About Carbon Risk?" (April 2020) NBER Working Paper 26968.

• Most divestment efforts therefore target companies whose core businesses are built around disfavoured ESG activities. There is nothing an oil and gas company can do, for example, to remove itself from the oil and gas industry. As a result, shareholder pressure of this sort is necessarily ignored by corporate managers.

• The rationale for negative screening is that it will have the effect of driving down the price of bad actors' shares, forcing them to make changes. Basic finance theory suggests this is unlikely to occur. The value of a corporate share is not set by supply and demand, it is a function of the future expected cash flows of the underlying business.[70] (In other words, the demand curve for stock is a horizontal line). Undervalued shares do not tend to remain undervalued for long, as less socially engaged investors buy the companies' shares until their price once again reflects the expected risk-adjusted gain from holding the shares.

• Most of the empirical research on the impact of negative screens on corporate behaviour has been conducted in relation to the divestment campaign against companies doing business in apartheid-era South Africa. It seems to vindicate economic theory:

> i. The divestment campaign had no impact on the price of affected companies' shares.[71]
>
> ii. The share prices of companies announcing they were leaving South Africa *declined* relative to companies that refused to leave, reflecting market opinion the change in strategy was politically – not financially – motivated.[72]
>
> iii. Qualitative assessments of the divestment campaign conclude it had little impact on either corporate behaviour or the decisions of South Africa's political leaders.[73]

• Finally, to the extent negative screening can temporarily affect share prices, researchers have concluded it will likely reward, rather than punish, corporate leaders with poor ESG

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[70] See example, Richard Brealey, Stewart Myers & Franklin Allen, *Principles of Corporate Finance*, 11th ed (New York City: McGraw Hill Education, 2013) at 80-84.

[71] Laurian Casson Lytle & O Maurice Joy, "The Stock Market Impact of Social Pressure: The South African Divestment Case" (1996) 36:4 Q Rev Economics & Finance 507 ("it appears that portfolio divestment announcements by major pension funds and endowment associations had no important impact on stock prices of firms doing business in South Africa" at 519); Siew Hong Tech, Ivo Welch & C Paul Wazzan, "The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott" (1999) 72:1 J Business 35 ("the announcement of legislative or shareholder pressure had no discernable effect on the valuation of banks and corporations with South African operations" at 79); Wallace N Davidson, Dan L Worrell & Abuzar El-Jelly, "Influencing Managers to Change Unpopular Corporate Behavior through Boycotts and Divestitures: A Stock Market Test" (1995) 34:2 Bus & Society 171 (finding "no significant market responses" at 190) [Davidson, "Influencing Managers"].

[72] Lytle & Joy, *supra.*

[73] Davidson, "Influencing Managers", *supra* note 62 ("divestitures do not seem to motivate change" at affected companies at 171); Tech, Welch & Wazzan, *supra* note 62 (finding "little visible effect on the financial markets" at 33); Paul Lansing & Sarosh Kuruvilla, "Business Divestment in South Africa: In Whos' Best Interest?" (1988) 7:8 J Bus Ethics 561 ("the imposition of economic sanctions and divestment has, if anything, only strengthened the economic power of the Whites, and perhaps increased their determination to keep apartheid").

performance.[74] Companies generally use long-term compensation schemes that make short-term declines in share prices caused by negative screening quite accretive to executives receiving annual equity grants.

b. Positive Screening or Paying a Premium

The idea behind positive screening is that investors will pay a premium for good environmental performers, which will reduce their cost of capital and advantage them relative to competitors with poor environmental track records.

• Finance theory suggests that in the public markets, companies are unlikely to enjoy higher relative risk-adjusted valuations of their cash flows over the long term. Any financially motivated investor could sell shares of the high-ESG companies and buy shares of their undervalued competitors until the arbitrage opportunity disappeared.[75]

• The moment at which this strategy supposedly advantages environmentally friendly firms is when the company in question raises capital through the issuance of new shares and receives the benefit of the lower cost of capital. However, a search of the finance literature fails to turn up any instance of this premium being paid.[76]

• Anecdotally, most positive screens discussed by ESG funds seem to depend mainly on the broad industry a firm belongs to, such as electric vehicles or alternative energy. This ignores most companies that matter (because it ignores most companies) and it ignores the fact that companies in these favoured industries have their own serious environmental issues, which are not engaged with by shareholders pursuing these crude screens.[77]

• Positive screens require even more granular engagement with firm-specific strategies on the part of shareholders than negative screens. This engagement is extremely unlikely in light of the incentives, market pressures, and informational barriers already discussed. The most significant reduction of emissions in the United States was the result of fracking techniques making natural

[74] Shaun William Davies & Edward Dickersin Van Wesep, "The Unintended Consequences of Divestment" (2018) 128 J Financial Economics 558 ("very few executives would be hurt be a divestment campaign of any size. A large majority would not be meaningfully affected under the most favourable conditions for campaigners...[S]ome mangers would benefit substantially from a divestment campaign" at 571).
[75] Paul Brest, Ronald J Gilson & Mark A Wolfson, "How Investors Can (and Can't) Create Social Value" (March 2018) ECGI Working Paper No 394/2018.
[76] *Ibid* at 15. In contrast, there is considerable evidence for these sorts of premiums being paid in private securities markets: Brad M Barber, Adair Morse & Ayako Yasuda, "Impact Investing" (December 2019) NBER Working Paper 26582 (social impact venture capital funds earn 4.7% less IRRs than peer venture capital funds).
[77] Theocharis Tsoutsos, Niki Frantzeskaki & Vassilis Gekas, "Environmental Impacts from the Solar Energy Technologies" (2005) 33:3 Energy Policy 289 (finding the impacts of solar energy technologies include greenhouse gas emission, water and soil pollution, impacts on sensitive ecosystems and energy consumption among others); Rahman Saidur et al, "Environmental Impact of Wind Energy" (2011) 15:5 Renewable & Sustainable Energy Rev 2423 (finding negative impacts on the environment of wind farms include impacts on wildlife, noise impacts and visual impacts among others); Victoria Flexer, Celso F Baspineiro & Claudia I Galli, "Lithium Recovery from Brines: A Vital Raw Material for Green Energies with a Potential Environmental Impact in its Mining and Processing" (2018) 639 Science Total Environment 1188 (finding the process of lithium extraction for batteries is a chemical intensive, heavily water dependant process).

gas cheaper than coal. The companies that made these innovations would not have been the beneficiaries of the industry-wide screens used by investors.

c. Shareholder Engagement: Proposals

Corporate law provides very few tools for shareholders to engage with corporations. None of them are suited to the kind of nuanced, quick-footed experimentation necessary for innovating around corporate strategy. When discussing shareholder proposals earlier we focused on what they tell us about shareholder motivation. Part of the problem also arises from the nature of shareholder proposals themselves.

The weakness of shareholder proposals as a method of effecting strategic changes is reflected in a very broad empirical literature. Most of this research was conducted before ESG considerations reached their current prominence among investors and so they reflect attempts by shareholders to engage with the much more straightforward project of increasing corporate financial returns, usually by improving governance:

> i. Proposals are only brought by a narrow circle of "gadflies" and some union or public pension funds that obtain private benefits from these proposals.[78] Institutional investors solely interested in firm-specific performance almost never bring proposals.
>
> ii. The market reaction to shareholder proposals is either negative or indifferent.[79]
>
> iii. A recent review of the seventeen long-run price studies found "the available evidence is most consistent with the conclusion that shareholder proposals and negotiations are not associated with long-run stock returns."[80]

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[78] Ronald J Gilson & Jeffery N Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights" (2013) 113:4 Colum L Rev 863 at 887-88; Roberta Romano, "Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance" (2001) 18 Yale J Reg 174 at 179 at 231 (arguing union pension fund managers receive private benefits from bring proposals); John G Matsusaka, Oguzhan Ozbas & Irene Yi, "Opportunistic Proposals by Union Shareholders" (2015) University of Southern California Law School Working Paper No 177, online (pdf): <law.bepress.com/cgi/viewcontent.cgi?article=1313&context=usclwps-lss> (finding union pension funds bring proposals to enhance their bargaining positions); Geeyoung Min & Hye Young You, "Active Firms and Active Shareholders: Corporate Political Activity and Shareholder Proposals" (2019) 48 J Legal Studies 81 (finding public pension funds target Republican-leaning firms).

[79] Johnathan M Karpoff, Paul H Malatesta & Ralph A Walkling, "Corporate Governance and Shareholder Initiatives: Empirical Evidence" (1996) 42 J Finance Economics 365; Stuart L Gillan & Laura T Starks, "Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors" (2000) 57 J Finance Economics 275; Nickolay Gantchev & Mariassunta Giannetti, "The Costs and Benefits of Shareholder Democracy" (2018) European Corporate Governance Institute Finance Working Paper No 586/2018 at 39-40, table 6 (also note, "the average shareholder proposal generates zero or negative returns around the meeting date." at 16); Joao Dos Santos & Chen Song, "Analysis of the Wealth Effects of Shareholder Proposals" (2008), online (pdf): *US Chamber of Commerce* <www.uschamber.com/sites/default/files/legacy/files/analysis_wealth_effects_volume2.pdf> (finding no short- term or long-term improvements in corporate value); Jun Yang, Eric Zengxiang Wang & Yunbi An, "Canadian Exceptionalism: Shareholder Proposals, Filer Identities, and Voting Outcomes" (2012) 38 Managerial Finance 456 at 475-76 (finding that "shareholder proposals in Canada are not very value-driven" at 461).

[80] Matthew R Denes, Jonathan M Karpoff & Victoria B McWilliams "Thirty Years of Shareholder Activism: A Survey of Empirical Research" (2017) 44 J Corporate Finance 405 at 410.

iv. The same meta-review of the empirical work on shareholder proposals found that studies that measure impact by looking at return on assets, return on equity and return on sales, also show proposals provide no benefits.[81]

v. Curiously, shareholders almost never use the proposal mechanism in ways that suggest they want them to have an impact. Professors Marcel Kahan and Edward Rock point out that shareholder proposals tend to pursue matters that are minor or irrelevant.[82] This includes shareholders deliberately weakening the impact of their proposals by making them precatory, rather than mandatory, and resisting using the proposal process to amend the articles of the company, which would make the proposal binding.

In conclusion, even when shareholders are focused merely on improving corporate cashflows and improving corporate governance, they evince little interest in engaging with corporate strategy, and their efforts have no impact on the things shareholders care about, like corporate performance.

d. Shareholder Engagement: Activism

We have only seen one instance of activism with an ostensible ESG purpose: Engine No. 1's proxy fight over a short-slate nominated to sit on Exxon's board. While ESG rhetoric was a big part of the campaign (in the same way that conflicts of interest, excessive compensation, and poor governance are rhetorically prominent in traditional activist campaigns) the heart of Engine No. 1's concerns was Exxon's relative financial underperformance.[83] Importantly, Engine No. 1 explicitly told the world that it did not have a strategic environmental alternative because it simply didn't know enough about Exxon's business to create one. Engine No. 1 also notably failed to connect Exxon's declining total shareholder returns to its failure to prepare for a carbon-less future. The focus of Engine No. 1's presentation to investors was Exxon's performance relative to Chevron and Shell, but there is no evidence this superior performance was provided by ESG factors.

In general, it is unlikely that activist shareholders will produce material improvements in corporate environmental performance. The difficulties arise from the fact that gains from ESG investments tend to only be realized over the long-term.[84] (It seems unlikely that corporate managers are

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[81] *Ibid* at 411.
[82] Marcel Kahan and Edward Rock, "Symbolic Corporate Governance Politics" (2014) 94 BUL Rev 1997.
[83] Bernard S Sharfman, "The Illusion of Success: A Critique of Engine No. 1's Proxy Fight at Exxon Mobil" (9 August 2021) George Mason Law & Economics Research Paper No. 21-20, online: *SSRN* <https://ssrn.com/abstract=3898607>; David Nicklaus "Exxon Board Fight Wasn't About Being Woke. It Was About Poor Performance", *St Louis Post Dispatch* (4 June 2021), online: <https://www.stltoday.com/business/subscriber/article_53207bb5-a365-5642-b347- 39ff623c030a.html>; Jinjoo Lee "Exxon Mobil Activist Victory Isn't Really All About Climate", *Wall Street Journal* (3 June 2021), online: <https://www.wsj.com/articles/exxon-mobil-activist-victory-isnt-really-all-about-climate-11622718180>.
[84] Peter Iliev & Lukas Roth, "Do Directors Drive Corporate Sustainability" (20 January 2021), online: SSRN <https://ssrn.com/abstract=3575501> ("[m]any corporate sustainability initiatives require a significant upfront investment with benefits that materialize in the distant future. These costs and benefits extend to expected future regulatory compliance and often involve hard-to-predict risks that involve international trends and competitive pressures" at 1); Paul Cox, Stephen Brammer & Andrew Millington, "An Empirical Examination of Institutional Investor Preferences for Corporate Social Performance" (2004) 52:1 J Bus Ethics 27 ("[t]here is a broad consensus in the conceptual literature that many financial gains from improved social performance accrue in the long run" at 29).

routinely missing opportunities for short and medium-term profits). The time-frame for even successful ESG investments to pay off creates problems for activist shareholders:

• The compensation structures of hedge funds are strongly sensitive to quarterly performance and skewed to short-term payoffs.[85]

• Researchers looking at the median period of time an investment is held by an activist hedge fund find that it is 12 months by one measure, and 22 by another.[86] Another study found that half of activist investments last slightly less than nine months.[87]

• The best evidence we have on activist shareholder behaviour is that it is focused on relatively straight-forward financial engineering moves that produce short-term gains for shareholders.[88]

• Activists' failures at corporate strategy are reflected in the often significant underperformance of companies on which they place directors, unless those companies are subsequently sold.[89]

e. Shareholder Engagement: Informal Communications

In section 3 of this letter, I indicated that the best evidence we have from the empirical literature is that the arrival of ESG investors in a company's stock is not accompanied by superior environmental and emissions performance. It is hard, therefore, to credit informal communications with any meaningful impact on corporate behaviour.

7. The Disclosure Contemplated by the Instrument May Actually Reduce Emissions Efforts

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[85] Jongha Lim, Berk A Sensoy & Michael S Weisbach, "Indirect Incentives of Hedge Fund Managers" (2016) 71 J Fin 871 at 901; William W Bratton, "Hedge Funds and Governance Targets" (2007) 95 Geo LJ 1375 at 1384 (describing aspects of the short-term nature of hedge funds).

[86] John C Coffee & Darius Palia, "The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance" (2016) 41 J Corp L 545 at 573. at 567, 572; Alon Brav et al, "Hedge Fund Activism, Corporate Governance, and Firm Performance" (2008) 63 J Fin 1729 at 1749.

[87] Yvan Allaire & François Dauphin, "'Activist' Hedge Funds: Creators of Lasting Wealth? What do the Empirical Studies Really Say?" (17 July 2014), online (pdf): *Institut sur la gouvernance* <www.igopp.org/wp-content/uploads/2014/07/IGOPP_Article_Template2014_ Activism_EN_v6.pdf>

[88] For a survey of the literature see: Bryce C Tingle, "Two Stories About Shareholders" (2021) 58:1 Osgoode Hall L J 57 at 85-94.

[89] Ed deHaan, David Larcker & Charles McClure, "Long-Term Economic Consequences of Hedge Fund Activist Interventions" (2018) European Corporate Governance Institute Finance Working Paper No 577/2018 at 1, online (pdf):<ecgi.global/sites/default/files/working_papers/documents/finaldehaanlarckermcclure.pdf> at 6; Allaire & Dauphin, "Creators of Lasting Wealth?", *supra* note 84 at 16; Robin Greenwood & Michael Schor, "Investor Activism and Takeovers" (2009) 92 J Fin Econ 362; William Bratton, "Hedge Funds and Governance Targets: Long-Term Results" (University of Pennsylvania Institute for Law and Economics Research Paper No 10-17, 2010), online: <www.ssrn.com/abstract=1677517>; Jonathan Macey & Elaine Buckberg, "Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation" (17 August 2009), online (pdf): *National Economic Research Associates* <www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf> (noting that there are "[s]everal...studies [that] establish that when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contest" at 12).

It is generally understood that innovation is adversely impacted by disclosure regimes.[90] First mover advantages only accrue to firms when there are significant barriers – like patents or secrecy – to competitors following them. In the absence of these barriers, being the first to make a novel investment is often a mistake, as the firm's competitors, by waiting, can take advantage of future technological, market or policy developments. Disclosure of the sort proposed by the Instrument makes the risk of being a first-mover worse, as an issuer's disclosure of its emissions strategy and results will give its competitors guidance on costs, returns, mistakes to avoid, and how to improve results. Thus, the Instrument will have the perverse effect of reducing the risk-adjusted returns to pursuing "green" strategies.

The modern history of disclosure regimes designed to secure a social outcome, provides ample evidence of unintended consequences stemming from their public nature:

• Our executive compensation disclosure rules have likely played a role in *increasing* executive pay, which sky-rocketed after those disclosure rules began to be introduced.[91] Executives can now see whether they are underpaid; boards have a natural reluctance to pay executives in ways that put them below the average of their peers. This disclosure operates as a kind of ratchet pushing the average compensation package higher.[92]

• The post-Enron adoption of rules in the U.S. and Canada requiring disclosure around internal codes of ethics was followed by a noticeable weakening of those codes. A survey of the most recent empirical literature finds that following the new disclosure rules, codes of ethics "exhibit a greater concern about actions against the firms than actions by the corporation."[93] A study of

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[90] See e.g. Sergio Gilotta, "Disclosure in Securities Markets and the Firm's Need for Confidentiality: Theoretical Frameworks and Regulatory Analysis" (2012) 13:1 Eur Bus Organization L Rev 45; Luigi Zingales, "The Future of Securities Regulation" (2009) 47:2 J Accounting Research 391 at 394; Wolfgang Schon, "Corporate Disclosure in a Competitive Environment – The Quest for an Advantage to Rivals" (2006) 6:2 J Corporate L Studies 259 at 294-96.

[91] Bryce C Tingle, "Framed! The Failure of Traditional Agency Cost Explanations for Executive Pay Practices" (2017) 54:4 Alta L Rev 899; Steven M Davidoff & Claire A Hill, "Limits of Disclosure" (2013) 36:2 Seattle U L Rev 599 at 604, 623-6 ("the history of executive compensation disclosure suggests that heeding disclosure does not work as intended and, indeed, sometimes can have unintended negative effects" at 623); Geoffrey A Manne, "The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure" (2007) 58 Ala L Rev 473 at 476-77.

[92] *Ibid*. See also, Alexandre Mas, "Does Disclosure affect CEO Pay Setting? Evidence from the Passage of the 1934 Securities and Exchange Act" (March 2016) Working Paper, online: *Princeton University* <https://www.princeton.edu/~amas/papers/CEODisclosureMandate.pdf>; Luca Enriques & Sergio Gilotta, "Disclosure and Financial Market Regulation" (April 2014) ECGI Working Paper No 252/2014 at 10 (referencing "the so-called Lake Wobegon effect of compensation disclosure." Lake Wobegon is a place where all the children are above average).

[93] Maira Babri, Bruce Davidson & Sven Helin, "An Updated Inquiry into the Study of Corporate Codes of Ethics" (2021) 168 J Bus Ethics 71. See also, Lori Holder-Webb & Jeffrey Cohen, "The Cut and Paste Society: Isomorphism in Codes of Ethics" (2012) 107 J Bus Ethics 485 (the new ethics codes are designed to "minimize the effects of the Code on constraining organizational behavior" at 485); Luca Enriques & Sergio Gilotta, "Disclosure and Financial Market Regulation" (April 2014) ECGI Working Paper No 252/2014 ("[i]ndeed, rather than decreasing the number and scope of [ethical code] waivers granted to top managers, MD [mandatory disclosure] induced firms to relax their internal codes" at 25); Lutz Preuss, "Ethical Sourcing Codes of Large UK-Based Corporations: Prevalence, Content, Limitations" (2009) 88:4 J Bus Ethics 735 (finding ethical sourcing codes of large public companies mostly are designed to push responsibility to firms lower on the supply chain); Usha Rodrigues & Mike Stegemoller, "Placebo Ethics: A Study in Securities Disclosure Arbitrage" (2010) 96:1 Va L Rev 1 (finding disclosure of ethical codes and waivers to be "unhelpful and inefficient" at 2).

Canadian ethics codes found the same thing.[94] The obvious reason for this is that by requiring firms to disclose their codes of ethics, regulators increased the risk those codes could be relied upon by securities class-action plaintiffs in the event of a breach. This produced the perverse result of issuers reducing the ethical constraints on corporate behaviour provided by those codes.

• Various attempts to use the securities disclosure regime to effect changes in the developing world have also yielded perverse results. For example, the conflict minerals certifications imposed by Dodd-Frank appear to have actually increased violence in the Democratic Republic of the Congo.[95]

• The wide-spread adoption of disclosure rules around issuers' payments to foreign governments (enacted in Canada by the *Extractive Sector Transparency Measures Act*) has resulted in a small but meaningful increase in payments to host governments (up 12%) but a reduction of investment in those countries of 28%.[96] Companies listed in countries with mandatory disclosure rules submit fewer bids for new licenses.[97] Oil and gas wells that were transferred from companies in disclosing jurisdictions (like Canada) to those in non-disclosing jurisdictions (like the U.S.) experienced productivity declines of 3.5%.[98] The effects seem to result in larger and better-known resource companies leaving countries with a reputation for corruption in order to avoid negative publicity.

The perverse results of these disclosure regimes are a function of their public nature. Securities disclosure is available to lots of people besides its intended audience, who then use that disclosure for their own purposes. Corporations know this and so they act to reduce their risks; this is often the opposite of what the advocates of the disclosure regime originally wanted them to do. Companies will be aware that their emissions disclosure under the Instrument will be used by competitors intent on improving their relative performance to take market share, plaintiff lawyers who will scour the disclosure for evidence of failures, and NGO's looking for anything embarrassing to the company. It would be surprising if the Instrument didn't have the effect of scaling back issuer ambitions in the very area it is supposed to improve.

8. The Corporate Governance Channel is Not Capable of Producing Material Changes in Issuer Behaviour

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[94] Virginia Bodolica & Martin Spraggon, "An Examination into the Disclosure, Structure, and Contents of Ethical Codes in Publicly Listed Acquiring Firms" (2015) 126:3 J Bus Ethics 459.

[95] Nik Stoop, Marijke Verpoorten & Peter van der Windt, "More Legislation, More Violence? The Impact of Dodd-Frank in the DRC" (2018) 13:8 PloS one e0201783 (finding the introduction of the certification requirements of Dodd-Frank was accompanied by a significant upsurge in battles, looting, and violence against civilians); Lauren Wolfe, "How Dodd Frank is Failing Congo" (9 August 2018), online: *Foreign Policy* <https://foreignpolicy.com/2015/02/02/how-dodd-frank-is-failing-congo-mining-conflict-minerals/> (discussing an open letter by 70 academics and researchers asserting Dodd-Frank is "contributing to, rather than alleviating, the very conflicts they set out to address." As well discussing Washington Post reporting of the way Dodd-Frank "set off a chain of events that has propelled millions of miners and their families deeper into poverty"); Dominic P Parker & Bryan Vadheim, "Resource Cursed or Policy Cursed? US Regulation of Conflict Minerals and Violence in the Congo" (2017) 4:1 J Assoc Environmental & Resource Economists (finding increased looting and shifting battles in the wake of Dodd-Frank).

[96] Thomas Rauter, "The Effect of Mandatory Extraction Payment Disclosures on Corporate Payment and Investment Policies Abroad" (2020) 58:5 J Accounting Research 1075 at 1077.

[97] *Ibid*

[98] *Ibid* at 1080.

Even if every previous argument made in this letter is wrong, the proposed Instrument is unlikely to produce material changes to corporate carbon emissions. Traditional government regulation (like a carbon tax) is imposed on all firms in a market and imposes costs on companies that fail to adhere to the regulations. In contrast, actions taken through the corporate governance channel are discretionary, and there is no financial penalty associated with those actions. Most importantly, social welfare objectives pursued voluntarily, as a matter of corporate governance, affect only the firm in question.

In a perfectly competitive market, no corporation can voluntarily increase its costs and remain in business if its competitors do not act similarly.[99] Markets are not perfectly competitive, of course, but in general they provide a strong constraint on financially sub-optimal investment strategies. In 2019, the last full year without COVID-19, non-financial U.S. companies averaged only a 6.35% pre-tax net margin on sales.[100] Attempts by prominent finance scholars to calculate the profits generated by public companies after deducting their cost of capital and taxes tend to estimate corporate profits over all costs as ranging between approximately zero and 1.43%.[101] This provides very little room for investments with lower marginal returns than the alternatives.

The problem of corporate behaviour being constrained by competitive markets is exacerbated by several other factors:

• The profits are not distributed equally among companies. A recent study found that since 1926, the equity risk premium generated by all U.S. public companies was produced by only 4% of those companies.[102] In other words, 96% of American companies appear to have failed to even meet the cost of their equity.[103]

• Business markets are volatile as a result of innovation, new entrants, shifts in consumer sentiment, or changes to the macro-economic environment. The risk of future adverse changes

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[99] Stephen A Ross et al, *Corporate Finance*, 8th Canadian ed (Canada: McGraw Hill Education, 2019) at 176-177, 360.
[100] "Data Archives" (Jan 5, 2020), online: *Damodaran* <http://pages.stern.nyu.edu/~adamodar/New_Home_Page/dataarchived.html> ("operating and net margins by industry 1/20").
[101] Eugene F Fama & Kenneth R French, "The Corporate Cost of Capital and the Return on Corporate Investment" (1999) 54:6 J Finance 1939 at 1940 (Suggesting the profits between 1950 and 1996 were 1.43%. The authors note this may overstate the returns to corporate investment, as book value, which they use for their calculations, may understate the actual asset values); Michael J Anderson & Brian L Betker, "Additional Evidence on the Corporate Cost of Capital and the Return to Corporate Investment" (2009) 19:1/2 J Applied Finance 91 (estimating non-technology company returns over costs of 1.39% at 97); Gerard T Olson & Michael S Pagano, "The Empirical Average Cost of Capital" (18 August 2020) Villanova School of Business Working Paper at 4, online: *SSRN* <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=348800> (estimating that for the first seven years of the 1990s average corporate returns fell below their marginal costs and barely broke even for the next seven years). The issue with this literature generally is that we lack good ex ante evidence for the cost of capital: see e.g. Edwin J Elton, "Expected Return, Realized Return, and Asset Pricing Tests" (1999) 54:4 J Finance 1199.
[102] Hendrik Bessembinder, "Do Stocks Outperform Treasury Bills?" (2018) 129:3 J Financial Economics 440.
[103] We cannot be absolutely certain of this for the previous mentioned reason that we lack good ex ante data on the cost of capital: see Elton, "Expected Return" *supra* note 98.

will further reduce the amounts even profitable companies feel they can invest in lower-return environmental strategies.[104]

• Even if an issuer is lucky enough to generate high profits, they will not take this situation for granted and will still be unwilling to make financially sub-optimal investments. Companies listed on U.S. public markets before 1970 had a 92% chance of surviving the next five years, whereas companies listed after 2000 had only a 63% chance of surviving that long, even after controlling for the financial crisis and dot-com recession.[105] Over 76% of companies that formed the UK FTSE 100 have disappeared in the last thirty years.[106] Note these statistics measure outcomes of only the most successful companies. The U.S. Bureau of Labor Statistics finds 75% of all businesses fail in less than 15 years.[107] Most profitable public companies are run with a healthy amount of paranoia about the future.

• A company that nevertheless decides to invest in financially sub-optimal emission reduction measures, or refrains from entering into a high return project with adverse emissions profiles, will become subject to a variety of consequences:

> i. Its share price will decline until its shares provide the market rate of return on investments with a similar risk profile.[108]
>
> ii. Shareholders may decide, as a result of the company's relative underperformance, to vote against the board.
>
> iii. Executive pay, which is tied closely to shareholder return, will decline, leading to the departures of the firm's most valuable employees.
>
> iv. Activist shareholders and potential acquirors will note the shares are undervalued relative to the profit-making potential of the business, taking action to displace the managers.[109]

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[104] See e.g. Iliev & Roth, *supra* note 81 (finding "firms with greater R&D expenses and higher cash flow uncertainty invest less in improving their sustainability performance" at 5).
[105] Vijay Govindarajan & Anup Srivastava, "Strategy When Creative Destruction Accelerates" (7 September 2016) Tuck School of Business Working Paper No 2836135. See also, Dane Stangler & Sam Arbesman, "What Does Fortune 500 Turnover Mean?" (June 2012), online (pdf): Kauffman Foundation <https://www.kauffman.org/wp-content/uploads/2012/06/fortune_500_turnover.pdf> (measuring accelerating corporate replacement); Scott D Anthony et al, "2018 Corporate Longevity Forecast: Creative Destruction is Accelerating" (February 2018), online: *Innosight* <https://www.innosight.com/wp-content/uploads/2017/11/Innosight-Corporate-Longevity-2018.pdf>.
[106] Alex Hill, Liz Mellon & Jules Goddard, "How Winning Organizations Last 100 Years" (27 September 2018), online: *Harvard Business Review* <https://hbr.org/2018/09/how-winning-organizations-last-100-years>.
[107] "Table 7, Survival of Private Sector Establishments by Opening Year", online: *US Bureau of Labor Statistics* <https://www.bls.gov/bdm/us_age_naics_00_table7.txt>.
[108] See e.g. Charles P Cullinan, Lois Mahoney & Pamela B Roush, "Entrenchment vs Long-Term Benefits: Classifed Boards and CSR" (2019) 10:1 J Global Responsibility 69 (showing CSR announcements are followed by share price declines).
[109] Mark Maffett, Anya Nakhmurina & Douglas J Skinner, "Importing Activists: Determinants and Consequences of Increased Cross-Border Shareholder Activism" (October 2020), online: *SSRN* <https://ssrn.com/abstract=3721680> (finding firms facing a high threat of activism reduce investments and increase payouts to shareholders); James Cox & Randall Thomas, "Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation" (2016) 95:1 NCL Rev 19.

v. The company's relative cost of capital will increase to reflect corporate revenues are being used in less remunerative ways. This will further reduce the competitive position of the company.

Competitive markets do not, of course, provide a constraint on voluntary, unilateral emissions reductions if the investment in reducing carbon emissions is actually the highest return use of corporate resources. If this was true, then far from constraining corporate investment in emissions reduction, competitive markets would provide powerful incentives to make these socially useful investments. However, it is unlikely emissions reduction investments have this character:

• If meaningful emission reductions were actually among the highest net present value investments available to a corporation, why are they not already being made? Why is pressure on management through corporate governance channels even necessary? Is it plausible that firms are consistently making a mistake this basic to the operation of their business?

• Most emission reduction investments on their face increase costs without increasing the amounts of product produced by the company. Consumers will pay a small premium for products with green credentials, but most companies are not consumer facing, and most consumers are poorly informed about the relative carbon intensity of various companies.

• There is generally strong support in the empirical literature that ESG investments are less remunerative than alternatives.[110] Market reactions to announcements of ESG investments are generally negative, suggesting the market believes corporate assets are being put to less efficient uses.[111] Increases in ESG ratings are associated with negative future stock returns and declines in firm Return on Assets.[112] Investors that actually invest in superior social-return businesses both expect and receive lower returns.[113] Summarizing the empirical literature on this topic, one group

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[110] Avishek Bhandari & David Javakhadze, "Corporate Social Responsibility and Capital Allocation Efficiency" (2017) 43 J Corporate Finance 354 (finding investments made by high ESG firms are less valuable, presumably because the firm chose not to pursue more accretive opportunities); Joscha Nolet, George Filis & Evangelos Mitrokostas, "Corporate Social Responsibility and Financial Performance: A Non-Linear and Disaggregated Approach" (2016) 52 Economic Modelling 400 (finding a negative return on capital from ESG); Sung C Bae, Kiyoung Chang & Ha-Chin Yi, "Are More Corporate Social Investments Better? Evidence of Non-Linearity Effect on Costs of US Bank Loans" (2018) 38 Global Finance J 82 (finding lenders view CSR investments beyond a certain level to be wasteful).

[110] Philipp Kruger, "Corporate Goodness and Shareholder Wealth" (2015) 115:2 J Financial Economics 304 ("investing in CSR is not, on average, beneficial for shareholder value. In other words, the negative stock market reaction suggests that (i) implementing CSR policies is costly and (ii) the expected benefits of from implementing these policies fall short of the cost" at 313). See also, Gunther Capelle-Blanchard & Aurelien Petit, "Every Little Helps? ESG News and Stock Market Reaction" (2019) 157:2 J Bus Ethics 543 (reviewing 33,000 ESG news stories and finding firms gain nothing from positive events.

[111] Philipp Kruger, "Corporate Goodness and Shareholder Wealth" (2015) 115:2 J Financial Economics 304 ("investing in CSR is not, on average, beneficial for shareholder value. In other words, the negative stock market reaction suggests that (i) implementing CSR policies is costly and (ii) the expected benefits of from implementing these policies fall short of the cost" at 313). See also, Gunther Capelle-Blanchard & Aurelien Petit, "Every Little Helps? ESG News and Stock Market Reaction" (2019) 157:2 J Bus Ethics 543 (reviewing 33,000 ESG news stories and finding firms gain nothing from positive events).

[112] Alberta Di Giuli & Leonard Kostovetsky, "Are Red or Blue Companies More Likely to Go Green? Politics and Corporate Social Responsibility" (2014) 111:1 J Financial Economics 158.

[113] Brad M Barber, Adair Morse & Ayako Yasuda, "Impact Investing" (December 2019) NBER Working Paper 26582.

of scholars observe, "the evidence that socially responsible firms have lower discount rates, and thereby investors have lower expected returns, is stronger than the evidence that socially responsible firms deliver higher profits or growth."[114]

9. Conclusion

In this letter I have argued: (i) shareholders are the most likely consumers of the disclosure contemplated by the Instrument; (ii) shareholders are constrained by market conditions to avoid investing their resources in firm-specific information gathering and governance interventions; (iii) researchers have empirically demonstrated that shareholders behave as if they are not really engaged with emissions-related activities; (iv) securities disclosure is poorly suited to informing third parties how emissions might be reduced; (v) securities disclosure of the sort contemplated by the Instrument is likely to make progress on reducing carbon emissions harder in many respects; (vi) the tools available to shareholders to effect changes in issuers' emissions strategies are poorly suited to this task; and (vii) nearly all companies operate under market constraints that make meaningful *voluntary* carbon emission reduction activities almost impossible.

It is important to note that while most of the empirical research in this paper makes use of American data, the situation in Canada is almost certainly worse. For example, the Canadian public markets largely consist of small-cap and micro-cap companies that have no parallel in American markets.[115] These companies have smaller profits and thus less room for voluntary environmental investments. Indeed, a large percentage of Canadian public companies are at a very early stage or are not profitable for other reasons. As well, Canada largely lacks large-scale companies protected from market pressure by technology barriers or network effects. The relative impact of the Instrument will be much worse here than a similar regime in the United States.

Global warming is a serious problem that demands an effective solution. The costs of the proposed Instrument clearly outweigh any potential benefits. If the CSA feels that something like the Instrument must be introduced here, perhaps it should be confined in its application only to companies of a certain size, preferably measured by revenue or earnings, so that its impact can be absorbed by companies possessing the necessary resources, and so that the Instrument does not provide yet another deterrent to new companies choosing to enter the public markets in this country.

I hope this is helpful to your analysis of, and deliberations on, the Instrument.

Sincerely,

Bryce C. Tingle QC

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[114] Bradford Cornell & Aswath Damodaran, "Valuing ESG: Doing Good or Sounding Good?" (20 March 2020), online: *SSRN* <https://ssrn.com/abstract=3557432> at 22.

[115] C. Nicholls, "The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to Sarbanes-Oxley", Maintaining a Competitive Capital Market in Canada: Canada Steps Up: Research Study for the Task Force to Modernize Securities Legislation in Canada, vol. 4 (Toronto, Task Force to Modernize Securities Legislation in Canada, 2006) at 159-161.