Incentives, Sustainability and Law:

The relationship between executive pay regulation and corporate social responsibility

Laurenz Goldhahn

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Abbreviations

AGM	Annual General Meeting
BCW	Barzuza, Curtis and Webber
CDS	Credit Default Swap
CDP	Carbon Disclosure Project
CD&A	Compensation Discussion and Analysis
CEBS	Committee of European Banking Supervisors
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CRD IV	Fourth Capital Requirements Directive
CRR	Capital Requirements Regulation
CSP	Corporate Social Performance
CSR	Corporate Social Responsibility
CSRD	Corporate Sustainability Reporting Directive
EBA	European Banking Authority
EC	European Commission
ECJ	European Court of Justice
ESG	Environmental, Social and Governance
EU	European Union
EUR	Euro
E&S	Environmental and Social
FSB	Financial Stability Board
FSF	Financial Stability Forum
GL	Glass, Lewis & Co.
GRI	Global Reporting Initiative
ICMA	International Capital Markets Association
IFRS	International Financial Reporting Standards

ILO	International Labour Organization
ISS	Institutional Shareholder Services Inc.
KPI	Key Performance Indicator
MNE	Multi-National Enterprise(s)
NFRD	Non-Financial Reporting Directive
OECD	Organisation for Economic Co-operation and Development
PRI	Principles for Responsible Investment
RTS	Regulatory Technical Standards
SASB	Sustainability Accounting Standards Board
SEC	United States Securities and Exchange Commission
SLB	Sustainability-Linked Bond
SME	Small and Medium Enterprise(s)
SRD II	Second Shareholder Rights Directive
SRI	Socially Responsible Investment
SSGA	State Street Global Advisors
TARP	Troubled Asset Relief Program
TCFD	Task Force on Climate-Related Financial Disclosures
UN	United Nations
US	United States
USD	US-Dollar

Chapter One
Connecting Corporate Social Responsibility and Executive Pay Regulation: An Overview of the Thesis

SUMMARY. This short chapter is the introduction to the thesis. It introduces the topic, defines the research questions, and outlines the methodology and structure.

The thesis deals with the relationship between pay regulation and corporate social responsibility (CSR) in the broader context of the role of CSR in corporate law and governance. Current scholarship fails to fully explain the influence of law on CSR; the regulatory instruments of CSR legislation are still being developed. As the key incentive mechanism in corporate governance, the thesis focuses on compensation. There are two research questions: how does existing pay regulation affect CSR? And should pay regulation by adapted to accommodate CSR, and if so, how?

The thesis is divided into this introduction, five content chapters, and a conclusion. Its methodology is derived from law and economics, agency theory, and institutional theory. It employs positive and normative economic analysis of law and a case study to answer the two research questions.

Section 1: Introduction

1 What are the issues that come to people's minds when they hear the terms 'corporate social responsibility' and 'executive compensation' together? Their associations may, for example, circle around the notion that managers earn too much in comparison to the multitude of employees in a firm, and that 'excessive' rewards contradict fair wages. Or will they criticise that CEOs' earnings do not correspond to what they contribute to either the firm or society in general, because they are paid to pursue only short-term, narrowly defined objectives? Intuitively, another response could express the view that corporate social responsibility is an obligation to which firms fail to live up, because their decisionmakers receive generous bonuses for what is detrimental to constituents other than shareholders.[1] Much of the debate around 'corporate social responsibility' and sustainability has recently coalesced into ESG or 'environmental, social, and governance' criteria people have started to apply to assess the performance of firms beyond pure profit maximisation. Subsequently, the connection between

[1] All these examples have been collected from real discussions on the topic of this thesis. For a contribution on 'excessive' compensation from a law and economics perspective, cp. R. Posner, 'Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?', *Duke Law Journal*, vol. 58(6), 2009, pp. 1013-70.

these forms of non-financial performance and corporate policies, objectives and pay structures has come under scrutiny.

2 Distributional concerns and an *ex post* view of the justifications of executive pay form a recurring pattern in the public debate.[2] This stands in a stark contrast to the prevailing understanding in academia of compensation as a key instrument to align managerial incentives with the interests of a firm's owners, i.e. shareholders.[3] Through material payoffs, compensations allows to influence managerial behaviour, set performance targets, and reduce the agency costs that result from the separation of ownership and control in corporations.[4] This view is one of the core tenets of how corporate governance is understood and developed today;[5] nevertheless, it has failed to gain comparable ground in the public debate, which is dominated by social concerns. As a consequence, corporate social responsibility (CSR) has mostly been absent from academic discussions on executive pay, its design, and how it is addressed by law. Likewise, where policymakers have expressed the aim of supporting, driving, or shaping CSR, pay regulation has not yet become an integral part of any of the legislative toolsets employed to achieve that aim. This blind spot in corporate governance—the relationship between compensation, CSR, and law—is the topic of this thesis.

3 To address the aforementioned shortcomings, two key endeavours are pursued: the first is to understand how pay regulation, i.e. the body of all legal rules that affect the process and outcome of private pay schemes in corporations, changes incentives to engage in CSR. 'Socially responsible' behaviour by firms is a broad and complex topic, and it is an ongoing task in scholarship to understand the role of law as one of its determinants. Building upon those insights, a second step is to draw practical conclusions on whether and how existing legal rules of pay regulation should be adjusted to optimise incentives for CSR engagement. The following anecdotes further illustrate the context and direction of this research.

4 A famous example of 'social concerns' as a driver of pay regulation was Sect. 953(b) of the US Dodd-Frank Act,[6] introduced in 2015. Known as the 'pay ratio requirement,' it obliges corporations to disclose the CEO's and median employee's pay, as well as the ratio between the two. Intended to alleviate distributional concerns over vertical wage gaps, it received heavy criticism from scholarship[7] and regulators, including then-SEC commissioner Michael Piwowar who called it "wrong" and "pander[ing] to politically-connected special interest groups."[8] European lawmakers who had initially planned to introduce a similar rule abandoned

[2] Cp. K. Murphy & M. Jensen, 'The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation', *Journal of Law, Finance & Accounting*, vol. 3(2), 2018, pp. 189-242.
[3] M. Jensen & K. Murphy, 'Performance Pay and Top Management Incentives', *Journal of Political Economy*, vol. 98(2), 1990, pp. 225-64.
[4] E. Fama & M. Jensen, 'Separation of Ownership and Control', *Journal of Law and Economics*, vol. 26(2), 1983, pp. 301-25.
[5] Cp. M. Jensen & W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *Journal of Financial Economics*, vol. 3(4), 1976, pp. 305-60.
[6] United States Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376 (2010) [herein: Dodd-Frank Act].
[7] For example, Murphy and Jensen call it "[t]he most mischievous and controversial compensation provision in Dodd-Frank", Murphy & Jensen (2018), *supra* note 2.
[8] M. Piwowar, *Dissenting Statement at Open Meeting on Pay Ratio Disclosure*, U.S. Securities and Exchange Commission Public Statement, 5 August 2015, available at https://www.sec.gov/news/statement/dissenting-statement-at-open-meeting-on-pay-ratio-disclosure.html.

this endeavour early on. In the literature, 'social concerns' are overwhelmingly seen as attacks on the economic efficiency of compensation as a governance mechanism.[9]

5 In the EU, CSR has found its ways into other areas of corporate law. 2017 marked the first in year in which large European companies were obliged to publish 'non-financial information' in their annual reports. This includes issues such as environmental protection, employee treatment, respecting human rights or diversity on the company board. The underlying legislative act, the Non-Financial Reporting Directive, had been adopted three years prior as part of a policy initiative by the European Commission to promote CSR for more sustainable economic growth in the EU.[10] With the Second Shareholder Rights Directive (SRD II) of 2017, this approach even began to touch upon the area of executive pay regulation:[11] this Directive both empowers and obliges shareholders to play a more active role in corporate governance in an effort to bring about more efficient and shareholder-friendly pay schemes. Notably, that included the tentative requirement for corporations to "indicate […], where appropriate, criteria relating to corporate social responsibility, and explain how they contribute to the [firm's] objectives".[12] SRD II relies on market forces, especially shareholders, to act as drivers of corporate performance, including CSR, as part of a move towards better governance.[13] But how do market forces affect social engagement, and why did this particular inclusion of social concerns not meet similar criticism like Sect. 953(b)?

6 To answer that, it helps to understand what CSR is. The European Commission succinctly defines it as "the responsibility of enterprises for their impact on society."[14] This vague concept means that companies should create value not only for shareholders, but 'everybody,' and prevent any harms that emerge from their course of business. What makes CSR so prominent is the fact that it has gained a significant foothold in the way companies operate today: the Business Roundtable, a prominent association of American CEOs, announced in 2019 that it would abandon its decades-old definition of the purpose of business as, in essence, 'shareholder value creation' in favour of a new, colourful vision of delivering value to 'all corporate stakeholders.'[15] This message may sound bold, but how much of its commitment is measurable change in business practice, and what is mere lip service? Concerns are justified.[16] One paradigmatic example for how social responsibilities can fail is found in Germany: to comply with international human rights commitments, policymakers introduced a National Action Plan in 2016 that 'encouraged' corporations to monitor, report, and remedy severe human rights violations such as forced or child labour in their supply chains through 'voluntary self-

[9] Cp. G. Ferrarini & M. Ungureanu, 'Executive Remuneration', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[10] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, 2014 O.J. L330/1 [herein Non-Financial Reporting Directive, NFRD].
[11] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017 [herein: Second Shareholder Rights Directive; SRD II].
[12] Art. 9a VI subpara. 3 SRD II.
[13] Rec. 14 SRD II.
[14] European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions A Renewed EU strategy 2011-14 for Corporate Social Responsibility*, 2011, COM(2011) 681 final, at p. 6.
[15] Business Roundtable, *Statement on the Purpose of a Corporation*, 19 August 2019, available at https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationJuly2021.pdf.
[16] For substantiated criticism, cp. L. Bebchuk & R. Tallarita, 'The Illusory Promise of Stakeholder Governance', *Cornell Law Review*, vol. 106(1), 2021, pp. 91-178.

regulation.'[17] Despite positive initial feedback, a follow-up survey revealed that most companies had not even bothered to establish the necessary corporate functions and processes to do so. Voluntary self-regulation was deemed a failure and supply chain due diligence transcribed into coercive regulation in 2021.[18] This disappointing experience leads to the following key question: how do the legal environment and economic incentives need to be designed so that business self-regulation may work more successfully in the future?

7 Here, the debate returns to executive pay regulation. The budding field of CSR legislation mostly still restricts itself to matters of external governance like disclosure, but begins to stretch towards legal instruments that affect all aspects of corporate legal life.[19] Out of those areas, pay regulation is worth particular attention for its influence on managerial incentives and thus its capacity to directly influence corporate decision-making. As explained above,[20] conventional pay regulation is occupied with efficiency and protecting shareholder interests. However, even though investors often act as drivers of CSR engagement, situations occur in which their interests hinder socially responsible corporate conduct. Here, the conflict between efficiency and 'social concerns' ostensibly returns. Is current pay regulation an impediment or support to CSR engagement? And is it possible to reconcile conventional profit maximisation and CSR encouragement as regulatory objectives?

8 A detour into the banking sector may help, which offers both the most comprehensive and a special case of pay regulation. In the aftermath of the global financial crisis of 2008, scholarship discussed why—contrary to the previous predictions of corporate governance—banks with a stronger alignment between shareholder interests and managerial incentives had performed significantly worse.[21] Due to peculiarities in the organisational and capital structure of financial institutions, shareholders have an interest in excessive risk-taking, as they fully internalise profits, but large losses are born by creditors and governments.[22] Where these interests are translated into pay schemes, socially suboptimal incentives result. As a consequence, modern bankers' pay regulation is designed to directly restrict shareholders and prevent the imposition of incentives for excessive risk-taking.[23] The banking sector thus is a prominent example of how social concerns can override shareholder welfare as the primary objective in corporate governance in an economically justified way. This makes it a promising area of research to draw lessons for CSR legislation.

9 What do all these examples share in common? A few observations should come to attention: CSR and executive pay are connected to each other in several ways. Social concerns have

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[17] Cp. German Foreign Ministry, *National Action Plan for Business and Human Rights*, 21 December 2016, available at https://www.auswaertiges-amt.de/de/aussenpolitik/themen/aussenwirtschaft/wirtschaft-und-menschenrechte/-/227580.
[18] Cp. German Foreign Ministry, *The Due Diligence Act: Making Globalisation More Socially Just*, 3 March 2021, available at https://www.auswaertiges-amt.de/en/aussenpolitik/themen/aussenwirtschaft/wirtschaft-und-menschenrechte/-/2445576.
[19] On the relationship between corporate law and corporate governance, cp. R. Gilson, 'From Corporate Law to Corporate Governance', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[20] *Supra*, para. 4.
[21] R. Fahlenbach & R. Stulz, 'Bank CEO Incentives and the Credit Crisis', *Journal of Financial Economics*, vol. 99(1), 2011, pp. 11-26.
[22] M. Becht, P. Bolton & A. Röell, 'Why Bank Governance Is Difference', *Oxford Review of Economic Policy*, vol. 27(3), 2011, pp. 437-63.
[23] L. Bebchuk & H. Spamann, 'Regulating Bankers' Pay', *Georgetown Law Journal*, vol. 98(2), 2010, pp. 247-88.

always been a driver of pay regulation, which has received severe criticism in the economic literature for its lack of measurable welfare-enhancing benefits. However, compensation as a pecuniary incentive also affects CSR engagement as one of its key, firm-level determinants. Shareholders—the owners of corporations—have an ambivalent relationship to CSR and can act as either drivers or inhibitors, depending on their interests, preferences, and the respective business environment. This is where the legal conundrum originates: corporate law moves towards the adoption of CSR engagement as a regulatory objective. However, it is unclear to which extent this trend conflicts with conventional goals and how regulation should be designed to affect CSR efficiently. One reason why this remains persistently unanswered is because there is still no theoretical consensus on the concept of CSR, as it is addressed in various disciplines with a different definition and methodology in each. That is why also the existing empirical evidence on CSR, executive pay, and law is scattered and incomplete and does not provide compelling answers. Focusing on compensation as a key incentive mechanism of private governance, this thesis provides a cohesive theoretical framework and analysis of the relationship between CSR and executive pay regulation to explain how this specific area of corporate law affects CSR.

10 As indicated, there is a multitude of theories on CSR in the literature that requires a restriction in scope. In this thesis, a functional concept of CSR is developed based on two methodological approaches: agency theory is key to analyse the role of CSR in corporate governance, while institutional theory explains the interaction between CSR and its social, legal, and economic environment. It is important to note that while the concept developed here is applicable to all forms of CSR engagement, it is but "one view of the cathedral".[24] As the examples given above illustrate,[25] CSR is complex and an essentially contested concept.[26] This means that there is no consensus on the core characteristics of CSR, and each academic inquiry must provide a definition tailored to the specific research objectives and methodological approach. That is why this thesis develops a concept of CSR based on law and economics and institutional theory of "voluntary private self-regulation" that is further differentiated by a categorisation of CSR activity types, derived from agency theory and behavioural economics. Throughout the analytical chapters of the thesis, this concept is used as the central approach to discuss the role of CSR in corporate governance, its relationship with executive pay regulation, and to explain the transmission of CSR motivations into decision-making incentives as a basis for CSR legislation.

11 On the other side, the thesis identifies a set of core elements of pay regulation that are subjected to analysis. Pay regulation can broadly be distinguished into *governance prescriptions* that target the pay-setting process and *structural regulation* that directly affects the content and composition of compensation schemes.[27] The elements of governance prescriptions covered here make up the main body of pay regulation in general corporate law: *say-on-pay* rules that equip shareholder with decision-making rights in the pay-setting process, *disclosure requirements* such as the ones mentioned above[28] and *independence requirements* for the directors in charge of pay-setting. Structural regulation, which is discussed at the example of

[24] On the origin of this metaphor in law and economics, cp. G. Calabresi & D. Melamed, 'Property Rules, Liability Rules and Inalienability: One View of the Cathedral', *Harvard Law Review*, vol. 85(6), 1972, pp. 1089-1128.
[25] *Supra*, para. 6-7.
[26] Cp. B. Sheehy, 'Defining CSR: Problems and Solutions', *Journal of Business Ethics*, vol. 131(3), 2015, pp. 625-48.
[27] Ferrarini & Ungureanu (2018), *supra* note 9.
[28] *Supra*, para. 4-5.

the financial sector, includes rules on the *absolute levels* of compensation, the *composition* of different pay instruments and *pay-for-performance* regulation on the design of incentive schemes, contractual clauses, and the use of performance targets. Where it provides additional insights, regulatory regimes in the US and the EU are discussed and compared, including varying national implementation in EU Member States.

12 Within the multitude of topics explained above, the thesis has a clear focus: the relationship between compensation—as part of corporate governance—and CSR activities, and how this relationship is affected by law and regulation. It maps out the ways in which executive pay regulation affects managerial incentives for CSR engagement and discusses the use of this knowledge for the design of future pay regulation.

13 The central idea of the thesis is to delineate the gap in existing research on CSR and corporate law at the specific example of executive pay regulation. That gap includes an insufficient inquiry into the functioning of existing mechanisms and institutions and the absence of a coherent theoretical framework that bridges the different prevalent methodological approaches to accommodate future and existing empirical work. Understanding these relationships is key to the ongoing integration of CSR into corporate law and the design of effective CSR legislation.

14 Thus, the main objective of this dissertation is to provide a contribution that fills this epistemological gap to achieve a better understanding of the determinants of CSR engagement in law and corporate governance. This is done to help both scholarship and business practice to explain and predict the conditions under which CSR emergence either succeeds or fails, and to clarify the legislative instruments that can be employed to efficiently steer or shape CSR engagement.

Section 2: Research Questions and Objectives

15 How do economic incentives in the form of compensation affect a firm's engagement in CSR activities? How does CSR relate to financial performance? How is CSR affected by law, if it is understood as 'voluntary' engagement and thus by definition outside the scope of coercive rules? These are questions that require empirical input and the economic analysis of legal rules, but more critically they demand a theoretical fundament to embrace the existing research on this topic that is scattered across various disciplines. These drivers specify the research interest: what do we know about the implications of corporate governance regulation for CSR, most importantly pay regulation? And can this knowledge be used to make more precise judgments about CSR endeavours in policymaking?

16 Executive compensation as just one element of corporate governance stands out for several reasons: first, it is at the centre of the agency relationship between managers and shareholders.[29] This agency relationship is a core feature of the corporation, resulting from the separation of ownership and control.[30] The shareholder-manager agency relationship is also the lens through which corporate scholarship studies CSR, its determinants, and outcomes. Following major

[29] Jensen & Meckling (1976), *supra* note 5.
[30] Fama & Jensen (1983), *supra* note 4.

reforms after the accounting scandals in the early 2000s and the global financial crisis of 2008/09, pay regulation has become an important area of corporate governance regulation that focuses on shareholder empowerment, performance sensitivity and economic sustainability. Furthermore, the emergence of CSR legislation and the continuous rejection of non-economic grounds for regulatory intervention establish the necessity to illustrate how pay regulation can contribute to social welfare in a way that is consistent with the conventional economic approach to corporate governance.

17 The thesis is split into two main research questions, which also form the underlying structure for the chapters in this book. The first research question is asking for the effects of executive pay regulation on CSR engagement. This is addressed through a descriptive analysis that looks at existing forms of pay regulation and how they affect corporate decision-making incentives to engage in different, functionally defined categories of CSR activities.

18 The second research question is based on the insights of the first one and asks—from a normative perspective—whether CSR engagement should be adopted as an objective of pay regulation and how its existing rules should be altered to maximise social welfare. Following a law and economics methodology, this includes a specification of the contributions of CSR to social welfare, its imperfections in private market settings, and the possibilities of law to remedy those.

19 Pay regulation is discussed *pars pro toto* for the ongoing integration of CSR and corporate law, and specific attention is paid to the central role of shareholders as the driving actors of both pay schemes and CSR engagement. The ongoing developments in business practice and organisational structure that have unfolded with the proliferation of CSR as well as the concurrent changes in ownership and investing affect all areas of corporate governance. Due to its peculiar characteristics, the study of pay regulation holds insights that may be extended to the entirety of corporate law: it is a key incentive mechanism to shape and steer managerial decision-making and subsequently corporate activities; in the process through which compensation is determined, the main elements of corporate governance coalesce: the allocation of corporate decision rights, information asymmetries, diverging actor interests, and the separation of ownership and control. This thesis thus provides answers that aim to not just elucidate the confined topic of pay regulation. Instead, these answers are formulated such as to allow the extrapolation of theoretical implications, provide more general insights on the role of corporate law for CSR, and serve as an outline for further research into its other areas.

20 The main argument of this thesis is that corporate law matters in its existing forms for CSR beyond its state as passive institutional environment ascribed to it by legal scholarship.[31] Instead, it can be employed as a driver of CSR to increase social welfare. A comprehensive theoretical framework, a functional understanding of CSR, and law and economics analysis are key to provide reliable results in an area that is polarised and controversially discussed in different disciplines.

[31] Cp. *infra*, para. 30.

Section 3: Motivation

21 Corporations have naturally never been entirely detached from a 'responsibility towards society,' as they are obliged to comply with a variety of legal rules that protect social concerns in a wider sense, such as employment protection, anti-discrimination, or anti-money-laundering provisions. With the advent of CSR, however, these concerns have started to affect corporate practices more directly and have begun to make their way into the law all around the world. The most ambitious example of CSR legislation is India, where firms are legally obliged to spend a fixed portion of annual profits on CSR projects since 2013.[32] But even elsewhere, the development of international frameworks, non-financial reporting standards, and industry organisations have turned CSR into a practice that hardly any corporation can opt out of today. Its integration into standard business practices and the proliferation of 'socially responsible investing' (SRI) in capital markets have further blurred the lines between CSR as profits-sacrificing philanthropy and economically sustainable entrepreneurship. CSR has become and will remain for the foreseeable future a central topic of business administration, economics, and policymaking.

22 Analytically, the principal-agent relationship between managers and shareholders is at the core of both executive compensation and the economic understanding of CSR. Regarding compensation, the design, structure, and levels of pay are regarded as a method of aligning managerial long-term incentives with shareholder interests to reduce agency costs.[33] Consequently, the same holds for CSR activities: extensive 'business case' theories explore how CSR engagement can improve a firm's financial performance and governance.[34] This is contrasted by the view originally formulated by Milton Friedman of CSR as an agency cost through which self-serving managers spend shareholders' money.[35] Even though the latter approach has been replaced by a more differentiated view of actor preferences, this dichotomy of CSR as either shareholder welfare or rent extraction still dominates. Many of the most impactful contributions as well as criticisms today are still based on agency theory and incentive analysis.[36] Thus, this methodology is indispensable to understand the relationship between CSR and compensation, creating the challenge of connecting this approach to the literature on CSR and law.

23 CSR is a polarising topic. Even in scholarship, many have predetermined notions of it as either the panacea for sustainable economic growth or just a useless diversion from the actual purpose of business. To provide a common ground of understanding, this thesis is motivated by the desire to improve comprehension of CSR, simply taking it as the phenomenon widely occurring in business practice, international organisations, and policymaking that it is. Based on this

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[32] Cp. L. Gatti et al., 'Are We Moving Beyond Voluntary CSR? Exploring Theoretical and Managerial Implications of Mandatory CSR Resulting from the New Indian Companies Act', *Journal of Business Ethics*, vol. 160(4), 2019, pp. 961-72.
[33] Jensen & Meckling (1976), *supra* note 5.
[34] Cp. E. Kurucz, B. Colbert & D. Wheeler, 'The Business Case for Corporate Social Responsibility', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.
[35] M. Friedman, 'The Social Responsibility of Business Is to Increase Its Profits', *New York Times Magazine*, 13 September 1970, pp. 122-26.
[36] E.g. L. Bebchuk & R. Tallarita, 'The Illusory Promise of Stakeholder Governance', *Cornell Law Review*, vol. 106(1), 2020, pp. 91-178.

knowledge, normative conclusions on the purpose of CSR and the role of law in it can be derived. This contribution is best understood in the context of the existing literature.

Section 4: The Thesis within the Literature

24 This thesis develops a functional concept of CSR, i.e. a descriptive one based on its economic purpose and interactions, contrary to managerial, ethical, or legal approaches. Consequently, there is no limitation to a single definition of CSR on which to build; Sheehy provides an overview of the issues in defining CSR.[37] The subject of the thesis fits into several fields of inquiry in academic and policy debates, including CSR scholarship, corporate law and governance, theories of regulation, and institutional economics.

25 There are a few noteworthy, fundamental theoretical contributions to the topic of CSR made since its inception.[38] Carroll was the first to model CSR as the interaction of a firm's economic, legal, ethical, and philanthropic responsibilities, which still outlines the scope of functional CSR scholarship today.[39] On a larger scale, Matten and Moon's model of 'implicit and explicit' CSR explains basic differences of how countries either integrate social concerns into their legal and governance systems or leave them to corporate discretion.[40] Merging behavioural theory and microeconomics, Bénabou and Tirole provide a model of CSR as the result of convening material interests and non-financial preferences.[41] On the firm level, McWilliams and Siegel explain CSR as the outcome of cost-benefit optimisation that is determined by market influences.[42] Campbell expands on this by introducing institutional factors as mediators of economic influences,[43] Aguilera et al. provide a multi-level theory of CSR as the result of firm-level determinants, governance, national economic systems and heterogeneous actor motives.[44]

[37] Sheehy (2015), *supra* note 26.
[38] On the history of CSR, cp. A. Carroll, 'A History of Corporate Social Responsibility: Concepts and Practices', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.
[39] A. Carroll, 'The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders', *Business Horizons*, vol. 34, 1991, pp. 39-48.
[40] D. Matten & J. Moon, '"Implicit" and "Explicit" CSR: A Conceptual Framework for a Comparative Understanding of Corporate Social Responsibility', *Academy of Management Review*, vol. 33(2), 2008, pp. 402-24.
[41] R. Bénabou & J. Tirole, 'Individual and Corporate Social Responsibility', *Economica*, vol. 77(1), 2010, pp. 1-19.
[42] A. McWilliams & D. Siegel, 'Corporate Social Responsibility: A Theory of the Firm Perspective', *Academy of Management Review*, vol. 26(1), 2001, pp. 117-27.
[43] J. Campbell, 'Why Would Corporations Behave in Socially Responsible Ways? An Institutional Theory of Corporate Social Responsibility', *Academy of Management Review*, vol. 32(3), 2007, pp. 946-67.
[44] R. Aguilera et al., 'Putting the S Back in Corporate Social Responsibility: A Multi-Level Theory of Social Change in Organizations', *Academy of Management Review*, vol. 32(3), 2007, pp. 836-63.

26 The agency view of the firm that stands in the tradition of seminal contributions by Berle and Means[45] as well as Jensen and Meckling[46] is the primary approach to CSR in management studies and most empirical work. In response to Friedman's critique of CSR as a managerial agency cost,[47] Davis put forward that CSR, if executed correctly, could contribute to shareholder welfare.[48] From those two rivalling hypotheses, two strands of literature have developed that consider CSR as either an agency cost—key contributions are by Barnea and Rubin on excessive discretion[49] and Cespa and Cestone on managerial entrenchment[50]—or a 'business case' opportunity.[51] Also, a vast body of empirical literature on the link between CSR and financial performance exists, which has had a strong influence on CSR practice in steering it towards an alignment with profitability.[52]

27 Executive pay is equally understood through agency theory, and there are two similar concepts of compensation as either a remedy to or source of agency costs. The modern theory of incentive pay goes back to Jensen and Murphy,[53] who have also formulated a general critique of pay regulation from that perspective.[54] Bebchuk, Fried and Walker on the other hand have made the case that compensation may be exploited by managers as a source of rent extraction.[55] An overview of the different theories of how compensation instruments affect financial performance as well as an overview of the empirical knowledge is provided by Edmans, Gabaix and Jenter.[56] Kraakman et al. cover in their economic analysis of corporate law the role of executive compensation as an incentive and its role in corporate governance and regulation.[57] The specificities of regulating bankers' pay are laid out by Bebchuk and Spamann.[58] The resulting triangular relationship between CSR, compensation, and financial performance is also addressed in the empirical literature. While a thorough review of that literature is conducted in

[45] A. Berle & G. Means, *The Modern Corporation and Private Property*, New York, Macmillan, 1932.
[46] Jensen & Meckling (1976), *supra* note 5.
[47] Friedman (1970), *supra* note 35.
[48] K. Davis, 'The Case for and Against Business Assumption of Social Responsibilities', *Academy of Management Journal*, vol. 16(2), 1973, pp. 312-22.
[49] A. Barnea & A. Rubin, 'Corporate Social Responsibility as a Conflict between Shareholders', *Journal of Business Ethics*, vol. 91(1), 2010, pp. 71-86.
[50] G. Cespa & G. Cestone, 'Corporate Social Responsibility and Managerial Entrenchment', *Journal of Economics & Management Strategy*, vol. 16(3), 2007, pp. 741-71.
[51] For an overview of the 'business case' literature, cp. Kurucz et al. (2008), *supra* note 34.
[52] For an overview of the empirical literature on CSR and financial performance, cp. cp. M. Orlitzky, F. Schmidt & S. Rynes, 'Corporate Social and Financial Performance: A Meta-Analysis', *Organization Studies*, vol. 24(3), 2003, pp. 403-41.
[53] M. Jensen & K. Murphy, 'Performance Pay and Top Management Incentives', *Journal of Political Economy*, vol. 98(2), 1990, pp. 225-64.
[54] K. Murphy & M. Jensen, 'The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation', *Journal of Law, Finance, and Accounting*, vol. 3(2), 2018, pp. 189-242.
[55] L. Bebchuk, J. Fried & D. Walker, 'Managerial Power and Rent Extraction in the Design of Executive Compensation', *University of Chicago Law Review*, vol. 69(3), 2002, pp. 751-846.
[56] A. Edmans, X. Gabaix & D. Jenter, 'Executive Compensation: A Survey of Theory and Evidence', *ECGI Working Paper Series in Finance*, Working Paper No. 514/2017, 2017.
[57] R. Kraakman et al., *The Anatomy of Corporate Law A Comparative and Functional Approach*, Oxford, Oxford University Press, 2017.
[58] Bebchuk & Spamann (2010), *supra* note 23.

Chapter Two,[59] a noteworthy recent contribution that reflects the current stand is by McGuire et al.[60]

28 The central role of shareholders is expressed in Shleifer and Vishny's definition of corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[61] The rise of powerful institutional investor, particularly large index funds, has challenged the necessity for corporate law to focus on shareholder protection. Important contributions on how corporate law and governance should accommodate shareholders who are capable of enforcing their own interests but face their own agency and stewardship issues have been made by Gilson and Gordon[62] or Bebchuk and Hirst.[63] In CSR, shareholders play an equally important role. Johnson and Greening show that different types of investors impact the CSR engagement profile of a company.[64] Hart and Zingales discuss the question whether corporations may deviate from the objective of profit maximisation to pursue the satisfaction of shareholders' non-financial preferences.[65] A notable contribution to the ongoing research on how index funds influence CSR has been made by Barbuza et al.[66]

29 The related field of stakeholder theory has developed as both a complement and a competing approach to the shareholder-centred approach of agency theory. Freeman has originally constructed stakeholder theory as a managerial strategy to integrate stakeholder concerns.[67] Donaldson and Preston have developed 'radical stakeholder theory', which aims to replace shareholder welfare maximisation with that of stakeholders.[68] Another strand of 'instrumental stakeholder theory' integrates stakeholder interests into profit maximisation similar to the CSR 'business case'.[69] Jensen provides such an approach that has gained widespread recognition termed 'enlightened stakeholder theory'.[70]

[59] *Chapter Two*, at pp. 55 et seq.
[60] J. McGuire et al., 'Do Contracts Make Them Care? The Impact of CEO Compensation Design on Corporate Social Performance', *Journal of Business Ethics*, vol. 157(2), 2019, pp. 375-90.
[61] A. Shleifer & R. Vishny, 'A Survey of Corporate Governance', *Journal of Finance*, vol. 52(2), 1997, pp. 737-83.
[62] R. Gilson & J. Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights', *Columbia Law Review*, vol. 113(4), 2013, pp. 863-927.
[63] L. Bebchuk & S. Hirst, 'Index Funds and the Future of Corporate Governance', *Columbia Law Review*, vol. 119(8), 2019, pp. 2029-2146.
[64] R. Johnson & D. Greening, 'The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance', *Academy of Management Journal*, vol. 42(5), 1999, pp. 564-76.
[65] O. Hart & L. Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value', *Journal of Law, Finance, and Accounting*, vol. 2(2), 2017, pp. 247-74.
[66] M. Barzuza, Q. Curtis & D. Webber, 'Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance', *Southern California Law Review*, vol. 93(6), 2021, pp. 1243-1322.
[67] R. Freeman, *Strategic Management: A Stakeholder Approach*, Pitman, Boston, 1984.
[68] T. Donaldson & L. Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications', *Academy of Management Review*, vol. 20(1), 1995, pp. 65-91.
[69] T. Jones, 'Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics', *Academy of Management Review*, vol. 20(2), 1995, pp. 404-37.
[70] M. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function', *Business Ethics Quarterly*, vol. 12(2), 2002, pp. 235-56.

30 The relationship between CSR and its economic, legal, and societal environment is addressed by institutional theory, which is mostly based on North's analytical frameworks.[71] Kang and Moon show that corporate governance and CSR are two broad, complementary systems to accommodate the obligations of businesses.[72] A key conceptual work on CSR and law is Eijsbouts' theory of CSR and law as a spectrum of mechanisms to enforce substantive social norms.[73] McBarnet provides a theory of multiple relationship types in which CSR can happen beyond, through or instead of the law.[74] The unilateral enforcement of CSR through legal instruments is addressed by Gond et al.[75] or Comminetti and Seele.[76] Liang and Renneboog provide the empirical evidence that legal systems are a major determinant of the nature and extent of CSR engagement.[77]

31 Finally, the law and economics literature has provided explanations on the purpose of CSR. Besley and Ghatak describe CSR as a way of voluntary public good provision,[78] Heal as a mechanism to internalise negative externalities.[79] Kitzmueller and Shimshack explain how this is the result of market forces and actor preferences.[80] Broadly, CSR is thus related to the literature on how private parties solve market failures based on the Coase Theorem.[81] Unlike either transactional bargaining or public regulation, however, CSR is understood as a unilateral mechanism *sui generis* and defined as a form of self-regulation.[82] Ogus and Carbonara adopt this explanation and define CSR as 'voluntary private self-regulation',[83] making it susceptible to the traditional economic analysis of private regulation put forward by Ogus[84] and Black.[85]

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[71] D. North, *Institutions, Institutional Change and Economic Performance*, Cambridge, Cambridge University Press, 1990.

[72] N. Kang & J. Moon, 'Institutional Complementarity between Corporate Governance and Corporate Social Responsibility: A Comparative Institutional Analysis of Three Capitalisms', *Socio-Economic Review*, vol. 10(1), 2012, pp. 85-108.

[73] J. Eijsbouts, *Corporate Responsibility, beyond Voluntarism: Regulatory Options to Reinforce the Licence to Operate*, Maastricht, Maastricht University Press, 2011.

[74] D. McBarnet, 'Corporate Social Responsibility beyond Law, through Law, for Law', in: D. McBarnet, A. Voiculescu & T. Campbell (eds.), *The New Corporate Accountability—Corporate Social Responsibility and the Law*, Cambridge, Cambridge University Press, 2009.

[75] J. Gond, N. Kang & J. Moon, 'The Government of Self-Regulation: On the Comparative Dynamics of Corporate Social Responsibility', *Economy and Society*, vol. 40(4), 2011, pp. 640-71.

[76] M. Cominetti & P. Seele, 'Hard Soft Law or Soft Hard Law? A Content Analysis of CSR Guidelines Typologized along Hybrid Legal Status', *uwf UmweltWirtschaftsForum*, vol. 24(2), 2016, pp. 127-40.

[77] H. Liang & L. Renneboog, 'On the Foundations of Corporate Social Responsibility', *Journal of Finance*, vol. 72(2), 2017, 853-910.

[78] T. Besley & M. Ghatak, 'Retailing Public Goods: The Economics of Corporate Social Responsibility', *Journal of Political Economy*, vol. 91(9), 2007, pp. 1645-63.

[79] G. Heal, 'Corporate Social Responsibility? An Economic and Financial Framework', *Geneva Papers on Risk and Insurance: Issues and Practice*, vol. 30(3), 2005, pp. 387-409.

[80] M. Kitzmueller & J. Shimshack, 'Economic Perspectives on Corporate Social Responsibility', *Journal of Economic Literature*, vol. 50(1), 2012, pp. 51-84.

[81] R. Coase, 'The Problem of Social Cost', *Journal of Law and Economics*, vol. 3(1), 1960, pp. 1-44.

[82] D. Baron, 'Morally Motivated Self-Regulation', *American Economic Review*, vol. 100(4), 2010, pp. 1299-1329.

[83] A. Ogus & E. Carbonara, 'Self-Regulation', in: G. de Geest (ed.), *Encyclopedia of Law and Economics*, Cheltenham, Edward Elgar, 2017.

[84] A. Ogus, 'Rethinking Self-Regulation', *Oxford Journal of Legal Studies*, vol. 15(1), 1995, pp. 97-108.

[85] J. Black, 'Constitutionalising Self-Regulation', *Modern Law Review*, vol. 59(1), 1996, pp. 24-55.

Section 5: Methodology

32 The main methodology in this thesis is derived from the economic analysis of law.[86] The first research question is answered using positive law and economics to understand the effects of executive pay regulation on CSR engagement as both an influential factor in corporate governance and part of a firm's institutional environment. The analytical approach itself is constructed drawing from agency theory to explain the internal, firm-level mechanisms of CSR determination and institutional theory for the relationship between CSR and law. The second research question requires a normative law and economics analysis to determine whether and how CSR-oriented pay regulation is socially desirable. This includes defining the social welfare contributions of CSR, its shortcomings and the failure of CSR emergence, as well as possible legal responses to remedy those shortcomings. While a significant strand of literature addresses CSR on a normative or purely theoretical level, this thesis develops a functional concept of CSR that is applicable in the different analyses of the thesis. A thorough emphasis is placed on describing CSR not on the macroscopic social level but applying methodological individualism and breaking it down on the singular-actor level.[87]

33 Empirical work is an integral component of CSR and corporate governance research. Throughout the dissertation, much attention is paid to the insights gained from existing empirical contributions to evaluate competing hypotheses. Empirical work is explained and localised in its theoretical context to develop an overview of the interactions and relationships between the different elements of CSR, compensation, law, and governance. A key part of the work conducted here is to connect disparate economic insights and translate them into legal and regulatory guidance.

34 Current CSR legislation and executive pay regulation are compared between jurisdictions using functional comparative analysis to highlight similarities and differences between analogous legal institutions and to explain their emergence.[88]

35 Finally, a case study is carried out to assess the role, interests, and influence of shareholders in CSR at the example of large index funds.[89] This is done, because shareholders are a firm's key constituency and the design of pay regulation majorly depends on the role that shareholders assume in corporate governance.

[86] Cp. F. Parisi, 'Positive, Normative and Functional Schools in Law and Economics', *European Journal of Law and Economics*, vol. 18(3), 2004, pp. 259-72.
[87] Cp. K. Arrow, 'Methodological Individualism and Social Knowledge', *American Economic Review*, vol. 84(2), 1994, pp. 1-9.
[88] Cp. K. Zweigert, 'Methodological Problems in Comparative Law', *Israel Law Review*, vol. 7(4), 1972, pp. 465-74; Kraakman et al. (2017), *supra* note 57.
[89] Cp. K. Eisenhardt & M. Graebner, 'Theory Building from Cases: Opportunities and Challenges', *Academy of Management Journal*, vol. 50(1), 2007, pp. 25-32.

Section 6: Structure

36 Including this introduction, the thesis is divided into seven chapters. Out of the following six chapters, one develops the analytical framework, two each address the first and second research question, while the last chapter forms a conclusion.

37 The second chapter lays the analytical foundation of the thesis by constructing the research framework. It answers three questions: what is CSR? What is the relationship between law and CSR? And how does compensation connect to CSR? It derives a definition of CSR that suits the research project and circumvents the shortcomings of existing concepts. A further differentiation is made by developing a tripartite categorisation of CSR activities that captures competing actor-level motivation for CSR engagement based on agency theory. The concept of CSR as self-regulation is used to discuss its relationship with law and to outline several distinct ways in which the two elements affect each other. Lastly, CSR and compensation are explained through their common link to financial performance. A literature review is then conducted to show what is already known about the relationship between CSR and executive pay.

38 *Chapter Three* begins to address the first research question. Building upon the framework developed in *Chapter Two*, it connects the elements of CSR, compensation, and law to analyse the effects of executive pay regulation on CSR. It covers the basic elements of pay governance prescriptions in US and EU corporate law that are designed to minimise shareholder-manager agency costs and discusses their effects on the different categories of CSR activities outlined before.

39 *Chapter Four* forms the second half of the answer to the first research question. Continuing the approach of *Chapter Three*, it covers pay regulation in the financial sector, which consists of structural regulation aimed to directly control decision-making incentives to prevent excessive risk-taking. This specific area is covered to gain a comprehensive overview of all the available legal instruments in pay regulation, which can either empower, protect, or restrict shareholder interests. The invasive regulatory regime of the financial is discussed as an outstanding example of a situation in which shareholder interests can oppose social welfare maximisation, which offers valuable insights on the design of CSR-oriented pay regulation. Thus, the chapter also outlines the conditions under which insights on the CSR-law relationship taken from a specific sector such as banking can be generalised to other areas of corporate law.

40 *Chapter Five* answers the second research question. It discusses the economic purpose of CSR, its shortcomings, and possible private and legal remedies. Based on that, new principles are developed for CSR-oriented pay regulation along the regulatory instruments analysed in the previous two *Chapters*.

41 The previous chapters have outlined the conditions under which the implementation of CSR-oriented pay regulation may function. *Chapter Six* addresses the most important variable in that endeavour, which is shareholder behaviour. It conducts a case study of the world's three major index funds and elucidates their proclaimed and factual engagement in CSR. *Chapter Six* answers three main questions: how do institutional investors affect CSR? What is the relative importance of shareholders as drivers of CSR compared to the ones identified so far? And, building upon those results, in which situations does pay regulation need to either empower, protect, or restrict shareholder interests to efficiently promote CSR engagement? Results are discussed as an outlook for the future development of corporate law and the integration of CSR.

42 Chapter Seven provides a summary of the thesis, discusses its conclusions, limitations and directions for future research. It positions this research project in the broader context of law and economics scholarship and critically evaluates its contribution.

Chapter Two
Constructing a Research Framework: CSR, Law and Executive Compensation

SUMMARY. This chapter provides a theoretical framework to analyse the effects of executive pay regulation on corporate social responsibility (CSR). To connect those two conceptually and methodologically disparate topics, three main questions are asked: what is CSR? What is the relationship between law and CSR? And how does executive pay connect to CSR? In answering these questions, a methodology for the subsequent analyses is constructed.

For this research project, CSR is defined as a "form of private self-regulation". This circumvents the shortcomings of conventional concepts and links the economic, institutional, and legal literature of CSR. It also connects to the existing literature on self-regulation, opening CSR to an economic analysis under social-welfare considerations. It is furthermore shown that CSR is not, as often conjectured, a 'voluntary activity' unrelated to law. Instead, legal systems are a major determinant of CSR; specific legal rules can substitute, incentivise, or restrict CSR engagement.

On the firm level, a new categorisation of CSR activities is constructed using agency theory and behavioural economics to analyse its different financial and non-financial motivations. This categorisation consists of (i) instrumental CSR, (ii) managerial CSR, and (iii) CSR as delegated shareholder philanthropy. Lastly, the role of executive compensation, as part of the broader corporate governance environment and a CSR incentive is covered. Based on an empirical literature review, it is shown that particularly pay-for-performance instruments cause an alignment of CSR engagement with financial performance and that CSR-performance targets are a second governance tool to influence CSR engagement.

This chapter demonstrates that both legal rules and executive compensation are forces that shape CSR. It identifies gaps in the existing theoretical and empirical literature and develops a methodology to research the effects of executive pay regulation on CSR engagement.

Section 1: Introduction

1 The decade that has passed since the financial crisis was a remarkably prominent period to observe 'social concerns' forming a recurrent motivation in legislative initiatives to regulate executive pay.[1] At the same time, legislators like the European Union have also become visible actors in the rising field of corporate social responsibility (CSR), trying to promote CSR

[1] For a critical review, cp. K. Murphy & M. Jensen, 'The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation', *Journal of Law, Finance, and Accounting*, vol. 3(2), 2018, pp. 189-242.

engagement through legal instruments.[2] This thesis argues that a connection between those different developments exists and that executive pay regulation should be considered as a determinant of CSR engagement and potential instrument of CSR policymaking.

2 The two research projects resulting from this approach—a positive analysis of the effects of executive pay regulation on CSR engagement and a normative analysis of CSR as a potential objective of pay regulation—require more light to be shed on this vague connection, though. Laws on executive pay and CSR seem to be neither thematically nor methodologically linked in any direct way at first sight. As a first step, this chapter thus establishes how these different topics are interrelated and develops a corresponding research methodology. More specifically, the chapter asks three questions: first, what is CSR at all? This is a surprisingly complex question and the choice of answer is crucial for the methodological approach. Secondly, what is the relationship between CSR and the law? CSR, a form of ostensibly voluntary corporate engagement,[3] and legal coercion do not seem to fit easily. That makes it necessary to clarify the basic role of law in it. Lastly, how does executive pay connect to CSR? To analyse the effects of executive pay regulation on CSR, the relationship of executive pay as an element of private corporate governance[4] with CSR needs be understood first. Taken together, the answers to these three questions form the baseline to the analysis of the remainder of the thesis.

3 As the object of inquiry in this research, it is an obvious first step to define CSR. This is difficult though, as CSR is a complex issue and no universally agreed upon definition exists. Another distinction needs to be made between the notion of CSR and its actual practice.[5] That is why a differentiation is made between CSR as a theoretical concept and a description of corporate behaviour. Merging different schools of thought, this thesis argues that the concept of CSR is best understood as a 'form of private self-regulation'.[6] This definition not only conceptualises the development of CSR more accurately than conventional definitions in management studies, but also explains its economic and societal function. As an alternative to legal rules in expressing and enforcing social norms,[7] CSR as self-regulation has an intricate relationship with the law that is susceptible to the analytical methodology of law and economics.

4 The link between self-regulation and legal rules is exploited to develop a framework of the relationship between CSR and the law. While the role of law in CSR is often reduced to that of a compliance baseline beyond which CSR begins, it is in fact more complex. This chapter argues that different elements of the law can promote, substitute, or prohibit CSR engagement. This framework allows to research the interplay of legal rules and CSR and serves as the basis for the analysis of the effects of executive pay regulation on CSR. It is also used to set the results of this analysis into the context of other forms of CSR-related legislation.[8]

5 CSR on the firm level requires a different approach than what has been used to develop the definition of CSR as an abstract concept and its relationship with the law. As the economic

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[2] See *infra*, para. 17-19.
[3] Different notions of what constitutes CSR are discussed *infra*, para. 11 et seq.
[4] Cp. G. Ferrarini & M. Ungureanu, 'Executive Remuneration', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[5] Cp. A. Carroll, 'A History of Corporate Social Responsibility: Concepts and Practices', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.
[6] See *infra*, para. 21 et seq.
[7] Cp. G. Morgan & S. Quack, 'Law as a Governing Institution', in: G. Morgan et al. (eds.), *The Oxford Handbook of Comparative Institutional Analysis*, Oxford, Oxford University Press, 2010.
[8] Cp. *infra*, para. 38.

purpose of CSR as self-regulation offers a link between theory and practice, it is argued that focus should lie on a delineation of corporate activities. The corporate governance literature distinguishes CSR based on its motivations and treats it either as a financial investment or an agency problem. The empirical literature shows that these are not mutually exclusive explanations for CSR, but instead describe different forms of it. Insights corporate scholarship has adopted from behavioural economics furthermore indicate that the non-financial preferences of shareholders cannot be subsumed under the conventional focus on financial performance. Thus, a novel, tripartite categorisation of CSR activities is developed that allows to analyse different concurrent motivations for CSR engagement in varying governance settings. It includes financially motivated 'instrumental CSR', 'managerial CSR' as an agency problem, and 'delegated shareholder philanthropy' as a special form of non-financial preferences, imposed as a corporate objective by shareholders. This categorisation serves as the definition of CSR used in the subsequent analyses of the thesis.

6 Staying on the firm level, the last question for the link between executive compensation and CSR is answered. As a central instrument of corporate governance to align managers' incentives with the interests of shareholders,[9] executive pay shares the alignment with financial performance that has also been developed under agency theory for CSR. The empirical literature indicates that executive pay, as an incentive for managerial decision-making, also affects CSR engagement. Understanding this influence is a necessary step to analyse how the changes in compensation arrangements and the pay-setting process caused by regulatory intervention affect CSR.

7 In answering the three questions, the chapter draws from different theoretical fields to connect the disparate topics of CSR, law and executive pay. Institutional theory is employed to define the concept of CSR as self-regulation and to elucidate its relationship with the law. Agency theory in turn is the common frame for the categorisation of CSR activities and the influence of executive compensation on CSR. Both theories are compatible, as institutional theory is used to cover CSR on the macro-level from a social welfare perspective and agency theory for CSR on the firm level with a focus on private actors. This dual-track methodology allows to analyse different layers of CSR consistently and is maintained throughout the remainder of the thesis.

8 The following *Section 2* explains the problems of conventional definitions of CSR and introduces the concept of CSR as a form of private self-regulation. *Section 3* builds on that and provides a framework for the relationship between CSR and the law. *Section 4* turns to CSR on the firm level and develops a tripartite categorisation of CSR activities. The literature review of executive compensation and CSR follows in *Section 5*; *Section 6* concludes.

Section 2: Defining CSR

9 Reaching a working definition of CSR for this research is a more complicated endeavour than at first it may seem. CSR is a complex topic with no universally agreed upon definition. *Section 2.1* explains the underlying reasons for this problem, showing that any definition must be developed from the analytical context in which it is to be used. It is shown that the traditional

[9] Cp. M. Jensen & W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *Journal of Financial Economics*, vol. 3(4), 1976, pp. 305-60.

concepts of CSR, which understand it as a form of voluntary engagement, are ill-suited: they fail to explain the historical development of CSR practice and do not account for the role of law in CSR, a relationship which ought to receive special attention due to the research focus. In *Section 2.2*, the concept of CSR developed here is compared to and delineated from the topic of ESG, which has permeated the debate on sustainability issues especially in management studies and investing.

10 As an alternative to those concepts, *Section 2.3* introduces the definition of CSR as a 'form of private self-regulation.' It explains why this definition is superior to the concept of CSR as 'voluntary engagement' and connects it to the relevant legal and economic literature. The benefits of this definition in assessing CSR from a social welfare perspective are explained as well as its use in the following section on CSR and the law.

2.1 Conventional Definitions and Their Shortcomings

11 Because of said distinction between the meaning and practice of CSR, this section starts with the notion behind it to examine how this idea translates into different concepts. After delineating the territory for defining CSR, criteria for the adoption of a definition can be identified.

12 What is CSR about? Most basically, it is concerned with the ethical aspects of the impact modern corporations have on their social and ecological environment. As Davis phrased it in 1973, it is "the firm's consideration of, and response to, issues beyond the narrow economic, technical, and legal requirements of the firm."[10] This view has expanded and become more integrative since then. The *Oxford Handbook on Corporate Social Responsibility* describes CSR as a way of "conceptualising the business and society interface".[11] Instead of a delimitation, focus is shifted towards the interplay of those legal, economic, ethical and social obligations of businesses.[12] In practice, social or ethical responsibilities are considered those in which corporations engage voluntarily, exceeding legal compliance and adhering to the expectations of 'society.'

13 Specific definitions of CSR can vary significantly, however: within the *Oxford Handbook*, they range from "discretionary spending in furtherance of [… a] social objective consistent with relevant social norms and laws"[13] to an "obligation to respond to the externalities created by

[10] K. Davis, 'The Case for and Against Business Assumption of Social Responsibilities', *Academy of Management Journal*, vol. 16(2), 1973, pp. 312-22, at p. 312. On the relevance of this contribution to modern CSR scholarship, see the explanation *infra*, para. 54.

[11] A. Crane et al., 'The CSR Agenda', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.

[12] This description is based on Carroll's highly influential contributions to the theory of CSR, see A. Carroll, 'A Three-Dimensional Conceptual Model of Corporate Performance', *Academy of Management Review*, vol. 4(4), 1979, pp. 497-505; A. Carroll, 'The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders', *Business Horizons*, vol. 34, 1991, pp. 39-48.

[13] T. Dunfee, 'Stakeholder Theory: Managing Corporate Social Responsibility in a Multiple Actor Context', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.

market action".[14] A main reason for this divergence is that in CSR research, many disciplines—economics, ethics, law, sociology—convene, each with a different focus and methodology. Despite these differences, certain similarities in the content of definitions are observable. According to a survey by Dahlsrud, the most influential concepts of CSR all share five recurring key characteristics:[15] (i) a reference to environmental protection, (ii) the aim of contributing to a better society, (iii) a specification of the role of business in this, (iv) stakeholder relations as another important form of engagement, and (v) voluntary engagement by companies. This shows that there is a consensus on the topics CSR should address. Within this delineated territory, however, divergence remains on how CSR should deal with those topics.

14 Why is there no universally adopted concept of CSR—not even within the same discipline and shared methodology? According to Matten and Moon, there are three separate reasons for this, which need to be addressed to reach a definition.[16] The central problem is that within the academic debate, CSR is an 'essentially contested concept.'[17] This means that its core defining characteristics remain disputed due to the persistence of normative dissent.[18] On the level of CSR as an abstract concept, the debate is not about the descriptive use of the term for corporate practices, but about the objective and purpose of CSR. The cause for this lies in the nature of the topic, as CSR formulates "social imperatives".[19] It cannot be restricted to a purely descriptive use, as CSR "captures both a normative idea and a positive description of some behaviour."[20] Scholarship has produced two reactions to this dilemma: a first view holds that this lack of consensus on the normative dimension of CSR cannot be resolved and research needs to subsist with an undefined concept.[21] Another direction contends that research should develop a definition that is sufficiently abstract in both its normative core and its behavioural description to include and express that normative dissent.[22] It is this latter view that is adopted and pursued in the following section.[23]

15 The other two reasons listed by Matten and Moon of why defining CSR is difficult support this approach, too:[24] first, CSR is an 'umbrella term', overlapping and competing with various other

[14] J. Salazar & B. Husted, 'Principals and Agents: Further Thoughts on the Friedmanite Critique of Corporate Social Responsibility', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.
[15] A. Dahlsrud, 'How Corporate Social Responsibility is Defined: An Analysis of 37 Definitions', *Corporate Social Responsibility and Environmental Management*, vol. 15(1), 2008, pp. 1-13.
[16] D. Matten & J. Moon, '"Implicit" and "Explicit" CSR: A Conceptual Framework for a Comparative Understanding of Corporate Social Responsibility', *Academy of Management Review*, vol. 33(2), 2008, pp. 402-24, at pp. 405-06.
[17] Cp. J. Moon, A. Crane & D. Matten, 'Can Corporations Be Citizens? Corporate Citizenship as a Metaphor for Business Participation in Society', *Business Ethics Quarterly*, vol. 15(3), 2005, pp. 429-53.
[18] W. Gallie, 'Essentially Contested Concepts', *Proceedings of the Aristotelian Society*, vol. 56(1), 1956, 167-98.
[19] Matten & Moon (2008), *supra* note 16, at p. 405.
[20] B. Sheehy, 'Defining CSR: Problems and Solutions', *Journal of Business Ethics*, vol. 131(3), 2015, pp. 625-48, at p. 640.
[21] Cp. J. Gond & J. Moon, *Corporate Social Responsibility in Retrospect and Prospect: Exploring the Life-Cycle of an Essentially Contested Concept*, New York, Routledge, 2011.
[22] E.g. Sheehy (2015), *supra* note 20.
[23] *Infra*, para. 21 et seq.
[24] Matten & Moon (2008), *supra* note 16.

concepts.[25] Using them concurrently can either serve a delineation or create redundancies.[26] For the most part, this diverse terminology is the result of said normative disagreement on the idea of CSR. That is why this thesis adopts the single term of 'CSR,' with a differentiation on the level of behavioural descriptions for corporate activities, covered in *Section 4*.[27] Lastly, CSR is a 'dynamic phenomenon,'[28] whose notion and realisation differ across time, cultures and individual corporations.[29] This entails a trade-off between specific and general explanatory capacity. As the analysis in this thesis follows a comparative approach to CSR in different legal settings, this also speaks in favour a more abstract definition.

16 Taken together, these three issues—CSR being an essentially contested concept, an umbrella term, and a dynamic phenomenon—explain why every research project requires a definition of CSR justified by its individual approach and methodology. As this thesis deals with the relationship between CSR and executive pay regulation, special attention is required for the role of legal rules within CSR. Traditional concepts of CSR pose an obstacle to this approach, however: as Dahlsrud shows,[30] a key characteristic of CSR is 'voluntary engagement'. This view, which has its roots in the management literature,[31] is meant to delineate CSR from activities firms are legally or contractually required to carry out. Despite its persistence in the way CSR has always[32] been understood, this thesis argues that it is ill-conceived. Besides methodological shortcomings, which are addressed at a later stage,[33] it fails to conceptualise the factual development of CSR within the last decades. This particularly concerns the increased involvement of legislators in CSR and its perception by businesses. The development of CSR regulation in the European Union is a paradigmatic example to illustrate this new role of legislators as well as the problems of the 'voluntary' or 'beyond compliance' view in that context.

17 The EU introduced CSR into its public policy in the context of the Lisbon Agenda, a framework strategy for economic development, where it served as a contribution to sustainability and innovation.[34] The European Commission subsequently published a Green Paper in 2001 on an EU framework for CSR, where it initially defined it as a "concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with stakeholders on a voluntary basis."[35] This is a salient example of a definition containing all of

[25] These concepts may for example be corporate citizenship, corporate social performance, corporate sustainability or business philanthropy. For a critical overview, cp. D. Baden & I. Harwood, 'Terminology Matters: A Critical Exploration of Corporate Social Responsibility Terms', *Journal of Business Ethics*, vol. 116(3), 2013, pp. 615-27.
[26] Cp. D. Matten & A. Crane, 'Corporate Citizenship: Toward an Extended Theoretical Conceptualisation', *Academy of Management Review*, vol. 30(1), 2005, pp. 166-79.
[27] *Infra*, para. 50 et seq.
[28] Matten & Moon (2008), *supra* note 16.
[29] For an overview cp. A. Carroll, 'Corporate Social Responsibility—Evolution of a Definitional Construct', *Business & Society*, vol. 38(3), 1999, pp. 268-95.
[30] Dahlsrud (2008), *supra* note 15; cp. *supra*, para. 13.
[31] Cp. A. McWilliams & D. Siegel, 'Corporate Social Responsibility: A Theory of the Firm Perspective', *Academy of Management Review*, vol. 26(1), 2001, pp. 117-27.
[32] Voluntariness as an essential characteristic of CSR can already be found in its seminal theoretical works, cp. H. Bowen, *The Social Responsibilities of the Businessman*, New York, Harper, 1953; Davis (1973), *supra* note 10; Carroll (1979), *supra* note 12; and Carroll (1991), *supra* note 12.
[33] *Infra*, para. 25.
[34] European Council, *Lisbon European Council 23 and 24 March 2000 Presidency Conclusions*, 2000.
[35] European Commission, *Green Paper: Promoting a European Framework for Corporate Social Responsibility*, 2001, DOC/01/9, at p. 6.

Dahlrud's five key characteristics.[36] The EU regarded CSR as a contribution of the business sector to society by not only meeting the requirements of the law but going 'beyond compliance' in the treatment of employees, stakeholder relations and the environment. Further central aspects are its characterisation as inherently voluntary and "not [...] a substitute to regulation or legislation concerning social rights or environmental standards".[37] As such, the EC adopted the existing understanding of CSR in the academic literature. This was mostly developed in North America and understood CSR as an endeavour in which firms engage voluntarily out of an 'enlightened self-interest'[38] that pays off financially in the long term.[39] The EU's initiative was interpreted as a reaction to the rise of CSR on the international stage and seminal legislative developments in Member States like the UK or Denmark.[40]

18 Based on a feedback process[41] and as a response to the global financial crisis and its impact on public trust in businesses, the EC published a 'Renewed CSR Strategy' in 2011. It contained a new definition of CSR as "the responsibility of enterprises for their impacts on society."[42] This redefinition amounted to a shift in paradigm, changing the understanding of 'voluntary engagement' and the role of policymakers. The necessity of going 'beyond compliance' in corporate efforts was reiterated as a "prerequisite" to qualify as CSR in the new definition. However, the Commission no longer left the decision of how CSR investments should look like to the discretion of the firm. Describing CSR as no "optional 'add-on' […] but about the way in which businesses are managed",[43] the EC specified new requirements: corporate processes were to integrate stakeholder concerns into all tiers of decision-making to avert negative impacts on third parties, maximising value for both shareholders and stakeholders. The Commission also recommended the inclusion of risk-based due diligence assessments for supply chains and the adoption of formal CSR guidelines where available.[44] This reduction in discretion corresponds to the fact that any wording of 'voluntariness' had deliberately been dropped from the new definition. Even though the Renewed Strategy emphasised that CSR remains a concept primarily driven and led by the corporate sector, it also stressed the role of public policymakers to create an environment that encourages CSR through supporting and complementary regulation.[45]

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[36] Dahlsrud (2008), *supra* note 15; cp. *supra*, para. 13.
[37] European Commission, (2001), *supra* note 35, at p. 6.
[38] Cp. M. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function', *Business Ethics Quarterly*, vol. 12(2), 2002, pp. 235-56.
[39] Cp. *infra*, para. 51 et seq.
[40] For an analysis of the emergence of CSR as a topic in European policy-making, see: L. Eberhard-Harribey, 'Corporate social responsibility as a new paradigm in the European policy: how CSR comes to legitimate the European regulation process', *Corporate Governance*, vol. 6(4), 2006, pp. 358-68.
[41] In 2002, the EC launched a 'European Multi-Stakeholder Forum' to develop further policy recommendations, see European Commission, *Communication from the Commission concerning Corporate Social Responsibility: A business contribution to Sustainable Development*, 2002, COM(2002) 347 final.
[42] European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions A Renewed EU strategy 2011-14 for Corporate Social Responsibility*, 2011, COM(2011) 681 final, at p. 6.
[43] European Commission (2002), *supra* note 41, at p. 5.
[44] European Commission (2011), *supra* note 42, at p. 6.
[45] This already started in 2006, see European Commission, *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee Implementing the Partnership for Growth and Jobs: Making Europe a Pole of Excellence on Corporate Social Responsibility*, 2006, COM(2006) 136 final.

19 Both the EU's new understanding of CSR as well as the role it envisages for public regulation in promoting CSR indicate a stronger influence of public authorities and, more generally, a closer interdependence between law and CSR. This is by no means an isolated trend: the audit and consultancy firm 'KPMG' noted in its global survey on corporate sustainability reporting in 2017 that "voluntary guidelines are rapidly transitioning into mandatory reporting requirements in many parts of the world."[46] The debate on the difficulty of a distinction between mandatory and voluntary engagement has been ongoing for a longer time, as CSR was increasingly experienced as a factual obligation and "less as a concept that companies can either buy into or not".[47] CSR reporting was evolving into "*de facto* law for business".[48] The UN Special Representative on Business and Human Rights eventually came to the conclusion that a dichotomous distinction between mandatory and voluntary engagement is "artificial."[49] The conclusion from this development is, in Eijsbouts' words, that the view of CSR as voluntary engagement "must be challenged on two levels: first, adoption [….] is for many companies no longer voluntary, and, second, the content [… of CSR] is no longer optional in many respects."[50]

20 The understanding of CSR as 'beyond compliance' and voluntary engagement clearly does not—at least not anymore[51]—capture reality: it fails to account for the role policymakers and legislators occupy in CSR today and misses its perception by businesses. In scholarship, this approach has yet failed to induce any convergence in the multitude of competing CSR definitions, leaving the arbitrariness of CSR concepts as a persistent intellectual and practical weakness of the discipline.[52] More importantly though, concepts building upon the 'mandatory vs. voluntary engagement' view have a severe methodological shortcoming, as they do not account for the basic relationship between CSR and legal norms. In the words of Brammer et al., it captures "just a fraction of corporate activities at the interface of business and society."[53] The remainder of this section explains how this relationship stretches far beyond legislators' attempts to influence corporate trends. Instead, it is explained why the relationship between

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[46] KPMG, KPMG International Survey of Corporate Responsibility Reporting 2017, p. 7, available at https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2017/10/kpmg-survey-of-corporate-responsibility-reporting-2017.pdf.
[47] S. Idowu, R. Schmidpeter & M. Fifka (eds.), *Corporate Social Responsibility in Europe*, Heidelberg, Springer, 2005, at pp. 504-05.
[48] KPMG, KPMG International Survey of Corporate Responsibility Reporting 2011, available at https://www.kpmg.de/docs/Survey-corporate-responsibility-reporting-2011.pdf.
[49] Business and Human Rights: SRSG (UN Special Representative of the Secretary General) Consultation,
Summary Report, *Improving the Human Rights Performance of Business through Multi-Stakeholder Initiatives*, The Hague, Netherlands, 6–7 November 2007.
[50] J. Eijsbouts, 'Corporate Codes as Private Co-Regulatory Instruments in Corporate Governance and Responsibility and Their Enforcement', *Indiana Journal of Global Legal Studies*, vol. 24(1), 2017, pp. 181-205.
[51] Some argue that earlier stages of CSR can still adequately be described as 'voluntary engagement', e.g. C. Williams, 'Corporate Social Responsibility and Corporate Governance', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[52] Cp. F. Bakker, P. Groenewegen & F. den Hond, 'A Bibliometric Analysis of 30 Years of Research and Theory on Corporate Social Responsibility and Corporate Social Performance', *Business and Society*, vol. 44(3), 2005, pp. 283-317.
[53] S. Brammer, G. Jackson & D. Matten, 'Corporate Social Responsibility and Institutional Theory: New Perspectives on Private Governance', *Socio-Economic Review*, vol. 10(1), 2012, pp. 3-28, at p. 21.

CSR and the law is actually the key to understand CSR, and how this results in a definition of CSR as a 'form of private self-regulation.'

2.2 CSR as Self-Regulation

21 Law is a central element of the environment that shapes CSR. A key empirical contribution by Liang and Renneboog from 2017 shows that, in fact, the legal system of a company's country of origin is the strongest single determinant of CSR engagement.[54] They, as well as similar studies,[55] connect this influence to specific legal elements and provisions, such as shareholder rights and public regulation protecting stakeholders or the environment. The empirical legal literature makes an important contribution by documenting the general influence of the law on CSR and by identifying important junctions of a causal relationship. However, empirical contributions alone fail to provide a coherent, more overarching theory.

22 One such potential theory is Matten and Moon's comparative model of 'implicit' and 'explicit' CSR.[56] Building upon general approaches to cross-national divergences in corporate governance,[57] their central proposition is an explanation of when CSR occurs: the authors contend that obligations towards the various corporate stakeholders can either be an integrated part of the regulatory, contractual and governance system ('implicit'), or be left to the discretion of corporations to engage in what is conventionally understood as CSR ('explicit'). They argue that CSR has traditionally been a North American endeavour, because European systems had integrated the social obligations of companies into their 'national business environments.'[58] The more recent turn towards 'explicit' CSR in Europe could also be explained by the same institutional forces,[59] especially the involvement of governments and stakeholder organisations.[60] The socio-economic focus of this approach has mainly given rise to subsequent inquiries into the complementarity between corporate governance and CSR,[61] to which more attention is paid below.[62] Additionally, though, Matten and Moon offer two central insights about the relationship between CSR and the law: first, that the two elements are complementary, as obligations can either be translated into law or into CSR. Secondly, the

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[54] H. Liang & L. Renneboog, 'On the Foundations of Corporate Social Responsibility', *Journal of Finance*, vol. 72(2), 2017, pp. 853-910.
[55] E.g. C. Gainet, 'Exploring the Impact of Legal Systems and Financial Structure on Corporate Responsibility', *Journal of Business Ethics*, vol. 95(2), 2010, pp. 195-222; A. Ferrell, H. Liang & L. Renneboog, 'Socially Responsible Firms', *Journal of Financial Economics*, vol. 122(3), 2016, pp. 585-606.
[56] Matten & Moon (2008), *supra* note 16.
[57] E.g. L. Bebchuk & M. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance', *Stanford Law Review*, vol. 52(1), 1999, 127-70; R. Aguilera & G. Jackson, 'The Cross-National Diversity of Corporate Governance: Dimensions and Determinants', *Academy of Management Review*, vol. 28(3), 2003, pp. 447-65.
[58] On the comparative analysis of 'national business systems', cp. R. Whitley, *Divergent Capitalisms: The Social Structuring and Change of Business Systems*, Oxford, Oxford University Press, 1997.
[59] Matten & Moon (2008), *supra* note 16.
[60] As Schmidpeter et al. emphasise: "In Europe, legal and institutional frameworks have largely set the stage for socially responsible behavior", Idowu et al. (2015), *supra* note 47, at p. 505.
[61] Cp. N. Kang & J. Moon, 'Institutional Complementarity between Corporate Governance and Corporate Social Responsibility: A Comparative Institutional Analysis of Three Capitalisms', *Socio-Economic Review*, vol. 10(1), 2012, pp. 85-108.
[62] *Infra*, para. 50.

government and legal system can function as active drivers of CSR engagement. While this approach explains when CSR occurs, it leaves the process through which obligations are translated into either law or CSR unaddressed.

23 Among the legal theorists who have stepped into this breach, Eijsbouts has made a central contribution on CSR and law as two alternatives for the enforcement of social norms.[63] He claims that CSR consists of "multiple substantive social norms"[64] enforced through "multiple regulatory forms".[65] The first part of this proposition refers to the normative dissent that makes defining CSR problematic, which has been outlined above.[66] It responds to the problem why, in the words of Brammer et al., "a universally adopted definition [is] not even desirable":[67] acknowledging the multiple social norms at the core of CSR can be the first step towards a definition that includes this multiplicity. Eijsbouts outlines the function of those norms as "internalizing or managing externalities, multiple stakeholder orientation and alignment of social and economic responsibilities",[68] which notably corresponds to the general functions of the law.

24 The second aspect—the 'multiple regulatory forms' of CSR—means that there is no sharp distinction between CSR and law as methods of enforcing social norms. Instead, the two are better seen as the ends of a spectrum of enforcement methods with varying degrees of codification.[69] A substantive social norm can, for example, be enforced through law, CSR, or both simultaneously. In turn, this means that CSR is not merely the outcome of a certain institutional environment, notably its legal system.[70] Instead, law and CSR serve as alternatives in the form of public or private institutions: institutions are expressions of social norms with an attached sanctioning mechanism;[71] they can be codified and enforced by the state's monopoly of force or stay informal rules that rely on social sanctions. From this institutional approach to CSR, two important results are yielded: based on this understanding of the relationship between CSR and the law, a definition of CSR can be derived that fills the "black box"[72] of the social element in CSR, whose void has produced the 'voluntary engagement' view. Secondly, this approach also serves as the basis for an extended analysis of the bidirectional relationship between CSR and the law, conducted in the subsequent section.[73]

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[63] J. Eijsbouts, *Corporate Responsibility, beyond Voluntarism: Regulatory Options to Reinforce the Licence to Operate*, Maastricht, Maastricht University Press, 2011.
[64] Ibid., at p. 15.
[65] Ibid., at p. 22.
[66] *Supra,* para. 14.
[67] Brammer et al. (2012), *supra* note 53, at p. 21.
[68] Eijsbouts (2011), *supra* note 63, at p. 14.
[69] Eijsbouts uses the term "concentric circles of CSR regulation", that range from 'decent business' at the centre outwards to self-regulation & soft law, mandatory transparency, corporate law, tort law, and administrative & criminal law as the strictest forms of codification; ibid., at p. 23. The model and its alternatives are discussed the following section, see *infra*, para. 34 et seq.
[70] Cp. Morgan & Quack (2010), *supra* note 7.
[71] North defines institutions as "humanly devised constraints that shape interaction", Voigt's more detailed definition is that of "commonly known rules to structure recurrent interaction situations that are endowed with a sanctioning mechanism." See D. North, *Institutions, Institutional Change and Economic Performance*, Cambridge, Cambridge University Press, 1990, at p. 3; S. Voigt, 'How (Not) to Measure Institutions', *Journal of Institutional Economics*, vol. 9(1), 2013, pp. 1-26, at p. 5.
[72] Brammer et al. (2012), *supra* note 53, at p. 4.
[73] *Infra*, para. 34.

25 The issues outlined so far can be addressed by defining CSR as a form of 'self-regulation'. The 'self' in self-regulation entails that CSR is a privately organised way of enforcing norms, which can vary in its formality or explicitness.[74] This includes 'discretionary spending' in Dunfee's definition mentioned at the beginning of *Section 2.1*[75] as much as the perception of CSR as '*de facto* law for business.'[76] 'Regulation' in turn acknowledges that CSR has a normative core enforced in some way through behavioural constraints and (positive or negative) sanctions.[77] These sanction can take any form and range from bad reputation for 'irresponsible behaviour,' affecting consumer and investor preferences, to the suspension from industry organisations promoting codes of corporate conduct. Even though 'regulation' is here understood in a broader sense than the traditional legal concept,[78] legal terminology can be employed to differentiate the various ways of CSR enforcement.[79]

26 The definition of 'self-regulation' is abstract enough to address the challenge of CSR as an 'essentially contested concept',[80] as the term 'regulation' implies the possibility of expressing multiple social norms. Again, though, specific definitions vary: Norman writes of "self-regulation",[81] Vogel of "private regulation",[82] Sheehy reaches the definition of "international private self-regulation".[83] Highlighting the complementary relationship between CSR and the law, Eijsbouts explicitly favours "co-regulation" over self-regulation.[84] None of these concepts show normative dissent or are mutually exclusive, however. That is why, here, CSR is simply defined as a 'form of private self-regulation.' A single delineation is made, though, from concepts of CSR as "morally motivated self-regulation".[85] As is explained below in greater detail,[86] restricting CSR to moral or altruistic motives omits the financial self-interest dimension of CSR and fails to explain its professionalisation beyond core business ethics.

[74] Voigt distinguishes four types of private institutions based on enforcement: conventions (self-enforcement), ethical rules (self-commitment), customs (informal societal control) and formal private rules (organised private enforcement). CSR can mainly consist of ethical rules, customs, and formal private rules, e.g. codes of conduct; see Voigt (2013), *supra* note 71, at p. 6.
[75] Dunfee (2008), *supra* note 13; *supra* para. 13.
[76] Cp. *supra*, para. 19.
[77] Sheehy (2015), *supra* note 20.
[78] On the legal concepts of regulation, cp. J. Black, *Regulatory Innovation: A Comparative Analysis*, Cheltenham, Edward Elgar Publishing, 2005.
[79] W. Norman, 'Business Ethics as Self-Regulation: Why Principles that Ground Regulations Should Be Used to Ground Beyond-Compliance Norms as Well', *Journal of Business Ethics*, vol. 102(1), 2011, pp. 43-47.
[80] Defining CSR as self-regulation embraces its normative variety. Sheehy concludes: "CSR is not truly an essentially contested concept. Rather, […] the issue is not epistemological; instead, it is ontological marked by a strong normative disagreement. [… W]hat type of thing or phenomenon is CSR? It may be no more than a simple tool in the toolkit of managers, or an effort to regulate industrial organisations' harms including social costs." See Sheehy (2015), *supra* note 20, at pp. 636-37.
[81] Norman (2011), *supra* note 79.
[82] D. Vogel, 'The Private Regulation of Global Corporate Conduct: Achievements and Limitations', *Business and Society*, vol. 49(1), 2010, pp. 68-87.
[83] Sheehy (2015), *supra* note 20.
[84] Eijsbouts (2017), *supra* note 50.
[85] D. Baron, 'Morally Motivated Self-Regulation', *American Economic Review*, vol. 100(4), 2010, pp. 1299-1329; A. Ogus & E. Carbonara, 'Self-Regulation', in: G. de Geest (ed.), *Encyclopedia of Law and Economics*, Cheltenham, Edward Elgar, 2017, at pp. 244-46.
[86] *Infra*, para. 63 et seq.

27 What are the implications of defining CSR as self-regulation? In legal sciences, 'self-regulation' originally used to refer to "law formulated by private agencies to govern professional and trading activities".[87] It can be the result of either governmental delegation[88] or autogenous emergence.[89] The modern understanding, especially in law and economics,[90] is much broader and encompasses the spectrum of collective and derivative individual constraints that do not directly emanate from governmental regulation and are not the result of pure market behaviour alone.[91] Just like public hard law, self-regulation is a response to market failure and can be a more efficient solution than the former.[92] Ogus and Carbonara's view of CSR in law and economics shares the approach of defining it as self-regulation and describes its function as "the voluntary (private) provision of a public good".[93] This is congruent with the economic literature on the role of CSR: Kitzmueller and Shimshack equally define CSR as a "public good provision"[94] channel, as do Besley and Ghatak.[95] Heal follows the same approach of CSR as a response to market failure and defines CSR as "actions taken to reduce externalized costs or to avoid distributional conflicts".[96] Further theories of CSR as a unilateral business response to externalities come from Beltratti[97] or Heath.[98] It is evident that the definition of CSR as private self-regulation is underpinned by the institutional, legal, and economic literature. That is why, based on Ogus and Carbonara and the relevant economic theories of CSR, the definition of 'private self-regulation' adopted here is further refined by describing its function as 'the voluntary provision of public goods, internalisation of externalities or private redistribution.'

28 'Voluntary' here describes the unilateral, self-imposed collective and individual constraints of businesses. This delineates CSR from externality internalisation through either direct governmental regulation or the market mechanism. It is captured very well by Baron's description of CSR as "providing benefits beyond those generated by economic transactions

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87 Ogus & Carbonara (2017), *supra* note 85, at p. 228; also cp. I. Bartle & P. Vass, 'Self-Regulation within the Regulatory State: Towards a New Regulatory Paradigm?', *Public Administration*, vol. 85(4), 2007, pp. 885-905.
88 Cp. P. DeMarzo, M. Fishman & K. Hagerty, 'Self-Regulation and Government Oversight', *Review of Economic Studies*, vol. 72(3), 2005, pp. 687-706.
89 On the most prominent example of medieval and modern *lex mercatoria*, cp. A. Greif, P. Milgrom & B. Weingast, 'Coordination, Commitment, and Enforcement: The Case of the Merchant Guild', *Journal of Political Economy*, vol. 102(4), 1994, pp. 745-76; G. Cuniberti, 'Three Theories of *Lex Mercatoria*', *Columbia Journal of Transnational Law*, vol. 52(1), 2013, pp. 369-434.
90 Ogus & Carbonara (2017), *supra* note 85.
91 See A. Ogus, 'Rethinking Self-Regulation', *Oxford Journal of Legal Studies*, vol. 15(1), 1995, pp. 97-108; J. Black, 'Constitutionalising Self-Regulation', *Modern Law Review*, vol. 59(1), 1996, pp. 24-55.
92 Ogus (1995), *supra* note 91.
93 Ogus & Carbonara (2017), *supra* note 85, at p. 244. Note that "voluntary" here corresponds to the understanding of CSR as "morally motivated" as explained *supra* note 16.
94 M. Kitzmueller & J. Shimshack, 'Economic Perspectives on Corporate Social Responsibility', *Journal of Economic Literature*, vol. 50(1), 2012, pp. 51-84.
95 T. Besley & M. Ghatak, 'Retailing Public Goods: The Economics of Corporate Social Responsibility', *Journal of Political Economy*, vol. 91(9), 2007, pp. 1645-63.
96 G. Heal, 'Corporate Social Responsibility? An Economic and Financial Framework', *Geneva Papers on Risk and Insurance: Issues and Practice*, vol. 30(3), 2005, pp. 387-409.
97 A. Beltratti, 'The Complementarity between Corporate Governance and Corporate Social Responsibility', *Geneva Papers on Risk and Insurance: Issues and Practice*, vol. 30(3), 2005, pp. 373-86.
98 J. Heath, 'Business Ethics without Stakeholders', *Business Ethics Quarterly*, vol. 16(3), 2006, pp. 533-57; J. Heath, 'An Adversarial Ethic for Business: or When Sun-Tzu Met the Stakeholder', *Journal of Business Ethics*, vol. 72(4), 2007, pp. 359-74.

with the firm or required by law."[99] While the difference between CSR and public regulation is arguably obvious, it also needs to be conceptually separated from contractual, i.e. bargaining solutions to market failures. Such responses to externalities are captured by the existing literature on the Coase Theorem.[100] Despite certain similarities, most notably the absence of governmental intervention,[101] there is a key difference between CSR and Coasian bargaining though: while the latter crucially depends on transaction costs, CSR is a unilateral activity, depending on fundamentally different conditions.[102] This delineation is important to develop precise criteria under which CSR can be an efficient solution to market failures, which is the subject of *Chapter Five*.[103]

29 Public goods and externalities are separately included in this definition. They are overlapping concepts and differ by their beneficiaries and the manner of consumption.[104] From the perspective of the corporation, this differentiation does not matter much as no compensation is received for the incurred costs of provision in either case; in reality, CSR occurs as a response to both forms of market failure.[105] Private redistribution as another possible form of CSR captures, for example, the payment of 'fair wages' above labour market equilibria or traditional corporate philanthropy.[106] This market-failure-centred approach to self-regulation merges legal and economic theories on CSR. It is also used to link the abstract concept of CSR to its practice on the corporate level in *Section 4*.[107] The following figure summarises the definition of CSR developed thus far.

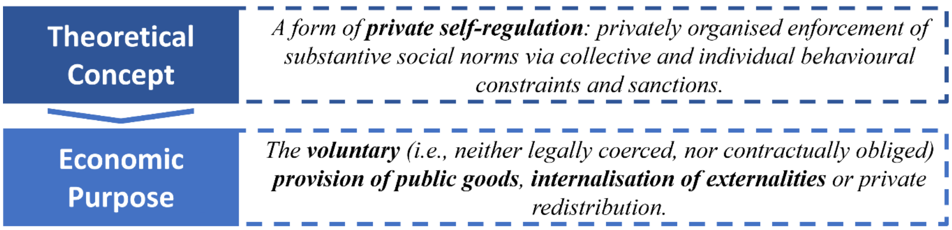

Figure 1: The definition of CSR in this thesis, part 1.

[99] D. Baron, 'Private Politics, Corporate Social Responsibility, and Integrated Strategy', *Journal of Economics & Management Strategy*, vol. 10(1), 2001, pp. 7-45, at p. 11.
[100] R. Coase, 'The Problem of Social Cost', *Journal of Law and Economics*, vol. 3(1), 1960, pp. 1-44; for an overview of the literature, cp. F. Parisi, *The Language of Law and Economics: A Dictionary*, Cambridge, Cambridge University Press, 2013, at pp. 47-48 ("Coase Theorem").
[101] Heal even calls CSR a "Coasian solution", arguing that "where costs are externalized, corporations bargain with society about who will ultimately bear these costs"; in exchange for 'voluntary' internalisation, corporations were in turn compensated with legitimacy provided by society. As explained below in greater detail, such social legitimacy theories are problematic to transpose to the individual corporate level, which is why this 'Coasian' interpretation of CSR is not pursued here; Heal (2005), *supra* note 96; cp. *infra*, para. 58.
[102] *Infra*, para. 65; for a transaction cost analysis of self-regulation, cp. Ogus (1995), *supra* note 91.
[103] *Chapter Five*, at p. 157.
[104] For a differentiation see S. Holtermann, 'Externalities and Public Goods', *Economica*, vol. 39(153), 1972, pp. 78-87.
[105] Practical examples are provided in the contributions cited above, notably in Besley & Ghatak (2007), *supra* note 95; Heal (2005), *supra* note 96.
[106] Cp. Heal (2005), *supra* note 96, at pp. 392-93.
[107] See *infra*, para. 50.

30 To summarise, drawing from the different disciplines referenced in this section, the concept of CSR is defined as a 'form of private self-regulation,' understood as 'the voluntary provision of public goods, internalisation of externalities or private redistribution.' This economic definition formally excludes arbitrary moral preferences[108] and the strategic use of corporate philanthropy to influence political decision-making as a form of lobbying or corruption.[109] The role of social norms and moral preferences in this concept of CSR is discussed below in *Section 4*.[110] It is not argued that this definition of CSR is *per se* superior to other concepts. Rather, it offers certain advantages in the context of this research project: accounting for both the changing normative core as well as the diverse realisation of CSR, it can be used in a comparative study of CSR in different legal settings. It is also the basis of a positive analysis of CSR activities on the corporate level, i.e. the first research question of this thesis contained in *Chapters Three* and *Four*.[111] Understanding CSR as a response to market failure and linking it to the existing law and economics literature on CSR self-regulation[112] in turn makes it possible to analyse its efficiency and desirability under social welfare considerations. This will be the starting point of the second research question that deals with CSR as a potential objective of executive pay regulation.[113]

2.3 ESG and CSR

31 Another prevalent concept from which the definition of CSR developed in this chapter needs to be distinguished is that of ESG. ESG stands for 'environmental, social and governance' and is a conceptualisation of the main categories of issues firms can address through CSR: the environment, including ecological sustainability and climate change, social issues that affect stakeholders, communities, or society at large, and good corporate governance in the conventional sense. In the CSR debate, which has long been characterised by a use of overlapping terms and concepts,[114] ESG has gained significant prominence. That is because of its focus on the operationalisation of CSR principles, making it amply employed in management practice, and its translation into measurable KPIs, which has become particularly valuable for investors. Lastly, also legislators like the European Commission have adopted ESG terminology in disclosure and taxonomy regulation to implement CSR policy objectives.[115] Undoubtably, ESG has gained a central role in the CSR debate of the most recent years, which necessitates briefly discussing its influence on CSR scholarship and delineating it from the definition developed here.

32 While CSR is rooted in different areas of scholarship and revolves around the notion of firms going 'beyond compliance', ESG is an approach to categorise CSR engagement based on the main areas affected by corporate activities. Having emerged in the 2010s, it is closely linked to and influenced by the 'triple bottom line' concept of the late 1990s and 2000s that

[108] On the influence of moral preferences, cp. H. Hong & M. Kacperczyk, 'The Price of Sin: The Effects of Social Norms on Markets', *Journal of Financial Economics*, vol. 93(1), 2009, pp. 15-36.
[109] Cp. M. Bertrand et al., 'Tax-Exempt Lobbying: Corporate Philanthropy as a Tool for Political Influence', *American Economic Review*, vol. 110(7), 2020, pp. 2065-2102.
[110] *Infra*, para. 50.
[111] See *Chapter Three*, at p. 65; *Chapter Four*, at p. 107.
[112] Most notably Ogus & Carbonara (2017), *supra* note 85.
[113] See *Chapter Five*, at p. 155.
[114] Cp. Carroll (2008), *supra* note 5.
[115] On European CSR legislation, cp. *infra*, para. 38.

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differentiates companies' environmental, social, and financial performance under the label 'planet, people, profits.'[116] ESG is the result of the success of CSR at proliferating as a business philosophy: its demarcation of broad areas of engagement serves as the base for the development of business strategies, operative activities and KPIs and other indicators to measure, evaluate and compare firms' CSR performance. The fact that ESG includes 'good governance' next to environmental and social issues results from the insight that the quality of a firm's decision-making structures is just as important for long-term business success as it for considering non-financial aspects; the link between governance, financial performance and CSR performance is discussed in detail in *Section 4*.[117] ESG can thus be seen as a form of realised CSR engagement, providing management, stakeholders and investors with the necessary taxonomy and measurability.

33 Regarding the areas of ESG engagement, one may argue that this thesis focuses on the 'S' and 'G' dimensions: the economic approach to CSR adopted in this section comes from the standpoint of the interests and utility of economic actors, which prioritises human stakeholders. The focus on pay regulation furthermore clearly falls under the 'governance' dimension. It is thus worthwhile to be aware that any results developed in the subsequent chapters may be particularly relevant for these two ESG dimensions. It has been made clear, however, that the concept of CSR as a form of private self-regulation developed in this section is defined to address the self-imposed restrictions of businesses to address market failures more broadly. It can be just as well applied to a company's environmental engagement as to its stakeholder relations, for example. The objective of this thesis is to derive general conclusions about the circumstances and influences that determine corporate decision-making in these cases. While ESG terminology has gained widespread use and popularity, as it touches very topical aspects of the currently ongoing CSR debate, the term of CSR is continued to be used as the more basic and general concept here that emphasises theory over practical application. *Chapter Seven* returns to the ESG debate to discuss implications of the results derived in the thesis for those more practical areas of applications.[118] Before turning to the practice of CSR on the corporate level and its link to executive compensation, the currently pursued, institutional approach lends itself to answer another question: what role is there for law in CSR?

Section 3: CSR and the Law

34 Analysing the effects of executive pay regulation on CSR as this thesis aims to requires clarifying the general role of law in CSR, given that this link is not obvious at first sight. While the specificities of executive pay regulation are laid out throughout the subsequent chapters,[119] a basic framework of the relationship between law and CSR is provided in this section. The definition of CSR as self-regulation developed above provides a link to the existing literature on public and private regulation. Here, this literature is combined with legal theories of CSR

[116] Cp. J. Elkington, *Cannibals with Forks: The Triple Bottom Line of the 21st Century*, Oxford, Capstone, 1997.
[117] Cp. *infra*, para. 50.
[118] See *Chapter Seven*, at p. 231.
[119] See *Chapter Three*, at p. 65; *Chapter Four*, at p. 107.

to elaborate a framework of different types of CSR-law relationships and their interaction as a basis for the analysis of executive pay regulation.

3.1 Towards a Comprehensive Theory

35 The previous section lays out that a main problem of conventional CSR definitions is their failure to conceptualise the relationship between CSR and the law. This is troubling, given the importance empirics attribute to legal systems as CSR determinants[120] and the growing, active involvement of legislators.[121] This research project requires a more refined understanding than what is provided by the management literature, which sees law as a mere compliance threshold for CSR.[122] In this section, a framework is developed that captures the different relationship types of CSR and the law. Such a framework allows to determine the different ways in which executive pay regulation can affect CSR. Subsequently, it also facilitates analysing the interaction of CSR with other legal rules as part of its institutional environment. Here, three forms of CSR-law relationship types are distinguished: based on the nomenclature of a categorisation by McBarnet,[123] they are called *CSR because of the law*, *CSR instead of the law*, and *CSR against the law*.

3.1.1 CSR because of the Law

36 Central insights for CSR can already be drawn from the legal literature on self-regulation. In her seminal work on this field, Black lays out that "[n]o particular relationship with the state is implied by the term 'self-regulation'."[124] Instead, she claims that legal rules could promote, mandate or coerce self-regulation.[125] The same holds true for CSR: in a categorisation of CSR-government relationships, Gond et al. include a distinction between "CSR facilitated by government" and "CSR as mandated by government".[126] Both characterisations commonly describe ways in which the law incentivises CSR engagement. Law scholarship, however, usually places greater emphasis on the technical differences between these legal instruments than their measurable effects. Cominetti and Seele have developed a two-dimensional classification of CSR norms along their legal origin and whether they are coercive or voluntary in nature: they conclude that a perfect distinction between public and private CSR norms is not

[120] Cp. Liang & Renneboog (2017), *supra* note 54.
[121] For examples, see *infra* para. 36 et seq.
[122] E.g. McWilliams & Siegel (2001), *supra* note 31; D. Vogel, *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility*, Washington, Brookings Institution Press, 2005; A. McWilliams & D. Siegel, 'Creating and Capturing Value: Strategic Corporate Social Responsibility, Resource-Based Theory, and Sustainable Competitive Advantage', *Journal of Management*, vol. 37(5), 2011, pp. 1480-95; a historical precursor of this line of thought is: J. McGuire, *Business and Society*, New York, McGraw-Hill, 1963.
[123] D. McBarnet, 'Corporate Social Responsibility beyond Law, through Law, for Law', in: D. McBarnet, A. Voiculescu & T. Campbell (eds.), *The New Corporate Accountability—Corporate Social Responsibility and the Law*, Cambridge, Cambridge University Press, 2009.
[124] Black (1996), *supra* note 91, at p. 27.
[125] Ibid.
[126] J. Gond, N. Kang & J. Moon, 'The Government of Self-Regulation: On the Comparative Dynamics of Corporate Social Responsibility', *Economy and Society*, vol. 40(4), 2011, pp. 640-71.

possible and that their enforceability is independent of that legal origin.[127] This confirms Eijsbouts' theory of CSR and law as a spectrum of 'multiple regulatory forms'[128] and speaks against focusing on legal technicalities. Here, rules that act as drivers of CSR[129]—regardless of their legal strategies—are thus grouped as a first relationship type termed *CSR because of the law*.

37 Law scholars' efforts to differentiate what is grouped together here and the ostensibly contradictory term of 'legally mandated CSR' warrant further explanation. What these instruments share from an economic viewpoint[130] is their function of creating incentives that stipulate CSR engagement. The decisive criterion here thus is not what technical instruments are employed by the law, but, instead, which incentives are created. From this viewpoint, the contradiction of 'mandated CSR' can be resolved.[131] Legal instruments to promote voluntary CSR engagement, also termed 'meta-regulation',[132] can employ either legal coercion to create direct incentives or make use of indirect, market-based incentives. The differences and commonalities of the direct and indirect incentive effect of legal rules on CSR are best displayed at two real-world examples of CSR legislation, the EU and India.

38 As part of its CSR policy described above,[133] the EU pursues an approach of 'complementary regulation' to CSR. It introduced the 'Non-Financial Reporting Directive'[134] in 2014, whose aim was to improve disclosure of CSR-related information to enhance its quality and comparability.[135] This included reporting duties on "the development, performance, position and impact"[136] of activities in various CSR-related fields and descriptive information on business models, corporate policies and risk assessment processes. This aimed at remedying market failures in the current practice of CSR, as companies failed to meet the increasing demand for non-financial disclosure from investors and consumers.[137] This is because of

[127] M. Cominetti & P. Seele, 'Hard Soft Law or Soft Hard Law? A Content Analysis of CSR Guidelines Typologized along Hybrid Legal Status', *uwf UmweltWirtschaftsForum*, vol. 24(2), 2016, pp. 127-40.
[128] Eijsbouts (2011), *supra* note 63.
[129] For an overview cp. J. Moon, 'Government as a Driver of Corporate Social Responsibility', *International Centre for Corporate Social Responsibility Research Paper Series*, No. 20-2004, 2004.
[130] "The economic approach applies incentives analysis to all economic and non-economic activities.", writes: C. Veljanovski, *Economic Principles of Law*, Cambridge, Cambridge University Press, 2007, at p. 22.
[131] There is an increasing amount of legal literature on liability risks associated with 'CSR non-compliance,' which is not meant here; cp. D. Schaefer & C. Kaeb, 'The Five Levels of CSR Compliance: The Resilience of Corporate Liability under the Alien Tort Statute and the Case for a Counterattack Strategy in Compliance Theory', *Berkeley Journal of International Law*, vol. 29(1), 2011, pp. 334-97.
[132] Cp. C. Parker, 'Meta-Regulation: Legal Accountability for Corporate Social Responsibility?', in: D. McBarnet, A. Voiculescu & T. Campbell (eds.), *The New Corporate Accountability – Corporate Social Responsibility and the Law*, Cambridge, Cambridge University Press, 2009.
[133] *Supra*, para. 17-19.
[134] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, 2014 O.J. L330/1 [herein: Non-Financial Reporting Directive, NFRD].
[135] European Commission, SWD(2013) 127 final.
[136] Art. 19a para. 1 no. 1 Directive 2013/34/EU as amended by Directive 2014/95/EU.
[137] Cp. European Commission, SWD(2013) 127 final, at pp. 7 et seq.

"green-washing":[138] information asymmetries between corporations and outsiders allow free-riding, as companies not investing in CSR may still benefit from the reputation of their competitors or the industry.[139] By remedying these information asymmetries, the EU aims to increase market pressure[140] on companies to engage in CSR. A similar approach is pursued in the financial sector through current regulatory proposals, the 'Sustainable Finance' package of 2018.[141]

39 Indian CSR legislation is an example of legal instruments employing a direct, more coercive strategy to incentivise CSR. Since 2013, companies above a certain size threshold[142] are legally obliged to spend two percent of average annual net profits on CSR activities.[143] The law provides a list of preferred areas of CSR engagement, e.g. eradicating extreme hunger and poverty or improving infant and maternal health, but also contributions to environmental stability, employee vocational skills or social business projects.[144] Historically, this form of CSR has arisen from a longstanding practice of business philanthropy and a failure of centralised government to remedy persistent shortcomings in humanitarian development.[145] Notably, the rule relies lacks coercive enforcement mechanisms and merely requires comply-or-explain reports,[146] granting it the description of "soft hard law".[147]

40 Insights from these examples are twofold: first, legal incentives for CSR engagement are a wide spectrum. While the EU combines private forces of CSR with publicly enforced but indirect rules, India creates direct legal obligations for CSR enforced via the market. Secondly, insights on mandated self-regulation as established by Black apply *mutatis mutandis* to CSR as well: India is an example where companies only have discretion in deciding how to engage in CSR, not whether to engage at all. Including these forms of 'mandated CSR' in the analysis establishes a wide potential spectrum for the law to incentivise CSR and shows that the

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[138] Traditionally, the term 'green-washing' was used to refer to misleading information about the environmental impact of firms alone, but is now often seen to incorporate also humanitarian and other aspects of CSR, cp. P. Seele & L. Gatti, 'Greenwashing Revisited: In Search of a Typology and Accusation-Based Definition Incorporating Legitimacy Strategies', *Business Strategy and the Environment*, vol. 26(2), 2017, pp. 239-52.

[139] Cp. M. Delmas & A. Keller, 'Free Riding in Voluntary Environmental Programs: The Case of the U.S. EPA WasteWise Program", *Policy Sciences*, vol. 2(3), 2005, pp. 91-106.

[140] On the market forces of CSR, cp. W. Maroun, 'A Conceptual Model for Understanding Corporate Social Responsibility Assurance Practice', *Journal of Business Ethics*, vol. 161(1), 2019, pp. 187-209.

[141] EU High-Level Expert Group on Sustainable Finance, *Final Report 'Financing a Sustainable European Economy'*, 31 January 2018, available at https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf.

[142] Pursuant to Sect. 135 para. 1 Indian Companies Act, 2013, the threshold is either a net worth of five billion INR (ca. EUR 65 million as of February 2020), a turnover of ten billion INR (ca. EUR 130 million) or a net profit of 50 million INR (ca. EUR 650,000).

[143] The measure also aims at institutionalising CSR in the form of corporate committees, policies, projects and the use of quantitative KPIs; see N. Mitra & R. Schmidpeter (eds.), *Corporate Social Responsibility in India*, Basel, Springer, 2017.

[144] Schedule VII of the appendix to the Indian Companies Act, 2013.

[145] For an overview of CSR in India, see P. Sundar, *Business and Community: The Story of Corporate Social Responsibility in India*, New Delhi, Sage India, 2013.

[146] Cp. L. Gatti et al., 'Are We Moving Beyond Voluntary CSR? Exploring Theoretical and Managerial Implications of Mandatory CSR Resulting from the New Indian Companies Act', *Journal of Business Ethics*, vol. 160(4), 2019, pp. 961-72; on a similar initiative of 'mandatory CSR' in Indonesia, cp. P. Waagstein, 'The Mandatory Corporate Social Responsibility in Indonesia: Problems and Implications', *Journal of Business Ethics*, vol. 98(3), 2011, pp. 455-66.

[147] Cominetti & Seele (2016), *supra* note 127.

boundary between CSR and legal obligations can be a grey area. These insights are derived from legal rules intentionally designed to affect CSR. The purpose of this research project is to apply these insights to executive pay regulation, which is currently not designed to target CSR, and widen the existing understanding of legal CSR determinants and its institutional environment.

3.1.2 CSR instead of the Law

41 CSR and legal rules can also be substitutes for each when they serve as alternatives in the enforcement of substantive social norms. Here, this relationship is described with the term *CSR instead of the* law. At its core, it covers the traditional view of CSR as an activity left to the discretion of corporations; as Gond et al. say, CSR "may complement governmental actions by filling institutional and legal voids in an 'implicit' understanding of what is required for business social legitimacy".[148] More broadly, it encompasses all specific codes and standards issued or adopted by the private sector. These codes can be drafted as a market response to the demand for standardised rules and as such also the product of independent third parties.[149] However, they may also be provided by public authorities to encourage and create room for self-regulation, as the EU does with its principles for better self- and co-regulation.[150] Especially on the international level, governmental organisations are the source of such codes, whose enforcement is left up to the private sector as a form of soft law.[151]

42 International agreements are an important source of voluntary standards to be adopted by businesses for self-regulation. These soft law frameworks are often deliberately designed as guidelines or best practices for enterprises: they signal universal recognition and thus reduce information costs, because they also function as "authoritative guidance"[152] for national policymakers and thus also provide a minimum of international coordination. However, these soft law standards also assume a gap-filling function for non-existent or failing governmental activity.[153] Most of them, like the UN Global Compact, the OECD Guidelines for Multinational Enterprises (MNE) or the ILO Tripartite Declaration, address basic humanitarian and economic issues like violations of human and labour rights, environmental pollution or corruption. They

[148] Gond et al. (2011), *supra* note 126, at p. 646.
[149] E.g. the 'Global Reporting Initiative' or the UN 'Principles for Responsible Investment'; see Global Reporting Initiative standards, available at https://www.globalreporting.org/standards; Principles for Responsible Investment, available at https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment; for an overview, cp. Cominetti & Seele (2016), *supra* note 127.
[150] For an overview, see European Commission, *The "Principles better self- and co-regulation"*, available at https://ec.europa.eu/digital-single-market/en/cop-principles-better-self-and-co-regulation.
[151] Cp. R. Bismuth, 'Mapping a Responsibility of Corporations for Violations of International Humanitarian Law Sailing between International and Domestic Legal Orders', *Denver Journal of International Law and Policy*, vol. 38(2), 2010, pp. 203-26.
[152] European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions A Renewed EU strategy 2011-14 for Corporate Social Responsibility*, 2011, COM(2011) 681 final, p. 6; for the special attention the European Commission pays to the implementation of the UNGP cp. European Commission, *Commission Staff Working Document on Implementing the UN Guiding Principles on Business and Human Rights – State of Play*, 2015, SWD(2015) 144 final.
[153] Cp. A. Scherer & G. Palazzo, 'The New Political Role of Business in a Globalized World: A Review of a New Perspective on CSR and Its Implications for the Firm, Governance, and Democracy', *Journal of Management Studies*, vol. 48(4), 2011, pp. 899-931.

appeal to corporations to respect these fundamental rights, which are recognised in international treaties, where they are not enforced by public authorities. Most often, this is the case because developing nations lack adequate state capacity, but also because cross-jurisdictional boundaries and international supply chain structures frustrate enforcement. The UN Guiding Principles, endorsed by the UN Human Rights Council in 2011,[154] are the latest and most comprehensive international instrument that relies on CSR to reduce corporate-related human rights transgressions. In recent years however, there have been endeavours led by developing nations to replace this CSR-centred approach with extraterritorial criminal and administrative enforcement.[155] Most developed nations and home states of large multi-national enterprises, including the EU, oppose this.[156] Political disagreements thus persist on the efficiency of CSR as a substitute for governmental power vacuums in the international sphere.

43 CSR can substitute legal rules, by either directly replacing them or filling voids unoccupied by the law. This means that the law has a passive role in delineating the substantive scope for CSR, which is also expressed by the conventional understanding of CSR as 'beyond compliance'. The example of the international sphere however shows that beyond this passive relationship, governments may also actively provide the content of substitutive CSR norms. Today, corporations rely on the provision of soft law standards by international bodies, which has significantly contributed to the institutionalisation of CSR. For this research, *CSR instead of the law* has two implications: first, it shows that it is important to identify the substantive social norms addressed by CSR to map its regulatory environment. Secondly, it shows that it is necessary to look for the role of the law in providing substitutive CSR norms, which is different from the incentivising role discussed above.

3.1.3 CSR against the Law

44 The third type of relationship between CSR and the law is the case of legal rules that actively restrict or prohibit CSR engagement.[157] This is most prominent in corporate law and has been constitutive for the emergence of CSR: Carroll notes that in the late 19th century, limited charter power and the concept of managers as trustees of shareholders were the central obstacles to the development of private to corporate philanthropy.[158] Today, this tension has remained most eminently in the case of managerial fiduciary duties. Fiduciary duties constitute a legal response to the agency conflict in firms and function as a restriction of managerial decision-making capacities to protect shareholder interests. Insofar as CSR benefits stakeholders over shareholders, e.g. in the case of corporate philanthropy, it may constitute a breach of their

[154] United Nations OHCHR (2011), 'Guiding Principles on Business and Human Rights', HR/PUB/11/04.
[155] See UN Human Rights Council resolution, *Elaboration of an international legally binding instrument on transnational corporations and other business enterprises with respect to human rights*, A/HRC/RES/26/9 (14 July 2014); UN Human Rights Council, IGWG on TNCs (3rd session 2017), *Elements for a draft legally binding instrument on transnational corporations and other business enterprises with respect to human rights*.
[156] European Union, *written contribution to the first session of the open-ended intergovernmental working group on transnational corporations and other business enterprises with respect to human rights*, available at https://www.ohchr.org/Documents/HRBodies/HRCouncil/WGTransCorp/Session1/EuropeanUnion.doc.
[157] McBarnet (2009), *supra* note 123.
[158] Carroll (2008), *supra* note 5, at p. 21.

fiduciary duties. Even though many jurisdictions today partially recognise fiduciary duties towards stakeholders as a strategy to protect non-shareholder constituencies,[159] the United States, influenced by the Berle-Dodd debate,[160] still upholds shareholder protection as the primary objective of fiduciary duties. The influence of corporate law and the 'legalisation' of CSR in the US are crucial to understand how CSR has developed: as McBarnet argues,[161] it explains both the widespread adoption of agency theory in CSR scholarship and the importance of the 'business case' for CSR in management studies.[162]

45 The development of *CSR against the law* in the United has been shaped by court decisions which have created leeway for managers to act 'socially responsible.' An important decision was the legalisation of charitable contributions by corporations, established in 1953 by the Supreme Court of New Jersey. It argued that "modern conditions require that corporations acknowledge and discharge social as well as private responsibilities."[163] This decision and its proliferation in other states has generally been regarded as a first normative recognition of stakeholder interests in US corporate law and an example of how the early CSR discourse has precipitated into jurisprudence.[164] Next to court rulings, the business judgment rule has greatly enabled CSR engagement by—broadly speaking—sparing managerial discretion in ordinary business decisions from judicial control for any potential violations of fiduciary duties. The business judgment rule imposes a burden of proof on shareholders to demonstrate that managers were uninformed, not disinterested or independent, or grossly negligent in their decision-making.[165] In the CSR literature, this is regarded as another abandonment of shareholder primacy, allowing managers to benefit other constituencies in the course of daily business decisions. The question whether the provision of benefits to third parties like stakeholders is an argument for or against the presumption of managerial self-interest remains debated.[166] Nevertheless, the business judgment rule has been one reason in the past for US courts to uphold managerial decisions that were apparently 'sacrificing' shareholder profits.[167]

46 Beyond the specific liabilities and obligations that the law creates, fiduciary duties may also unfold restrictive capacity through the societal preference they signal and legitimacy they provide or withhold. An anecdotal example for this is the Daraprim scandal: In 2015, Turing

[159] Cp. R. Kraakman et al., *The Anatomy of Corporate Law A Comparative and Functional Approach*, Oxford, Oxford University Press, 2017, pp. 97-99.
[160] The question to whom corporate managers owe fiduciary duties was extensively discussed in corporate law during the early 1930s, cp. A. Berle, 'Corporate Powers as Powers in Trust', *Harvard Law Review*, vol. 44(7), 1931, pp. 1049-74; E. Dodd, 'For Whom Are Managers Trustees?', *Harvard Law Review*, vol. 45(7), 1932, pp. 1145-63; A. Berle, 'For Whom Corporate Managers Are Trustees: A Note', *Harvard Law Review*, vol. 45(8), 1932, pp. 1365-72; for an overview, see A. Sommer, 'Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later', *Delaware Journal of Corporate Law*, vol. 16(1), 1991, pp. 33-56.
[161] McBarnet (2009), *supra* note 123.
[162] Cp. *infra*¸ para. 54 et seq.
[163] *A.P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581, 586 (N.J. 1953).
[164] L. Fairfax, 'The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms', *Journal of Corporate Law*, vol. 31(3), 2008, pp. 675-718.
[165] As so in Delaware law: *in re* Los Angeles Dodgers LLC, — B.R. ---, 2011 WL 2937905 (Bkrtcy.D.Del 2011).
[166] Critiques of CSR in line with Friedman's arguments vary between an interpretation of the motives of managers as either rational self-interest to promote one's social reputation or immaterial altruism; cp. Salazar & Husted (2008), *supra* note 14.
[167] J. You, *Legal Perspectives on Corporate Social Responsibility – Lessons from the United States and Korea*, New Delhi, Springer, 2015, at pp. 67 et seq.

Pharmaceuticals acquired the rights for Daraprim, a drug often used by patients with HIV, and subsequently raised its price by ca. 5,500 percent for the US market. Turing's CEO Martin Shkreli responded to the public backlash this had caused with his alleged fiduciary duty under Delaware law to do everything that maximises financial returns to shareholders.[168] While corporate law does in fact not provide any such imperatives,[169] fiduciary duties may be perceived as a signalling device of societal preferences that prioritise shareholders' over stakeholders' interests.[170]

3.2 Conclusions for Executive Pay Regulation

47 As this section has laid out, the law plays a much more significant role for CSR than merely that of a compliance baseline. Legal rules can incentivise CSR, either directly or indirectly by relying on market mechanisms (*CSR because of the law*). At the same time, CSR works as a substitute for law in enforcing substantive social norms (*CSR instead of the law*), a relationship complicated by the fact that governments today are major providers of substitutive CSR norms on the institutional stage. Lastly, corporate law plays an important role in restricting CSR engagement due to its focus on the manager-shareholder relationship (*CSR against the law*). The study of different national examples has furthermore confirmed the view that the CSR-law relationship is highly contextual;[171] the analysis that builds on this framework thus needs to account for the regulatory and cultural context of both CSR and the specific legal rules.

48 One of the three main questions this chapter addresses—what role is there for law in CSR?—has been answered. Based on the concept of CSR as a form of private-self regulation, a framework was developed that merges the different relevant forms of relationships. The figure below visualises this framework and highlights how different legal norms simultaneously interact with CSR. The main benefit of using this framework is that it follows an economic approach and allows covering the interaction of multiple legal rules with CSR, which is necessary for the analysis of executive pay regulation.

[168] Cp. Pharmalive, *Turing's Martin Shkreli Says He Should Have Increased the Price of Daraprim Higher than 5,000%*, 4 December 2015, http://www.pharmalive.com/turings-says-he-should-have-increased-the-price-of-daraprim-higher-than-5000/.
[169] Cp. O. Hart & L. Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value', *Journal of Law, Finance, and Accounting*, vol. 2(2), 2017, pp. 247-74.
[170] Hart and Zingales criticise the confusion in legal scholarship over the role non-financial preferences should play in the concept of shareholder value; see also behavioural explanations that attribute a role to the law in expressing public preferences, independent of any sanctions it imposes. See ibid.; R. McAdams, 'A Focal Point Theory of Expressive Law', *Virginia Law Review*, vol. 86(8), 2000, pp. 1649-1729.
[171] Cp. Matten & Moon (2008), *supra* note 16.

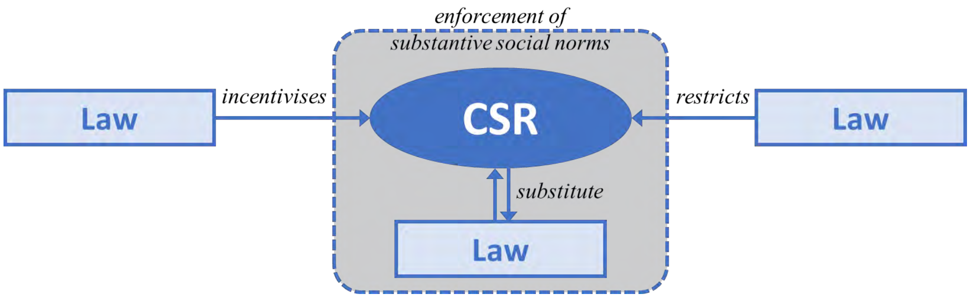

Figure 2: Analytical framework for the relationship between CSR and law.

49 How can executive pay regulation be allocated within the framework? This depends on the specific purpose of the legal rule. One recurrent theme in executive pay regulation is the pursuit of 'social concerns' as described in the introductory chapter.[172] This can be interpreted as the use of pay regulation to impose substantive social norms that are otherwise considered 'socially responsible' business conduct, i.e. a substitute relationship as displayed above. As it is usually considered incompatible with the view held in corporate governance scholarship of executive compensation as an *ex ante* incentive, this form of pay regulation is usually rejected in economics.[173] What remains is the dual aspect of executive pay regulation as incentivising or restricting CSR engagement, which is the primary focus of this thesis. It has already been explained that executive pay functions as an incentive, but also that corporate law is heavily shaped by the concept of shareholder primacy, which restricts CSR.[174] A more detailed placement of executive pay regulation in this framework thus requires an examination of the role of CSR on the firm level and its link to executive compensation.

Section 4: CSR in Corporate Governance

50 The approach followed thus far provides a useful definition of the concept of CSR and a framework to analyse its relationship with law. The more attention is paid to the role of executive pay regulation, however, the more obvious the necessity becomes to shed light on how CSR engagement is determined on the firm level. Such a focus requires a turn away from the abstract idea behind CSR, as developed in *Section 2*,[175] towards a definition of specific CSR activities. The main aim of this section is to develop a categorisation of CSR activities based on its firm-level determinants, which will serve as the main form of how CSR is analysed within the subsequent chapters.[176] It is based on a critical review of the extent to which agency theory is able to explain CSR engagement and whose shortcomings are complemented by insights from behavioural economics on the role of non-financial preferences.

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[172] *Chapter One*, at p. 1.
[173] Justifications of executive pay regulation are covered in greater detail in *Chapter Three*, at pp. 68 et seq.
[174] Cp. *infra*, para. 51.
[175] *Supra*, para. 9 et seq.
[176] See *Chapter Three*, at p. 65; *Chapter Four*, at p. 107.

4.1 Agency Theory: CSR and Financial Performance

51 The institutional literature has extensively criticised management scholarship for treating "the 'social' element as a black box"[177] in CSR research. Its own methodology, however, equally neglects the intra-corporate decision-making process.[178] Despite a few valuable contributions that elucidate the intermediating effect of institutions on firm-level CSR determinants,[179] the main approaches to explain why firms engage in CSR therefore remain based on agency theory. Adopting agency theory at this point offers two central advantages: structurally, it serves as a complement to institutional theory, as their combination allows describing both intra-corporate determinants of CSR and its social and regulatory environment. Secondly, agency theory provides a common framework for the analysis of the relationship between CSR and executive pay, which is shown in the following section.[180] As it is argued here, this is because the adoption of agency theory in CSR research has consoled it with conventional views of corporate governance. This approach has significantly contributed to its integration in management practice and methodologically provides access to the incentives and motivations of CSR engagement.

52 It has been noted above while discussing *CSR against the law* that corporate law establishes fiduciary duties for managers to act in the interests of shareholders.[181] This fact is the result of a historical, normative debate which concluded that corporate decision-makers should primarily be responsible to the owners of the company, who hold an interest in long-term profit maximisation.[182] This view has largely remained dominant in modern corporate scholarship, as demonstrated by Shleifer and Vishny's influential definition of corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[183] Corporate governance—including fiduciary duties—is thus primarily concerned with mitigating the agency conflict between shareholders and manager, i.e. reducing the agency costs that result from the separation of ownership and control.[184] It has been from this perspective that CSR came under heavy criticism, when the notion of ethical businesses

[177] Brammer et al. (2012), *supra* note 53, at p. 4.
[178] Cp. Ogus & Carbonara (2017), *supra* note 85.
[179] Most notably J. Campbell, 'Why Would Corporations Behave in Socially Responsible Ways? An Institutional Theory of Corporate Social Responsibility', *Academy of Management Review*, vol. 32(3), 2007, pp. 946-67; R. Aguilera et al., 'Putting the S Back in Corporate Social Responsibility: A Multi-Level Theory of Social Change in Organizations', *Academy of Management Review*, vol. 32(3), 2007, pp. 836-63; for an overview, cp. H. Aguinis & A. Glavas, 'What We Know and What We Don't Know About Corporate Social Responsibility: A Review and Research Agenda', *Journal of Management*, vol. 38(4), 2012, pp. 932-68.
[180] *Infra*, para. 87.
[181] *Supra*, para. 44.
[182] Cp. A. Berle & G. Means, *The Modern Corporation and Private Property*, New York, Macmillan, 1932.
[183] A. Shleifer & R. Vishny, 'A Survey of Corporate Governance', *Journal of Finance*, vol. 52(2), 1997, pp. 737-83.
[184] Note that even where corporate governance is not occupied with the protection of the interests of shareholders as a class, it upholds the methodology of agency theory to address such other conflicts; see Kraakman et al. (2017), *supra* note 159, at pp. 29 et seq.

responsibilities proliferated in the United States during the 1960s and began to influence corporate decision-making.[185]

53 Until today, criticism of CSR from the vantage point of agency theory is based on Milton Friedman's fervent 1970 article *The Social Responsibility of Business Is to Increase Its Profits*.[186] Mainly devised as a political argument,[187] it rejects CSR for two reasons: first, because business executives were less able to address social issues than public policymakers who are specialised in such tasks. Secondly, because unlike democratically legitimised bureaucrats, managers acted without a mandate from their shareholders, whose interest Friedman explicitly assumes were profit maximisation. That is why, he concludes, "political mechanisms, not market mechanisms […] determine the allocation of scarce resources"[188] in CSR firms, which undermined efficiency. Managers engaging in it did so either out of ignorance, as they felt a misleading moral sense of duty, or out of malevolence to portray themselves as social benefactors.[189] This 'Friedmanite' view expresses what later scholarship has come to term 'CSR as an agency problem.'[190] In property rights theory, it is well established that rational managers maximise personal utility by deviating from financial performance optimisation to satisfy personal preferences.[191] Incentives and legal constraints are thus designed to align managerial interests with those of corporate owners and deter any wasteful activities.[192] Indeed, if CSR meant that managers primarily pursued their—either moral or material—self-interest, it would be an economic agency costs for shareholders as well as a breach of fiduciary duties and should be deterred by corporate governance.

54 This substantial critique has given rise to a countermovement in academics to provide new legitimacy for CSR, known as the 'business case' literature. It rejects the 'Friedmanite' view of CSR as an agency problem as well as a less adversarial interpretation of shareholder consent to CSR as a 'profit-sacrificing' activity, known as the "trade-off hypothesis."[193] Methodologically, though, the 'business case' adopts the approach of agency theory to the shareholder-manager relationship, claiming that CSR may in fact contribute to the long-term financial performance of companies. Davis' 1973 article *The Case for and Against Business Assumption of Social Responsibilities*,[194] a direct response to Friedman, is generally considered the first such inquiry into CSR.[195] Davis develops several managerial theories of how CSR

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[185] Cp. Carroll (2008), *supra* note 5.
[186] M. Friedman, 'The Social Responsibility of Business Is to Increase Its Profits', *New York Times Magazine*, 13 September 1970, pp. 122-26.
[187] Friedman concluded that CSR proponents "[i]n fact […] are—or would be if they or anyone else took them seriously—preaching pure and adulterated socialism. Businessmen [sic] who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades." Ibid.
[188] Ibid.
[189] Ibid.
[190] Cp. Salazar & Husted (2008), *supra* note 14; R. Masulis & S. Reza, 'Agency Problems of Corporate Philanthropy', *The Review of Financial Studies*, vol. 28(2), 2015, pp. 592-636.
[191] E. Furubotn & S. Pejovich, 'Property Rights and Economic Theory: A Survey of Recent Literature', *Journal of Economic Literature*, vol. 10(4), 1972, pp. 1137-62.
[192] Cp. Kraakman et al. (2017), *supra* note 159, at pp. 62 et seq.; Jensen & Meckling (1976), *supra* note 9.
[193] E. Kurucz, B. Colbert & D. Wheeler, 'The Business Case for Corporate Social Responsibility', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008, at p. 87.
[194] Davis (1973), *supra* note 10.
[195] Carroll (2008), *supra* note 5, at p. 27.

engagement can be a profitable investment, depending on its economic, social and regulatory environment.[196] Instead of an activity with questionable legality under corporate law and considered wasteful by conventional economic theory, this approach frames CSR as an imperative for the pursuit of shareholder interests. The 'business case' is a complex topic though, given that the link between profit generation and philanthropy is not straightforward and its theories stem from various different disciplines.[197] Despite following different managerial schools of thought, however, all 'business case' strategies share a few core characteristics, given their shared intention of substantiating CSR with economic and legal sustainability.[198] These characteristics are the theoretical foundation for the link between compensation arrangements structured along financial performance and incentives for CSR engagement discussed below in *Section 5*. Four main forms of the 'business case' can be differentiated, which are briefly explained here.[199]

55 The first form of 'business case' promotes CSR as a costs and risks reduction strategy. This operative view primarily relates to the internalisation of negative externalities caused by the firm and the risks it imposes on third parties or the environment.[200] It is claimed that CSR could broaden the perspective and time-horizon of management and reveal previously undetected business opportunities, cost saving potentials or risks to mitigate. In the words of Davis: "if business's innovative ability can be turned to social problems, many problems could be handled profitably according to traditional business concepts."[201] A recurrent example for this is BP's development of an internal CO_2 emission trading scheme in the 1990s to address climate change concerns, bringing about net cost savings of approximately USD 600 million.[202]

56 The second category is CSR as a reputational strategy, covering expenditures that create a positive reputation of the company among its stakeholders—notably customers—employees, and investors.[203] This reputation can translate into a comparative advantage vis-à-vis competitors and thus improve long-term financial performance. Gary Becker also noted that companies spending money on CSR may in fact only survive in a competitive market "if they are able to attract employees and customers that also value these other corporate goals."[204] Additionally, CSR may be a way to attract capital from investors with non-financial

[196] Davis (1973), *supra* note 10.
[197] Cp. E. Garriga & D. Melé, 'Corporate Social Responsibility Theories: Mapping the Territory', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.
[198] Carroll succinctly phrases this outcome in the words: "In today's world of intense global competition, it is clear that CSR can be sustainable only so long as it continues to add value to corporate success.", Carroll (2008), *supra* note 5, at p. 42.
[199] More detailed overviews are provided by: Kurucz et al. (2008), *supra* note 193; A. Carroll & K. Shabana, 'The Business Case for Corporate Social Responsibility: A Review of Concepts, Research and Practice', *International Journal of Management Reviews*, vol. 12(1), 2010, pp. 85-105.
[200] Cp. Kurucz et al. (2008), *supra* note 193, at p. 87.
[201] Davis (1973), *supra* note 10, at p. 317.
[202] Cp. Harvard Business School case "Global Climate Change and BP Amoco", Harvard Business School Case N9-700-106. Today, BP is generally associated with the 'Deepwater Horizon' environmental catastrophe that took place in the Gulf of Mexico in 2010. Scholarship uses this development to underline the importance of corporate culture as a determinant of corporate (ir-) responsibility; cp. B. van Rooj & A. Fine, 'Toxic Corporate Culture: Assessing Organizational Processes of Deviancy', *Administrative Science*, vol. 8(3), 2018, pp. 1-38.
[203] Cp. Davis (1973), *supra* note 10.
[204] G. Becker, 'On Corporate Altruism', *The Becker-Posner Blog*, 2 February 2008, available at https://www.becker-posner-blog.com/2008/02/on-corporate-altruism-becker.html.

preferences, as the burgeoning market for 'socially responsible investments' (SRI) demonstrates.[205] It is noteworthy that reputational 'business case' strategies are intertwined with costs and risks strategies, as reputation among stakeholders is also seen as a possible insurance against non-financial risks.[206]

57 Stakeholder management is a similar, yet less unilateral approach than reputational strategies. It caters to the basic notion that corporations should not only serve the needs of its shareholders, but also those of its stakeholders and develops corresponding management principles.[207] Under the 'business case', stakeholder theory has been developed towards a concept of how managing and balancing the interests of a corporation's various stakeholders can contribute to its long-term self-interest.[208] This view has been termed "instrumental"[209] or "enlightened stakeholder theory".[210] Its core idea is that stakeholder engagement can convert conflicts of interests into mutually beneficial bargaining solutions:[211] Michael Jensen succinctly captures this, arguing that "we cannot maximize the long-term market value of an organization if we ignore or mistreat any important constituency."[212]

58 Lastly, the most abstract 'business case' strategies are those of social legitimacy: legitimacy expresses the notion that corporations enjoy social and legal freedom granted to them by society, which they need to exercise responsibly in order to maintain it.[213] It is also known as the "licence to operate"[214] and, outside sociological approaches, addresses the substitutive relationship between private and public regulation that has been outlined above.[215] In this view, CSR can contribute to profit maximisation by upholding the public good of freedom of businesses and forestalling regulatory intervention that would be more costly than voluntary internalisation.[216]

59 These different strategies show that there is no central, universal link between CSR and financial performance; the 'business case' rather challenges management to discover opportunities to integrate CSR engagement and profit maximisation. The emergence of the

[205] For an overview, cp. L. Kurtz, 'Socially Responsible Investment and Shareholder Activism', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.
[206] P. Godfrey, 'The Relationship between Corporate Philanthropy and Shareholder Wealth: A Risk Management Perspective', *Academy of Management Review*, vol. 30(4), 2005, pp. 777-98.
[207] Seminal contributions of stakeholder theory are: R. Freeman, *Strategic Management: A Stakeholder Approach*, Pitman, Boston, 1984; T. Donaldson & L. Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications', *Academy of Management Review*, vol. 20(1), 1995, pp. 65-91; T. Jones & A. Wicks, 'Convergent Stakeholder Theory', *Academy of Management Review*, vol. 24(2), 1999, pp. 206-21.
[208] Cp. Kurucz et al. (2008), *supra* note 193, at p. 88.
[209] T. Jones, 'Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics', *Academy of Management Review*, vol. 20(2), 1995, pp. 404-37.
[210] Jensen (2002), *supra* note 38.
[211] A recent contribution on this is: A. Edmans, *Grow the Pie: How Great Companies Deliver Both Purpose and Profit*, Cambridge, Cambridge University Press, 2020.
[212] Jensen (2002), *supra* note 38, at p. 16.
[213] Cp. S. Sethi, 'A Conceptual Framework for Environmental Analysis of Social Issues and Evaluation of Business Response Patterns', *Academy of Management Review*, vol. 4(1), 1979, pp. 63-74.
[214] Cp. Eijsbouts (2011), *supra* note 63, at pp. 30 et seq.
[215] *Supra*, para. 21.
[216] Cp. Heal (2005), *supra* note 96; Kurucz et al. (2008), *supra* note 188, at pp. 90-91.

view of CSR an agency problem and the 'business case' as two rivalling explanations for CSR under agency theory have given way to an extensive body of empirical research. Testing the two views as rivalling hypotheses, empirics analyses the link between CSR and corporate financial performance to determine which view better described the practice of CSR. Several shortcomings of this approach however limit the explanatory capacity of agency theory in CSR.

60 One reason for this is that results on CSR and financial performance were originally rather mixed and display a clear trend over time. Earlier studies were more likely to find a negative link between CSR and financial performance, supporting the view of a trade-off between profitability and CSR engagement[217] or, at least, CSR as a performance-neutral way of spending 'excess' profits.'[218] Other studies that find a negative link focus on specific areas of corporate activism.[219] Several studies also find no correlation between CSR and financial performance at all.[220] The growing body of empirical literature has been summarised and evaluated by several meta-studies that allow a clearer picture. In an early literature review, Griffin and Mahon find a positive link between CSR and financial performance and methodological differences as a cause of prior divergence.[221] Orlitzky et al. also find a positive link and blame poor methodology for contradicting results.[222] Margolis and Walsh conclude that little evidence exists for a negative association,[223] while van Beurden and Gössling stress that "outdated evidence" is often the cause of finding a negative link.[224] Overall, the empirical literature documents a noticeable trend of alignment between CSR and financial performance; this indicates that agency theory has exerted significant normative pressure in shaping CSR instead of being a purely descriptive approach to its drivers. While financial performance alignment thus remains central in understanding contemporary CSR, it also means that the view of CSR as an agency problem and the 'business case' are better seen as complements, not rivalling hypotheses.

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[217] E.g. B. Kedia & E. Kuntz, 'The Context of Social Performance: An Empirical Study of Texas Banks', in: L. Preston (ed.), *Research in Corporate Social Performance and Policy*, Greenwich, JAI, 1981; L. Lerner & G. Fryxell, 'An Empirical Study of the Predictors of Corporate Social Performance: A Multi-Dimensional Analysis', *Journal of Business Ethics*, vol. 7(12), 1988, pp. 951-59.
[218] S. Waddock & S. Graves, 'The Corporate Social Performance-Financial Performance Link', *Strategic Management Journal*, vol. 18(4), 1997, pp. 303-19.
[219] E.g. divestment in South Africa during the apartheid regime or corporate environmental activism; see P. Wright & S. Ferris, 'Agency Conflict and Corporate Strategy: The Effects of Divestment on Corporate Value', *Strategic Management Journal*, vol. 18(1), 1997, pp. 77-83; J. Cordeiro & J. Sarkis, 'Environmental Proactivism and Firm Performance: Evidence from Security Analyst Earnings Forecasts', *Business Strategy and the Environment*, vol. 6(2), 1997, pp. 104-14.
[220] E.g. W. Abbott & J. Monsen, 'On the Measurement of Corporate Social Responsibility: Self-Reported Disclosures as a Method of Measuring Corporate Social Involvement', *Academy of Management Journal*, vol. 22(3), 1979, pp. 501-15; A. McWilliams & D. Siegel, 'Corporate Social Responsibility and Financial Performance: Correlation or Misspecification?', *Strategic Management Journal*, vol. 21(5), 2000, pp. 603-09.
[221] J. Griffin & J. Mahon, 'The Corporate Social Performance and Corporate Financial Performance Debate', *Business & Society*, vol. 36(1), 1997, pp. 5-31.
[222] M. Orlitzky, F. Schmidt & S. Rynes, 'Corporate Social and Financial Performance: A Meta-Analysis', *Organization Studies*, vol. 24(3), 2003, pp. 403-41.
[223] J. Margolis & J. Walsh, 'Misery Loves Companies: Rethinking Social Initiatives by Business', *Administrative Science Quarterly*, vol. 48(2), 2003, pp. 268-305.
[224] P. van Beurden & T. Gössling, 'The Worth of Values – A Literature Review on the Relation between Corporate Social and Financial Performance', *Journal of Business Ethics*, vol. 82(2), 2008, pp. 407-24.

61 A second problem the empirical literature stresses is how much the ability of corporate scholarship to draw confident conclusions suffers from inconsistencies in the definition and measurement of CSR. Clark and Viehs complain that “comparing studies on CSR is difficult because there are many different CSR measures and CSR consists of many different facets and dimensions—it is almost impossible to reach consensus on a proper CSR measure or definition.”[225] Over time, measurement of CSR expenditures and effects has partially ameliorated with the proliferation of standardised practices and databases.[226] Nevertheless, it remains an inherent problem due to the contested nature of CSR concepts and the high dependence of CSR practices on their cultural, economic and legal environment.

62 Can CSR be understood through its link to financial performance? In Barnea and Rubin’s words, “the results are rather mixed, but it would be fair to say that the majority of studies show a positive relation between CSR ratings and financial performance.”[227] Agency theory is thus a useful contribution in understanding CSR determinants, but the temporal changes and early inconclusiveness suggest that it does not explain the entire picture. Rather, the ‘business case’ as a response to the agency-problem view of CSR needs to be seen as a normative force instead of a descriptive theory. It is the dominant approach to CSR today, which has developed towards a “tighter coupling with organizations’ financial goals”[228] and moved from “explicitly normative and ethics-oriented arguments to implicitly normative and performance-oriented managerial studies.”[229] The remainder examines the original role of altruism in CSR and shows how it can complement agency theory in explaining CSR determinants.

4.2 The Role of Non-Financial Preferences

63 Agency theory tries to rationalise CSR entirely under either managerial or shareholders’ self-interest. Notwithstanding the normative influence of the two agency-based CSR approaches—CSR as an agency problem and the ‘business case’—in shaping contemporary CSR, their descriptive capacity in answering the question why CSR engagement occurs is limited. The traditional view of CSR as a form of business ethics or philanthropy, which has been displaced by the ‘business case’, centred around the notion of altruism. Even the definition of CSR adopted in *Section 2* understands ‘voluntary engagement’ as not externally motivated, e.g. through contractual reward or legal coercion, which explicitly leaves room for materialistic as well as altruistic drivers.[230] This section discusses the role of non-financial preferences—summarising all those preferences that deviate from wealth maximisation in the context of

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[225] G. Clark & M. Viehs, ‘The Implications of Corporate Social Responsibility for Investors: An Overview and Evaluation of the Existing CSR Literature’, *SSRN Electronic Journal*, 2014, available at https://ssrn.com/abstract=2481877.

[226] The Kinder, Lydenberg & Domini Social Index (KLD) is considered one of the most reliable and most frequently used indices; cp. A Chatterji, D. Levine & M. Toffel, ‘How Well Do Social Ratings Actually Measure Corporate Social Responsibility?’, *Journal of Economics & Management Strategy*, vol. 18(1), 2009, pp. 125-69; J. Mattingly & S. Berman, ‘Measurement of Corporate Social Action: Discovering Taxonomy in the Kinder Lydenberg Domini Ratings Data’, *Business & Society*, vol. 45(1), 2004, pp. 24-46.

[227] A. Barnea & A. Rubin, ‘Corporate Social Responsibility as a Conflict between Shareholders’, *Journal of Business Ethics*, vol. 91(1), 2010, pp. 71-86.

[228] M. Lee, ‘A Review of the Theories of Corporate Social Responsibility: Its Evolutionary Path and the Road Ahead’, *International Journal of Management Review*, vol. 10(1), 2008, pp. 53-73.

[229] Ibid.

[230] *Supra*, para. 27.

corporate objectives—for the different stakeholders of the firm. It is argued that while the non-financial preferences of external stakeholders and managers can be subsumed under the conventional view of agency theory, shareholder altruism is a distinct form of CSR.

64 Insights from behavioural economics are well established today in law and economics and have provided significant contributions to the understanding of rationality and human motivation.[231] Altruism, in principle understood as "costly acts that confer economic benefits on other individuals",[232] is an important deviation from the neoclassical model of selfish wealth maximisation. Embedded in socio-evolutionary theory,[233] altruism is found to be a consistent part of human behavioural patterns,[234] which suggests its relevance as a driver of CSR engagement. It is important to note that in economic theory, altruism is interpreted as a rational form of personal utility maximisation, even though individual preferences for altruism are highly heterogeneous.[235] Altruism thus is a special form of self-interested behaviour, making it susceptible to the traditional instruments of agency and incentives analysis.[236] Due to the complexity of the modern corporation, in which situations of direct personal interaction form the exception to the organised activity of CSR, it is necessary to highlight three forms of 'impure altruism': first, as noted by Gary Becker, prosocial behaviour can be motivated by non-intrinsic reasons, like the prospect of prestige, improved personal relations, or the avoidance of social scorn.[237] Secondly, Andreoni's theory of 'warm glow' posits that people gain utility not directly from the improved wellbeing of others, but the act of giving itself.[238] This has important implications for the provision of public goods, as the individual's perception of their contribution is decisive, not its actual effect. Lastly, Rose-Ackerman has introduced the concept of 'gratitude' to non-profit enterprises: this is a form of delegated altruism in which people derive utility from financially supporting a company which in turn spends this money on an altruistic cause.[239] These different forms—pure and impure altruism, the warm glow effect of giving and gratitude in delegated altruism—are the main determinants of people's 'non-financial preferences' for CSR engagement.[240] Together with material incentives and

[231] Cp. R. Posner, 'Rational Choice, Behavioral Economics, and the Law', *Stanford Law Review*, vol. 50(5), 1998, pp. 1551-76.
[232] E. Fehr & U. Fischbacher, 'The Nature of Human Altruism', *Nature*, vol. 425, 2003, pp. 785-91.
[233] Evolutionary theory generally distinguishes kin altruism and reciprocal altruism, see W. Hamilton, 'The Genetical Evolution of Social Behavior', *Journal of Theoretical Biology*, vol. 7(1), 1964, pp. 1-16; R. Trivers, 'The Evolution of Reciprocal Altruism', *Quarterly Review of Biology*, vol. 46(1), 1971, pp. 35-57.
[234] H. Gintis et al., 'Explaining Altruistic Behavior in Humans', *Evolution and Human Behavior*, vol. 24(3), 2003, pp. 153-72.
[235] H. Simon, 'Altruism and Economics', *American Economic Review*, vol. 83(2), 1993, pp. 156-61; J. Andreoni & J. Miller, 'Giving According to GARP: An Experimental Test of the Consistency of Preferences for Altruism', *Econometrica*, vol. 70(2), 2002, pp. 737-53.
[236] Cp. M. Jensen, 'Self-Interest, Altruism, Incentives, and Agency Theory', *Journal of Applied Corporate Finance*, vol. 7(2), 1994, pp. 40-45.
[237] G. Becker, 'A Theory of Social Interaction', *Journal of Political Economy*, vol. 82(6), 1974, pp. 1063-93.
[238] J. Andreoni, 'Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving', *The Economic Journal*, vol. 100(401), 1990, pp. 464-77.
[239] S. Rose-Ackerman, 'Altruism, Nonprofits, and Economic Theory', *Journal of Economic Literature*, vol. 34(2), 1996, pp. 701-28.
[240] Cp. M. Henderson & A. Malani, 'Corporate Philanthropy and the Market for Altruism', *Columbia Law Review*, vol. 109(3), 2009, pp. 571-628; A. Gautier & A. Pache, 'Research on Corporate Philanthropy: A Review and Assessment', *Journal of Business Ethics*, vol. 126(3), 2015, pp. 343-69.

social norms, they determine prosocial behaviour.[241] The way in which non-financial preferences affect CSR, however, depends on the identity of the corporate actor: stakeholders, managers and shareholders.

65 A corporation's stakeholders[242] can be distinguished into contractual and non-contractual constituencies. Contractual constituencies, including customers, employees and investors, are able to incorporate non-financial preferences in their bargaining process with the corporation and offer contractual compensation for their consideration. While the relationship between employees and the firm is a distinct topic in corporate governance[243] and extensively addressed in labour economics,[244] customers and investors more clearly fall into the realm of CSR: *Section 4.1* above outlines that the non-financial preferences of these groups are internalised as part of financial performance maximisation, e.g. through targeted marketing or reputational risk management strategies.[245] Investors play a special role as shareholders, who are treated below; the emergence of a 'socially responsible' bonds market however indicates that profit maximising strategies to CSR have permeated financial markets.[246] Non-contractual constituencies, e.g. those affected by externalities[247] or simply the public who holds an opinion on the company, affect the corporation in two ways according to Bénabou and Tirole:[248] their non-financial preferences can influence policymaking and thus find expression in public regulation;[249] as it has been shown above, corporations also respond to public regulation with CSR under profit maximisation concerns. Otherwise, politically unattended views can be picked up by activists like NGOs; Baron has shown that corporations respond to activist pressure with CSR as profit maximisation as well.[250] Thus, whenever CSR responds to the non-financial preferences of stakeholders, it happens as a form of profit maximisation and is congruent with agency theory under the 'business case'.

[241] R. Bénabou & J. Tirole, 'Incentives and Prosocial Behavior', *American Economic Review*, vol. 96(5), 2006, 1652-78.
[242] 'Stakeholders' here is understood in Freeman's narrow sense as all those "who can affect or [are] affected by the achievement of the organization's objective" excluding shareholders and executive management; Freeman (1984), *supra* note 207, at p. 46.
[243] Cp. Kraakman et al. (2017), *supra* note 159, at pp. 89 et seq.
[244] Cp. G. Akerlof, 'Gift Exchange and Efficiency Wage Theory: Four Views', *American Economic Review*, vol.74(2), 1984, pp. 79-83.
[245] *Supra*, para. 51.
[246] *The Economist* reports that since its inception in 2017, the 'sustainable bonds' market for sustainability-linked loans has grown to USD 122 billion in 2019; see The Economist, *Green Paper*, 15 February 2020, p. 60.
[247] Regularly, those affected by corporate externalities are tort victims and thus uphold a legal affiliation with the corporation, albeit not a contractual one; cp. Kraakman et al. (2017), *supra* note 159, at p. 92.
[248] R. Bénabou & J. Tirole, 'Individual and Corporate Social Responsibility', *Economica*, vol. 77(1), 2010, pp. 1-19.
[249] A basic model on the interaction of heterogeneous ethical preferences, policymaking and CSR is provided by Kitzmueller & Shimshack (2012), *supra* note 94; also cp. R. Bénabou & J. Tirole, 'Belief in a Just World and Redistributive Politics', *Quarterly Journal of Economics*, vol. 121(2), 2006, pp. 699-746. The literature on the role of moral for public regulation indicates, however, that the development of more sophisticated models is still an area of future research for CSR scholarship, cp. A. Rustichini, 'Morality, Policy, and the Brain', *Journal of Economic Literature*, vol. 56(1), 2018, pp. 217-33.
[250] Baron (2001), *supra* note 99.

66 Managers, i.e. those executives who wield decision-making capacity in the corporation, are a simpler case. It is empirically well documented that managerial personal characteristics are an important determinant of CSR,[251] which makes the success of any CSR strategy dependent on its initiators. If managers impose their personal non-financial preferences on the corporate decision-making process in a deviation from set targets, though, they redistribute the wealth of shareholders.[252] The imposition of non-financial preferences by managers thus corresponds to the view of CSR as an agency cost and a problem of corporate governance.[253]

67 The role of shareholders is different. The concept of investor ownership posits that a corporation should be run in their interest, which is generally assumed to be long-term profit maximisation. If shareholders impose non-financial preferences on the firm, however, financial performance can deteriorate.[254] This complicates the agency model of shareholders and managers,[255] as the assumption that profit-sacrificing CSR is an agency cost no longer holds. Baron goes as far as to say that this extends to all forms of CSR that are *ex ante* known to investors and thus internalised in the share price.[256] CSR delegated by shareholders thus fits neither of two traditional agency views. Hart and Zingales argue that due to their unique position as owners, the interests of shareholders should override the presumed and generic aim of long-term financial firm value.[257] While this view still precludes agency problems among shareholders[258] as well as the internal complexity of institutional investors,[259] it is evident that the imposition of shareholders' non-financial preferences is a form of CSR that needs to be treated separately from the 'business case' and the agency problem views of CSR.

4.3 Towards a Categorisation of CSR Activities

68 The institutional literature introduced in *Section 2* has established that CSR is a complex phenomenon that differs across time, jurisdictions, cultures and corporations.[260] A review of the literature on CSR on the firm-level shows that it is equally not a monolithic phenomenon, but the result of multiple interacting, coexisting determinants. Neoclassical agency theory, especially the dichotomy of the 'business case' and rent-seeking hypothesis as rivalling hypotheses, fail to fully explain CSR. That is why for the purpose of this thesis, CSR is not understood as a single form of corporate engagement, but instead differentiated along those determinants into separate categories. With these categories of CSR activities, it is possible to analyse the effects of different incentives in the corporate governance environment, particularly executive compensation, on different forms of CSR.

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[251] M. Manner, 'The Impact of CEO Characteristics on Corporate Social Performance', *Journal of Business Ethics*, vol. 93, supplement 1, 2010, pp. 53-72.
[252] Baron (2001), *supra* note 99. Furubotn & Pejovich (1972), *supra* note 191.
[253] *Supra*, para. 53.
[254] Cp. Baron (2001), *supra* note 99.
[255] Cp. Salazar & Husted (2008), *supra* note 14.
[256] D. Baron, 'Corporate Social Responsibility and Social Entrepreneurship', *Journal of Economics & Management Strategy*, vol. 16(3), 2007, pp. 683-717.
[257] Hart & Zingales (2017), *supra* note 169.
[258] Cp. Kraakman et al. (2017), *supra* note 159, at pp. 79 et seq.
[259] On the internal complexity of institutional investors, cp. *Chapter Three*, at pp. 84-89.
[260] *Supra*, para. 22.

69 Differentiating CSR along its drivers is not a novel endeavour. Baron sees CSR as either a profit maximising strategy, the result of altruism or threats by activists.[261] As shown above, however, CSR as a response to activist threats can be equally rationalised under profit maximisation, and altruism needs to be differentiated along the relevant actors' roles. Aguilera et al. differentiate instrumental, relational and moral motives for CSR engagement.[262] This categorisation, while suitable to inform managerial decision-making, fails to address the role incentives as understood in corporate governance. The categorisation that resembles most closely the approach adopted here is that of Bénabou and Tirole: they distinguish between 'win-win' CSR, i.e. financially motivated engagement; delegated philanthropy, describing CSR as the result of altruism; and insider-initiated CSR, which in essence captures the agency problem view.[263] For the arguments brought forward in *Section 4.2*, it is argued that CSR as a response to external stakeholders' altruism is captured by the 'business case' view, leaving solely the non-financial preferences of shareholders as a distinct category. Based on a modification of Bénabou and Tirole's approach, this thesis thus proposes the following categorisation of CSR activities:

> *(i) Instrumental CSR*: This category all forms of CSR engagement that are motivated by improving the company's financial performance. It incorporates the 'business case' literature and the influence of stakeholders' non-financial preferences.
>
> *(ii) Managerial CSR*: This category describes the conventional view of CSR as an agency cost. It is the result of managerial—material or altruistic—self-interest where it is detrimental for shareholders.
>
> *(iii) CSR as delegated shareholder philanthropy*: This last category captures CSR that is initiated by shareholders to satisfy their non-financial preference at the expense of financial performance.

70 These three categories provide a synthesis of the agency literature on CSR that draws from the existing empirical evidence and includes insights from the role of non-financial preferences in corporate governance. The remainder of this section further elaborates on them and discusses their implications for the role of CSR in corporate governance.

4.3.1 Instrumental CSR

71 With a varying definitional scope, the attribute 'instrumental' is used in the literature to describe financially motivated CSR and delineate it from various other forms.[264] Here, the term is understood to encompass all forms of CSR as defined in *Section 2*[265] that are intended to

[261] Baron (2007), *supra* note 251.
[262] Aguilera et al. (2007), *supra* note 179.
[263] Bénabou and Tirole furthermore use a wider understanding of CSR than the economic definition developed in this chapter, as their inclusion of the example of 'sin stocks' shows. See Bénabou & Tirole (2010), *supra* note 248.
[264] Garriga and Melé use the term for narrow, economic activities of CSR, Aguilera et al. use it to distinguish material from personal motivations, Moir uses the broadest definition to distinguish financially from ethically motivated CSR. See Garriga & Melé (2008), *supra* note 192; Aguilera et al. (2007), *supra* note 174; L. Moir, 'What Do We Mean by Corporate Social Responsibility?', *Corporate Governance: International Journal of Business and Society*, vol. 1(1), 2001, pp. 16-22.
[265] *Supra*, para. 26.

improve a company's long-term financial performance. It thus functions as an umbrella term for the different forms of the 'business case' that outline all the potential ways in which CSR can contribute to financial performance.

72 Arguably, summarising these different forms of CSR under one category whose sole common characteristic is financial performance improvement may bring about analytical disadvantages. Stakeholder relations, environmental risk management and anticipating public regulation, for instance, are hardly dependent upon the same economic conditions. That is why other categorisations sometimes distinguish profit-motivated CSR further by the prevalence of non-financial preferences[266] or the role of internal and external actors.[267] Such approaches allow a more detailed evaluation for managerial decision-makers which kind of strategy to pursue. Here, a broad categorisation is nevertheless pursued, because it allows a better integration of CSR and corporate governance, which is a prerequisite to analyse the relationship between executive compensation and CSR. Corporate governance, at its core, is occupied with the agency conflict between shareholders and managers and incentivising the latter to pursue long-term firm value maximisation.[268] Even though corporate governance systems also address the interests of stakeholder to varying degrees and in different ways, the basic notion that decisions should be made in the interest of shareholders if no overriding, contrary reason exists persists in every jurisdiction.[269] This particularly holds true for executive compensation, which—as is explained below—is an element of internal governance designed to address the shareholder-manager agency conflict.[270] The relationship between CSR and corporate governance, besides the implicit inclusion of stakeholder interests,[271] is thus mainly determined by financial performance.[272] The main exercise of the analysis in the subsequent chapters in this regard will thus be to identify the conditions of whether and how managerial incentives to improve financial performance are translated into type-(i) instrumental CSR.

73 This approach is supported by the consistent empirical evidence that shows a positive effect of corporate governance quality on CSR engagement.[273] This is indicative of the prominence of the 'business case' in modern CSR and its positive contribution to financial performance.[274] Another important reason for this observation is that many forms of instrumental CSR—balancing stakeholder interests, mitigating non-financial risks, adopting and enforcing codes of conducts and standards—require a sophisticated governance system.[275] An crucial dimension of this is time horizon: instrumental CSR is generally considered to benefit financial

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[266] E.g. Bénabou & Tirole (2010), *supra* note 248.
[267] E.g. Baron (2001), *supra* note 99.
[268] Cp. Jensen & Meckling (1976), *supra* note 9; Shleifer & Vishny (1997), *supra* note 183.
[269] Cp. Kraakman et al. (2017), *supra* note 159, at pp. 22-24.
[270] *Infra*, para. 88.
[271] Matten & Moon (2008), *supra* note 16.
[272] Cp. Williams (2018), *supra* note 51.
[273] H. Jo & M. Harjoto, 'The Causal Effect of Corporate Governance on Corporate Social Responsibility', *Journal of Business Ethics*, vol. 106(1), 2012, pp. 53-72; C. Mallin, G. Michelon & D. Raggi, 'Monitoring Intensity and Stakeholders' Orientation: How Does Governance Affect Social and Environmental Disclosure?', *Journal of Business Ethics*, vol. 114(1), 2013, pp. 29-43.
[274] Cp. Williams (2018), *supra* note 51.
[275] As argued by e.g. Jo & Harjoto (2012), *supra* note 268. Note that this relationship between corporate governance and CSR only holds for instrumental CSR: empirical evidence shows that CSR as an agency problem is linked to a lack of functioning governance; cp. P. Arora & R. Dharwadkar, 'Corporate Governance and Corporate Social Responsibility (CSR): The Moderating Roles of Attainment Discrepancy and Organization Slack, *Corporate Governance An International Review*, vol. 19(2), 2011, pp. 136-52.

performance in the long run, which is contrasted by short-term expenditures.[276] A failure of corporate governance to counter short-termism, which has extensively been covered in the management literature,[277] is thus usually related to both a decrease in long-term financial performance and CSR engagement.[278] Compensation schemes play a paramount role among the instruments to incentivise long-term managerial decision-making.

74 Apart from these basic governance conditions, the link between CSR and profits essentially depends on the idiosyncrasies of business. CSR engagement looks different in every industry, and thus its determinants change: proximity to consumers and the public make reputational risks more salient, while in an environmental sector, CSR can mitigate long-term financial risks.[279] Depending on the type of industry and company, stakeholder interests are different, which for example affects the ability of CSR to attract employees.[280] Market structure and competitiveness are further important factors.[281] As CSR can have a different meaning in different places, making the definition of type-(i) instrumental CSR dependent upon this factors risks diluting comparability of results. The analysis in the subsequent chapters thus focuses on how corporate governance mechanisms incentivise CSR separately from the influence of any external factors.

4.3.2 Managerial CSR

75 This category describes CSR as an agency cost, i.e. a form of rent extraction that financially harms the company and benefits its manager.[282] 'Manager' here generally refers to executive directors who stand in a contractually determined agency relationship with shareholders; however, it also applies to managerial decision-makers below the board level.[283] The 'Friedmanite' view of type-(ii) managerial CSR is that of corporate funds allocated to philanthropic expenditures instead of a business purpose.[284] This view is based on the traditional economic literature that identifies managerial personal preferences[285] and

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[276] R. Eccles, I. Ioannou & G. Serafeim, 'The Impact of Corporate Sustainability on Organizational Processes and Performance', *Management Science*, vol. 60(11), 2014, pp. 2835-57.
[277] For a seminal contribution, cp. K. Laverty, 'Economic "Short-Termism": The Debate, the Unresolved Issues, and the Implications for Management Practice and Research', *Academy of Management Review*, vol. 21(3), 1996, pp. 825-60.
[278] Bénabou & Tirole (2010), *supra* note 248.
[279] Cp. M. Maloni & M. Brown, 'Corporate Social Responsibility in the Supply Chain: An Application to the Food Industry', *Journal of Business Ethics*, vol. 68(1), 2006, pp. 35-52; H. Jenkins & N. Yakovleva, 'Corporate Social Responsibility in the Mining Industry: Exploring Trends in Social and Environmental Disclosure', *Journal of Cleaner Production*, vol. 14(3-4), 2006, pp. 271-84.
[280] Cp. D. Turban & D. Greening, 'Corporate Social Performance and Organizational Attractiveness to Employees', *Academy of Management Journal*, vol. 40(3), 1997, pp. 658-72.
[281] Cp. M. Porter & M. Kramer, 'Strategy and Society: The Link between Competitive Advantage and Corporate Social Responsibility', *Harvard Business Review*, vol. 84(12), 2006, pp. 78-92.
[282] The term 'rent extraction' is explained in the context of executive compensation; see *infra*, para. 87.
[283] This definition excludes independent directors, i.e. members of the board who do not perform executive management functions; their role is covered in *Chapter Three*, at pp. 90-97.
[284] Cp. *supra*, para. 53.
[285] Furubotn & Pejovich (1972), *supra* note 191.

discretion[286] as key factors of agency costs. As explained above,[287] the development of CSR away from such discretionary philanthropy towards institutionalised self-regulatory codes and practices has been a response to these issues. Conversely to this form of CSR, which is captured by the first category above, 'managerial CSR' is defined as CSR expenditures that are intended to benefit managers at the financial detriment of shareholders.

76 There are two problems that complicate the traditional view of CSR as an agency cost. The first problem is that today the question whether CSR, in general, is an agency problem can be answered with 'no.'[288] The emergence of the 'business case' has induced an alignment of CSR with financial performance maximisation that makes discretionary philanthropy a rather exceptional appearance. The second problem is that, as the empirical literature shows, the preferences and personal characteristics of managers are an important determinant of CSR engagement *per se*, not just agency-cost CSR.[289] The fact that there is comparatively little discretion in modern CSR and that the prevalence of managerial non-financial preferences alone are no indicator of rent-seeking either make the traditional 'Friedmanite' view difficult to apply. Two theoretical approaches provide a response to this issue by offering more refined theories of CSR as an agency problem.

77 The first approach is known as the overinvestment hypothesis, introduced by Barnea and Rubin.[290] It is an extension of the 'Friedmanite' view and assumes an existing cost-benefit equilibrium in which CSR investments maximise profits.[291] This accounts for the prevalence of CSR engagement schemes embedded in corporate strategies and thus at least partially outside of managerial discretion. Managers may, however, receive a 'warm glow' effect[292] or any external, e.g. reputational, benefit from investing into CSR. This poses an incentive to overinvest and exceed the cost-benefit equilibrium of CSR.[293] The overinvestment hypothesis is thus an adaptation of the 'Friedmanite' view of CSR that recognises the overall prevalence of financially motivated CSR and combines it with insights about the role of non-financial preferences and weak governance.[294]

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286 O. Williamson, 'Managerial Discretion and Business Behavior', *American Economic Review*, vol. 53(5), 1963, pp. 1032-57.
287 *Supra*, para. 54-58.
288 H. Liang & L. Renneboog, 'Is Corporate Social Responsibility an Agency Problem?', in: S. Boubaker, D. Cumming & D. Nguyen (eds.), *Research Handbook of Finance and Sustainability*, Cheltenham, Edward Elgar Publishing, 2018; F. Li, T. Li & D. Minor, 'CEO Power, Corporate Social Responsibility, and Firm Value: A Test of Agency Theory', *International Journal of Managerial Finance*, vol. 12(5), 2016, pp. 611-28.
289 Manner (2010), *supra* note 246; C. Hemingway & P. Maclagan, 'Managers' Personal Values as Drivers of Corporate Social Responsibility', *Journal of Business Ethics*, vol. 30(1), 2004, pp. 33-44; R. Borghesi, J. Houston & A. Naranjo, 'Corporate Socially Responsible Investments: CEO Altruism, Reputation, and Shareholder Interests', *Journal of Corporate Finance*, vol. 26(1), 2014, pp. 164-81.
290 Barnea and Rubin do not only apply this model to managers, but also insider shareholders; see Barnea & Rubin (2010), *supra* note 227.
291 On trade-offs in CSR investments, cp. L. Becchetti, R. Ciciretti & I. Hasan, 'Corporate Social Responsibility, Stakeholder Risk, and Idiosyncratic Volatility', *Journal of Corporate Finance*, vol. 35(1), 2015, pp. 297-309.
292 Cp. Andreoni (1990), *supra* note 238.
293 Barnea & Rubin (2010), *supra* note 227.
294 Cp. M. Bertrand & S. Mullainthan, 'Enjoying the Quiet Life? Corporate Governance and Managerial Preferences', *Journal of Political Economy*, vol. 111(5), 2003, pp. 1043-75.

78 The second approach, called entrenchment hypothesis, has been developed by Cespa and Cestone and posits that managers may use any discretion they have in CSR to entrench themselves,[295] i.e. protect against removal or shareholder control.[296] By over-investing into stakeholder management, managers 'buy' the support of influential corporate constituencies. This makes their dismissal more costly, as stakeholders would oppose such attempts and the departure of an executive known to promote CSR engagement may cause reputational losses for the company.[297] The entrenchment hypothesis differs from the overinvestment hypothesis insofar as it postulates CSR not to be the consequence of weak corporate governance, but instead an instrument to circumvent functioning governance control. Empirical evidence supports the use of CSR as an entrenchment mechanism[298] and a link between entrenchment and stakeholder expenditures.[299]

79 The overinvestment and entrenchment hypothesis are adaptations of the traditional view of CSR as an agency problem to the contemporary form of institutionalised CSR, organised along the 'business case' normative. While managerial discretion still plays a role in both approaches, CSR as overinvestment is the result of a lack of control and CSR as entrenchment a response to circumvent control. This has implications for the analysis in the subsequent chapters, which needs to account for the interplay of discretion and governance mechanisms. While 'Friedmanite' agency-cost CSR may still occur where CSR is less institutionalised, the focus of type-(ii) managerial CSR is on those two approaches.

4.3.3 CSR as Delegated Shareholder Philanthropy

80 Bénabou and Tirole use the term "delegated philanthropy" to refer to CSR as the expression of non-financial preferences.[300] As explained above, stakeholder preferences are internalised through instrumental CSR,[301] leaving 'delegated shareholder philanthropy' as a third category outside the agency view of CSR and with an ambiguous relationship to financial performance. Whenever shareholders impose non-financial preferences on corporations, they are willing to sacrifice profits or at least neutral towards its effects on financial performance. Such cases are a deviation from the assumption that profit maximisation equals shareholder welfare, along which governance is traditionally structured. Including type-(iii) delegated shareholder philanthropy as a form of CSR necessitates clarifying what the preferences of shareholders are, how they are imposed and how they relate to the conventional empirical approach to CSR based on financial performance.

81 In principle, non-financial preferences are traits of human beings. While individual persons are still a relevant shareholder group, especially in jurisdictions with traditionally dispersed ownership patterns, institutional investors have become the most prevalent shareholder type in

[295] G. Cespa & G. Cestone, 'Corporate Social Responsibility and Managerial Entrenchment', *Journal of Economics & Management Strategy*, vol. 16(3), 2007, pp. 741-71.
[296] Cp. E. Fama, 'Agency Problems and the Theory of the Firm', *Journal of Political Economy*, vol. 88(2), 1980, pp. 288-307.
[297] Cespa & Cestone (2007), *supra* note 295.
[298] J. Surroca & J. Tribó, 'Managerial Entrenchment and Corporate Social Performance', *Journal of Business Finance & Accounting*, vol. 35(5-6), 2008, pp. 748-89.
[299] H. Cronqvist et al., 'Do Entrenched Managers Pay Their Workers More?', *Journal of Finance*, vol. 64(1), 2009, pp. 309-39.
[300] Bénabou & Tirole (2010), *supra* note 248, at p. 10.
[301] *Supra*, para. 67.

many jurisdictions though.[302] As investment companies with complex internal governance themselves,[303] the preferences of institutional investors and their influence on CSR are less easy to determine. For once, a market for 'sustainable' or 'socially responsible investments' (SRI) has emerged, in which investors make non-financial criteria explicitly part of their investment decision. While still a niche, SRI is growing fast, having reached a total asset volume of USD 31 trillion in 2018, a 34-percent increase within two years.[304] Secondly, also large mainstream investors have begun to pay attention to CSR performance. In 2020, Blackrock's CEO Larry Fink announced divestments from "high sustainability-related risk" companies and the intention to exert pressure for improved CSR disclosure by companies.[305] The effect of institutional investor presence on CSR engagement has long remained ambiguous, however,[306] and only more recent empirical evidence suggests a positive relationship.[307] This likely reflects the fact that institutional investors have embraced CSR as a long-term strategy to improve financial performance, which makes separating material from altruistic motivations a difficult endeavour.[308]

82 Where they hold any non-financial preferences, investors have two channels to impose them: either through market pressure, i.e. diverting the supply of capital, or through shareholder activism. Market pressure in the case of unaffiliated outside investors is a form of type-(i) instrumental CSR, as it affects corporations through the financial channel of shifts in capital supply.[309] For actual shareholders, divestment can be a market-mechanism-based choice or a credible threat as part of an activist engagement strategy. Empirical evidence suggests that institutional investors rather impose their preferences through public or 'behind closed doors' negotiations than 'voting with their feet'.[310] This choice depends a lot on the existing governance arrangements: where shareholders are directly empowered, e.g. by voting rights, they can more easily impose their preferences within a corporation's governance processes. Where the law instead aims to protect the shareholder instead of empowering them to do so themselves, it usually assumes profit maximisation to be their main or sole interest. This makes the imposition of non-financial preferences for shareholders more difficult. The conflict of

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302 Cp. Kraakman et al. (2017), *supra* note 159, at pp. 25-28.
303 Cp. R. Gilson & J. Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights', *Columbia Law Review*, vol. 113(4), 2013, pp. 863-927.
304 Global Sustainable Investment Alliance, *2018 Global Sustainable Investment Review*, 2019, available at http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf.
305 L. Fink, *Annual Letter to CEOs – A Fundamental Reshaping of Finance*, 2020, available at https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceo-letter.
306 Cp. S. Graves & S. Waddock, 'Institutional Owners and Corporate Social Performance', *Academy of Management Journal*, vol. 37(4), 1994, pp. 1034-46; R. Johnson & D. Greening, 'The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance', *Academy of Management Journal*, vol. 42(5), 1999, pp. 564-76; D. Neubaum & S. Zahra, 'Institutional Ownership and Corporate Social Performance: The Moderating Effects of Investment Horizon, Activism and Coordination', *Journal of Management*, vol. 32(1), 2006, pp. 108-31; Borghesi et al. (2014), *supra* note 289.
307 A. Dyck et al., 'Do Institutional Investors Drive Corporate Social Responsibility? International Evidence', *Journal of Financial Economics*, vol. 131(3), 2019, pp. 693-714.
308 Cp. P. Krueger, Z. Sautner & L. Starks, 'The Importance of Climate Risks for Institutional Investors', *Review of Financial Studies*, vol. 33(3), 2020, pp. 1067-1111.
309 Cp. *supra*, para. 65, 67.
310 Dyck et al. (2019), *supra* note 307.

empowering versus protecting the interests of shareholders in governance arrangements[311] is a key part of the analysis in the subsequent chapter for type-(iii) CSR.

83 Measuring delegated shareholder philanthropy is difficult. While the conventional agency view of CSR regularly employs financial performance as a proxy indicator to infer the motivations behind CSR engagement, this approach is not viable where profits are not considered. Type-(iii) delegated shareholder philanthropy may also constitute an agency problem where a controlling blockholders' preferences override those of minority shareholders.[312] This complicates an empirical approach to the topic, but *Section 4.2* has demonstrated that including this category is necessary for a complete picture of CSR on the firm level. Focus will thus lie on a qualitative analysis of governance arrangements for the effects of executive pay regulation on delegated shareholder philanthropy.

4.4 Summary

84 With this tripartite categorisation, an attempt has been made to provide a comprehensive summary of the firm-level determinants of CSR engagement. The main advantage of this approach is that it allows to simultaneously analyse the effects of changes in the governance environment on different drivers of CSR. The role of non-financial preferences has been reconciled with the conventional, agency-based approach to CSR that focuses on financial performance. The following figure shows the complete definition of CSR used in this thesis, consisting of its theoretical-conceptual layer, its economic purpose, and the level of measurable corporate activities:

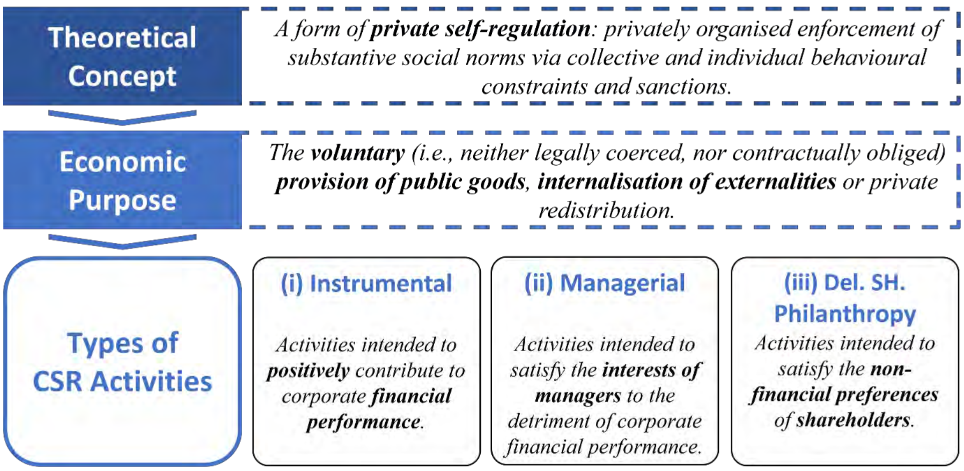

Figure 3: The definition of CSR in this thesis, part 2.

85 A few restrictions of this approach are important to stress. First, Bénabou and Tirole correctly note that in practice, any such division between different forms of CSR can be "elusive".[313]

[311] Cp. K. Cremers & S. Sepe, 'The Shareholder Value of Empowered Boards', *Stanford Law Review*, vol. 68(1), 2016, pp. 67-148.
[312] Cp. Barnea & Rubin (2010), *supra* note 227.
[313] Bénabou & Tirole (2010), *supra* note 248, at p. 12.

Motivations may overlap and result in forms of CSR that present a mix of different categories. While that is a general problem of CSR theory in general, this approach explicitly focuses on the level of motivations to analyse their interplay with incentives. Secondly, little attention is paid to the external conditions under which these motivations and incentives are translated into actual CSR engagement. That is why a separate analysis of these conditions is conducted in *Chapter Four*.[314]

86 This categorisation also accounts for the normative importance of the agency view, which promotes the 'business case' and discourages CSR where it is perceived to be an agency cost. The role of delegated shareholder philanthropy remains debated and its desirability more ambiguous.[315] The differentiation nevertheless allows to develop a more refined understanding of how different governance arrangements affect any of these forms and, consequently, how regulation incentivises or disincentivises CSR. The central governance elements regarding managerial incentives, executive compensation, is covered in the next section.

Section 5: CSR and Executive Compensation

87 So far, this chapter has derived a definition for the concept of CSR, provided a structural overview of its relationship with the law, and developed a categorisation of CSR activities based on its firm-level determinants. A final step towards an analysis of the effects of pay regulation on CSR engagement is elucidating the role of executive compensation itself in this framework. As already hinted at in the previous section, corporate governance mechanisms determine the interplay of external incentives with personal motivations in CSR engagement. In this section, it is explained why executive pay is the key governance element to shape incentives, highlighting structural commonalities with CSR under agency theory and setting out its elements relevant for this research (*section 5.1*). Subsequently, the empirical CSR-executive pay literature is reviewed to identify the effects of different compensation instruments on CSR (*section 5.2*). Building upon these insights, conclusions are derived for the analysis of executive pay regulation in the following chapters (*section 5.3*).

5.1 Executive Compensation in Agency Theory

88 Compensation arrangements are, together with managerial labour and corporate control markets,[316] the key source for decision-making incentives in a corporation. Conventionally, executive compensation is understood through agency theory,[317] which has produced two rivalling views of it. These views, known as the 'optimal contracting' and 'rent extraction hypothesis' respectively, interpret compensation either as an instrument to align managerial incentives with shareholder interests or a source of agency costs *sui generis*.[318] These views

[314] *Chapter Four*, at p. 146.
[315] Cp. Hart & Zingales (2017), *supra* note 169.
[316] As seminal contributions, cp. Fama (1980), *supra* note 291; E. Fama & M. Jensen, 'Separation of Ownership and Control', *Journal of Law and Economics*, vol. 26(2), 1983, pp. 301-25.
[317] Ferrarini & Ungureanu (2018), *supra* note 4.
[318] For an overview, cp. ibid., at pp. 334-36.

are similar to the 'business case' and the 'Friedmanite' view of CSR.[319] Agency theory thus provides a common analytical framework, focused on the shareholder-management relationship, for the subsequent chapters. It highlights the importance of the structure of compensation, i.e. different elements of pay, as incentive mechanisms, particularly regarding financial performance maximisation, time horizon and risk preferences. It also points towards the governance quality of the pay-setting process under agency concerns and the imposition of CSR performance targets as possible direct incentivisation channel.

89 The original function of executive pay, which is captured by the 'optimal contracting hypothesis', is that of compensation as a private remedy to the agency conflict between managers and shareholders that arises from the separation of ownership and control.[320] This agency conflict, which is further exacerbated in corporations by the degree of ownership dispersion,[321] can be countered by tying managerial payoffs to indicators of shareholder wealth, a practice known as 'pay-for-performance'.[322] Today, this is generally achieved through the use of equity compensation and linking variable compensation to pre-determined performance indicators.

90 The 'rent extraction hypothesis' conversely claims that executive pay does not always need to be a remedy to but can itself be a form of agency costs as well.[323] Compensation schemes between a corporation and its management are regularly negotiated by the board of directors on the shareholders' behalf. As agents themselves, directors may lack incentives to draft optimal pay schemes. Commonly, directors are also part of executive management and thus have conflicting interests in setting their own compensation.[324] This can induce managers to extract rents for themselves through 'excessive' levels of pay, inefficiently low performance targets and opaque contractual design to obfuscate these practices.[325] The rent extraction hypothesis stresses the importance of protecting "the effectiveness of the executive pay contract as a remedy for manager/shareholder agency costs […] from conflicts between the board, as pay-setters, and the shareholders."[326] This entails inhibiting compensation practices that qualify as so-called 'pay-for-non-performance'[327] and establishing the appropriate governance processes to safeguard such self-dealing transactions.

91 The 'optimal contracting' and 'rent extraction hypothesis', which both pursue shareholder welfare maximisation, are best understood as complementary explanations for executive

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[319] Cp. *supra*, para. 51 et seq.
[320] Cp. Kraakman et al. (2017), *supra* note 159, at pp. 11-15, 52 et seq.; Fama & Jensen (1983), *supra* note 316.
[321] Jensen & Meckling (1976), *supra* note 9.
[322] M. Jensen & K. Murphy, 'Performance Pay and Top Management Incentives', *Journal of Political Economy*, vol. 98(2), 1990, pp. 225-64.
[323] L. Bebchuk, J. Fried & D. Walker, 'Managerial Power and Rent Extraction in the Design of Executive Compensation', *University of Chicago Law Review*, vol. 69(3), 2002, pp. 751-846; L. Bebchuk & J. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, Harvard, Harvard University Press, 2004.
[324] Cp. Kraakman et al. (2017), *supra* note 159, at pp. 146 et seq.
[325] M. Jensen & K. Murphy, 'Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them', *ECGI Working Paper Series in Finance*, Working Paper No. 44/2004, 2004.
[326] Ferrarini & Ungureanu (2018), *supra* note 4, at p. 335.
[327] Cp. L. Bebchuk & J. Fried, 'Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage', *Journal of Corporation Law*, vol. 30(4), 2004, pp. 807-22.

compensation.[328] In an extensive literature survey, Edmans et al. conclude that neither hypothesis alone fully explains the empirical evidence, stressing that "[n]o one perspective can explain all of the evidence, and a narrow attachment to one perspective will distort rather than inform our view of executive pay."[329] This conclusion unveils several similarities in executive pay and CSR. Corporate governance scholarship interprets both as issues of the same shareholder-manager agency relationship. Similar to the 'business case' and 'Friedmanite' view of CSR,[330] the 'optimal contracting' and 'rent-seeking hypothesis' predict an either positive or negative effect of executive pay on corporate financial performance. The central question thus is whether and under which conditions compensation structured to incentivise financial performance maximisation translates into incentives for instrumental CSR engagement.[331] To better understand this link, it is necessary to go into greater detail on the structure of compensation and the pay-setting process, through which compensation schemes and performance targets are set.

92 Total compensation is structured into the different elements of fixed pay, i.e. salary, and various forms of variable or 'incentive pay'.[332] Variable pay includes cash bonuses and equity compensation. Equity, i.e. shares or share-linked instruments, is considered the most direct and simplest form of tying managerial payoffs to the wealth of shareholders,[333] which is why it constitutes the main element of executive pay today, especially in the US.[334] A first step in the analysis thus is to clarify whether and how these basic elements of compensation—salary, cash bonuses, equity—affect incentives for CSR engagement. Going into greater detail, two specificities of variable pay components are relevant: effects on time horizons and risk preferences. As explained above, CSR activities linked to financial performance are often long-term investment and risk mitigation strategies.[335] That is why the following evaluation of the empirical literature pays attention to the use of stock options, which encourage managerial risk-taking,[336] and restricted stock and bonuses for their internalisation of long-term performance.[337]

93 Elucidating whether compensation instruments create any indirect incentives for CSR engagement via the channel of financial performance is a first step. A second, more direct way of incentivising CSR is the use of performance targets. Variable compensation may be awarded conditionally upon reaching certain qualitative or quantitative performance targets, which is a

[328] Murphy criticises their treatment as rivalling hypothesis to be a major structural shortcoming of the current literature on executive compensation; see K. Murphy, 'Executive Compensation: Where We Are, and How We Got There', in: G. Constantinides et al. (eds.), *Handbook of the Economics of Finance*, vol. 2A, Amsterdam, Elsevier, 2013.
[329] A. Edmans, X. Gabaix & D. Jenter, 'Executive Compensation: A Survey of Theory and Evidence', *ECGI Working Paper Series in Finance*, Working Paper No. 514/2017, 2017, at p. 103.
[330] *Supra*, para. 51.
[331] *Supra*, para. 71.
[332] Other forms of compensation like perquisites ('perks') or pension claims are omitted at this stage for reasons of simplicity.
[333] K. Murphy, 'Corporate Performance and Managerial Remuneration: An Empirical Analysis', *Journal of Accounting and Economics*, vol. 7(1), 1985, pp. 11-42.
[334] Murphy (2013), *supra* note 328.
[335] *Supra*, para. 54-58.
[336] Cp. Ferrarini & Ungureanu (2018), *supra* note 4, at pp. 340-41.
[337] Cp. S. Bhagat & R. Romano, 'Reforming Executive Compensation: Focusing and Committing to the Long Term', *Yale Journal of Regulation*, vol. 26(2), 2009, pp. 359-72; L. Bebchuk & J. Fried, 'Paying for Long-Term Performance', *University of Pennsylvania Law Review*, vol. 158(7), 2010, pp. 1915-60; D. Walker, 'The Challenge of Improving the Long-Term Focus of Executive Pay', *Boston College Law Review*, vol. 51(2), 2010, pp. 435-72.

possibility to tie managerial payoffs directly to CSR engagement. As this does not affect CSR through its link to financial performance, it raises the question whether and under which governance conditions performance targets also incentivise type-(ii) managerial CSR and type-(iii) delegated shareholder philanthropy. The following section thus also reviews the prevalence and effectiveness of CSR performance targets in incentivising CSR engagement and the conditions under which corporations employ such targets.

5.2 Literature Review: CSR and Executive Pay

94 The role of pay regulation as part of the institutional determinants of CSR depends on the channels through which compensation affects incentives for CSR engagement. Compared to other elements of corporate governance, executive compensation merits special attention because it can be directly influenced by the board of directors and shareholders. This review of the empirical literature on the causal relationship between executive pay and CSR focuses on three elements: different pay instruments, governance of the pay-setting process, and the use CSR performance targets. As the literature often reaches contradictory results, attention is paid to theoretical discrepancies in the underlying hypotheses and study design. Conclusions are derived for the subsequent use of the tripartite categorisation of CSR activities developed above.

95 One of the first inquiries into the relationship of executive pay and CSR was conducted by Stanwick and Stanwick in 2001.[338] Based on US data from 1990-91 and the *Fortune* Corporate Reputation Index, they find a negative relation between total CEO compensation and reputation for environmental performance. The authors conclude that executives were financially discouraged from pursuing a strong environmental reputation. Despite quantitative limitations in the data and criticism of their CSR measurement,[339] the study was the first to provide empirical evidence that corporations do not incentivise CSR engagement.

96 A more extensive analysis of the effects of different pay instruments on CSR was conducted by McGuire et al. in 2003.[340] Notably, they differentiate between strong and poor social performance as two distinct dimensions of CSR. That is because particularly the avoidance of poor social performance is related to the cost and risk management aspects of the 'business case' for CSR. This distinction is useful given that the effects of executive pay on managerial risk preferences are well established[341] and executive compensation generally does not stipulate extraordinary social performance.[342] However, McGuire et al. find no evidence for a link between any compensation instrument and strong social performance.[343] Instead, they find a positive effect of stock options, used as a measure of long-term compensation, on poor social performance, which the authors interpret as evidence for a trade-off between CSR and financial performance. The effect is stronger in firms with high levels of institutional ownership. Their

[338] P. Stanwick & S. Stanwick, 'CEO Compensation: Does It Pay to Be Green?', *Business Strategy and the Environment*, vol. 10(3), 2001, pp. 176-82.
[339] Cp. G. Fryxell & J. Wang, 'The *Fortune* Corporate 'Reputation' Index: Reputation for What?', *Journal of Management*, vol. 20(1), 1994, pp. 1-14.
[340] J. McGuire, S. Dow & K. Argheyd, 'CEO Incentives and Corporate Social Performance', *Journal of Business Ethics*, vol. 45(4), 2003, pp. 341-59.
[341] Cp. Edmans et al. (2017), *supra* note 329, at pp. 87 et seq.
[342] Cp. K. Murphy, 'Performance Standards in Incentive Contracts', *Journal of Accounting and Economics*, vol. 30(3), 2000, pp. 245-78.
[343] McGuire et al. (2003), *supra* note 340.

results thus support the view of CSR as an agency cost. Criticism includes the lack of differentiation in the form of institutional ownership, given prior evidence that some institutional investor types also stipulate CSR engagement,[344] and the use of stock options as a proxy for long-term compensation, which is elaborated below in greater detail.[345]

97 In two subsequent studies,[346] Mahoney and Thorn criticise McGuire et al.'s statistical model. Following their approach with a different methodology to a Canadian data set, their first study finds a negative effect of stock options on poor social performance, which they interpret as evidence for the risk management hypothesis.[347] Their second study, which includes further compensation instruments, does not support this link anymore, however.[348] Instead, they find a positive effect of stock options and bonuses on strong social performance, which they interpret as evidence of a positive link between CSR and financial performance.

98 In a different study design, Deckop et al. analyse the effects of short- and long-term compensation on CSR engagement in US firms, using KLD data.[349] Building on the prior empirical literature,[350] the authors presume a positive effect of CSR on long-term firm value and test whether a trade-off between short-term financial targets and CSR investments exist. They find a negative effect of bonuses, i.e. short-term compensation, and a positive effect of restricted stock and stock options, i.e. long-term compensation, on CSR, which they interpret as evidence in favour of their hypothesis.

99 Coombs and Gilley test for reverse causality in the CSR-executive pay relationship.[351] They find a negative effect of several dimensions of CSR on salary, which they interpret as punishment by the board for pursuing non-shareholder related initiatives. The authors also find evidence, however, that some dimensions of CSR have combined positive effects with financial performance on certain pay instruments, indicating that executives are encouraged to pursue CSR strategies that benefit firm value.

100 Berrone and Gomez-Mejia follow Coombs and Gilley's approach, but focus exclusively on polluting industries.[352] They find environmental performance to be a key determinant of CEO total compensation, which speaks in favour of CSR as risk management in these settings and contradicts Stanwick and Stanwick's[353] results. They argue that CEOs are rewarded for pursuing strategies that provide "intangible benefits that go beyond 'hard-core' financial

[344] Cp. Johnson & Greening (1999), *supra* note 306.
[345] *Infra*, para. 105.
[346] L. Mahoney & L. Thorn, 'Corporate Social Responsibility and Long-term Compensation: Evidence from Canada', *Journal of Business Ethics*, vol. 57(3), 2005, pp. 241-53; L. Mahoney & L. Thorn, 'An Examination of the Structure of Executive Compensation and Corporate Social Responsibility: A Canadian Investigation', *Journal of Business Ethics*, vol. 69(2), 2006, pp. 149-62.
[347] Mahoney & Thorn (2005), *supra* note 346.
[348] Mahoney & Thorn (2006), *supra* note 346.
[349] J. Deckop, K. Merriman & S. Gupta, 'The Effects of CEO Pay Structure on Corporate Social Performance', *Journal of Management*, vol. 32(3), 2006, pp. 329-42.
[350] Orlitzky et al. (2003), *supra* note 222; Margolis & Walsh (2003), *supra* note 223.
[351] J. Coombs & M. Gilley, 'Stakeholder Management as a Predictor of CEO Compensation: Main Effects and Interactions with Financial Performance', *Strategic Management Journal*, vol. 26(9), 2005, pp. 827-40.
[352] P. Berrone & L. Gomez-Mejia, 'Environmental Performance and Executive Compensation: An Integrated Agency-Institutional Perspective', *Academy of Management Journal*, vol. 52(1), 2009, pp. 103-26.
[353] Stanwick & Stanwick (2001), *supra* note 338.

performance",[354] referring to reputation, legitimacy, and stakeholder consent. They also find stock options, restricted stock, and other forms of long-term pay to be effective incentives for pollution prevention. In a similar, more recent study from 2018, Karim et al. find that CSR engagement leads to an increase in equity pay.[355] The authors attribute this to the CSR dimensions of environment, diversity, and employee relations and take it as evidence that CSR is a strategy to maximise long-term financial performance.

101 Cai et al. follow Coombs and Gilley's[356] study design as well and use a larger US sample for a 15-year period.[357] They find an increase in CSR engagement to lead to a follow-up decrease in cash compensation (salary and bonus) and especially total compensation. The authors also find an inverse relation between executive compensation and employee relations. They interpret their results as evidence in favour of stakeholder management as a conflict resolution mechanism and against CSR as a tool of managerial entrenchment or overinvestment.[358] Their results are supported by Rekker et al., who differentiate the same model along different categories of CSR engagement and compensation instruments.[359]

102 Fry et al. examine how the link between executive compensation and financial performance differs in firms classified as socially responsible and in average firms.[360] They find that even though the link between executive pay and firm value is weaker in socially responsible firms, such companies are more likely to discharge CEOs for bad financial performance. Moreover, stock options, normally a topic in the executive pay literature with regard to excessive risk-taking,[361] are not related to increased future risk-taking in socially responsible firms, which is seen as an argument for the risk management dimension of CSR. Frye et al. link their first result to prior studies indicating socially responsible firms have differently structured agency costs as well as boards with better monitoring qualities. Less pay-for-performance sensitivity is thus not interpreted as a negative link between CSR and financial performance, but to the contrary as less necessity for incentive pay in socially responsible firms.

103 Jian and Lee offer an important contribution by claiming that the negative association between CSR and executive compensation found by many previous studies[362] is due to a lack of distinction between 'normal' and 'abnormal' CSR.[363] This view assumes diminishing marginal returns to CSR investments and defines 'normal' ('abnormal') CSR as such that contributes to (exceeds) this cost-benefit equilibrium. They find evidence that suggests the negative link

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[354] Berrone & Gomez-Mejia (2009), *supra* note 352, at p. 116.
[355] K. Karim, E. Lee & S. Suh, 'Corporate Social Responsibility and CEO Compensation Structure', *Advances in Accounting*, vol. 40(1), 2018, pp. 27-41.
[356] Coombs & Gilley (2005), *supra* note 351.
[357] Y. Cai, H. Jo & C. Pan, 'Vice or Virtue? The Impact of Corporate Social Responsibility on Executive Compensation', *Journal of Business Ethics*, vol. 104(2), 2011, pp. 159-73.
[358] Cp. Cespa & Cestone (2007), *supra* note 290; Barnea & Rubin (2010), *supra* note 227.
[359] S. Rekker, K. Benson & R. Faff, 'Corporate Social Responsibility and CEO Compensation Revisited: Do Disaggregation, Market Stress, Gender Matter?', *Journal of Economics and Business*, vol. 72, 2014, pp. 84-103.
[360] M. Frye, E. Nelling & E. Webb, 'Executive Compensation in Socially Responsible Firms', *Corporate Governance*, vol. 14(5), 2006, pp. 446-55.
[361] Cp. K. Shue & R. Townsend, 'How Do Quasi-Random Option Grants Affect CEO Risk-Taking?', *Journal of Finance*, vol. 72(6), 2017, pp. 2551-88.
[362] Particularly Coombs & Gilley (2005), *supra* note 351; Cai et al. (2011), *supra* note 357; Rekker et al. (2014), *supra* note 359.
[363] M. Jian & K. Lee, 'CEO Compensation and Corporate Social Responsibility', *Journal of Multinational Financial Management*, vol. 29, 2015, pp. 46-65.

between overall CSR and executive compensation can be contributed to 'abnormal' CSR, while 'normal' CSR is positively related to compensation.

104 Callan and Thomas criticise previous studies[364] for not accounting for the endogeneity of executive compensation, CSR, and financial performance.[365] Callan and Thomas find this endogeneity supported, raising caution about the omission of any of the three variables. Notably, the authors find that even if financial performance is included, CSR persists as a determinant of executive pay, which they take as an indicator that financial performance effects cannot alone explain the link. Fabrizi et al. extend Callan and Thomas' endogeneity model by including non-monetary managerial incentives.[366] They find that equity incentives and short-term bonuses are negatively associated with CSR, while career concerns, legitimacy building, managerial power and entrenchment are positively related.

105 In what so far remains the largest and most recent study of the CSR-compensation link, McGuire et al. (2019) examine the effects of different compensation instruments on poor and strong social performance,[367] similar to the earlier design of McGuire et al. (2003).[368] They find a negative effect of pay-for-performance sensitivity on poor as well as strong social performance, and a negative effect of a complex measure of long-term compensation on poor social performance.[369] Unlike several earlier studies,[370] McGuire et al. (2019) do not use share options as a proxy for long-term orientation of executive pay. This is crucial, as the contemporary compensation literature suggests that share options are linked to excessive risk-taking[371] and a short-term focus on share prices, if awarded unrestricted.[372] These findings indicate that share options may not incentivise, but to the contrary discourage instrumental CSR.

106 The second topic of this review is the use of performance targets linked to CSR objectives as a more direct method of incentivising CSR. Evidence of their institutionalisation is provided by the UN Principles on Responsible Investment (PRI) of 2012, which give best practice recommendations for the inclusion of ESG (environmental, social and governance) metrics into

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[364] Particularly McGuire et al. (2003), *supra* note 403; Mahoney & Thorn (2005), *supra* note 346; Mahoney & Thorn (2006), *supra* note 346; Deckop et al. (2006), *supra* note 349.
[365] S. Callan & J. Thomas, 'Executive Compensation, Corporate Social Responsibility, and Corporate Financial Performance: A Multi-Equation Framework', *Corporate Social Responsibility and Environmental Management*, vol. 18(6), 2011, pp. 332-51.
[366] M. Fabrizi, C. Mallin & G. Michelon, 'The Role of CEO's Personal Incentives in Driving Corporate Social Responsibility', *Journal of Business Ethics*, vol. 124(2), 2014, pp. 311-26.
[367] J. McGuire et al., 'Do Contracts Make Them Care? The Impact of CEO Compensation Design on Corporate Social Performance', *Journal of Business Ethics*, vol. 157(2), 2019, pp. 375-90.
[368] McGuire et al. (2003), *supra* note 340.
[369] McGuire et al. (2019), *supra* note 367.
[370] Studies that use share options as a sole proxy for long-term orientation are Mahoney & Thorn (2005), *supra* note 341; Mahoney & Thorn (2005), *supra* note 341; Coombs & Gilley (2005), *supra* note 346; studies that include options as part of a proxy variable are McGuire et al. (2003), *supra* note 335; Berrone & Gomez-Mejia (2009), *supra* note 352.
[371] Cp. Ferrarini & Ungureanu (2018), *supra* note 4, at pp. 340-41; Shue & Townsend (2017), *supra* note 361.
[372] Cp. A. Edmans et al., 'Dynamic CEO Compensation', *Journal of Finance*, vol. 67(5), 2012, pp. 1603-47; I. Marinovic & F. Varas, 'CEO Horizon, Optimal Pay Duration, and the Escalation of Short-Termism', *Journal of Finance*, vol. 74(4), 2019, pp. 2011-53.

compensation.[373] As explained above, attention is paid not only to the efficacy of CSR performance targets, but also the governance conditions that contribute to their implementation.

107 Hong et al. find that firms with more shareholder-friendly corporate governance are also more likely to provide compensation linked to CSR outcomes.[374] Their results also suggest that equipping executives with such incentives is an effective tool to increase firm-level CSR engagement, and that corporate governance as a determinant of CSR engagement is positively linked to financial performance.[375] In a similar approach, Cho et al. confirm these results by finding a negative effect of CEO power on the usage of CSR performance targets, which is mitigated by governance mechanisms like strong remuneration committees.[376] Al-Shaer and Zaman find a positive effect of board-level sustainability and external sustainability reporting assurance on the use of CSR performance targets.[377] Abdelmotaar and Abdel-Kader equally find a positive effect of different corporate governance mechanisms on the usage of CSR performance targets.[378] Those findings are consistent with the prior literature that finds a causal effect of corporate governance quality and less CEO power on CSR engagement.[379] Eccles et al. stress the long-term effects of integrating CSR into corporate governance and culture by finding that companies which adopted CSR policies by 1993 "exhibit by 2009[,] distinct organizational processes", including CSR performance targets for top management.[380]

108 Critical input on corporate governance and CSR performance targets stems from Li and Thibodeau, who find evidence indicating that CSR-linked compensation may be a substitute for earnings management, pointing towards the possible agency problems in the pay-setting process.[381] A notable, more recent study by Bebchuk and Tallarita raises caution on the link between CSR communications and its institutionalisation in governance processes.[382] They find only a significant minority of those firms that verbally claim to adhere to CSR to also translate this commitment into compensation schemes.

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[373] Principles for Responsible Investment, *Integrating ESG issues into executive pay – Guidance for investors and companies*, June 2012, available at https://www.unglobalcompact.org/docs/issues_doc/lead/ESG_Executive_Pay.pdf.
[374] B. Hong, Z. Li & D. Minor, 'Corporate Governance and Executive Compensation for Corporate Social Responsibility', *Journal of Business Ethics*, vol. 136(1), 2016, pp. 199-213.
[375] Ibid.; a literature review of the link between CSR and corporate governance is provided by T. Jain & D. Jamali, 'Looking Inside the Black Box: The Effect of Corporate Governance on Corporate Social Responsibility', *Corporate Governance: An International Review*, vol. 24(3), 2016, pp. 253-73.
[376] M. Cho, S. Ibrahim & Y. Yan, 'The Use of Nonfinancial Performance Measures in CEO Bonus Compensation', *Corporate Governance: An International Review*, vol. 27(4), 2019, pp. 301-16.
[377] H. Al-Shaer & M. Zaman, 'CEO Compensation and Sustainability Reporting Assurance: Evidence from the UK', *Journal of Business Ethics*, vol. 158(1), 2019, pp. 233-52.
[378] H. Abdelmotaar & M. Abdel-Kader, 'The Use of Sustainability Incentives in Executive Remuneration Contracts: Firm Characteristics and Impact on the Shareholders' Returns', *Journal of Applied Accounting Research*, vol. 17(3), 2016, pp. 311-30.
[379] Jo & Harjoto (2012), *supra* note 268; J. Walls, P. Berrone & P. Phan, 'Corporate Governance and Environmental Performance: Is There Really a Link?', *Strategic Management Journal*, vol. 33(8), 2012, pp. 885-913; Li et al. (2016), *supra* note 283.
[380] Eccles et al. (2014), *supra* note 276.
[381] Z. Li & C. Thibodeau, 'CSR-Contingent Executive Compensation Incentive and Earnings Management', *Sustainability*, vol. 11(12), 2019, 3420.
[382] L. Bebchuk & R. Tallarita, 'The Illusory Promise of Stakeholder Governance', *Cornell Law Review*, vol. 106(1), 2021, pp. 91-178.

109 Maas researches the use of CSR targets in executive compensation in more detail and finds that prior CSR engagement is no determinant of the usage of such targets.[383] Furthermore, usage of CSR targets in executive compensation *per se* is not found to lead to increased CSR performance. Such an effect has only been found where quantitative, hard performance targets were employed, contrary to softer qualitative targets which are linked to symbolism or 'raising awareness' at most. The latter finding is contradicted by Ikram et al., who also find a positive of effect of corporate governance quality on the usage of quantitative CSR performance targets but emphasise large differences across industries and CSR categories. [384] However, the authors find that qualitative CSR performance targets may also be efficacious if high uncertainty inhibits the use of objective measurements and strong corporate governance ensures that the resulting discretion is not abused. The interplay of CSR performance targets and intrinsic incentives remains unanswered, as the literature suggests that personal characteristics are an important driver of CSR engagement,[385] but may also be crowded out by pecuniary incentives.[386]

5.3 Summary: CSR Determinants in Executive Pay

110 The first research question of this thesis is whether and how executive pay regulation affects CSR, i.e. to elucidate the extent to which it is part of the institutional environment of CSR determinants.[387] This section has established the basic channels through which executive pay—the object of the legal rules in question—affects CSR.

111 Before drawing conclusions from the existing literature, several caveats must be emphasised: comparability of empirical results is limited by different measurement approaches. This applies to CSR, for which varying definitions, measurement indices are used, and which are analysed in different institutional settings. Measurements of executive compensation differ as well, specifically the problematic use of share options as a proxy for long-term orientation limits the explanatory capacity of many earlier studies from a theoretical viewpoint. More recent studies like McGuire et al. (2019)[388] employ more refined variables and achieve greater coherence. Lastly, changes in the practices of CSR and compensation limit intertemporal comparability. While the emergence of the 'business case' and the institutionalisation of CSR described above[389] may explain its alignment with financial performance over time, the design and structure of compensation instruments have changed as well.[390] This fact may partially explain the inconclusiveness of earlier studies.

112 The empirical literature, especially more recent studies, confirm a link between compensation and CSR engagement. Particularly, incentive pay structured along financial performance seems

[383] K. Maas, 'Do Corporate Social Performance Targets in Executive Compensation Contribute to Corporate Social Performance?', *Journal of Business Ethics*, vol. 148(3), 2018, pp. 573-85.
[384] A. Ikram, Z. Li & D. Minor, 'CSR-Contingent Executive Compensation Contracts', *Journal of Banking & Finance*, 2019, available at https://doi.org/10.1016/j.jbankfin.2019.105655.
[385] Cp. Y. Yuan et al., 'CEO Ability and Corporate Social Responsibility', *Journal of Business Ethics*, vol. 157(2), 2019, pp. 391-411.
[386] Cp. T. Besley & M. Ghatak, 'Competition and Incentives with Motivated Agents', *American Economic Review*, vol. 95(3), 2005, pp. 616-36; Fabrizi et al. (2014), *supra* note 366.
[387] Cp. *supra*, para. 22.
[388] McGuire et al. (2019), *supra* note 367.
[389] *Supra*, para. 62.
[390] For an overview, cp. Murphy (2013), *supra* note 328.

to incentivise instrumental CSR engagement, while the use of CSR performance targets for managerial rent extraction negatively depends on the governance quality of the pay-setting process. This confirms the link between financial-performance-oriented compensation and CSR developed in *section 5.1* under agency theory. What remains to be explored in detail are the conditions under which financial-performance incentives translate into instrumental CSR.[391]

113 The nascent empirical literature on the use of CSR performance targets confirms their efficacy in incentivising CSR engagement[392] and indicates that their use depends on the governance quality of the pay-setting process. This can be attributed to the underlying agency relationship, as the link between corporate governance and financial performance is well established.[393] A second explanation may also be that CSR as a long-term activity beyond the primary financial objectives of the corporation requires sufficiently sophisticated governance mechanisms.[394] More attention to this question is paid in the subsequent chapter when discussing the use of performance targets to impose the non-financial interests of shareholders on the corporation.[395]

114 The subsequent chapters will build their analysis of the effects of executive pay regulation on CSR engagement on the insights gained here. More attention will be paid to the questions neglected here, specifically the interplay of executive compensation and other elements of corporate governance in affecting CSR[396] and the conditions under which financial-performance-oriented compensation translates into CSR incentives.[397]

Section 6: Conclusion

115 The purpose of this chapter is to establish a theoretical framework for an analysis of the effects of executive pay regulation on corporate social responsibility and to create a corresponding research methodology. Because CSR and pay regulation are neither conceptually nor methodologically linked in any obvious way, basic clarifications were required. These are provided here by answering three questions: what is CSR? What is the role of law for CSR? And what are the effects of executive pay on CSR? The first question of what CSR is needs to be split into two separate inquiries. First, a definition is derived for its theoretical notion, which is linked to the second question on law and CSR. Then, a microeconomic concept of CSR activities on the firm level is developed, which in turn is linked to the third question on the effects of executive pay on CSR. The answers to these questions highlight the importance of executive pay regulation among the institutional determinants of CSR and enable an inquiry into this topic.

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[391] That question is part of the analysis in *Chapter Four*, at p. 65.
[392] This applies given the general pitfalls in the use of performance targets, cp. B. Bennett et al., ‘Compensation Goals and Firm Performance’, *Journal of Financial Economics*, vol. 124(2), 2017, pp. 307-30.
[393] P. Gompers, J. Ishii & A. Metrick, ‘Corporate Governance and Equity Prices’, *Quarterly Journal of Economics*, vol. 118(1), 2003, pp. 107-56.
[394] Cp. Jo & Harjoto (2012), *supra* note 273; Mallin et al. (2013), *supra* note 273.
[395] *Chapter Three*, at p. 84.
[396] *Chapter Three*, at p. 65.
[397] *Chapter Four*, at p. 146.

116 Defining CSR is both a necessary and complicated endeavour because it is an 'essentially contested concept',[398] i.e. without a universally agreed upon definition. Here, the definition of CSR as a "form of private self-regulation" is adopted,[399] based on the research approach of its application and the shortcomings of other conventional definitions. It captures the essential characteristics of CSR in a way that is sufficiently abstract to incorporate the cultural and temporal variations of CSR practice. Unlike definitions from management studies,[400] it also allows analysing the institutional determinants of CSR, particularly the role of the law, and connects to the economic function of CSR as a channel for externality internalisation and public good provision.

117 That role of the law has been highlighted, based on insights from the institutional literature,[401] as a particularly important determinant of CSR by more recent empirical advances.[402] This shows the need for a better understanding of the CSR-law relationship, to which this thesis aims to contribute. Thus, the chapter has developed a framework of the different ways in which legal rules interact with CSR, based on existing contributions on CSR, law and self-regulation.[403] This framework shows how legal rules can incentivise, substitute, or restrict CSR engagement; those are the possible channels for executive pay regulation to affect CSR that are explored in the subsequent chapters.

118 Turning towards the firm level, a categorisation of CSR activities has been developed that transposes the abstract concept of CSR as self-regulation into corporate governance practice. This approach is primarily based on agency theory—the main rationalisation of CSR activities on the firm level—but, due its shortcomings, is complemented by insights from behavioural economics: a significant share of contemporary CSR practice can be rationalised through its alignment with financial performance. However, a separate driver of CSR that needs to be considered is the non-financial preferences of shareholders, whose position as owners grants them influence over corporate objectives.[404] Thus, the chapter has developed a novel categorisation of CSR activities distinguished by their firm level motivations into (i) instrumental CSR, (ii) managerial CSR and (iii) delegated shareholder philanthropy. This categorisation does not treat CSR as a monolithic corporate activity but allows to differentiate the various forms of CSR that can simultaneously occur and their determinants.

119 Lastly, the influence of executive pay on CSR is discussed, given its central position in corporate governance to affect managerial decision-making incentives. A review of the existing empirical literature reveals that executive pay affects CSR in two central ways: first, pay-performance-sensitivity, i.e. the use of compensation instruments to incentivise financial performance maximisation, contributes to an alignment of CSR engagement with its effects on financial performance. Secondly, the deliberate use of CSR performance targets, a more recently emerged practice, is an effective way of promoting and steering CSR engagement. That is particularly relevant for shareholders to impose non-financial preferences, depending on their capacity to do so in the pay-setting process. Compensation is thus an important

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[398] Gond & Moon (2011), *supra* note 21.
[399] *Supra*, para. 25 et seq.
[400] On Brammer et al.'s criticism of management studies for treating the "social element" of CSR as a "black box", see *supra*, para. 24, 28; Brammer et al. (2012), *supra* note 53, at p. 4.
[401] Cp. Matten & Moon (2008), *supra* note 16.
[402] Liang & Renneboog (2017), *supra* note 54.
[403] Cp. *supra*, para. 35.
[404] Hart & Zingales (2017), *supra* note 169.

determinant on the firm level, as both profit-oriented conventional practices affect CSR and performance targets are a viable strategy to manage CSR engagement.

120 The different elements covered in this chapter form a coherent picture when taken as a framework for the subsequent analysis. Both legal rules and executive pay belong to the forces that shape CSR engagement, either as part of its broader institutional environment or in the firm-level decision-making process. This points towards the relevance of executive pay regulation, an area of law so far neglected in its effects on CSR, and the need for an analysis of the different channels in corporate governance through which it can affect CSR. The following *Chapters Three* and *Four* thus use the methodology established here—the tripartite categorisation of CSR activities, the CSR-law framework, the empirical effects of executive pay on CSR engagement—and analyse the role of different elements of pay regulation for CSR. Based on those results and the understanding of CSR as private self-regulation, *Chapters Five* and *Six* explore the potential of pay regulation as a legislative instrument of CSR policymaking and the integration of CSR among the goals of corporate law.

Chapter Three

Shareholders First: A Selective Analysis of Executive Pay Regulation and CSR Engagement

SUMMARY. This chapter analyses the role of executive pay regulation as a determinant of corporate social responsibility (CSR). It covers three selected regulatory instruments of shareholder-value-oriented pay governance prescriptions: say-on-pay, compensation disclosure requirements and independence requirements for remuneration committees. CSR is functionally defined through a tripartite categorisation of CSR activities divided (i) instrumental CSR, (ii) managerial rent-seeking, and (iii) delegated shareholder philanthropy.

The chapter argues that shareholder-value-oriented pay regulation tends to stipulate the alignment of CSR engagement with corporate financial performance, incentivising type-(i) instrumental CSR and discouraging type-(ii) managerial CSR. Effects on type-(iii) delegated shareholder philanthropy are more ambiguous, depending on whether legal rules either empower or protect shareholders. While say-on-pay is an important driver of CSR activism, director independence can make the imposition of non-financial shareholder preferences more difficult. Remuneration disclosure can, if designed well, drive both an alignment of CSR with financial performance and shareholder CSR activism.

The chapter contributes to a better understanding of executive pay regulation as part of the institutional environment of CSR determinants and exemplifies a direct channel of interaction between law and CSR. It identifies financial performance alignment and shareholder preferences as the central forces in this area of corporate law that shape the quality of CSR. This forms the basis for further research of the effects of other forms of pay regulation on CSR and the possibilities of legislators to influence and steer CSR practices.

Section 1: Introduction

1 Corporate social responsibility (CSR) has established itself as a persistent topic in public policymaking as well as corporate governance—research on its determinants and the role of the law in shaping CSR, however, is still evolving. While executive compensation is a key instrument to shape managerial incentives and thus influences CSR engagement on the corporate level,[1] the role of public regulation in this remains obscure. This chapter opens an investigation into the role of executive pay regulation as a direct channel through which legal rules affect CSR. It adopts the approach established in the previous chapter[2] of executive pay as an *ex ante* incentive mechanism and extends the scope of inquiry to its legal regulation: as

[1] For an overview of the empirical literature on CSR and executive compensation, see *Chapter Two*, at p. 52.
[2] Cp. *Chapter Two*, at p. 15.

part of a positive[3] analysis of the effects of pay regulation on CSR engagement, it forms the basis for conclusions about the role of compensation in legislative efforts to promote CSR.

2 Pay regulation is rooted in the imperfections of compensation as an instrument of corporate governance to align the incentives of executives with the interests of their shareholder principals.[4] Thus, executive compensation also affects the extent and nature of CSR engagement in a firm.[5] However, it is also associated with several shortcomings: real-world pay practices may deviate from optimal 'efficient contracting' solutions.[6] Executive pay can also be an original source of agency costs in the form of managerial rent-seeking.[7] Certain pay practices may furthermore induce an excessive short-term focus on share prices.[8] Where private actors and the market fail to remedy these issues, the law offers another solution in the form of executive pay regulation. The claim that by influencing the structure or levels of remuneration in public corporations, executive pay regulation also affects incentives to engage in CSR.

3 The attention of legislators—especially in Europe[9]—towards CSR is rising. That is part of the reason why an ongoing transformation of CSR norms is observable from an originally voluntary corporate activity into a form of self-regulation increasingly shaped by hard-law public norms.[10] However, the pronounced aim of said legislators to promote CSR is accompanied by a lack of coherent theory in academia on the relationship between law and CSR.[11] Especially the area of executive pay regulation has received little attention regarding its provision of incentives to corporate decision-makers to engage in CSR. This lack of academic attention contravenes the proliferation of executive pay regulation within the last one and a half decades.[12] A possible explanation for this may be found in the competing motivations for pay regulation: in the public and political debate, thus also in law-making, executive pay is often treated as a 'social concern' *sui generis*. This view can be based on e.g. redistributive motives or an *ex post* view of its justifications, criticising a discrepancy between high earnings

[3] On the methodology, cp. F. Parisi, 'Positive, Normative and Functional Schools in Law and Economics', *European Journal of Law and Economics*, vol. 18(3), 2004, pp. 259-72.
[4] Cp. M. Jensen & W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *Journal of Financial Economics*, vol. 3(4), 1976, pp. 305-60.
[5] Cp. *Chapter Two*, at p. 60.
[6] R. Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Oxford, Oxford University Press, 2017, at pp. 66-68.
[7] L. Bebchuk, J. Fried & D. Walker, 'Managerial Power and Rent Extraction in the Design of Executive Compensation", *University of Chicago Law Review*, vol. 69(3), 2002, pp. 751-846.
[8] G. Ferrarini & N. Moloney, 'Executive Remuneration in the EU: The Context for Reform', *Oxford Review of Economic Policy*, vol. 21(2), 2005, pp. 304-23.
[9] Cp. S. Idowu, R. Schmidpeter & M. Fifka (eds.), *Corporate Social Responsibility in Europe*, Heidelberg, Springer, 2005.
[10] L. Gatti et al., 'Are We Moving Beyond Voluntary CSR? Exploring Theoretical and Managerial Implications of Mandatory CSR Resulting from the New Indian Companies Act', *Journal of Business Ethics*, vol. 160(4), 2019, pp. 961-72; M. Cominetti & P. Seele, 'Hard Soft Law or Soft Hard Law? A Content Analysis of CSR Guidelines Typologized along Hybrid Legal Status', *uwf UmweltWirtschaftsForum*, vol. 24(2), 2016, pp. 127-40.
[11] As an exceptional theoretical contribution, cp. D. McBarnet, 'Corporate Social Responsibility beyond Law, through Law, for Law', in: D. McBarnet, A. Voiculescu & T. Campbell (eds.), *The New Corporate Accountability – Corporate Social Responsibility and the Law*, Cambridge, Cambridge University Press, 2009; further cp. *Chapter Two* at p. 28.
[12] G. Ferrarini & M. Ungureanu, 'Executive Remuneration', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018, at pp. 350-51.

and past achievements. Such a ‘political’ interpretation of executive pay however is fiercely rejected in the economic literature, which emphasises its function to maximise long-term shareholder value by reducing agency costs.[13]

4 This chapter adopts the basic assumption of the agency view of the firm that the primary purpose of corporate governance is to maximise shareholder welfare.[14] This approach is chosen for the simplicity it offers as well as its centrality in the conventional economic analysis of corporate law;[15] other economic motivations of executive pay regulation are the subject of the subsequent chapter. Here, a set of three instruments is selected that reflects the spectrum of relevant strategies in corporate law to protect the interests of shareholders *vis-à-vis* the firm’s management.[16] As explained below,[17] these legal instruments aim to alter the governance environment of the pay-setting process to reduce agency costs and reach more desirable results for shareholders. The three instruments are: ‘say-on-pay’, a rule that grants shareholders certain approval voting rights during the pay-setting process; independent director requirements for remuneration committees, which aim to prevent conflicts of interests in the design of pay schemes; and remuneration disclosure requirements that remedy information asymmetries between corporate insiders and outsiders. Each of these rules addresses a different aspect of the agency problems in executive compensation and thus also has different implications for incentives for CSR engagement.

5 The aim of this chapter is to construct a theory that integrates existing insights about CSR into the literature on executive pay regulation. It adopts the definition established in the prior chapter of CSR as a form of private self-regulation, i.e. the (voluntary) provision of public goods, internalisation of externalities or private redistribution.[18] Employing a functional approach, CSR activities are consequently defined as “providing to others benefits beyond those generated by economic transactions with the firm or required by law.”[19] They are furthermore differentiated into three categories: (i) instrumental CSR, which is directly or indirectly aimed at long-term financial performance, (ii) CSR as rent-seeking by managers who abuse their discretion and employ it as a strategy to reap private benefits, and (iii) CSR as a form of delegated shareholder philanthropy, through which corporations satisfy their owners’ non-financial preferences.[20] Legal comparisons between EU and US jurisdictions are

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[13] Cp. K. Murphy & M. Jensen, ‘The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation’, *USC Law Legal Studies Paper No. 18-8*, 2018.
[14] Kraakman et al. (2017), *supra* note 6, at pp. 22-24; A. Shleifer & R. Vishny, ‘A Survey of Corporate Governance’, *Journal of Finance*, vol. 52(2), 1997, pp. 737-83.
[15] Cp. A Berle & G. Means, *The Modern Corporation and Private Property*, New York, Macmillan, 1932.
[16] Some of the rules covered may also be used to protect shareholders in other circumstances, e.g. in conflicts between minority shareholders and blockholders; see *infra,* para. 34.
[17] *Infra*, para. 8 et seq.
[18] Cp. A. Ogus & E. Carbonara, ‘Self-Regulation’, in: G. de Geest (ed.), *Encyclopedia of Law and Economics*, Cheltenham, Edward Elgar, 2017; in their definition of self-regulation, Ogus and Carbonara omit the characteristic of externality internalisation, which is structurally very similar to a public good, see H. Rosen & T. Gayer, *Public Finance*, Singapore, McGraw Hill, 2010, pp. 53 et seq.
[19] D. Baron, ‘Private Politics, Corporate Social Responsibility, and Integrated Strategy’, *Journal of Economics & Management Strategy*, vol. 10(1), 2001, pp. 7-45, at p. 7.
[20] For a more detailed explanation of how these categories are derived and understood, cp. *Chapter Two* at p. 45.

conducted to illustrate how regulatory instruments function in different governance environments.

6 *Section 2* explains the general economic rationale behind executive pay regulation and contrasts it with other political motivations; it then establishes the selection of shareholder-value-oriented regulatory instruments. The subsequent sections each analyse the implications of one of those elements of regulation for CSR engagement, beginning with say-on-pay (*section 3*), which enjoys specials attention due to its complexity and close link to different categories of CSR. The following sections treat independent directors in remuneration committees (*section 5*) and remuneration disclosure requirements (*section 4*) respectively. *Section 6* concludes.

Section 2: Executive Pay Regulation from a Shareholder-Value Perspective

7 'Executive pay regulation' is a broad term in the sense that it describes a variety of legal interventions into a corporation's compensation system and pay-setting process. The focus of this chapter on shareholder-value-oriented pay regulation is explained under *Section 2.1* and delineated from other concepts. *Section 2.2* outlines the most common regulatory strategies to protect shareholder interests and sets the framework for their subsequent analysis.

2.1 Executive Pay Regulation as a Response to Agency Problems

8 There are three concepts of justifying executive pay regulation: first, the shareholder-value approach based on agency theory which assumes that maximising returns to shareholders equals social welfare maximisation in corporate governance.[21] This is contrasted by what the literature terms 'political' motivations that pursue other aims than efficiency and social welfare, often distributive ones.[22] Thirdly, there are economic approaches that identify situations where social welfare deviates from shareholder value and pay regulation protects the interests of other actors. The shareholder-value approach is the most suited one for an initial inquiry into the link between executive pay regulation and CSR, even though this does not imply the normative proposition that corporate law should only maximise shareholder value.[23] Instead, shareholder value explains the basic structure of executive pay regulation. In the previous chapter, it has been laid out that executive compensation itself is regarded as a private, contractual remedy to the agency costs of shareholder-manager relationships.[24] By setting pecuniary incentives, the board of directors is able to induce executives to exert higher levels of effort and to align the

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[21] The differences between shareholder value, wealth and welfare are covered in greater detail in *Chapter Five*, at p. 160. For an overview, cp. O. Hart & L. Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value', *Journal of Law, Finance, and Accounting*, vol. 2(2), 2017, pp. 247-74.
[22] For an overview, see Ferrarini & Ungureanu (2018), *supra* note 12, at pp. 338-39.
[23] For a critique of the role of shareholder value in modern corporate law and social welfare maximisation, see W. Bratton, 'The Separation of Corporate Law and Social Welfare', *Washington & Lee Law Review*, vol. 74(2), 2017, pp. 767-90; also cp. Kraakman et al. (2017), *supra* note 6, pp. 22-24.
[24] Cp. *Chapter Two*, at p. 52.

focus of their activities, their time horizon and risk appetite with the interests of shareholders.[25] Concepts of regulating executive compensation are linked to the same underlying concepts of agency theory: optimal contracting and managerial power.

9 The optimal contracting approach emphasises the efficiency of executive compensation as a market outcome in achieving incentive alignment and maximising returns to shareholders. It thus argues that there is little need for regulatory intervention and that the role of the law is limited to one of reducing transaction costs to facilitate optimal contracting solutions without imposing too many restrictions.[26]

10 The managerial power hypothesis instead focuses on directors as imperfect agents of shareholders and the possibility for executives to influence the pay-setting process for their personal gains. Brought to the centre stage of corporate governance by Bebchuk, Walker and Fried in 2002,[27] it argues that compensation is not a sole remedy to agency costs, but may on the contrary be a source of agency costs as well.[28] Repudiating the assumption that boards deal at arm's length with executives, this view calls for a much stronger involvement of the law in order to protect the interests of shareholders.[29]

11 The optimal contracting and managerial power hypothesis each lead to significantly different implications regarding the question whether shareholders need protection at all, and if this aim should be pursued via public regulation.[30] They are usually treated as rivalling hypotheses when observed pay practices on the company level and the use of specific instruments are evaluated, and they fuel a continuous debate over new empirical evidence.[31] Nevertheless, it is important to stress that both theories pursue the same normative aim, shareholder value maximisation. To understand the entire phenomenon of executive pay, it is necessary to see them as mutually non-exclusive complements.[32] Both optimal contracting and managerial

[25] Cp. S. Sepe, 'Making Sense of Executive Compensation', *Delaware Journal of Corporate Law*, vol. 36(1), 2011, pp. 189-235.
[26] Cp. J. Gordon, 'Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"', *Journal of Corporation Law*, vol. 30(4), 2005, pp. 675-702.
[27] Bebchuk, Fried & Walker (2002), *supra* note 7.
[28] Cp. L. Bebchuk & J. Fried, 'Executive Compensation as an Agency Problem', *Journal of Economic Perspectives*, vol. 17(3), 2003, pp. 71-92.
[29] A more extensive account of this argument with more attention paid to policy recommendation is L. Bebchuk & J. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, Harvard, Harvard University Press, 2004.
[30] A considerable number of treatises on executive pay regulation still discuss the need for its existence as a whole with differing conclusions, cp. M. Jensen & K. Murphy, 'Remuneration: Where We've Been, How We Got There, What Are the Problems, and How to Fix Them', *ECGI Working Paper Series in Finance*, Working Paper No. 44/2004, 2004; Gordon (2005); *supra* note 26; R. Posner, 'Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?', *Duke Law Journal*, vol. 58(6), 2009, pp. 1013-70.
[31] A. Edmans, X. Gabaix & D. Jenter, 'Executive Compensation: A Survey of Theory and Evidence', *ECGI Working Paper Series in Finance*, Working Paper No. 514/2017, 2017; cp. *Chapter Two*, at p. 52.
[32] Murphy criticises their treatment as rivalling hypothesis to be a major structural short-coming of the current literature on executive compensation; see K. Murphy, 'Executive Compensation: Where We Are, and How We Got There', in: G. Constantinides et al. (eds.), *Handbook of the Economics of Finance*, vol. 2A, Amsterdam, North Holland, 2013.

power considerations are therefore the basis of the concept of shareholder-value-oriented pay regulation.

12 A different driver of executive pay regulation is what is summarised as political motivations. Arguably more than other topics that receive legislative attention, executive pay is subject to public debates that treat it from a political or distributive perspective and function as alternative justifications for regulation. From an economic perspective, this entails all approaches that do not pursue social welfare maximisation. These may be distributive justice concerns that criticise absolute pay levels—often in comparison to median worker's pay in the company[33] or average income—and neglect the pay-for-performance link. The evaluation of whether the earnings of an executive are justified can also ignore the incentive aspect of compensation, and instead assume an *ex post* perspective.

13 Such political motives for regulation usually receive heavy criticism from corporate governance scholarship:[34] economic approaches to law are based on the normative aim of maximising social welfare, which encompasses that of all the actors involved. When political pressure renders executive compensation itself a 'social concern', it deviates from a strategy that maximises social welfare. Furthermore, it might entail unintended economic consequences, potentially making some actors—and society—even worse off.[35] Gordon writes "[…] that executive compensation operates in at least two different worlds: one that focuses on maximizing shareholder value, the other that responds to concerns about the social implications of wealth and power. Strategies that may be desirable for one world may not suit the other. A system of simultaneous constraints may generate conflicting institutional results."[36] The approach taken here thus excludes politically motivated regulation that makes executive compensation itself an issue of social responsibility from its scope.

14 This only works to a certain extent however, as two restrictions apply: first, it is not always possible to perfectly delineate between economically and politically motivated regulatory interventions.[37] They might be mixed, reinforcing, or simply not empirically distinguishable. The term 'shareholder-value-oriented pay regulation' thus lacks absolute precision and is to be understood in relative terms. Secondly, common concepts and especially quantitative measurements of CSR regularly define executive pay as a 'social concern' *sui generis*. For example, the 'governance' dimension of commonly applied ESG criteria includes factors like public scandals caused by executive pay practices, which fall into the same line of thinking as

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[33] The disclosure of average employee and executive compensation is covered in greater detail below under *Section 4.1*.

[34] A recent and arguably one of the most fervent pieces of opposition against (politically motivated) executive pay regulation in the United States is: Murphy & Jensen (2018), *supra* note 13.

[35] Ibid.; D. Walker, 'The Challenge of Improving the Long-Term Focus of Executive Pay', *Boston College Law Review*, vol. 51(2), 2010, pp. 435-72.

[36] Gordon (2005), *supra* note 26.

[37] In this chapter, it is refrained from a public choice analysis of executive pay regulation, for an overview cp. K. Murphy, 'Executive Compensation: Where We Are, and How We Got There', in: G. Constantinides, M. Harris & R. Stulz (eds.), *Handbook of the Economics of Finance, Vol. 2A*, Amsterdam, North Holland, 2012.

politically motivated regulation.[38] While a theoretical approach is unhindered by this problem, it poses a significant challenge to any further empirical investigations.

15 The economic literature supports a third category of executive pay regulation. Where the basic assumption that shareholder value equals social welfare is refutable, protecting the interests of other corporate constituencies may become a viable objective. These forms of regulation, constituting an extension of the basic shareholder-value model above, often entail a trade-off between the interests of a company's owners and those affected by its actions, e.g. through externalities. Such concepts and their relationship with CSR merit attention as well and are the subject of the next chapter, which takes on the financial sector as the most prevalent example of such regulation.

2.2 Legal Strategies

16 Throughout most jurisdictions, corporate law has developed four main strategies to address executive pay that each target one of the central aspects of the shareholder-manager agency relationship. These aspects are a) the role of shareholders as principals, b) the role of directors as their agents, c) information asymmetries, and d) the use of pay instruments.

a) Control over directors can be strengthened by granting shareholders certain decision rights over executive compensation, a strategy known as 'say-on-pay'. Say-on-pay requires the ratification of either the compensation policy or report by a majority of shareholders in the AGM.[39] This deviation from the corporate principle of delegated management intends to ensure that directors do not diverge in their decision-making from shareholder interests. The legal design of say-on-pay varies significantly across jurisdictions, but the common characteristic is the aim of increasing pressure on the board and remuneration committee to act in the interest of shareholders. The role of say-on-pay for CSR is analysed with a focus on the potential for shareholders to directly impose non-financial preferences.

b) Boards may set suboptimal compensation structures because of conflicted interests when they enjoy personal or business ties with the corporation—e.g. by simultaneously fulfilling executive functions. Independence requirements are an *ex ante* strategy of incentive alignment to prevent diverging interests, so directors act as 'trustees' of shareholders. Corporate boards usually delegate this "control over reward calibration"[40] to remuneration committees. Here, independent remuneration committee requirements are analysed both for the effects they have on compensation structure, and their stakeholder networking role on CSR.

c) Corporate law commonly addresses information asymmetries—being a constitutive element of agency problem[41]—through mandatory disclosure. At relatively low

[38] Cp. Thomson Reuters, *Thomson Reuters ESG Scores*, May 2018, available at https://financial.thomsonreuters.com/content/dam/openweb/documents/pdf/financial/esg-scores-methodology.pdf.
[39] Kraakman et al. (2017), *supra* note 6, at p. 37.
[40] Ibid. at p. 67.
[41] Asymmetric information is the source of the incentive problem in an agency relationship, see B. Holmström, 'Moral Hazard and Observability', *Bell Journal of Economics*, vol. 10(1), 1979, pp. 74-

regulatory interference in corporate affairs, disclosure requirements can reduce monitoring costs for shareholders and facilitate external governance by financial markets and corporate stakeholders.[42] To strengthen the pay-for-performance link, disclosure requires both quantitative compensation data and qualitative information discussing the integration of executive pay into broader corporate policies and objectives.[43] *Section 5* looks at the potential of disclosure for the imposition of CSR performance targets, for which European rules are particularly interesting, as they already touch upon non-financial performance targets.

d) Lastly, the law may also simply restrict the use of specific compensation instruments when these are either deemed ineffective in promoting pay-for-performance or are too closely associated with managerial rent extraction. As is explained below in greater detail,[44] such strategies are less commonly applied due to their invasive nature in the private pay-setting process.

17 The selection of regulatory instruments in this chapter is subject to a restriction in scope. First, all the legal strategies above are from the field of corporate law, excluding other areas, most notably tax law. Especially the United States has persistently employed taxation rules to incentivise or restrain executive compensation in various ways.[45] In financial economics, tax law is considered an important determinant of executive compensation. It is nevertheless excluded here as there is little interaction with other elements of corporate governance, making its effects on executive pay very isolated.

18 Secondly, focus lies on mandatory regulation as opposed to soft law. Pay regulation is a dynamic field of regulation and has experienced a transitional shift from soft towards hard law in the recent one and a half decades.[46] Naturally, soft law in the form of endorsed best practices or corporate governance codes employs more indirect tools and enforcement mechanisms than what mandatory rules are capable to impose. The increasing use of hard public regulation in executive pay is why it is the preferred object of inquiry, also because a parallel trend is observable in CSR regulation.[47] This approach allows to analyse the interaction between executive pay and CSR regulation at a later stage of the thesis.[48]

19 Existing theories of how corporate law intervenes in executive pay to protect shareholder interests help better understand the four major strategies outlined above. A distinction can be made between what Ferrarini and Ungureanu call "governance prescriptions" and "regulation of pay structures".[49] Succinctly speaking, governance prescriptions aim to alter the conditions

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91. It is important however to distinguish the costs of monitoring from the costs of enforcement, cp. the separation between agency theory and the property rights approach by Jensen & Meckling (1976), *supra* note 4.

[42] Kraakman et al. (2017), *supra* note 6, at pp. 38-39.

[43] Ibid. at pp. 147 et seq.

[44] *Infra*, para. 20.

[45] Cp. Murphy & Jensen (2018), *supra* note 13.

[46] Ferrarini & Ungureanu (2018), *supra* note 12.

[47] Cp. J. Gond, N. Kang & J. Moon, 'The Government of Self-Regulation: On the Comparative Dynamics of Corporate Social Responsibility', *Economy and Society*, vol. 40(4), 2011, pp. 640-71; Cominetti & Seele (2016), *supra* note 10; H. Liang & L. Renneboog, 'On the Foundations of Corporate Social Responsibility', *Journal of Finance*, vol. 72(2), 2017, pp. 853-910.

[48] Cp. *Chapter Five*, at p. 155.

[49] Ferrarini & Ungureanu (2018), *supra* note 12.

under which the process of determining pay schemes takes place. Regulation of pay structures instead is a more direct form of intervention, as it mandates, encourages, restricts or prohibits the use of specific pay instruments. The three legal strategies of say-on-pay, director independence and disclosure, can be categorised as governance prescriptions. Ferrarini and Ungureanu express a preference for governance prescriptions to address agency problems and associate regulation of pay structures more often with political motivations.[50] A comparable, more general distinction is made by Kraakman et al. between governance strategies (empowering principals) and regulatory strategies (constraining agents),[51] further differentiating whether they are designed to *ex ante* alter incentives or as *ex post* responses.[52] These categorisations facilitate locating the selected regulatory instruments in their broader governance environment, understanding any interaction with other elements and thus analysing their effects on CSR engagement.

20 This chapter restricts itself to the analysis of governance prescriptions; regulation of pay structures is covered in the following chapter. This has two reasons: first, the more controversial nature of direct pay structure regulation as highlighted by Ferrarini and Ungureanu above makes it difficult to subsume it together with the other types under the concept of shareholder-value-oriented pay regulation. Secondly, while pay structure regulation is occasionally applied in general corporate law, governance prescriptions remain the predominant norm. A notable exception to this pattern is the financial sector, where a strict regime on the structure and levels of bankers' pay has been established after the financial crisis.[53] The specificities of the financial industry as well as the objectives of financial regulation—that deviate from shareholder-value maximisation—make it worthwhile to analyse pay structure regulation at that specific example and separately from the rules covered in this chapter. The rules covered in this chapter, say-on-pay (*Section 3*), remuneration committee independence (*Section 4*), and disclosure (*Section 5*) provide an adequate overview of the spectrum of governance prescriptions in executive pay regulation.

Section 3: Say-on-Pay

21 The catchword 'say-on-pay' describes a legal mechanism that grants a voting right to a corporation's shareholders on its executives' remuneration. As such, it constitutes a deviation from one of the defining characteristics of the corporate form, the principle of delegated management, according to which decision rights are regularly allocated with the board of directors.[54] Granting shareholders special decisions rights is an established practice to mitigate agency problems in the field of related-party transactions, which in its broader sense includes executive compensation.[55] Where the nature of the activity affects the ability of the agent to act

[50] Pay structure regulation "also responds to social issues and political pressures", ibid., at p. 362.
[51] Kraakman et al. (2017), *supra* note 6, at pp. 31 et seq.
[52] Ibid, pp. 37-38.
[53] The origins of executive pay regulation in the financial sector are covered in greater detail in *Chapter Four*, at p. 110.
[54] Kraakman et al (2017), *supra* note 6, at pp. 11-13.
[55] Ibid., at pp. 145 et seq.

in the principal's interest, additional shareholder decision rights can prevent agency costs from overruling the benefits of delegated management.

22 The establishment of shareholder decision rights in compensation matters significantly alters the governance balance and bears several implications for CSR engagement. To increase pay-for-performance sensitivity, say-on-pay aims to alter the composition of executive pay and thus managerial incentives. But beyond that, in recognising shareholder activism it allows shareholders to impose their preferences more directly on corporations, which is why channels for and the formation of non-financial shareholder preferences are also analysed. The results are compared in the light of different legal variations.

23 Since its inception in the early 2000s, a large number of jurisdictions have adopted a mandatory[56] say-on-pay rule into their corporate law regimes.[57] However, the concrete implementation of these rules varies significantly due to pre-existing differences in national corporate governance systems[58] as well as the political environment of legislation. This affects both the functioning of say-on-pay and its interaction with other governance mechanisms. Thus, the section continues with a legal overview of different say-on-pay rules and explains their functioning and rationale.

3.1 The Legal Structure of Say-on-Pay

24 A legal comparison necessitates a more comprehensive definition of say-on-pay than the explanation provided above. The definition by Thomas and Van der Elst encompasses the spectrum of functional legal differences and is thus adopted here as well. It describes say-on-pay as:

> "(1) a recurring, mandatory, (2) binding or advisory shareholders' vote, (3) provided by law, that (4) directly or indirectly through the approval of the remuneration system, […] report or […] policy, (5) governs the individual or collective global remuneration package of the executives or managing directors of the corporation."[59]

Other definitions exist that are more concise and omit non-essential characteristics of say-on-pay; however, such definitions are less suitable when attention is paid to the national differences in legal design, as they do not account for these aspects.[60]

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[56] The term 'mandatory' here describes the imposition of a say-on-pay rule by law; whether a say-on-pay rules entails legal consequences or not is described with the terms 'binding' and 'non-binding' or 'advisory'.
[57] For an overview, cp. J. Obermann & P. Velte, 'Determinants and Consequences of Executive Compensation-Related Shareholder Activism and Say-on-Pay Votes: A Literature Review and Research Agenda', *Journal of Accounting Literature*, vol. 40(1), 2018, pp. 116-51, at p. 133.
[58] The two main factors here are ownership patterns and general path dependence, cp. L. Bebchuk & M. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance', *Stanford Law Review*, vol. 52(1), 1999, pp. 127-70.
[59] R. Thomas & C. Van der Elst, 'Say on Pay around the World', *Washington University Law Review*, vol. 92(3), 2015, pp. 653-731, 658.
[60] Obermann & Velte for example merely define say-on-pay as "any shareholder vote regarding the approval of executive compensation or parts of it during the firms' annual general meetings", see Obermann & Velte (2018), *supra* note 57.

25 The main variation in the design possibilities of say-on-pay—as is illustrated in the legal comparison below in greater detail[61]—entails the following: the vote can be binding or advisory, implying different consequences of a negative vote (ranging from no legal consequences at all to the nullification of the remuneration policy or the withholding of compensation). The vote may happen *ex ante* on a remuneration policy, i.e. the system underlying future pay schemes, or *ex post* on a remuneration report, approving past compensation practices. It can include separate votes on the individual remuneration of each executive, up to single compensation instruments, or be a collective vote on overall compensation. Also, the minimum period prescribed for the recurrence of the vote may vary. This section mainly focuses on the three main aspects of whether the vote is *ex ante* or *ex post*, whether its binding, and its recurrence.

26 The comparison aims to give a comprehensive overview of the forms say-on-pay can take while remaining as concise as possible.[62] The jurisdictions of the US and the EU are covered, which offer different regulatory approaches and cover an important part of real-life legal practice. The EU furthermore concedes a significant scope in variation to member states for national implementation; the Netherlands, France and Germany have been selected as examples for different strategies to implement say-on-pay into their respective corporate law regimes.

27 In the United States, say-on-pay was initiated in the wake of the financial crisis, when the American Recovery and Reinvestment Act of 2009 required the implementation of mandatory say-on-pay votes in all firms that received financial aid from the Department of Treasury under the Troubled Asset Relief Program (TARP).[63] Shortly after, the Dodd-Frank Act of 2010 introduced mandatory say-on-pay for all corporations in the US.[64] The provisions of the Dodd-Frank Act require shareholders to approve their company's executive pay schemes in a non-binding, i.e. advisory vote. The vote takes place *ex post* on the collective compensation of those executives the corporation is required to list in its compensation disclosure report.[65] The vote must be conducted at least every three years, while an additional advisory vote on this frequency must happen at least every six years.[66] Regarding any consequences of the vote, the board is merely obliged to disclose how it has considered the results from the previous year in its decision-making in a 'compensation discussion and analysis' (CD&A).[67]

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[61] *Infra*, para. 28.
[62] More exhaustive comparative overviews are provided by Thomas & Van der Elst (2015), *supra* note 59; Obermann & Velte (2018), *supra* note 57.
[63] Precursors of a nationwide say-on-pay rule can be found in state law as well as national taxation rules which stipulated shareholder votes; cp. R. Thomas, A. Palmiter & J. Cotter, 'Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?', *Cornell Law Review*, vol. 97(5), 2012, pp. 1213-66.
[64] Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203 [herein: Dodd-Frank Act of 2010], Sect. 951.
[65] Requirements of executive pay disclosure in the US are covered in greater detail below, cp. *infra* para. 94.
[66] 17 CFR § 240.14a-21 - Shareholder approval of executive compensation, frequency of votes for approval of executive compensation and shareholder approval of golden parachute compensation.
[67] Thomas et al. (2012), *supra* note 63, at p. 1226.

28 The European Union introduced say-on-pay into EU law in 2017;[68] at that point, 13 member states had already adopted national say-on-pay rules, ten of which required binding votes.[69] Say-on-pay was made part of the Second Shareholder Rights Directive (SRD II),[70] amending the First Shareholder Rights Directive of 2007[71] by introducing several new provisions intended to increase the long-term focus of investors and the control of directors' pay by linking it more closely to corporate financial performance.[72] The EU say-on-pay rule is peculiar in its comprehensiveness of mandating both an *ex ante* and an *ex post* vote.

29 Art. 9a SRD II[73] obliges corporations to establish a remuneration policy, on which shareholders need to hold a binding vote in the annual general meeting. Remuneration may only be paid in accordance with such an approved policy, if it has been rejected, a revised one must be submitted to the next AGM. A vote must happen at least every four years and whenever material changes occur. Member states may allow deviations from the remuneration policy under "exceptional circumstances"[74] or even make the vote entirely non-binding. In that case, remuneration can only be paid in accordance with a policy that has at least been submitted to a vote. Pursuant to Art. 9b SRD II,[75] shareholders must hold an advisory *ex post* vote on a remuneration report that contains on each director's remuneration within the last fiscal year. The report of the following year must explain how the prior vote has been taken into consideration in the company's decision-making. Member states may deviate and allow small and medium-sized enterprises[76] (SME) to only hold a "discussion" instead of a vote.

30 The Netherlands, which has been considered a frontrunner of say-on-pay legislation since its introduction of a binding *ex ante* rule in 2004,[77] started adapting its corporate law to comply

[68] A first recommendation to Member States to establish say-on-pay votes for share-based remuneration was published in 2004, see European Commission, *Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies*, 2004/913/EC.
[69] Mandatory say-on-pay votes existed in Belgium, Bulgaria, Denmark, Hungary, Latvia, The Netherlands, Portugal, Slovakia, Sweden and the United Kingdom. Advisory votes existed in the Czech Republic, Italy and Spain.
[70] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017 [herein: Second Shareholder Rights Directive; SRD II].
[71] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, OJ L 184, 14.7.2007 [herein: First Shareholder Rights Directive; SRD I].
[72] European Commission, *Impact Assessment on Proposed Shareholder Rights Directive II*, SWD(2014) 127 final, at pp. 25 et seq.
[73] Art. 9a of consolidated Directive 2007/36/EC (SRD I) as amended by Directive 2017/828/EU (SRD II).
[74] Art. 9a para. 4 of consolidated Directive 2007/36/EC (SRD I) as amended by Directive 2017/828/EU (SRD II).
[75] Art. 9b of consolidated Directive 2007/36/EC (SRD I) as amended by Directive 2017/828/EU (SRD II).
[76] As defined in Art. 3(2) and (3) of Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC [Accounting Directive].
[77] C. Van der Elst & A. Lafarre, 'Shareholder Voice on Executive Pay: A Decade of Dutch Say on Pay', *European Business Organization Law Review*, vol. 18(1), 2017, pp. 51-83.

with SRD II by presenting a draft bill to Parliament in October 2018. It adopts most of the structure from SRD II, including a binding, regular *ex ante* vote at least every four years and in case of significant changes to the remuneration policy. The scope of application is extended from the management board to the supervisory board as well (and non-executive directors in one-tier boards respectively). Exceptional circumstances allow for temporary deviations. The advisory ex post vote is implemented as prescribed in SRD II including the exception for SME.

31 France already introduced an advisory *ex post* say-on-pay vote into the country's corporate governance code, the AFEP-MEDEF, in 2013. Following a scandal in in 2016 in which the board of Renault approved the compensation package of its CEO Carlos Ghosn despite a failed say-on-pay vote and attempts to intervene by the French State as a major shareholder,[78] France adopted a law imposing the strictest say-on-pay regime in the world, coming into force 2017/18.[79] Art. 161 *Sapin II* mandates a binding *ex ante* vote on the remuneration policy in the AGM. The vote has to happen at least every year, going beyond the four-year minimum requirement of SRD II. Furthermore, the *ex post* vote on the remuneration report of the last financial year is made binding as well, exceeding the EU rules as well. If the vote is negative, variable and exceptional remuneration must be withheld. It is not the report that is voted upon, but the individual remuneration of the executives or board members separately.[80] No exceptions are made for SME.

32 Germany's dualistic board system complicates matters, as the remuneration of the supervisory board is already determined by the AGM or the charter.[81] In turn, the supervisory board sets the remuneration scheme for the management board. In 2009, however, the Act on the Appropriateness of Management Board Compensation explicitly allowed corporations to establish advisory *ex post* say-on-pay votes for the management board,[82] which became soft law when adopted as a best practice in the German Corporate Governance Code.[83] A draft bill for the transposition of SRD II into national law was published in 2018 that uses the discretion in national implementation provided by SRD II to minimise changes in existing regulation.[84] It requires no binding, but an advisory *ex ante* vote by the AGM on the remuneration policy for the management board drafted by the supervisory board every four years and in case of material changes. A non-binding *ex post* vote is mandated in accordance with SRD II, from which SME are excluded in favour of a mere "discussion".

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[78] A. Pietrancosta, *Say On Pay: The New French Legal Regime in light of the Shareholders' Rights Directive II*, Oxford Business Law Blog, 30 November 2017, available at https://www.law.ox.ac.uk/business-law-blog/blog/2017/11/say-pay-new-french-legal-regime-light-shareholders-rights-directive.

[79] Say-on-Pay was adopted via an amendment to the 'Sapin II' called Law on Transparency, the Fight against Corruption and Modernization of Economic Life (*Loi n° 2016-1691 du 9 décembre 2016 relative à la transparence, à la lutte contre la corruption et à la modernisation de la vie économique*) [herein: Sapin II].

[80] This depends on whether the corporation has adopted a one- or two-tier board structure.

[81] § 113(1) German Stock Corporation Act (*Aktiengesetz*).

[82] § 120(4) German Stock Corporation Act (*Aktiengesetz*), as introduced by the Act on the Appropriateness of Management Board Compensation (*Gesetz zur Angemessenheit der Vorstandsvergütung*) of 2009.

[83] Thomas & Van der Elst (2015), *supra* note 59, at pp. 689-90.

[84] German Federal Ministry of Justice and Consumer Protection, *Draft Implementation Bill of the Second Shareholder Rights Directive*, available in German at https://www.bmjv.de/SharedDocs/Gesetzgebungsverfahren/DE/Aktionaersrechterichtlinie_II.html.

33 The differences in national say-on-pay legislation are summarised in the following table. It shows that in the US, where shareholders traditionally enjoy little control,[85] say-on-pay introduces modest decision-rights for shareholders and relies in its enforcement on market response and private shareholder engagement with the firm.[86] Europe instead is may be used as an example for a much stronger regulatory regime, driven by the intention to make shareholder engagement a major driver of pay-for-performance.[87] The divergence between EU member states shows that the implementation of say-on-pay depends on the pre-existing regulatory and governance environment as well as the motives of legislators.

Table 1: The characteristics of different national say-on-pay regimes.

\	*Ex Ante* Vote		*Ex Post* Vote		
	Consequences	Recurrence	Consequences	Recurrence	Procedure
US	-	-	Advisory	≤ 3 years	Collective
EU	*Binding*	*≤ 4 years*	*Advisory*	*≤ 1 year*	*Collective*
NL	Binding	≤ 4 years	Advisory	≤ 1 year	Collective
FR	Binding	≤ 1 year	Binding	≤ 1 year	Individual
DE	Advisory	≤ 4 years	Advisory	≤ 1 year	Collective

34 Ownership patterns are an important determinant of say-on-pay. Dispersion raises the importance of executive compensation as a substitutive mechanism for direct control to induce managerial incentive alignment with shareholder interests.[88] At a first glance, the case for say-on-pay thus tends to be weaker in jurisdictions with more concentrated ownership patterns such as countries of continental Europe.[89] There, the presence of controlling blockholders has limited the necessity to employ executive compensation to combat agency problems.[90] However, a second driver is the prevalence of institutional investors, who have sufficient resources at their disposal to assume a more active role in corporate governance and thus discipline executives through the effective use of decision rights like say-on-pay.[91] The recent years have also shown a decrease in ownership concentration in Europe and a ubiquitous rise in shareholding by institutional investors, especially such from abroad.[92] The argument that pay-for-performance can be a strategy to protect minority shareholders in corporations with controlling blockholders also lends itself to a justification of say-on-pay.[93] In some

[85] Shareholder-centrism has nevertheless experienced a slow but steady increase in the US within the last decades, marking a trend of global conversion; see E. Rock, 'Adapting to the New Shareholder-Centric Reality', *University of Pennsylvania Law Review*, vol. 161(7), 2013, pp. 1907-88.
[86] The function of say-on-pay is covered below, see *infra*, para. 38 et seq.
[87] Cp. European Commission, *European Commission proposes to strengthen shareholder engagement and introduce a "say on pay" for Europe's largest companies*, press release, 9 April 2014, Brussels.
[88] Jensen & Meckling (1976), *supra* note 4.
[89] This does not include political motivations to regulate pay, such as the endeavor to curb 'excessive' or 'unjustified compensation' by linking it more closely to performance or shareholder-imposed targets, cp. Thomas & Van der Elst (2015), *supra* note 59, at pp. 711 et seq.
[90] Ferrarini & Moloney (2005), *supra* note 8.
[91] The role of institutional investors as well as activist shareholders is discussed in greater detail below, see *infra*, para. 52 et seq.
[92] Thomas & Van der Elst (2015), *supra* note 59, at pp. 716 et seq.
[93] Ferrarini & Moloney (2005), *supra* note 8.

jurisdictions, the role of state-controlled enterprises is also a driver for politicians to introduce more shareholder control.[94]

35 More than its US counterpart, say-on-pay in SRD II must be understood in connection with disclosure requirements and rules on the structure of pay, which are covered below. Notably, the Directive also explicitly mentions CSR in the form of "effective and sustainable shareholder engagement" as a lever to improve the financial non-financial performance of companies, referring to ESG factors and the UN PRI.[95] The Directive furthermore emphasises the importance of "respect[ing] the diversity of corporate governance systems within the Union [… regarding] the roles of companies and of bodies responsible for the determination of the remuneration policy".[96]

36 German reluctance to re-allocate the decision rights of the supervisory board to determine management compensation to shareholders needs to be understood in this light. It points towards the special role of the supervisory board in a dualistic system traditionally characterised by blockholding,[97] but also the peculiarity of co-determination law: due to labour representation on the supervisory board, any shift of decision rights towards shareholders incites a conflict of interest with employees as a crucial corporate constituency. The case of France instead demonstrates how political developments and the role of the state as a shareholder can influence say-on-pay into the direction of stronger control of management. As argued by Pietrancosta, the French legislator exceeds the original rationale behind SRD II to empower (controlling) shareholders to determine executive pay schemes themselves.[98] The Netherlands as an early adopter of say-on-pay is touched upon again below with regard to its role as a jurisdictions with high levels of CSR shareholder activism.[99]

37 Comparing the respective current and *de lege ferenda* design of say-on-pay in different jurisdictions allows the conclusion that it is far from being a uniform mechanism. Instead, it is realised very differently, depending on several factors that also influence the way say-on-pay works in practice and affects the corporate decision-making process. This implies a limitation of the comparability of empirical economic studies on the effects of say-on-pay and of the generalisability of conclusions on its functioning. To evaluate the influence of say-on-pay on CSR engagement, a theoretical framework is thus necessary that combines general effects with those of legal divergence. Next, an overview of the state of empirical evidence is used to show, which general statements on say-on-pay can be made.

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[94] This is discussed below at the example of France, see *infra*, para. 66-67.
[95] Directive 2017/828/EU (SRD II), recital 14.
[96] Directive 2017/828/EU (SRD II), recital 28.
[97] Due to co-determination laws, members of the supervisory board are also appointed by employees and thus not only representatives of shareholders, a re-allocation of decision rights would thus affect multiple dimensions of German corporate governance; cp. Kraakman et al. (2017), *supra* note 6, at pp. 105-07.
[98] Pietrancosta (2017), *supra* note 78.
[99] Cp. A. Lafarre & C. Van der Elst, 'Shareholder Sustainability Activism in the Netherlands', *ECGI Working Paper Series in Finance*, Working Paper No. 396/2018, 2018.

3.2 Effects and Functioning of Say-on-Pay

38 This section provides an overview of how say-on-pay functions in real-world practices and what effects it has on the activities and performance of firms. It elucidates the outcome of say-on-pay votes as well as the motivations behind such votes. Then, effects on executive compensation are covered, followed by the implications of say-on-pay for non-public shareholder engagement within firms.

39 The first effect of say-on-pay that is of interest is the outcome of the vote itself. Studies for most jurisdictions show that usually, shareholders display ample support for the compensation schemes of their company's management and rarely let it fail. In the US in 2011, the year the Dodd-Frank say-on-pay rule came into effect, only 1.6 percent of all votes failed, while average shareholder support was 91.2 percent.[100] Over the period of 2004-2014, average Dutch shareholder dissent was 5.8 percent, with median dissent being only 1.9 percent.[101] In the UK, only nine companies ever failed a vote between 2003 and 2009.[102] Studies for the UK[103] and Australia[104] show that shareholder dissent decreases over time after the adoption of say-on-pay. Even though these results for different jurisdictions demonstrate that say-on-pay does not lead to massive shareholder opposition, it remains one of the most controversial items in the AGM compared to other topics. [105]

40 This leads to the question of what motivates shareholders to cast their vote the way they do. Theory might suggest that shareholders primarily care about pay-for-performance sensitivity and thus show less disapproval the stronger the alignment between executive pay and firm value is. This is not supported by the empirical evidence[106]—rather, the picture is more complex: Fisch et al. state that shareholders only start evaluating pay-for-performance sensitivity as well as pay levels in their decision-making if the firm's economic performance is sufficiently bad in the first place.[107] As long as corporate financial performance is adequate, so they argue, shareholders do not make use of say-on-pay as an instrument to control management.[108]

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[100] Thomas et al. (2012), *supra* note 63.
[101] Van der Elst & Lafarre (2017), *supra* note 77.
[102] J. Delman, 'Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation', *Columbia Business Law Review*, vol. 2010(2), 2010, pp. 583-631.
[103] M. Conyon & G. Sandler, 'Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK', *Corporate Governance: An International Review*, vol. 18(4), 2010, pp. 296-312.
[104] Cp. R. Monem & C. Ng, 'Australia's 'Two-Strikes' Rule and Pay-Performance Link: Are Shareholders Judicious?', *Journal of Contemporary Accounting & Economics*, vol. 9(2), 2013, pp. 237-54.
[105] Cp. Institutional Shareholder Services, *2018 European Voting Results Report*, available at https://www.issgovernance.com/file/publications/2018_European_Voting_Results_Report.pdf, at p. 25.
[106] Cp. Obermann & Velte (2018), *supra* note 57.
[107] J. Fisch, D. Palia & S. Solomon, 'Is Say on Pay All about Pay? The Impact of Firm Performance', *Harvard Business Law Review*, vol. 8(1), 2018, pp. 101-29.
[108] The implications of this, i.e. whether say-on-pay is more of an instrument to control executive compensation or to just punish general underperformance, are discussed *Section 3.3* below. Other studies have linked these observations to behavioural reasons, especially shareholder loss aversion, see R. Krause, K. Whitler & M. Semadeni, 'Power to the Principals! An Experimental Look at

41 Even in that case, however, pay-for-performance sensitivity is not the main driver of say-on-pay. Most studies confirm that the main determinants of shareholder voting behaviour are total compensation figures—specifically more so than pay-for-performance sensitivity—and proxy advisor recommendations.[109] Proxy advisors, in turn, also react most strongly to total compensation levels.[110]

42 Results on the effects of say-on-pay are mixed. In one of the largest studies, Correa and Lel find cross-country evidence that the adoption of say-on-pay leads to a decline in CEO pay growth and increased pay-for-performance.[111] These effects materialise more strongly in firms with poor governance and financial performance.[112] Other studies find say-on-pay to increase pay-for-performance sensitivity in the US,[113] the UK,[114] and Australia,[115] even though results for the US suggest that total pay levels remain unaffected or even increase. Findings generally diverge on what proportion of dissent is necessary to trigger board reactions in changing compensation structures.[116]

43 Overall, the results show that say-on-pay is a complex mechanism, whose usage and effects are connected to other elements of governance as well.[117] The lack of differentiation in its legal design[118] reduces the explanatory power of economic theory and makes it difficult to attribute varying evidence in different countries to the different forms of say-on-pay. This also affects the conclusion above that pay-for-performance is not a major driver of shareholder engagement in say-on-pay voting, but consistently affected by it. One possible explanation may be that even the attention of shareholders is primarily caught by what is generally perceived as 'excessive'

Shareholder Say-on-Pay Voting', *Academy of Management Journal*, vol. 57(1), 2014, pp. 94-115; S. Kaplan & V. Zamora, 'The Effects of Current Income Attributes on Nonprofessional Investors' Say-on-Pay Judgements: Does Fairness Still Matter?', *Journal of Business Ethics*, vol. 153(2), 2018, pp. 407-25.

[109] Cp. Conyon & Sandler (2010); *supra* note 103; C. Armstrong, I. Gow & D. Larcker, 'The Efficacy of Shareholder Voting: Evidence from Equity Compensation Plans', *Journal of Accounting Research*, vol. 51(5), 2013, pp. 909-50; Y. Ertimur, F. Ferri & D. Oesch, 'Shareholder Votes and Proxy Advisors: Evidence from Say on Pay', *Journal of Accounting Research*, vol. 51(5), 2013, pp. 951-96.; C. Gerner-Beuerle & T. Kirchmaier, 'Say on Pay: Do Shareholders Care?', *ECGI Working Paper Series in Finance*, Working Paper No. 579/2018, 2018.

[110] Obermann & Velte (2018), *supra* note 57, at p. 120.

[111] R. Correa & U. Lel, 'Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Valuation around the World', *Journal of Financial Economics*, vol. 122(3), 2016, pp. 500-20.

[112] Ibid.

[113] Armstrong et al. (2013), *supra* note 109; P. Iliev & S. Vitanova, 'The Effects of the Say-on-Pay Vote in the United States', *Management Science*, vol. 65(10), 2019, pp. 4505-21.

[114] F. Ferri & D. Maber, 'Say on Pay Votes and CEO Compensation: Evidence from the UK', *Review of Finance*, vol. 17(2), 2013, pp. 527-63.

[115] M. Faghani, R. Monem & C. Ng, ''Say on Pay' Regulation and Chief Executive Officer Pay: Evidence from Australia', *Corporate Ownership & Control*, vol. 12(3), 2015, pp. 28-39; M. Grosse, S. Kean & T. Scott, 'Shareholder Say on Pay and CEO Compensation: Three Strikes and the Board Is Out', *Accounting & Finance*, vol. 57(3), 2017, pp. 701-25.

[116] Cp. D. Del Guercio, L. Seers & T. Woidtke, 'Do Boards Pay Attention When Institutional Activists Just Vote No?', *Journal of Financial Economics*, vol. 90(1), 2008, pp. 84-103; Ertimur et al. (2013), *supra* note 109.

[117] Obermann & Velte (2018), *supra* note 57.

[118] Thomas & Van der Elst (2015), *supra* note 59.

compensation—especially when perceived as unjustified, i.e. where financial performance is poor—to which pay-for-performance is regarded as a viable solution.

44 A second explanation is that the say-on-pay vote itself is not the main channel of engagement for shareholders. Especially institutional investors communicate their preferences to firms and intervene 'behind closed doors'.[119] In this sense, say-on-pay may simply be an additional instrument of last resort for investors to express opposition if less conflictive forms of engagement have failed. The consequence of this would be that the existing evidence on the effects of say-on-pay votes on executive compensation may merely be the tip of the iceberg. This, in turn, has implications for the theory of say-on-pay. On the one hand, binding votes grant shareholders stronger bargaining power, as withholding their consent directly affects the firm's compensation schemes. But then, if investors prefer less confrontational forms of engagement to public opposition in the AGM, they may be deterred from voicing dissent through a binding vote for the disruption it imposes on the firm, compared to the merely informational consequences of advisory votes. Generally, say-on-pay also has to be seen in context with other control rights shareholder have as bargaining power *vis-à-vis* management and cannot be treated as isolated.[120] Lastly, the role of proxy advisors in say-on-pay requires more attention, as they have significant influence on the decision-making of institutional investors.[121] These factors are taken into consideration below, focusing of the specific aspect of CSR engagement.

3.3 Say-on-Pay and CSR

45 So far, only one study has been conducted that investigates the link between say-on-pay and CSR, finding that strong CSR performance is a determinant of higher shareholder voting support.[122] This chapter attempts to address this lack of theory, applying the functional tripartite definition of CSR categories introduced earlier. Thus, a framework is built to understand the effects of say-on-pay on (i) instrumental CSR, (ii) CSR as rent-seeking and (iii) as a form of delegated shareholder philanthropy.

46 The subsequent analysis of the effects of say-on-pay on CSR engagement distinguishes two categories: first, there is the way in which say-on-pay alters pay structures. Insights derived from the existing literature on the link between executive pay instruments and CSR are used to explain how this affects CSR activities. Secondly, say-on-pay enhances the potential for shareholders to directly impose their preferences on corporate decision-making; this is further explored as a possible strategy to increase delegated shareholder philanthropy. Concomitantly,

[119] Cp. J. McCahery, Z. Sautner & L. Starks, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors', *Journal of Finance*, vol. 71(6), 2016, pp. 2905-32.
[120] Buchanan et al. note that UK shareholders have stronger proposal rights than their US counterparts and consistently employ them more frequently to oppose the board of directors, see B. Buchanan et al., 'Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and the United Kingdom', *American Business Law Journal*, vol. 49(4), 2012, pp. 739-803.
[121] N. Malenko & Y. Shen, 'The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design', *Review of Financial Studies*, vol. 29(12), 2016, pp. 3394-3427.
[122] C. Cullinan, L. Mahoney & P. Roush, 'Are CSR Activities Associated with Shareholder Voting in Director Elections and Say-on-Pay Votes?', *Journal of Contemporary Accounting & Economics*, vol. 13(3), 2017, pp. 225-43.

variations in the legal structure of say-on-pay and its wider governance framework are discussed.

3.3.1 Changes in Pay Structure

47 In Chapter Two, the links between the different categories of CSR and financial performance, corporate governance and executive compensation have been illustrated.[123] Instrumental CSR has been established as a set of activities that increase financial performance in the long run. Conversely, CSR as rent-seeking is majorly caused by excessive managerial discretion in CSR engagement and bad governance more broadly, affecting the firm's financial performance negatively. CSR as delegated shareholder philanthropy, i.e. the imposition of non-financial preferences by shareholders on the decisions of management, is ambiguous in its effects on financial performance.

48 As shown above, say-on-pay has consistently been found to strengthen the pay-for-performance link in executive remuneration.[124] Therefore, where instrumental CSR offers a possible channel for the firm to generate profits,[125] a stronger pay-for-performance link through say-on-pay creates additional incentives for executives to invest in instrumental CSR. This effect is exacerbated by the way say-on-pay influences the time horizon of executive remuneration: Short-term bonuses are found to increase AGM shareholder opposition against the remuneration policy[126] and firms have consistently cut down such short-term variable compensation as a response to say-on-pay voting dissent.[127] As a short-term pay focus disincentivises management to account for the benefits of CSR that materialise only in the long term,[128] a decrease in short-term bonuses induced by shareholder dissent further facilitates instrumental CSR engagement. Specifically, this relates to the restriction of share and share options: Ng et al. show that corporations react to shareholder dissent with a reduction of unrestricted share in the compensation mix of executives,[129] which leads to a more long-term incentive horizon.[130]

[123] Cp. *Chapter Two*, at pp. 52.
[124] A. Brav et al., 'Hedge Fund Activism, Corporate Governance, and Firm Performance', *Journal of Finance*, vol. 63(4), 2008, pp. 1729-75; M. Faghani, R. Monem & C. Ng, 'Say on Pay Regulation and Chief Executive Officer Pay: Evidence from Australia', *Corporate Ownership & Control*, vol. 12(3), 2015, 28-39; Correa & Lel (2016) *supra* note 111.
[125] For an overview of the link between CSR and corporate financial performance, cp. *Chapter Two* at p. 46, also G. Clark & M. Viehs, 'The Implications of Corporate Social Responsibility for Investors: An Overview and Evaluation of the Existing CSR Literature', *SSRN Electronic Journal*, 2014, available at https://ssrn.com/abstract=2481877.
[126] Van der Elst & Lafarre (2017), *supra* note 77.
[127] M. Grosse et al., 'Shareholder Say on Pay and CEO Compensation: Three Strikes and the Board Is Out', *Accounting & Finance*, vol. 53(3), 2017, pp. 701-25.
[128] J. Deckop, K. Merriman & S. Gupta, 'The Effects of CEO Pay Structure on Corporate Social Performance', *Journal of Management*, vol. 32(3), 2006, pp. 329-42.
[129] L. Ng et al., 'Does Shareholder Approval Requirement of Equity Compensation Plans Matter?', *Journal of Corporate Finance*, vol. 17(5), 2011, pp. 1510-30.
[130] Cp. S. Bhagat & R. Romano, 'Reforming Executive Compensation: Focusing and Committing to the Long-Term', *Yale Journal on Regulation*, vol. 26(2), 2009, pp. 359-72; D. Walker, 'The Challenge of Improving the Long-Term Focus of Executive Pay', *Boston College Law Review*, vol. 51(2), 2010, pp. 435-72.

49 An increase in pay-for-performance sensitivity as induced by say-on-pay leads to a decrease in rent-seeking, as executives need to trade off the personal benefits of rent-seeking with forgone pay resulting from sub-optimally employed corporate resources. The degree to which say-on-pay impedes rent-seeking-type CSR also depends on how increased pay-for-performance sensitivity restricts managerial discretion by setting CSR performance targets.[131] Hong et al. find that firms with more shareholder-friendly governance, and thus less managerial rent-seeking, are more likely to provide compensation linked to CSR targets.[132]

50 An objection to the link between say-on-pay and instrumental CSR as established above however may be that per-for-performance can only induce higher levels of CSR engagement if executives are sufficiently aware of the investment possibilities, provided that there are no direct CSR performance targets. This is unlikely to constitute a major obstacle: the 'business case' for CSR finds widespread acknowledgement today, a 2016 survey by the UN and a management consulting firm found that 97 percent of CEOs "believe that it is important to the future success of their business."[133] The UN PRI already provide best practice guides how to integrate CSR targets into executive pay.[134] Additionally, shareholders actively exert pressure on management to engage in CSR when it is related to financial benefits.[135]

51 The conclusions reached here need to be seen with caution, as conflicting evidence on the effects of say-on-pay persists, requiring further research. However, the following conjectures are made: say-on-pay is likely to lead to an increase in instrumental CSR and a decrease in rent-seeking CSR. This link is stronger the more prevalent the 'business case' notion of CSR among executives and shareholders is. Naturally, the degree to which pay-for-performance incentivises CSR engagement depends on a number of other firm-internal and external factors, to which more attention would have to be paid if a more detailed analysis were conducted.

3.3.2 Imposition of Shareholder Preferences

52 Say-on-pay is special compared to many other elements of corporate governance for its re-allocation of decision rights to exert control on corporate processes.[136] This means that it does not only affect instrumental and rent-seeking CSR—as categories defined by their link to

[131] Cp. A. Barnea & A. Rubin, 'Corporate Social Responsibility as a Conflict between Shareholders', *Journal of Business Ethics*, vol. 97(1), 2010, pp. 71-86; G. Cespa & G. Cestone, 'Corporate Social Responsibility and Managerial Entrenchment', *Journal of Economics & Management Strategy*, vol. 16(3), 2007, pp. 741-71.
[132] B. Hong, Z. Li & D. Minor, 'Corporate Governance and Executive Compensation for Corporate Social Responsibility', *Journal of Business Ethics*, vol. 136(1), 2016, pp. 199-213.
[133] Accenture, *The UN Global Compact – Accenture Strategy CEO Study*, available at https://www.accenture.com/us-en/insight-un-global-compact-ceo-study.
[134] UN Principles for Responsible Investment, *Integrating ESG Issues into Executive Pay*, June 2012, available at https://www.unglobalcompact.org/docs/issues_doc/lead/ESG_Executive_Pay.pdf.
[135] A. Dyck et al., 'Do Institutional Investors Drive Corporate Social Responsibility? International Evidence', *Journal of Financial Economics*, vol. 131(3), 2019, pp. 693-714.
[136] Alissa finds that say-on-pay lets boards react more quickly to shareholder dissatisfaction, see W. Alissa, 'Boards' Response to Shareholders' Dissatisfaction: The Case of Shareholders' Say on Pay in the UK', *European Accounting Review*, vol. 24(4), 2015, pp. 727-52.

financial performance—but also strengthens channels for shareholders to impose any non-financial preferences on the firm's decision-making.[137]

53 The imposition of shareholder preferences however is logically associated with a decrease in managerial discretion, which has been identified as one possible source of rent-seeking,[138] where it leads to the specification of CSR targets. Insofar, the facilitation of delegated shareholder philanthropy is likely to entail a decrease of rent-seeking CSR. It is also important to note that—as explained in *Section 2*—say-on-pay does not grant shareholders a direct decision right on setting executive pay itself, as this remains a task of the board.[139] The question thus is to what extent say-on-pay mechanisms empower shareholders to impose their CSR preferences, and in what way management responds. Also, the actual nature of shareholder preferences needs to be elucidated.

54 There are two main channels opened by say-on-pay for shareholders to influence the firm's CSR engagement: as Fisch et al. show, shareholders pay more attention to remuneration practices if a firm is performing badly and use say-on-pay as a mechanism to also express overall discontent with financial performance.[140] Consequently, the demonstration by Cullinan et al. that 'strong' CSR performance positively influences shareholder approval[141] shows that say-on-pay works as a sanctioning mechanism to evaluate CSR performance, posing an incentive for firms to respond accordingly.

55 The second channel for shareholder engagement is the control power granted by say-on-pay as a bargaining instrument to push for a stronger implementation of CSR in the remuneration policy. As shown in *Chapter Two*, corporations with more shareholder-friendly governance structures are already more likely to link compensation to CSR targets.[142] This is an indicator that either such firms combat rent-seeking potential in CSR by reducing managerial discretion or that shareholders impose their CSR preferences through performance targets. It has been shown that CSR performance targets are an effective instrument to improve CSR engagement;[143] anecdotal evidence suggests that shareholders also do so in real-life practice.[144] The extent to which the legal design of say-on-pay influences the capability of shareholders to influence the content of the remuneration policy is discussed below.

56 What are the preferences of shareholders? To a large degree, answering this question depends on what type of shareholder it is. As explained in *Chapter Two*,[145] a central role is attributed to institutional investors, who possess the resources and expertise to engage with firms.

137 Cp. Obermann & Velte (2018), *supra* note 57, at p. 123.
138 Cespa & Cestone (2017), *supra* note 131.
139 *Supra*, para. 38 et seq.
140 J. Fisch et al. (2018), *supra* note 107.
141 Cullinan et al. (2017), *supra* note 122.
142 B. Hong, Z. Li & D. Minor, 'Corporate Governance and Executive Compensation for Corporate Social Responsibility', *Journal of Business Ethics*, vol. 136(1), 2016, pp. 199-213; cp. *Chapter Two* at p. 59.
143 Ibid.; K. Maas, 'Do Corporate Social Performance Targets in Executive Compensation Contribute to Corporate Social Performance', *Journal of Business Ethics*, vol. 148(3), 2018, pp. 573-85; cp. *Chapter Two* at p. 60.
144 Cp. the case of Shell, which introduced environmental performance targets for all senior executives, see https://www.shell.com/media/news-and-media-releases/2018/leading-investors-back-shells-climate-targets.html.
145 Cp. *Chapter Two* at p. 50.

'Sustainable investment' has become a proliferated practice already among institutional investors; however, as has been suggested by both anecdotal[146] and empirical[147] evidence, the focus is often merely on the long-term financial benefits of CSR, which has been examined above.[148]

57 A different issue is what here is understood under 'Socially Responsible Investment' (SRI). According to the principles of SRI, investors explicitly make 'ethical' concerns part of their investment decision. Usually, institutional investors are bound by a fiduciary duty towards the beneficiary owners, i.e. those providing the capital for investment,[149] in their investment decision and will not pursue any non-financial preferences. This changes when they explicitly subscribe to SRI, e.g. in form of the UN PRI, which can be seen as supply to the market of sustainable investment opportunities. The focus is therefore on such institutional investors who apply SRI standards, for which a considerable asset volume of over USD 21 trillion was estimated in 2015.[150]

58 Evidence exists that activist investors regularly express non-financial preferences in their engagement with firms.[151] In the so far largest study, Dyck et al. investigate the link between institutional ownership and CSR performance.[152] They find that institutional ownership consistently encourages CSR performance, an effect measured twice as strongly for investors who signed the UN PRI compared to the average. These results are only partly attributed to the long-term financial benefits of CSR, as ethical norms of the investor's country of origin significantly influence the pursuit of non-financial preferences.[153] It is noteworthy that they find that even hedge funds and mutual funds are affected by these ethical norms and that pensions funds are found to consistently strengthen CSR performance regardless of their origin.[154]

59 Consistent with the existing evidence on engagement by institutional investors,[155] Dyck et al. find that entry-or-exit investment decision are only a minor strategy and that public and private expression of preferences towards the board is their main engagement approach.[156] This is

[146] Larry Fink, CEO of the world's largest asset manager Blackrock, stated in 2018 "that sustainable investing is the strongest foundation for client portfolios going forward"; in 2020, Blackrock subsequently announced to entirely withdraw from "high sustainability-related risk" investments. See L. Fink, 'Annual Letter to CEOs – A Sense of Purpose', 2018, available at: https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter; L. Fink, 'Annual Letter to CEOs – A Fundamental Reshaping of Finance', 2020, available at https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceo-letter.

[147] L. Dam & B. Scholtens, 'Does Ownership Type Matter for Corporate Social Responsibility?', *Corporate Governance: An International Review*, vol. 20(3), 2012, pp. 233-52.

[148] *Supra*, para. 38.

[149] Cp. D. Larcker, A. McCall & G. Ormazabal, 'Outsourcing Shareholder Voting to Proxy Advisory Firms', *Journal of Law and Economics*, vol. 58(1), 2015, pp. 173-204.

[150] Cp. T. Barko, M. Cremers & L. Renneboog, 'Shareholder Engagement on Environmental, Social, and Governance Performance', *ECGI Working Paper Series in Finance*, Working Paper No. 509/2017, 2017.

[151] Y. Ertimur, F. Ferri & V. Muslu, 'Shareholder Activism and CEO Pay', *Review of Financial Studies*, vol. 24(2), 2011, pp. 535-92.

[152] Dyck et al. (2019), *supra* note 135.

[153] Ibid.

[154] Ibid.

[155] Cp. McCahery et al. (2016), *supra* note 119.

[156] Dyck et al. (2019), *supra* note 135.

complemented by the insight that institutional investors often coordinate their engagement to counter collective action problems in changing a target's CSR performance.[157] Barko et al. find that these forms of shareholder engagement are more successful in target companies with lower ownership concentration and already better *ex ante* CSR records,[158] which indicates that shareholder activism rather is a tool to improve CSR performance than to establish it in the first place.

60 The importance of institutional investors is significant across all major jurisdictions, as a trend of convergence exists in national ownership patterns. In the US, a concentration process has been happening, with institutional ownership making up 70 percent of the 1,000 largest US public corporations in 2011.[159] In Europe, a trend towards institutional ownership is observable as well: in Germany, for example, institutional investors controlled on average 68 percent of a DAX company in 2013.[160] This development has to be seen in context with the rise of foreign ownership, however. Foreign investors often display a governance activism disadvantage[161] and are less likely to convince other investors to join CSR engagement activism.[162] Coordinated engagement is further obstructed by the heterogeneity of non-financial preferences based on the country of origin.[163] These restrictions, together with general scepticism towards the role of shareholders in promoting CSR,[164] must be considered as well in an evaluation of the impact of institutional investors on CSR. Nevertheless, evidence from the Netherlands suggests that the role of shareholders in promoting CSR and critically accompanying the pay-setting process is active and growing.[165]

61 Lastly, an important class of actors that cannot be omitted in an analysis of say-on-pay is that of proxy advisory firms like ISS or GL.[166] Institutional investors usually rely in their decision-making heavily on the recommendations made by advisory firms,[167] which is especially the case for say-on-pay decisions.[168] Malenko and Shen report an overall 25 percent decrease in

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[157] E. Dimson, O. Karakaş & X. Li, 'Coordinated Engagements', 24 December 2018, *SSRN Electronic Journal*, available at https://ssrn.com/abstract=3209072; also cp. A. Brav, A. Dasgupta & R. Mathews, 'Wolf Pack Activism', *ECGI Working Paper Series in Finance*, Working Paper No. 501/2017, 2017.
[158] Barko, Cremers & Renneboog (2017), *supra* note 150.
[159] R. Gilson & J. Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights', *Columbia Law Review*, vol. 113(4), 2013, pp. 863-927, at p. 865.
[160] Thomas & Van der Elst (2015), *supra* note 59.
[161] J. Kang & J. Kim, 'Do Foreign Investors Exhibit a Corporate Governance Disadvantage? An Information Asymmetry Perspective', *Journal of International Business Studies*, vol. 41(8), 2010, pp. 1415-38.
[162] Dimson, Karakaş & Li (2018), *supra* note 157.
[163] Dyck et al. (2019), *supra* note 135.
[164] Cp. B. Sjåfjell, 'Achieving Corporate Sustainability: What Is the Role of the Shareholder?', in: H. Birkmose (ed.), *Shareholders' Duties*, Alphen aan den Rijn, Kluwer Law International, 2016.
[165] Lafarre & Van der Elst (2018), *supra* note 99.
[166] Institutional Shareholder Services (ISS) and Glass Lewis (GL) are the two dominant global proxy advisors in terms of the number of institutional clients, cp. Kraakman et al. (2017), *supra* note 6, at p. 61.
[167] D. Larcker, A. McCall & G. Ormazabal, 'Proxy Advisory Firms and Stock Option Repricing', *Journal of Accounting and Economics*, vol. 56(2-3), 2013, pp. 149-69; Ertimur et al. (2013), *supra* note 109.
[168] Larcker et al. (2015), *supra* note 149.

shareholder voting support following a negative ISS recommendation.[169] According to Ferrarini and Ungureanu, "[c]ompanies that receive a negative recommendation from ISS almost always fail their say-on-pay vote, whereas no company that receives a positive ISS recommendation fails its say-on-pay vote."[170] Larcker et al. find that boards of directors proactively adjust their compensation programs prior to the vote to 'comply' with the recommendation policies of proxy advisors in order to avoid a negative say-on-pay voting recommendation.[171] Thus, the importance of proxy advisory firms is significant, and whether their stance on CSR may also impact the effect say-on-pay has on a firm's CSR engagement policy.

62 Both ISS and GL provide services in the field environmental and social concerns, have guidelines of best practices, company performance standards and offer corresponding voting recommendations.[172] The CSR policies of proxy advisors however attracted increasing attention after indications occurred that their voting recommendations had detrimental effects on shareholder value,[173] which is counter-intuitive given that it is shareholders to whom they sell their expertise and advice. One reason for this has been proposed by James Copland in a Wall Street Journal commentary, in which he claimed that proxy advisors are under extraordinarily high influence by "special interest investors like labour-union pension funds and 'socially responsible' investing vehicles".[174] He claims a conflict of interest by proxy advisors that leads to an increased focus on sustainability-related issues at the cost of shareholder value, which is further exacerbated by the fact that proxy advisors also offer consultancy services in these areas to companies to whose shareholders they offer voting and proposal recommendations. In the US, the SEC already acknowledged possible conflicts of interest and reacted with increased disclosure demands.[175] The pursuit of apparently non-instrumental CSR by proxy advisor has interesting theoretical implications for the formation of non-financial shareholder preferences, especially of institutional investors, who rely in their decision-making process on the services of proxy advisors.

63 It can be concluded that shareholders use say-on-pay voting behaviour to sanction a company's CSR performance; more importantly, however, say-on-pay contributes to the bargaining power of institutional investors in a non-public environment *vis-à-vis* the company's board. How exactly this bargaining power is exerted 'behind closed doors' remains an under-researched topic.[176] Nevertheless, it is evident that institutional investors are an active driver of CSR activities and that non-financial preferences are a substantive motivation for this engagement.

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[169] N. Malenko & Y. Shen, 'The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design', *Review of Financial Studies*, vol. 29(12), 2016, pp. 3394-3427.
[170] Ferrarini & Ungureanu (2018), *supra* note 12, at p. 352.
[171] Larcker et al. (2015), *supra* note 149.
[172] Cp. ISS, *Environmental & Social Disclosure QualityScore FAQ*, available at https://www.issgovernance.com/file/faq/Environmental-Social-QualityScore-FAQ.pdf; Glass Lewis, *ESG Services*, available at http://www.glasslewis.com/esg-services/.
[173] Larcker et al. (2015) *supra* note 149.
[174] J. Copland, 'Politicized Proxy Advisers vs. Individual Investors', *Wall Street Journal*, October 7, 2012, available at https://www.wsj.com/articles/SB10000872396390444620104578012252125632908.
[175] SEC, *Investment Advisers Act of 1940—Rule 206(4)-6: Egan-Jones Proxy Services,* SEC letter to Kent S. Hughes, May 27, 2004.
[176] McCahery et al. (2016), *supra* note 149.

Proxy advisors, who significantly influence institutional shareholders' decision-making, also contribute to this pressure on portfolio companies for more CSR.

3.3.3 Legal and Governance Variation

64 The considerable divergence in the legal design of say-on-pay rules around the world is a factor whose influence on shareholder engagement has received little attention in academia so far.[177] Whether a shareholder vote happens *ex ante* or *ex post* and whether it binds the board or not are thus possible explanations for national differences in the influence of investor preferences on corporate decision-making. The same holds true for the interaction of say-on-pay with other elements of governance, especially board structure and the allocation of further decision rights between management and shareholders. The problem that there is little to no empirical evidence on the effects of legal variation is exacerbated by a corresponding lack of law and economics theory. Studies of say-on-pay have so far focused on the positive description of legal variation and its origin[178] or attempts to explain its effects in national settings.[179]

65 The difference between an *ex ante* and an *ex post* vote is synonymous to either a vote on the remuneration policy or the remuneration report, as the European example of SRD II shows, incorporating both rules.[180] A vote on the remuneration policy, which determines the remuneration system for future years, is likely to affect managerial incentives more strongly than a vote on the report, which is a retrospective affirmation of prior practices. It also allows shareholders to assume a more active role in the design of incentives themselves, e.g. by proposing performance targets or corporate policy objectives. This difference, however, may be mitigated by the extent to which both rules induce a general communication and negotiation process between shareholders and the board prior to the vote. The fact that shareholders use private channels to engage with firms,[181] also with regard to CSR,[182] means that the implications of say-on-pay for investor bargaining power are mainly linked to the sanctions attached to a negative vote. These sanctions, in turn, depend on the consequences the law attaches to a failed vote, but also market forces.

66 *Ceteris paribus*, a binding say-on-pay rule entails more severe consequences than a mere advisory vote. In the case of a binding *ex ante* rule, a failed vote means that no new remuneration policy can be adopted and executives have to be paid in accordance with the old policy.[183] A failed binding *ex post* vote can lead to the withholding of variable and exceptional remuneration as in France.[184] However, shareholders might be more hesitant to express their discontent in a binding vote than in an advisory one because of the risk of bearing the costs of

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[177] Obermann & Velte (2018), *supra* note 57.
[178] Thomas & Van der Elst (2015), *supra* note 59.
[179] Obermann & Velte (2018), *supra* note 57.
[180] Cp. *supra*, para. 28-29.
[181] McCahery et al. (2016), *supra* note 119.
[182] Dyck et al. (2019), *supra* note 135.
[183] For the EU cp. Art. 9a of consolidated Directive 2007/36/EC (SRD I) as amended by Directive 2017/828/EU (SRD II).
[184] Cp. *supra*, para. 31.

disruption a failed vote would cause. It remains a topic of future research how these effects precisely relate to the sanctions the market attaches to failed say-on-pay votes.[185]

67 The voting procedure affects the control power of shareholders over management. Votes on the compensation of individual directors, as in *ex post* votes in France, allow the retaliatory practice of singling out and punishing them e.g. for malperformance. This regime shifts attention away from the overall alignment of compensation targets and practices with corporate policies though. Collective votes as in most other jurisdictions are thus more likely to place the focus of discussion on the general orientation of pay, emphasising its role as an incentive for the implementation of corporate objectives and shareholder preferences.

The integration of say-on-pay into existing mechanisms of monitoring and control is a complex yet crucial point to understand its functioning to the full extent. The German dualistic board structure serves as an example of a rather difficult environment for the integration of say-on-pay. The allocation of delegated control rights between the management board—consisting of executives—and the supervisory board—whose compensation is determined by shareholders—already renders the agency conflict of executive pay less severe and lessens the usefulness of say-on-pay. Additionally, directors on the supervisory board do not only act as shareholder trustees, but due to co-determination laws also as employee representatives;[186] a re-allocation of decision rights to shareholders also affects this corporate constituency. Overall, this legal comparison of say-on-pay rules and inquiry into investor engagement show that adjustments of shareholder decision rights on corporate incentive schemes can be an important contribution to more CSR engagement. Notably, this can happen through two channels simultaneously: instrumental CSR, which contributes to long-term financial performance, and delegated shareholder philanthropy, which investors can impose more easily if they have stronger decision rights. The role of directors, who are the primary actors in the pay-setting process, receives more attention in the following section.

Section 4: Independent Remuneration Committees

68 Legal independence requirements for directors predicate that members of the board who are neither part of executive management nor hold any other personal or business ties with the company lack the incentives to divert from shareholder interests.[187] Next to this negative dimension of the absence of self-regarding material incentives, positive reputational incentives are supposed to motivate independent directors to exert adequate levels of effort in the interest

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[185] Cp. the conclusions of K. Stathopoulos & G. Voulgaris, 'The Importance of Shareholder Activism: The Case of Say-on-Pay', *Corporate Governance: An International Review*, vol. 24(3), 2016, pp. 359-70.
[186] For an international overview cp. K. Hopt & P. Leyens, 'Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy', *European Company and Financial Law Review*, vol. 1(2), 2004, pp. 135-68.
[187] Cp. M. Eisenberg, 'Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants', *California Law Review*, vol. 63(2), 1975, pp. 375-439; R. Gilson & R. Kraakman, 'Reinventing the Outside Director: An Agenda for Institutional Investors', *Stanford Law Review*, vol. 43(4), 1991, pp. 863-906.

of the company, i.e. shareholders.[188] The legal strategy of imposing independence requirements upon directors is particularly salient regarding the composition of remuneration committees, as the determination of compensation schemes by executive directors falls into the realm of self-dealing transactions.[189] As actors with a direct influence on the pay-setting process, the question occurs whether there is a causal relationship between such requirements and CSR incentives. But beyond that, and more interestingly, the broader governance role of directors—particularly in remuneration committees—suggests that corporate law affects the nature and extent of CSR engagement.

69 The basic theoretical set-up outlined above is complicated by several additional aspects. This concerns the ownership pattern of the jurisdiction in which companies operate, as well as its interplay with (other) legal strategies, as director independence is not a complementary instrument, but a substitute for other mechanisms.[190] Both these facts explain why jurisdictions differ significantly in the extent of requiring director independence, and the variance in soft or hard law. Prior to an analysis of independent remuneration committees and CSR, these aspects are briefly elaborated under *Section 5.1* to explain the functioning and notable divergence of legal independence requirements in different jurisdictions.

70 The effects of independent director requirements for remuneration committees are analysed under *Section 5.2* along several channels: the first is, most obviously, the way they alter pay structures, primarily in terms of the instruments they employ and the compensation targets they set. This picture is then extended to include the broader governance role independent directors play in corporations: the do not only monitor and control executive management but fulfil an advisory function as well and serve as networkers between the company and its stakeholders. The influence they exert and the quality of their monitoring must be assessed in the light of informational deficiencies suffered by not being involved in operational decision-making, which differs among industries and corporations. Lastly, how directors themselves understand their roles—be it as trustees of shareholders or as stewards of a broader audience—influences their actions. This, in turn, flows back into legal considerations that do not only look at ‘independence from’, but also ‘dependence on’.

4.1 The Causes of Regulatory Divergence

71 Contrary to the other legal mechanisms covered in this chapter, director independence is applied with an irregular intensity and different qualitative requirements across jurisdictions. Two main causes of this observation can be identified: underlying ownership patterns and substitution by other governance mechanisms. These causes affect the decisions of legislators whether to impose independence requirements, how they do so, for which competencies of the board, and how ‘independence’ is legally defined.

[188] More precisely, independent directors “have incentives to develop reputations as experts in decision control.”, see E. Fama & M. Jensen, ‘Separation of Ownership and Control’, *Journal of Law and Economics*, vol. 26(2), 1983, pp. 301-25, at p. 315.
[189] Cp. Kraakman et al. (2017), *supra* note 6, pp. 145 et seq.; Murphy (2013), *supra* note 32.
[190] Even disclosure and board independence may serve as substitutes, see H. Chung, W. Judge & Y. Li, ‘Voluntary Disclosure, Excessive Executive Compensation, and Firm Value’, *Journal of Corporate Finance*, vol. 32(1), 2015, pp. 64-90.

72 The prevalent ownership patterns in a jurisdiction determine which intra-corporate agency conflicted is to be addressed by the independence strategy. In a setting of dispersed ownership, directors are expected to primarily act as 'trustees'[191] of disaggregate shareholders, who themselves lack the resources and incentives to monitor.[192] In concentrated ownership companies where blockholding shareholders have control over management, independent directors can effectively[193] protect the interests of minority shareholders and other corporate constituencies. This, however, further requires independence from the controlling shareholder.[194]

73 Unlike disclosure requirements, which work as a complement to other governance mechanisms, independent directors are a substitute for other monitoring and control strategies.[195] Where shareholders enjoy weak control rights, board independence is a much more prevalent mechanism than where they are already entitled to significant control;[196] where e.g. say-on-pay shifts decision-making authority in compensation matters from directors the investors, the former's ability to control can be reduced. Even different types of independent directors can serve as respective substitutes, as an independently staffed audit committee decreases the need for independent remuneration or nomination committees and vice versa.

74 The United States, which is also the origin of the concept of independent directors,[197] introduced compulsory independent remuneration committees with the Dodd-Frank Act of 2010 for all corporations.[198] 'Independence' is here understood and delineated based on a directors' source of income and any affiliation with the corporation or any of its subsidiaries.[199]

75 European jurisdictions instead mostly promote director independence through corporate governance codes instead of hard law. It is notable that this pattern persists despite the overall trend of executive pay regulation changing from soft to hard law.[200] The EC, in its reformation endeavours of pay-related corporate governance matters mentioned above,[201] expressed recommendations on the role of independent directors. These recommendations were held very vaguely, asking for an "appropriate balance"[202] between managing and independent directors on the board and a "sufficient number" of independent or non-executive directors in the

[191] 'Trusteeship' here is defined as an "incentive alignment strategy [… that] seeks to remove conflicts of interest *ex ante* to ensure that an agent will not obtain personal gain from disserving her principal.", see Kraakman et al. (2017), *supra* note 6, at p. 35.

[192] Ibid. at p. 62.

[193] J. Dahya, O. Dimitrov & J. McConnell, 'Dominant Shareholders, Corporate Boards and Corporate Value: A Cross-Country Analysis', *Journal of Financial Economics*, vol. 87(1), 2008, pp. 73-100.

[194] Cp. L. Bebchuk & A. Hamdani, 'Independent Directors and Controlling Shareholders', *University of Pennsylvania Law Review*, vol. 165(6), 2017, pp. 1271-1315; M. Gutiérrez & M. Sáez, 'Deconstructing Independent Directors', *Journal of Corporate Law Studies*, vol. 23(1), 2013, pp. 63-94.

[195] W. Ringe, 'Independent Directors: After the Crisis', *European Business Organization Law Review*, vol. 14(3), 2013, pp. 401-24.

[196] Cp. Buchanan et al. (2012), *supra* note 120.

[197] J. Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices', *Stanford Law Review*, vol. 59(6), 2007, pp. 1465-1568.

[198] Dodd-Frank Act of 2010, Sect. 952.

[199] 17 CFR § 240.10C-1 - Listing standards relating to compensation committees.

[200] Cp. Ferrarini & Ungureanu (2018), *supra* note 12.

[201] *Supra*, para. 77.

[202] European Commission, *Recommendation 2005/162/EC*, at para. 3.1.

nomination, audit and remuneration committee to be able to "play an effective role".[203] Independence is defined as having no business or personal relationship with the company, its management or a controlling shareholder, if such a relationship creates a conflict of interest for the director.[204] This goes beyond US independence requirements and acknowledges the additional agency conflict between blockholders and minority shareholders in European jurisdictions with concentrated ownership patterns.

76 The United Kingdom is the only major European jurisdiction to require fully independent remuneration committees in its Corporate Governance Code.[205] France and Italy recommend remuneration committees to be staffed with at least a majority of independent directors in their Codes, while Germany restricts itself to the recommendation of independent audit and nomination committees only.[206] The reluctance of Germany to impose requirements on the establishment and composition of board committees compared to other jurisdictions needs to be seen in the context of both its dualistic board structure and co-determination laws. These aspects already create a greater degree of independence for the supervisory board. In dualistic systems, 'independence' as discussed here entails a stronger degree of distance to shareholders, as an institutional separation from executive management is already provided.[207] Whereas the aim of legislators is to strengthen the rights of shareholders as a collective, the imposition of personal independence can be counter-productive because of the pre-existing functional independence of the board and rather be an instrument for the protection of minority shareholders.[208]

77 The divergent implementation of the independent director strategy shows that it cannot be taken as a monolithic instrument to improve corporate governance. This contributes to the mixed empirical evidence on its link to financial performance[209] and executive compensation, which is touched upon in the subsequent section, and makes a case for a narrow scope of application. Arguing that in jurisdictions without strict board independence requirements alternative mechanisms prevail, Ringe concludes that "independence is not a panacea, and certainly not an end in itself. Rather, it is submitted, *independence is a tool for solving a specific problem*."[210] The definition of 'independence', depending on the characteristics of each jurisdiction,[211] and the legal purpose of the instrument are thus central to understanding its effects on corporate governance and CSR.

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[203] Ibid. at para. 5.
[204] Ibid. at para. 13.1.
[205] United Kingdom Corporate Governance Code, July 2018, provision 32.
[206] Cp. Kraakman et al. (2017), *supra* note 6. For the sake of brevity, a comparison of independence requirements for different board committees in said jurisdictions is omitted.
[207] Ibid., at p. 64.
[208] The definition of 'independence' in Germany explicitly includes the absence of personal or business ties to any controlling shareholders, see Germany Corporate Governance Code, Recommendation C.9.
[209] For an overview, cp. R. Adams, B. Hermalin & M. Weisbach, 'The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey', *Journal of Economic Literature*, vol. 48(1), 2010, pp. 58-107.
[210] Ringe (2013), *supra* note 195.
[211] D. Johanson & K. Østergren, 'The Movement Toward Independent Directors on Boards: A Comparative Analysis of Sweden and the UK', *Corporate Governance: An International Review*, vol. 18(6), 2010, pp. 527-39.

4.2 Independent Remuneration Committees and CSR

78 Independent directors as a governance strategy have been sharply on the rise since the first half of the 2000s;[212] however, the empirical literature has provided mixed results on the link between director independence and firm value, relativising the case made for it in the theoretical literature.[213] Indeed, the employment of independent directors is connected to an acknowledged trade-off, as directors uninvolved in operational managerial affairs are in an inferior informational position on the performance of the company.[214] This lack of expertise may decrease the ability to monitor and control significantly and thus outweigh the benefits of independence—a problem that was drastically demonstrated by the banking sector during the financial crisis.[215] The functioning of this governance mechanism depends on further firm-specific characteristics, e.g. company size,[216] but also external factors such as the functioning of the stock market.[217]

79 Given this shaky baseline, what may be said about the influence of independent directors on executive compensation and financial incentives? Theory predicts that independence either reduces managerial capture of the pay-setting process and reduces absolute levels on pay while increasing pay-for-performance sensitivity or has little effect where optimal contracting structures prevail.[218] The effect of committee independence on absolute pay levels has been described by more recent studies as either uncorrelated[219] or even positive, which contradicts earlier results.[220] This does not mean, however, that independent remuneration committees may not strengthen the shareholder-value orientation of executive compensation:[221] there is clearer evidence that pay-for-performance sensitivity is increased,[222] which may also explain the

[212] Ferrarini & Moloney (2005), *supra* note 8.

[213] For studies critical of the effectiveness of director independence, cp. S. Bhagat & B. Black, 'The Non-Correlation Between Board Independence and Long-Term Firm Performance', *Journal of Corporation Law*, vol. 27(2), 2001, pp. 231-73; R. El-Faitouri, 'Board of Directors and Tobin's Q: Evidence from U.K. Firms', *Journal of Finance and Accounting*, vol. 2(4), 2014, pp. 83-99.

[214] B. Baysinger & R. Hoskisson, 'The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy', *Academy of Management Review*, vol. 15(1), 1990, pp. 72-87.

[215] M. Murphy, 'Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension', *Delaware Journal of Corporate Law*, vol. 36(1), 2011, pp. 121-64; this does not mean however that remuneration committee independence is no viable strategy in the financial sector, see *Chapter Four* at p. 124.

[216] P. Cybinski & C. Windsor, 'Remuneration Committee Independence and CEO Remuneration for Firm Financial Performance, *Accounting Research Journal*, vol. 26(3), 2013, pp. 197-221.

[217] Gordon argues that independent directors need to rely to a greater extent on the information provided by share prices than do executive directors involved in the corporation's affairs; Gordon (2007), *supra* note 197.

[218] See Bebchuk, Fried & Walker (2002), *supra* note 7; Bebchuk & Fried (2003), *supra* note 28.

[219] R. Anderson & J. Bizjak, 'An Empirial Examination of the Role of the CEO and the Compensation Committee in Structuring Executive Pay', *Journal of Banking and Finance*, vol. 27(7), 2003, pp. 1323-48; I. Gregory-Smith, 'Chief Executive Pay and Remuneration Committee Independence', *Oxford Bulletin of Economics and Statistics*, vol. 74(4), 2012, pp. 510-31.

[220] K. Guthrie, J. Sokolowsky & K. Wan, 'CEO Compensation and Board Structure Revisited', *Journal of Finance*, vol. 67(3), 2012, pp. 1149-68.

[221] If pay is less certain because it is being tied to performance targets, labour market conditions usually require additional compensation for undiversified, risk averse executives, see Edmans et al. (2017), *supra* note 31, at pp. 39-46.

[222] C. Mishra & J. Nielsen, 'Board Independence and Compensation Policies in Large Bank Holding Companies', *Financial Management*, vol. 29(3), 2000, pp. 51-69.

failure to decrease absolute pay levels, or even increases.[223] Evidence that independent directors improve compensation disclosure further supports this view.[224]

80 Do independent remuneration committees also affect CSR engagement directly? Cho et al. observe an increase in the use of CSR targets for variable compensation when committees members are independent from CEOs.[225] Their results fit into the broader literature on independent directors and CSR, which asserts a positive link between the two as well. [226] The fact that independent remuneration committees strengthen pay-for-performance sensitivity indicates that CSR effects translate into instrumental CSR. Coffee and Wang find that independent directors lead to less CSR initiated by managers,[227] which in turn speaks in favour of a reducing effect on type-(ii) CSR as managerial rent-seeking. If CSR activities are not the result of managerial engagement anymore, this may either indicate an institutionalisation of CSR engagement within the firm, as supported by the increased employment of CSR targets in compensation schemes, or the implementation of non-financial shareholder preferences, i.e. type-(iii) CSR. This differentiation leads to the question for further aspects of the role of independent directors within the company.

81 The capacity of independent directors to monitor and control corporate agents is hampered by the inferior information they have on executive affairs.[228] This does not only entail a trade-off and the need to find an equilibrium between independent and executive directors,[229] but also affects the capacity of the former to drive CSR engagement. Independent directors rely to a greater degree on accounting and external information and less on personal experience; a focus on overall financial performance limits the capacity of directors to monitor CSR performance directly.[230] The remuneration committee is entrusted with tasks that are still relatively remote from daily business. Nevertheless, this may entail problems for the drafting of non-financial operative performance targets in compensation schemes. This creates opportunities for managers to overstate successes or to exploit any information asymmetry to capture the pay-setting process, which may contribute to managerial CSR.

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[223] Cp. N. Fernandes et al., 'Are US CEOs Paid More? New International Evidence', *Review of Financial Studies*, vol. 26(2), 2013, pp. 323-67.
[224] Cp. I. Karamanou & N. Vafeas, 'The Association between Corporate Boards, Audit Committee and Management Earnings Forecasts: An Empirical Analysis', *Journal of Accounting Research*, vol. 43(3), 2005, pp. 453-86.
[225] M. Cho, S. Ibrahim & Y. Yan, 'The Use of Nonfinancial Performance Measures in CEO Bonus Compensation', *Corporate Governance An International Review*, vol. 27(4), 2019, pp. 301-16.
[226] B. Hong, Z. Li & D. Minor, 'Corporate Governance and Executive Compensation for Corporate Social Responsibility', *Journal of Business Ethics*, vol. 136(1), 2016, pp. 199-213; H. Jo & M. Harjoto, 'The Causal Effect of Corporate Governance on Corporate Social Responsibility', *Journal of Business Ethics*, vol. 106(1), 2012, pp. 53-72; E. Webb, 'An Examination of Socially Responsible Firms' Board Structure', *Journal of Management and Governance*, vol. 8(3), 2004, 255-77.
[227] B. Coffey & J. Wang, 'Board Diversity and Managerial Control as Predictors of Corporate Social Performance', *Journal of Business Ethics*, vol. 17(14), 1998, pp. 1595-1603.
[228] R. Adams & D. Ferreira, 'A Theory of Friendly Boards', *Journal of Finance*, vol. 62(1), 2007, pp. 217-50.
[229] On the benefits of executive directors vis-à-vis independent ones, cp. L. Donaldson & J. Davis, 'Boards and Company Performance – Research Challenges the Conventional Wisdom', *Corporate Governance An International Review*, vol. 2(3), 1994, pp. 151-60.
[230] J. Walls, P. Berrone & P. Phan, 'Corporate Governance and Environmental Performance: Is There Really a Link?', *Strategic Management Journal*, vol. 33(8), 2011, pp. 885-913.

82 The networking function of independent directors enables them to entertain closer links to stakeholders of the corporation, which is another driver of CSR engagement.[231] As explained in the previous chapter,[232] the influence of stakeholders usually translates into instrumental CSR. The degree to which intensified stakeholder communications lead to CSR engagement is contingent upon the broader institutional environment.[233] The more 'explicit' stakeholder relations are in that environment, the more they drive the company to carry out CSR activities, while an 'implicit' environment mediates this effect.[234]

83 While non-executive members of the board are usually equally dependent on election by the general meeting as their peers, under the current legal system of independence no further incentives exist for them to actively implement shareholder preferences in corporate decision-making. In dispersed ownership settings, their function as protectors of shareholders as a class and reliance on financial performance indicators make it likely that they create collective action barriers to the imposition of non-financial shareholder preferences. The reputation mechanism and their networking role may mediate this. In concentrated ownership jurisdictions, shielding the corporation from the non-financial preferences of blockholders is even an explicit function of independent directors. The specific legal definition of independence gains importance again though, as badly designed regulation can even increase blockholder control[235] and allow them to mandate deviations from the generic corporate objective of financial performance.

84 While the legal concept of independence protects shareholders, it merely prohibits certain personal ties and remains one-dimensional.[236] A closely linked concept is that of 'dependent directors', already existing in a few jurisdictions by making directors directly accountable to minority shareholders.[237] Contrary to merely independent directors, whose failure to adequately protect minority shareholders has been laid out in the literature,[238] making directors explicitly dependent on minority shareholders allows these to express non-financial preferences. It is difficult to tell how much they may accomplish as drivers of CSR, when they are designed as a line of defence against blockholder despotism and implementation remains limited despite the concept gaining foothold in academia.

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[231] C. Mallin, G. Michelon & D. Raggi, 'Monitoring Intensity and Stakeholders' Orientation: How Does Governance Affect Social and Environmental Disclosure?', *Journal of Business Ethics*, vol. 114(1), 2013, pp. 29-43.
[232] *Chapter Two*, at pp. 43-44.
[233] Cp. S. Brammer, G. Jackson & D. Matten, 'Corporate Social Responsibility and Institutional Theory: New Perspectives on Private Governance', *Socio-Economic Review*, vol. 10(1), 2010, pp. 3-28.
[234] D. Matten & J. Moon, '"Implicit" and "Explicit" CSR: A Conceptual Framework for a Comparative Understanding of Corporate Social Responsibility', *Academy of Management Review*, vol. 33(2), 2008, pp. 404-24.
[235] Cp. Bebchuk and Hamdani (2017), *supra* note 194, at pp. 1286-90; for a specific industry study, see A. Słomka-Gołębiowska, 'The Effect of Remuneration Committee Independence on the Pay-Performance Relationship: Evidence from the Banking Industry in Poland', *Eastern European Economics*, vol. 54(1), 2016, pp. 71-89.
[236] Cp. also D. Clarke, 'Three Concepts of the Independent Director', *Delaware Journal of Corporate Law*, vol. 32(1), 2007, pp. 73-111.
[237] Italy and Brazil have mandatory requirements for the representation of minority shareholder electees on the board of directors, see Kraakman et al. (2017), *supra* note 6, at p. 80.
[238] Ringe (2013), *supra* note 195; Gutiérrez & Sáez (2017), *supra* note 194; Bebchuk & Hamdani (2017), *supra* note 194.

85 Another version of dependent directors can be found in Germany's co-determination laws, which mandate labour representatives on the supervisory board.[239] This direct involvement of stakeholders in the corporate decision-making process has peculiar implication for CSR engagement:[240] trade unions regard co-determination as a possibility to enforce stakeholder interests and claim that labour representatives on remuneration committees to be the driving force behind the proliferation of non-financial performance targets in compensation schemes in Germany.[241] While employee interests form the core of their engagement, it explicitly also includes broader social and environmental issues. The direct imposition of stakeholder preferences on corporate decision-making supersedes the concept of shareholder centrality incorporate governance. Whether theoretical contributions on extensions of the concept of independent directors are a viable strategy to integrate CSR considerations into executive pay regulation is discussed at a later stage.[242]

86 At this point, the conclusion is that the effects of remuneration committee independence requirements on CSR remain complicated. Due to their reliance on financial performance indicators and the observed increase in non-financial pay targets, independent directors may be a driver of type-(i) instrumental CSR. Their networking role among corporate stakeholders reinforces this effect. The institutionalisation of CSR targets speaks in favour of a reduction of type-(ii) CSR as managerial rent-seeking—a view supported by the existing empirical literature.[243] The inferior informational position of independent directors towards executives however leaves opportunities for capture of the pay-setting process and CSR targets. Impartiality and personal independence impede type-(iii) delegated shareholder philanthropy. Where minority shareholder protection is the objective, this effect is even stronger, as it blocks the imposition of non-financial preferences by controlling shareholders and secures the focus on financial performance.

Section 5: Disclosure Requirements

87 Mandated disclosure is a strategy to lower the information asymmetry that is part of the principal-agent problem and allow principals to monitor at lower costs and control agents more effectively.[244] Requirements to disclose information on executive compensation in turn reduce the costs of drafting efficient compensation schemes and the scope for managerial rent-seeking

[239] German law on corporate co-determination ('*Unternehmensmitbestimmung*') requires corporations with more than 500 employees to staff one third of the supervisory board with employee representatives, and corporations with more than 2,000 employees to provide half of the seats of the board to them. For an overview, see Kraakman et al. (2017), *supra* note 6, at pp. 90-91.
[240] For an overview of CSR and co-determination, cp. M. Gelter, 'Employee Participation in Corporate Governance and Corporate Social Responsibility', *ECGI Working Paper Series in Law*, Working Paper No. 322/2016, 2016.
[241] F. Hadwiger, K. Schmid and P. Wilke, 'Die Anwendung von sozialen und ökonomischen Kriterien in der Vorstandsvergütung', *Hans-Böckler-Stiftung*, Arbeitspapier 293, 2014.
[242] Cp. *Chapter Five*, at p. 179.
[243] Cp. *supra*, para. 47 et seq.
[244] Cp. Kraakman et al. (2017), *supra* note 6, at pp. 38-39.

through excessive and opaque pay structures.[245] By empowering shareholders to exercise more control over managers, disclosure requirements can contribute to a reduction of rent-seeking in CSR and form a more rigid link to either financial performance or non-financial shareholder preferences. The picture is more complex, however, as disclosure also leads to greater involvement of external actors like investors and the general public. Different kinds of information lead to different responses from these actors, the legal details of disclosure requirements are important. Furthermore, disclosure only works as a complement to other control instruments; whether shareholders are able to exercise more effective control thus also depends on the broader governance environment.

88 While all types of shareholders can make at least better-informed affiliation decisions based on disclosed information,[246] especially institutional investors possess the resources to process such information for more direct engagement with the corporation and communication with its management.[247] Outside investors as well can gain an overview of the quality of incentive alignment and the existing agency relationship between executives and owners at relatively low compliance costs for the company.[248] Demand in the financial market and takeover risks also discipline managers. Notably, the general public as well has a stake in corporate affairs and may react to the disclosure of executive compensation with outrage over perceived excessiveness if the link between reward and success remains unclear.

89 That is why the legal details of disclosure requirements are so important. Simple 'headline pay' disclosure of total compensation allows little qualitative judgment about the agency relationship in a corporation but can easily to trigger public enragement and distort incentive schemes.[249] Instead, quantitative information broken down along its composition allows an analysis of the prevalence of pay-for-performance compensation. Further qualitative information with additional explanatory capacity about the link between corporate objectives, a compensation policy, individual performance targets and realised payments increases the comprehensibility of pay structures and strengthens shareholder control of the pay-setting process.[250] The more rigidly disclosure requirements are prescribed though, the more restricted is the scope to design pay structures, and corporations can be limited in their discretion to set up incentives for their executives. Legal details thus matter and are analysed under *Section 5*.

90 Disclosure requirements are functionally distinct from other strategies like governance prescriptions and pay structure regulation, as they only address the information asymmetry between executives and investors.[251] To result in effective control, shareholders require adequate mechanisms to express and impose their preferences and sanction managers accordingly.[252] Disclosure complements other governance instruments and can thus only be

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[245] Bebchuk and Fried have pointed out that deliberate opacity is a possible strategy for executives to hide inefficient pay practices from shareholder monitoring, see Bebchuk & Fried (2004), *supra* note 29.
[246] Kraakman et al. (2017), *supra* note 6, at pp. 38-39.
[247] Ferrarini & Moloney (2005), *supra* note 8.
[248] Ibid., at pp. 149-52.
[249] Gordon argues that "better disclosure may stoke nascent populism 'outrage' in a way that constrains compensation to levels that are too low", see Gordon (2005), *supra* note 26, at p. 125.
[250] In the US, this is generally being referred to as "compensation discussion and analysis", see ibid.
[251] Ferrarini & Moloney (2005), *supra* note 8; Kraakman et al. (2017), *supra* note 6, at pp. 38-39.
[252] As external actors like potential investors primarily affect the corporation via the market mechanism, the general opinion is that there is less need for the law or charter to grant them governance rights, see Kraakman et al. (2017), *supra* note 6, at pp. 95-97.

seen in their context. This is considered when the effects of compensation disclosure requirements on CSR are analysed in *Section 5*.

5.1 Remuneration Disclosure Requirements in the US and the EU

91 In the following, the rules in the United States and in the European Union on executive compensation disclosure are presented. As there is far less regulatory divergence than e.g. in say-on-pay legislation, an explanation of the situation in different EU member states is omitted.

92 The US have a long history of mandating executive pay disclosure, going back to the Securities Act of 1934.[253] Under current US law, disclosed information on executive compensation is located in the annual proxy statement and the annual form 10-K report on financial performance.[254] An extensive disclosure report is required, whose structure and informational details are prescribed by federal legislation.[255] It covers the CEO, the CFO and the three subsequent most highly paid executives of the corporation.[256] Structurally, the report consists of mainly two parts: a compensation discussion and analysis ('CD&A') and a list of tables with quantitative information. The CD&A is comparable to a remuneration policy with explanatory comments, as it covers the objectives of the compensation programme, performance goals, justifications for the choice of compensation elements, the consistency between individual pay targets and overall objectives, and the influence of say-on-pay on the compensation programme.[257] Following the CD&A, the submission of twelve tables is required that contain detailed quantitative information on current and future compensation of those five executives.[258] Lastly, a rather unique disclosure requirement exists that demands corporations to disclose the ratio between the median employee's and the CEO's total compensation.[259] This latter element, introduced by the Dodd-Frank Act[260] and under scrutiny for abolishment,[261] has often been characterised as a concession towards distributional and political concerns of interest groups like labour unions[262] over executive pay. Notwithstanding economic attempts

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[253] Murphy and Jensen call executive pay disclosure a "uniquely American requirement" for "nearly sixty years following the 1934 Securities Act", see Murphy & Jensen (2018), *supra* note 13.
[254] The 10-K report on financial performance may also just refer to the proxy statement instead, see US Securities and Exchange Commission, *Fast Answers: Executive Compensation*, available at https://www.sec.gov/fast-answers/answers-execomphtm.html.
[255] 17 CFR § 229.402 – (Item 402) Executive Compensation.
[256] 17 CFR § 229.402 – Item 402(a)(3). These are also the executives subject to the say-on-pay vote, see *supra* para. 27.
[257] 17 CFR § 229.402 – Item 402(b)(1).
[258] 17 CFR § 229.402 – Item 402(c)-(t).
[259] 17 CFR § 229.402 – Item 402(u).
[260] Sect. 953(b)(1) Dodd-Frank Act of 2010.
[261] Cp. U.S. Department of the Treasury, *A Financial System that Creates Economic Opportunities*, report of October 2017, at p. 29, available at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.
[262] The pay ratio disclosure rule has been an outspoken policy objective of US labour unions, cp. AFL-CIO, *New SEC Rule Will Expose Whether CEO-to-Worker Pay Ratio Is Out of Balance*, press release of 5 August 2015, available at https://aflcio.org/press/releases/new-sec-rule-will-expose-whether-ceo-worker-pay-ratio-out-balance.

to rationalise pay ratio disclosure on the grounds of long-term shareholder interests,[263] its efficacy as a regulatory tool in corporate governance remains heavily contested.[264]

93 First attempts to harmonise standards on executive pay disclosure in the EU were initiated after the accounting scandals of the early 2000s.[265] The European Commission (EC) publish three recommendations on executive pay regulation,[266] which included rules on the disclosure of the remuneration policy and the compensation of individual directors.[267] Many member states however preferred IFRS standards[268] that are less strict on individual disclosure;[269] the heterogeneous of the recommendations induced the EC to impose uniform pay disclosure requirements with SRD II.[270] Explicitly referencing US rules as a role model,[271] the EC included detailed requirements in SRD II on the information to be provided about the content of the remuneration policy and report, on which shareholders are given a vote in the AGM.[272]

94 The current EU remuneration disclosure requirements are intertwined with the shareholder empowerment provisions of say-on-pay and content requirements to the remuneration structure and policy: disclosure is required for the remuneration policy and the remuneration report, on which shareholders thereafter vote. The EU approach to executive pay regulation is more integrated than in the US and highlights the complementary nature of disclosure requirements. It also makes a less sharp distinction between qualitative and quantitative information: while the remuneration report details the amount and composition of the directors' compensation, it also contains an explanation of the relationship between realised compensation, the remuneration policy, performance targets and corporate financial performance.[273] The personal scope of application is wider than US requirements, as 'directors' are defined as all members

[263] Cp. L. Bebchuk, M. Cremers and U. Peyer, 'The CEO Pay Slice', *Journal of Financial Economics*, vol. 102(1), 2011, pp. 199-221.
[264] Cp. Edmans et al. (2017), *supra* note 31, at pp. 90-91; Murphy & Jensen (2018), *supra* note 13, at pp. 227-28.
[265] Cp. C. Van der Elst and M. van Falier, 'The European Remuneration Framework: Recent Policy Changes and Their Implications on Executive Remuneration Contracts', in: C. Van der Elst (ed.), *Executive Directors' Remuneration in Comparative Corporate Practice*, Alphen aan den Rijn, Kluwer Law International, 2015.
[266] European Commission, *Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies*, 2004/913/EC; European Commission, *Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board*, 2005/162/EC; European Commission, *Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies*, 2009/385/EC.
[267] European Commission, *Recommendation* 2004/913/EC.
[268] Kraakman et al. (2017), *supra* note 6, at p. 149.
[269] Cp. IFRS Standards, IAS 24 – Related Party Disclosures, available at https://www.ifrs.org/issued-standards/list-of-standards/ias-24-related-party-disclosures/.
[270] During the drafting process of SRD II, the EC noted that only eleven member states mandated disclosure of individual remuneration and merely six of them had fully implemented the recommendation, see European Commission, *Report on the application by Member States of the EU on the Commission Recommendation on directors' remuneration*, SEC 2007, 1022.
[271] European Commission, *Impact Assessment on Proposed Shareholder Rights Directive II*, SWD(2014) 127 final, at p. 27.
[272] Cp. *Section 3.1*. The SRD II also imposed obligations on the content of the remuneration policy itself, which is covered below under *Section 6* on pay structure regulation.
[273] Art. 9b para. 1 of consolidated Directive 2007/36/EC as amended by Directive 2017/828/EU.

of any administrative, management or supervisory board including the CEO and deputy CEO are covered, with the possibility for member states to further expand the scope.[274]

95 Performance targets and corporate objectives that in the US are covered by the CD&A form the remuneration policy. The prescriptions of SRD II cross the functional border between mere disclosure requirements and direct regulation of pay structure though. It does not merely mandate disclosure of these elements, but also prescribes the overall objective of the policy ("[…] shall contribute to the company's business strategy and long-term interests and sustainability")[275] and explicitly mandates the description of "financial and non-financial performance criteria, including, where appropriate, criteria relating to corporate social responsibility."[276] While the specification of the objective of the remuneration policy may appear redundant in the light of economic self-interest and no performance targets are forced to be included, the legislative intention to steer executive compensation towards stronger pay-for-performance, including CSR performance, is obvious. The EC itself states that disclosure "make[s] companies more accountable to other stakeholders like employees."[277] Similar to the US pay ratio, SRD II requires companies to disclose average employee pay "in a manner which permits comparison"[278] in the remuneration report and to explain not if, but "how the pay and employment conditions of employees […] were taken into account" in the remuneration policy.[279]

96 The EU and the US broadly follow the same basic understanding of the role of compensation disclosure, not at last because the Commission modelled its requirements along those of the SEC. While both jurisdictions aim to alleviate the information asymmetry between directors and shareholders and other external stakeholders, the EU approach goes beyond this. It allows far less flexibility than the US CD&A approach by imposing more detailed structural requirements on the remuneration policy and report. It employs an indirect 'comply-or-explain' approach typically known from soft law corporate governance codes[280] to steer remuneration in the EU towards pay-for-performance and the inclusion of non-financial performance targets and to boost active shareholder engagement. The notable inclusion of CSR disclosure requirements in EU executive pay regulation is part of the existing legislative approach to CSR.[281] The disclosure of non-financial performance targets is the bridge between general CSR performance disclosure based on the Non-Financial Reporting Directive[282] and measures to

[274] Art. 2 lit. i) of consolidated Directive 2007/36/EC as amended by Directive 2017/828/EU.
[275] Art. 9a para. 6 subpara. 1 of consolidated Directive 2007/36/EC as amended by Directive 2017/828/EU.
[276] Art. 9a para. 6 subpara. 3 of consolidated Directive 2007/36/EC as amended by Directive 2017/828/EU.
[277] European Commission, *Impact Assessment on Proposed Shareholder Rights Directive II*, SWD(2014) 127 final, at p. 53.
[278] Art. 9b para. 1 of consolidated Directive 2007/36/EC as amended by Directive 2017/828/EU.
[279] Art. 9a para. 6 subpara. 2 of consolidated Directive 2007/36/EC as amended by Directive 2017/828/EU.
[280] The traditional 'comply-or-explain' approach requires explanations from corporations when there is no compliance with soft law rules. The 'explain' approach of SRD II regarding non-financial performance targets does not set new rules that would indicate governance standards or best practices. The obligatory character of the disclosure requirements however indicates a normative importance of non-financial performance targets and fulfils an expressive role of shifting attention towards CSR performance. Cp. *infra*, para. 107.
[281] Cp. *Chapter Two*, at pp. 20-22.
[282] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by

increase shareholder activism like say-on-pay[283] to foster CSR engagement in the EU. The general effects of mandated compensation disclosure, as well as the peculiarities of the European regime, are discussed below.

5.2 Executive Pay Disclosure and CSR

97 By combating information asymmetries, executive pay disclosure is essential to monitor and control managers and align their incentives with the interests of shareholders. As Ferrarini and Moloney phrase it, "effective governance, in dispersed and blockholding ownership companies, […] depends on effective disclosure."[284] Thus, while regulated disclosure generally improves governance,[285] these effects can only be fully understood considering the role of other mechanisms that empower shareholders directly (e.g. say-on-pay) or protect them indirectly (e.g. independent remuneration committees). Such different governance channels determine whether disclosure improves CSR from a governance perspective, i.e. strengthens instrumental CSR and reduces managerial rent-seeking, and whether it enables shareholders to impose their own non-financial preferences on the company (delegated shareholder philanthropy). However, as disclosure goes beyond addressing shareholders, the role of market forces and the general public need to be considered as well regarding their influence on the pay-setting process and CSR engagement.

98 *Section 3* explains how say-on-pay regimes influence CSR engagement. It is no coincidence that SRD II combines increased disclosure requirements with strong mandatory say-on-pay rules for the empowering effect of disclosure with the control potential of mandatory say-on-pay. This way, a direct line can be drawn from the disclosure of a company's CSR performance to the disclosure of CSR considerations in the remuneration policy and pay targets to the ability of shareholders to influence this process. The more direct the possibilities of shareholders to influence the pay-setting process are, i.e. binding say-on-pay, the less activist shareholders need to rely on closed-doors engagement as the sole viable option of influencing corporate decision-making. As closed-doors engagement does not necessitate public disclosure, binding say-on-pay reinforces the effects of executive pay disclosure on CSR engagement more than consultative say-on-pay would.

99 It is already discussed above that shareholder engagement differs based on the composition of ownership and the nature of owners.[286] The same holds true for disclosure, as traditionally more shallow 'headline' disclosure has been prevalent in jurisdictions characterised by blockholding. There, the presence of controlling shareholders decreases the need for both incentive pay and public information on executive compensation.[287] The rise of detailed, qualitative disclosure in Europe is linked to the growing dispersion of ownership, the rising importance of institutional

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certain large undertakings and groups, 2014 O.J. L330/1 [herein: Non-Financial Reporting Directive, NFRD].

[283] As discussed *supra*, para. 22.

[284] Ferrarini & Moloney (2005), *supra* note 8, at p. 311.

[285] K. Lo, 'Economic Consequences of Regulated Changes in Disclosure: The Case of Executive Compensation', *Journal of Accounting and Economics*, vol. 35(3), 2003, pp. 285-314.

[286] Cp. *supra*, para. 52 et seq.

[287] Ferrarini & Moloney (2005), *supra* note 8, at p. 313.

ownership, and legislative intentions to push the latter towards more active governance engagement.

100 Compensation disclosure also increases the importance of a second governance mechanism, remuneration committees. These are forced to justify the compensation structure and realisation of payments, enhances their accountability towards shareholders and increases their visibility,[288] which gives them a stronger bargaining position and resilience against managerial pressure.[289] As it is argued in this chapter, director independence can be an instrument to strengthen the link of CSR to financial performance and combat managerial rent-seeking, while its effects on delegated shareholder philanthropy are dubious.[290] Enhanced compensation disclosure requirements in the EU that employ an indirect 'explain' strategy towards CSR performance targets can thus guide independent directors in setting priorities for the remuneration policy objectives towards more or less CSR inclusion.[291]

101 Beyond the engagement of shareholders, more information on the alignment of incentives and pay targets with CSR also allows investors to screen for ESG characteristics in their investment decisions, for example because they have subscribed to the UN PRI.[292] This allows for CSR engagement as a response to market forces in the form of demand for socially responsible investment opportunities. This effect is likely to be more prominent in the EU, where rules on the disclosure of the remuneration policy demand a discussion of how CSR-relevant criteria have been taken into account.

102 The general public receives information from corporate disclosure as well. Most commonly, executive pay disclosure triggers outrage based on notions of distributive justice or the notion of excessive, unearned rewards. The connection of quantitative pay data with explanatory information both in the US and the EU limits this and shifts the focus to justifying compensation via pay-for-performance. In the EU, the explicit disclosure of CSR aspects in executive pay may further increase the social acceptability of compensation practices.

103 This development may be countervailed by the practice of disclosing pay ratios between executive and median worker pay and the comparable EU rule. Disclosure of high pay ratio negatively affects the CSR perception of companies and thus may shift attention towards distributive concerns over executive pay, even though evidence suggests that this effect is weaker where pay-for-performance justifications exist.[293]

104 Due to criticism during the draft stage, the EU refrained from requiring disclosure of the pay ratio directly, and just demands 'comparability'. While on the one hand this may shift attention back towards distributive concerns over executive pay, it may also deter wasteful inflation of executive pay due to pay disclosure, known as the 'ratcheting effect'.[294] Institutional

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[288] Ferrarini & Ungureanu (2018), *supra* note 12, at p. 345.
[289] Gordon (2005), *supra* note 26, at p. 104.
[290] See *supra*, para. 84.
[291] Cp. R. McAdams, 'Focal Point Theory of Expressive Law', *Virginia Law Review*, vol. 86(8), 2000, pp. 1649-1729.
[292] Dyck et al. show that investors who are signatories to the UN PRI lead to a much higher level of CSR engagement than other investors, see Dyck et al. (2019), *supra* note 135.
[293] A. Benedetti & S. Chen, 'High CEO-to-Worker Pay Ratios Negatively Impact Consumer and Employee Perceptions of Companies', *Journal of Experimental Social Psychology*, vol. 79(1), 2018, pp. 378-93.
[294] Cp. Ferrarini & Ungureanu (2018), *supra* note 12, at p. 345.

economists pose that peer comparison is a driver of rising pay levels that are not justified by shareholder value considerations.[295]

105 This depends on the role of stakeholders, especially employees and labour unions, and their role within the governance process. They can use pay ratio disclosure as a bargaining tool. Making CSR and thus stakeholder considerations more visible in the pay-setting process may invite stakeholders to invest in rent-seeking to bring their interests into the compensation system. While this has been qualified as a form of instrumental CSR,[296] mandated disclosure of CSR-related information can also be to the financial detriment of shareholders.[297] There is thus a large scope in regulatory design to affect the payoffs of the corporate constituencies involved.

106 Disclosure shifts focus to pay-for-performance, this helps to increase instrumental CSR and decrease managerial rent-seeking. Disclosure also empowers shareholders to impose their preferences. This effect is stronger where CSR considerations are explicitly included in the disclosure requirements as in Europe and where shareholders have stronger engagement opportunities as with say-on-pay. Disclosure that focuses on the comprehensibility of the pay-for-performance mechanism of executive compensation helps to shift public attention away from outrage debates on distributional grounds and helps to see executive pay more as an incentive for CSR engagement. The role of pay ratios remains unclear.

107 In Europe, CSR concerns have notably found entrance into executive pay regulation with the field of disclosure. This is clearly emanating from the EU's CSR policy discussed in the previous chapter,[298] which aims at spreading CSR information and empowering shareholders. It is debatable whether such non-financial disclosure requirements are a sign that CSR is an independent objective of European executive pay regulation, or whether this can better be described as a spillover from the existing approach on corporate disclosure.

Section 6: Conclusion

108 In this chapter, an attempt has been made to theoretically frame whether and how executive pay regulation influences CSR. This approach rests upon the two claims substantiated in the previous chapter:[299] that law is a central institutional determinant of CSR and that executive compensation influences incentives for CSR on the firm level. Bringing together those two distinct lines of thought yields an understanding of pay regulation as a channel through which the law directly affects CSR engagement. The functional, tripartite categorisation of CSR activities proves to be crucial in avoiding unidimensional thinking; by differentiating possible causal effects, it instead accounts for the complexity of the agency relationships at work in the

[295] Cp. E. Lokin, 'Making Executive Compensation Less Controversial: The Rise of Pay Ratios', *Business Law International Journal*, vol. 20(3), 2019.
[296] Cp. *Chapter Two*, at p. 46.
[297] Y. Chen, M. Hung & Y. Wang, 'The Effect of Mandatory CSR Disclosure on Firm Profitability and Social Externalities: Evidence from China', *Journal of Accounting and Economics*, vol. 65(1), 2018, pp. 169-90.
[298] *Chapter Two*, at p. 20.
[299] Cp. *Chapter Two*, at p. 15.

corporate decision-making process. The results of this initial, selective inquiry allow first predictions about the role of executive pay regulation among CSR determinants.

109 The first affirmation that can be drawn from this analysis is that executive pay regulation matters for CSR. By either directly altering managerial incentives or indirectly affecting the governance environment in which decisions are made, pay regulation changes the determinants of CSR engagement. Notably, the regulatory elements covered have different effects on the three categories of CSR activities. The table below provides a simplified outline of the results reached in this chapter. It is important to note though that this stylised display hardly provides a full overview of the relationship between legal rules and CSR and does not include the interaction of pay regulation with other CSR determinants.[300]

Table 2: Stylised summary of the effects of governance prescriptions on CSR activities.

CSR Type / Rule	**Instrumental CSR**	**Managerial CSR**	**Delegated Share-holder Philanthropy**
Say-on-Pay	↑	↓	↑↑
Committee Independence	↑(/↓)	↓(/↑)	↓
Disclosure	↑	↓	↑

110 With say-on-pay, the law causes a significant re-allocation of decision rights within corporations. It affects CSR engagement through two main channels: the changes in compensation structures it achieves and the way in which it enhances the bargaining power of activist shareholders. Say-on-pay effectively reduces intra-corporate agency costs and enhances pay-for-performance sensitivity. Depending on the existing prevalence of CSR, this entails an increase in type-(i) instrumental CSR and a decrease in type-(ii) managerial CSR respectively. By strengthening the role of shareholders in the pay-setting process and granting them control rights, it is a crucial driver of CSR as type-(iii) delegated shareholder philanthropy: institutional investors in particular are not only prominent activist shareholders, but also central to the imposition of non-financial preferences. These results are subject to the legal complexity of say-on-pay as shown by the comparison of different jurisdictions. Functional comparative research on say-on-pay is still underdeveloped and allows only limited conclusions about the impact of legal variation. Additional open questions are the methods of 'behind closed doors' engagement of investors and the role of proxy advisors in formulating shareholder preferences. Overall, say-on-pay seems to strengthen the tie between CSR and financial performance and is central to shareholder CSR activism.

111 The role of independent remuneration committees is more difficult to assess. The positive effects of director independence on pay-for-performance sensitivity favours type-(i) instrumental CSR and discourages type-(ii) managerial CSR. This alignment of CSR with financial performance is further supported by the institutionalisation of CSR and the degree to which directors effectively engage in stakeholder management by fulfilling a networking role. These effects may be countered, however, by the information asymmetries that independence entails. This hems the imposition of operational CSR performance targets and increases the risk of managerial capture of the pay-setting process. The existing literature allows no final statement about the gravity of these issues. Effects on type-(iii) delegated shareholder

[300] These determinants, whose role has already been briefly discussed in the previous chapter, are covered in the next chapter; see *Chapter Two*, at p. 15; *Chapter Four*, at p. 146.

philanthropy are clearer: as independent directors—especially in concentrated ownership jurisdictions—enjoy independence from (controlling) shareholders, their presence on the board makes it more difficult to impose non-financial shareholder preferences. Beyond 'independence', concepts of 'dependent directors' are likely to fulfil a more active role in driving CSR engagement. The substitutive character of director independence can furthermore diminish the effectiveness of other governance mechanisms.

112 Compensation disclosure can, if well designed, increase public and investor focus on pay-for-performance sensitivity; this effect increases type-(i) instrumental CSR and decreases type-(ii) managerial CSR. The shift towards more extensive and qualitative disclosure in most jurisdictions supports this trend and indicates that *ex post* social concerns about executive compensation can be mitigated in the CSR-pay debate. Shareholders and outside investors depend on disclosure to formulate expectations about the precise role of CSR in compensation schemes, disclosure thus also facilitates type-(iii) delegated shareholder philanthropy. The general complementarity of disclosure with other governance mechanisms makes it a highly context-dependent instrument.

113 The three examples of say-on-pay, independent remuneration committees and compensation disclosure show that shareholder-value-orient-ed pay regulation shapes the nature of CSR engagement in different ways. All elements covered share an alignment of CSR with financial performance, which comes as no surprise: as 'governance prescriptions',[301] they aim to protect and enforce the interests of shareholders. The regimes of pay regulation discussed in this chapter do not consider CSR as a regulatory objective, shareholder interests are thus equated with financial performance. This entails significant implications for the imposition of non-financial shareholder preferences, which can be enhanced (e.g. say-on-pay) or discouraged (independent directors) by pay regulation. Overall, the analysis suggests that more work needs to be carried out on the role regulation has in shaping CSR. Any potential future endeavour to systematically integrate CSR into the objectives of executive pay regulation needs to account for these enabling as well as restricting effects and is connected to the broader role of legislators in shaping CSR.

114 Prospectively, the scope of inquiry may be broadened by considering what implications these results hold for the relationship between corporate law and CSR in general. The rules covered in this chapter are basic elements of pay regulation—the mechanisms through which they function, however, are also found in other areas of corporate governance regulation. An important direction for future research thus is to investigate whether the results reached here also hold more broadly. Say-on-pay is just one form of shareholder decision rights, remuneration committee independence personally restricts corporate agents, while remuneration disclosure is about information asymmetries between corporate insiders and outsiders. A key question for further research is whether the links between pay regulation and CSR reached for these mechanisms here still hold if the focus is shifted away from remuneration towards the more general relationship between such governance mechanisms and CSR. By focusing on these practical examples, this thesis has laid important groundwork for answering this subsequent question and contributes to a cohesive theoretical framework on the CSR-law relationship.

[301] Cp. Ferrarini & Ungureanu (2018), *supra* note 8.

115 So far, only a limited set of legal instruments has been covered out of a broad regulatory spectrum.[302] More direct forms of pay regulation have been omitted from this analysis as well as interventions motivated by other economic goals than shareholder value, which are possibly even closer to the normative core of CSR.[303] Additionally, the interaction of executive pay regulation with other determinants of CSR engagement has been mentioned but received insufficient attention so far. These aspects are the topic of the next chapter, which continues to use the methodology developed here to analyse pay regulation in the financial sector. Collectively, this chapter and the subsequent one form a comprehensive overview of executive pay regulation as a determinant of CSR engagement.

[302] Cp. the delineation of pay regulation *supra*, para. 16 et seq.

[303] On the normative core of CSR as an expression of substantive social norms, cp. J. Eijsbouts, *Corporate Responsibility, beyond Voluntarism: Regulatory Options to Reinforce the Licence to Operate*, Maastricht, Maastricht University Press, 2011.

Chapter Four
Beyond Shareholder Value: Lessons from the Financial Sector

SUMMARY. This chapter aims to answer the question whether and how EU pay regulation in the financial sector affects CSR engagement. The regulation of bankers' pay is special, as it does not aim at shareholder value maximisation, but the prevention of excessive risk-taking and mainly employs pay structure regulation. The regulatory objective thus shows significant similarities with CSR, which is understood as private self-regulation, i.e. the voluntary internalisation of externalities.

It is argued that several forms of pay regulation under CRD IV and CRR II have effects on CSR engagement. The imposition of mandatory pay-for-performance schemes, risk adjustments of performance-bound variable compensation, the regulation of the composition of variable pay, and mandatory deferral and clawback provisions encourage forms of CSR that are connected to financial performance. The rules are likely to decrease weak social performance. Effects on strong social performance are ambiguous and depend on the specific design of regulatory instruments: a focus on risk prevention and the legal imposition of performance targets discourages strong social performance. The rules also discourage CSR in the form of delegated shareholder philanthropy, as shareholder interests are part of the causes of excessive risk-taking in the financial sector. This raises questions for the role of shareholders as drivers of CSR more generally. The regulation of pay levels, as it is done with a 'bonus cap' in Europe, has undesirable effects on CSR engagement and social performance.

To reach more general conclusions on the effects of pay structure regulation on CSR, the chapter also pays attention to the peculiarities of the banking sector. Capital structure is a central determinant of shareholder interests in excessive risk-taking. Pay regulation that prevents externalities resulting from excessive risk-taking is a complement to more direct forms of regulation and needs to be analysed in the context of such regulation. The nature of stakeholders affected by the externalities influences the need for regulatory intervention as well. Lastly, the nature of externalities has implications for the design of pay regulation as well.

Section 1: Introduction

1 In corporate governance, executive compensation is treated as a central instrument to influence managerial decision-making and steer the activities of executives into desired directions.[1] In *Chapter Two*, it has been shown that corporate social responsibility (CSR) is an area of

[1] Cp. M. Jensen & W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *Journal of Financial Economics*, vol. 3(4), 1976, pp. 305-60.

engagement that is affected by the incentives set through compensation schemes.[2] Since CSR has become an area of interest for policymakers as well, the question arises how law and regulation can affect and shape CSR engagement, since the determinants of CSR are still imperfectly understood. Pay regulation can be functionally divided into governance prescriptions, shaping the process of setting pay schemes, and pay structure regulation, which intervenes directly in the structure and composition of compensation.[3] While the last chapter covered the effects of governance prescriptions, this chapter looks at the role of pay structure regulation at the example of EU rules for the financial sector.

2 The regulation of bankers' pay is special for several reasons: it is arguably the strictest and most pervasive form of rules on compensation for any form of corporation and makes use of pay structure regulation in a way not found elsewhere. The financial sector is thus particularly suitable for an analysis of these types of rules. Secondly, the rules do not pursue to maximise shareholder welfare, which is the typical objective of corporate law[4] and underlies the rules on pay governance covered in the previous chapter. Instead, pay regulation in the financial sector aims to prevent excessive risk-taking, which can damage creditors, taxpayers and the stability of the financial system as demonstrated by the global crisis of 2008/09. The reasons for this excessive risk-taking are found in the peculiarities of the banking business, capital and governance structure of banks, leading to an interest of shareholders in taking more risk than is socially optimal.

3 For the purpose of the analysis of this thesis, CSR has been defined as a form of private self-regulation.[5] Self-regulation is understood in law and economics as the (voluntary) provision of public goods, internalisation of externalities or private redistribution,[6] which is a shared objective of CSR and financial regulation that is otherwise not found in corporate law. The chapter thus tries to answer whether the instruments of pay regulation chosen in financial regulation affect CSR engagement and whether these results can hold more generally. Mülbert writes that "some elements [… of bank governance] have started to become an important issue in the general corporate governance debate as well. From this perspective, good corporate governance of banks shows the way forward for good corporate governance in general."[7] This chapter tries to draw such conclusions from bank governance for general corporate governance from the perspective of CSR. In order to do so, attention is paid to the peculiarities of the financial sector that motivate any regulatory deviation from the shareholder value paradigm in the first place. It depends on these peculiarities that shape executive pay regulation whether any more general conclusions can be reached on the efficacy of regulatory in affecting CSR engagement.

4 The chapter focuses on an analysis of rules on the level of the European Union (EU). This is done for two reasons. First, there is an exceptionally high degree of international coordination

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[2] *Chapter Two*, at p. 52.
[3] G. Ferrarini & M. Ungureanu, 'Executive Remuneration', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[4] R. Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Oxford, Oxford University Press, 2017, at pp. 22-24.
[5] B. Sheehy, 'Defining CSR: Problems and Solutions', *Journal of Business Ethics*, vol. 131(3), 2015, pp. 625-48.
[6] A. Ogus & E. Carbonara, 'Self-Regulation', in: G. de Geest (ed.), *Encyclopedia of Law and Economics*, Cheltenham, Edward Elgar, 2017.
[7] P. Mülbert, 'Corporate Governance of Banks', *European Business Organization Law Review*, vol. 10(3), 2009, pp. 411-36, at p. 413.

in financial regulation, making regulatory regimes in large industrial nations relatively similar. Secondly, focusing on EU rules allows to set them in context with European CSR regulation. *Chapter Two* has covered both the European Non-Financial Reporting Directive and the 'Sustainable Finance' regulatory proposals that aim to integrate CSR criteria into the financial sector.[8] As the regulatory environment of rules on executive compensation is especially important in the case of bankers' pay, focusing an Europe allows to reach more general conclusions.

5 In *Chapter Two*, a tripartite categorisation of CSR activities had been reached that is based on the agency theory framework of corporate governance and serves as the primary concept of CSR in the theoretical analyses of this thesis.[9] This categorisation integrates the relationship between CSR and corporate financial performance as well behavioural insights on about non-financial preferences on behalf of shareholders, managers, and other corporate stakeholders. The categories were labelled type-(i) instrumental CSR, encompassing CSR activities linked to improved long-term financial performance; type-(ii) CSR as managerial rent extraction, in which managers engage for private interests; and type-(iii) CSR as delegated shareholder philanthropy, being the result of the imposition of non-financial shareholder preferences on the corporation. This categorisation is maintained in this chapter as well and amended by the concept of strong and weak social performance, which account for the types of externalities addressed by CSR.

6 *Section 2* explains the economic rationale that underlies modern pay regulation in the financial sector and links it to the existing literature on CSR. It also gives an overview of CSR in the financial sector in practices and introduces the concept of strong and weak social performance. *Section 3* gives an overview of the EU rules on pay regulation and analyses a selected set of instruments from the Fourth Capital Requirements Directive on the different categories of CSR activities and dimensions of social performance. *Section 4* illustrates how the peculiar conditions of the financial sector affect the results reached in the previous section. *Section 5* concludes.

Section 2: Overview of Financial Regulation and CSR

7 In order to analyse the effects of pay regulation in the financial sector, it is necessary to understand the rationale behind this regulation, which differs significantly from standard corporate governance and the shareholder value paradigm. This section explains how that rationale, which instead focuses on the protection of stakeholders and financial stability from negative externalities, can be integrated with institutional approaches to CSR. A brief overview of CSR in the financial sector shows which forms of CSR are especially relevant for the analysis in the subsequent sections.

[8] *Chapter Two*, at p. 20.
[9] *Chapter Two*, at p. 45.

2.1 The Economic Rationale of Regulating Bankers' Pay

8 In order to analyse pay regulation in the financial sector as an incentive framework for CSR engagement and derive conclusions beyond those reached in the previous chapter,[10] it is necessary to understand how financial corporations deviate from the standard model. In banking, the regulatory intention is not to promote shareholder welfare, but to protect stakeholders and curb the externalities that arise from the course of business of financial institutions. Bank[11] governance differs significantly from standard corporate governance, and foremost the material interests of shareholders give rise to incentives for executives to engage in excessive risk-taking. This problem is further exacerbated by specific peculiarities of the banking sector. After the global financial crisis, corporate and finance scholarship has paid more attention to the contribution of compensation packages to the crisis and established a case for pay regulation as an addition to traditional banking regulation.

9 In standard corporate governance, executive compensation serves as a private remedy to the agency conflict between shareholders and managers, also known as type-I agency problem.[12] It serves as a means of incentive alignment through the use of different pay instruments and can thus promote social welfare by increasing managerial efforts and sanctioning managerial rent-seeking.[13] As shown in *Chapter Three*,[14] the law assumes a supporting role in this arrangement by improving the governance of the pay-setting process through requirements on disclosure, director independence or say-on-pay.[15] Such pay regulation explicitly stays within the normative boundaries of the shareholder value paradigm that equates shareholder wealth with social welfare.[16]

10 Bank governance deviates substantially from this baseline scenario, as does pay regulation. Shleifer and Vishny famously defined corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[17] In the case of banks, the main suppliers of finance are not shareholders, but creditors—notably depositors.[18] Due to this lack of shareholder dominance in their governance, financial institutions have been labelled "multi-constituency organizations".[19] This multiplicity of central corporate constituencies complicates governance relationships. Shareholders still

[10] Cp. *Chapter Three*, at p. 104.
[11] Throughout the chapter, the terms 'bank' and 'financial institutions' are used. While banks are obviously not the sole category of financial institutions, an elaboration of the organisational differences between different types of financial institutions is omitted; what is said about the basic insights on bank governance is thus to be applied *mutatis mutandis* to other financial institutions.
[12] Jensen & Meckling (1976), *supra* note 1.
[13] For an overview of the standard theory of executive compensation and agency theory, cp. *Chapter Two*, at p. 52.
[14] *Chapter Three*, at p. 104; also see Kraakman et al. (2017), supra note 4, at p. 139.
[15] On the general role of governance prescription as a method of pay regulation, see Ferrarini & Ungureanu (2018), *supra* note 3.
[16] Cp. Kraakman et al. (2017), *supra* note 4, pp. 22-24, 49-77.
[17] A. Shleifer & R. Vishny, 'A Survey of Corporate Governance', *Journal of Finance*, vol. 52(2), 1997, pp. 737-83.
[18] Debt usually makes up 90 percent or more of a bank's funding; see J. Macey & M. O'Hara, 'The Corporate Governance of Banks', *Federal Reserve Bank of New York, Economic Policy Review*, vol. 9(1), 2003, pp. 91-107.
[19] M. Becht, P. Bolton & A. Röell, 'Why Bank Governance Is Difference', *Oxford Review of Economic Policy*, vol. 27(3), 2011, pp. 437-63, at p. 438.

pursue an alignment of executive compensation with their own long-term interests.[20] However, this leads to additional conflicts of interests with stakeholders—known as type-III agency conflict[21]—in the specific form of creditors, usually referred to as the 'agency costs of debt'.[22]

11 As the capital of banks is mostly provided by creditors, they are highly leveraged. This leverage leads to moral hazard: shareholders, as the residual claimants, receive the full benefit of an investment, but internalise costs only to the very limited extent of their financial involvement—the rest of the losses is borne by creditors.[23] Shareholders thus have an interest risking greater losses than are socially optimal and translate this into managerial incentives,[24] encouraging excessive risk-taking.[25] Creditors provide most capital but have essentially no decision rights, facing the moral hazard problem of *ex post* risk shifting, i.e. a change in the institution's risk profile after a contract has been signed.[26] Thus, even in the absence of conventional governance and design problems in compensation structures, executives are incentivised to engage in excessive risk-taking, causing negative externalities for depositors and bondholders.[27] The permeation of governance problems into remuneration can furthermore be considered especially acute in the financial sector, as banks are unique[28] in their provision of high-powered incentives not only to top-level executives, but also to much lower rank employees in their front office functions.

12 The problem extends beyond the limited relationship between a bank and its contractual constituencies, however. The financial sector fulfils a vital role in a market economy and is a driver of economic growth.[29] Financial and monetary stability is generally regarded as a global public good: due to the interconnectedness of the international financial system,[30] it allows all countries to benefits from it if it runs well, but also affects all countries in times of crisis.[31] Financial institutions are the vital providers of this public good and take 'systemic risks' in

[20] Mülbert concludes that "[f]rom a shareholder's perspective, the holy grail of banks' corporate governance is to check management's short-term orientation without creating incentives for choosing a suboptimal low level of risk." See Mülbert (2009), *supra* note 7.
[21] A. Zalewska, 'A New Look at Regulating Bankers' Remuneration', *Corporate Governance: An International Review*, vol. 24(3), 2016, pp. 322-33.
[22] Cp. A. Mello & J. Parsons, 'Measuring the Agency Cost of Debt', *Journal of Finance*, vol. 47(5), 1992, pp. 1887-1904.
[23] The moral hazard problem of equity in leveraged firms has already been acknowledged early on by Jensen & Meckling (1976), *supra* note 1.
[24] L. Bebchuk & H. Spamann, 'Regulating Bankers' Pay', *Georgetown Law Journal*, vol. 98(2), 2010, pp. 247-88.
[25] P. Bolton, H. Mehran & J. Shapiro, 'Executive Compensation and Risk Taking', *Review of Finance*, vol. 19(6), 2015, pp. 2139-81.
[26] Mülbert (2009), *supra* note 7, at pp. 423-25.
[27] Bebchuk & Spamann (2010), *supra* note 24.
[28] Mülbert (2009), *supra* note 7, at p. 412.
[29] For seminal empirical evidence cp. R. King & R. Levine, 'Finance and Growth: Schumpeter might be right', *Quarterly Journal of Economics*, vol. 108(3), 1993, pp. 717-37; more critically: L. Zingales, 'Does Finance Benefit Society?', *Journal of Finance*, vol. 70(4), 2015, pp. 1227-63.
[30] Cp. Z. Liu, S. Quiet & B. Roth, 'Banking Sector Interconnectedness: What Is It, How Can We Measure It and Why Does It Matter?', *Bank of England Quarterly Bulletin*, vol. 55(2), 2015, pp. 130-38.
[31] M. Camdessus, 'International Financial and Monetary Stability: A Global Public Good', in: P. Kenen & A. Swoboda (eds)., *Reforming the International Monetary and Financial System*, Washington, International Monetary Fund, 2000.

their decision-making that can damage financial stability.[32] The shareholder interest in excessive risk-taking makes this matter worse.[33] Due to the inherent under-provision of public goods and the interconnectedness of banks that can cause risks at a single institution to escalate into critical chain reactions, maintaining financial stability is a central objective of financial regulators.[34]

13 The basic problems of the shareholder interest in excessive risk-taking and the under-provision of systemic financial stability are further exacerbated by several peculiar characteristics of the financial industry. The moral hazard problem of leverage is stronger the more dispersed ownership is, as it limits the loss bearing by individual shareholders further and implies a greater degree of diversification.[35] It also causes an so-called debt-overhang problem: in a solvency crisis, any amelioration disproportionally benefits creditors, as their claims are senior to those of shareholders, causing the latter to face suboptimal investment decision incentives.[36] Furthermore, asset substitution is easier in financial firms, which facilitates risk shifting. This leads to moral hazard because creditors as fixed claimants have an *ex post* interest in minimising risks, while the opposite holds true for shareholders.[37] As creditors enjoy no decision rights, they have few means to protect themselves against such *ex post* risk shifting.[38] The overall complexity of the financial business and the opacity of bank balance sheets make monitoring—especially by outsiders—more difficult, rendering agency problems in general more severe.[39] Lastly, governments play a role: due to deposit insurance, losses are further externalised to taxpayers. Similarly, the 'too-big-to-fail' problem provides the implicit guarantee that taxpayers will bear losses for banks where their insolvency would otherwise cause a crisis.[40] Both aspects disincentivise creditors to pay attention to the risk profile of banks, leading to a lack of external control, over-reliance and eventually more excessive risk-taking.[41]

14 That fact that these issues of bank governance translate into socially suboptimal incentives for managers to take excessive risks was brought to public attention and the centre stage of the

[32] S. Schwarcz, 'Systemic Risk', *Georgetown Law Journal*, vol. 97(1), 2008, pp. 193-249.
[33] Cp. J. Armour & J. Gordon, 'Systemic Harms and Shareholder Value', *Journal of Legal Analysis*, vol. 6(1), 2014, 35-85.
[34] According to its Charter, the Basel Committee of Banking Supervision (BCBS), which globally coordinates financial supervision and regulation, has the main aim of "enhancing financial stability", see Art. I(1) sentence 2 Basel Committee Charter of 5 June 2018. For an overview of the objectives of financial regulation, see J. Armour et al., *Principles of Financial Regulation*, Oxford, Oxford University Press, 2016, at pp. 51 et seq.
[35] Mülbert (2009), *supra* note 7, pp. 425-26.
[36] F. Occhino, 'Debt-Overhang Banking Crises: Detecting and Preventing Systemic Risk', *Journal of Financial Stability*, vol. 30(1), 2017, pp. 192-208.
[37] G. Ferrarini & M. Ungureanu, 'Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks', *Vanderbilt Law Review*, vol. 64(2), 2011, pp. 431-502.
[38] Becht, Bolton & Röell (2011), *supra* note 19, at p. 445.
[39] Mülbert (2009), *supra* note 7, at p. 425.
[40] Cp. R. Sorkin, *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System—and Themselves*, London, Viking Penguin, 2009; V. Acharya & N. Mora, 'A Crisis of Banks as Liquidity Providers', *Journal of Finance*, vol. 70(1), 2015, pp. 1-43; F. Allen et al., 'Moral Hazard and Government Guarantees in the Banking Industry', *Journal of Financial Regulation*, vol. 1(1), 2015, pp. 30-50.
[41] Cp. Armour et al. (2016), *supra* note 34, pp. 345 et seq.

political debate when such risks eventually materialised and caused the financial crisis.[42] The notion that remuneration structures in the banking sector—for the underlying reasons just explained—contributed to the crisis is the central justification for the regulatory approach adopted until today.[43] This nonetheless contested theory was subject to extensive empirical research, of which a few of the main findings are presented here.

15 Beltratti and Stulz did not find any evidence—as first suggested by the OECD[44]—that the crisis could be attributed to traditionally understood failures in corporate governance: their results did not indicate that banks with better governance performed better during the crisis, but to the contrary that more pro-shareholder boards actually performed worse.[45] Fahlenbach and Stulz found that better managerial incentive alignment with shareholder interests was related to worse financial performance during the crisis.[46] Cheng, Hong and Scheinkman found that high levels of compensation were no sign of incentive misalignment or managerial entrenchment, but instead the result of shareholder preferences for higher risk-taking.[47] Bebchuk, Cohen and Spamann attacked Fahlenbach and Stulz' conjecture that the large losses suffered by executives during the crisis spoke against remuneration incentives as a cause; studying compensation at Bear Stearns and Lehman, they instead argued that short-termism in compensation structures contributed to excessive risk-taking.[48] Cerasi and Oliviero show that lax regulation and greater variable CEO pay were associated with worse performance during the crisis.[49] Similarly, DeYoung, Peng and Yan registered a significant increase in incentive pay following US banking de-regulation.[50] Efing et al. found a direct link between pre-crisis compensation practices and excessive risk-taking in selected banking markets.[51]

16 The empirical literature supports the view that the issues of remuneration in the financial sector go beyond traditional good governance and played a part in incentivising excessive risk-taking, thus contributing to the financial crisis. It is true that short-termism[52] as well as managerial rent-seeking—which the evidence suggests was a determinant of managerial pay practices during and before the crisis as well[53]—are problems from the perspective of shareholders as

[42] Ferrarini & Ungureanu (2018), *supra* note 3, at pp. 336-38.
[43] Arguably the most influential contribution sparking the post-crisis debate on regulating bankers' pay was: Bebchuk & Spamann (2010), *supra* note 24.
[44] OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*, June 2009.
[45] A. Beltratti & R. Stulz, 'The Credit Crisis around the Globe: Why Did Some Banks Perform Better?', *Journal of Financial Economics*, vol. 105(1), 2012, pp. 1-17.
[46] R. Fahlenbach & R. Stulz, 'Bank CEO Incentives and the Credit Crisis', *Journal of Financial Economics*, vol. 99(1), 2011, pp. 11-26.
[47] I. Cheng, H. Hong & J. Scheinkman, 'Yesterday's Heroes: Compensation and Risk at Financial Firms', *Journal of Finance*, vol. 70(2), 2015, pp. 839-79.
[48] L. Bebchuk, A. Cohen & H. Spamann, 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008', *Yale Journal on Regulation*, vol. 27(2), 2010, pp. 257-82.
[49] V. Cerasi & T. Oliviero, 'CEO Compensation, Regulation, and Risk in Banks: Theory and Evidence from the Financial Crisis', *International Journal of Central Banking*, vol. 11(3), 2015, pp. 241-97.
[50] R. DeYoung, E. Peng & M. Yan, 'Executive Compensation and Business Policy Choices at U.S. Commercial Banks', *Journal of Financial and Quantitative Analysis*, vol. 48(1), 2013, pp. 165-96.
[51] M. Efing et al., 'Incentive Pay and Bank-Risk Taking: Evidence from Austrian German and Swiss Banks', *Journal of International Economics*, vol. 96(1), 2015, pp. 123-40.
[52] Mülbert states that the problem of short-termism is linked to the mechanics of an excessive reliance on equity incentives, which are employed by shareholders to induce higher levels of risk-taking, see Mülbert (2009), *supra* note 7, at p. 425.
[53] Cp. Bebchuk, Cohen & Spamann (2010), *supra* note 48.

well. This is why some scholars argue that private solutions to the issues of bankers' pay remain superior to public regulation.[54] Most regulators however have adopted the line of argument presented above that regulating remuneration schemes is necessary to prevent excessive risk-taking. It is employed as an addition and complement to traditional forms of prudential regulation like capital requirements or prescriptions on risk management.[55]

2.2 The Objectives of Financial Regulation and CSR

17 The aim of pay regulation in the financial sector is not primarily shareholder value, but to prevent the negative externalities resulting from the shareholder interest in excessive risk-taking, affecting creditors and the global public good of financial stability. The intention of this chapter is to analyse how a regime of pay regulation that is explicitly designed to benefit other constituencies than shareholders affects CSR engagement. At a first glance, however, it is dubious to equate legally mandated creditor protection with social responsibility; it is thus necessary to briefly elaborate how, drawing upon the institutional literature on CSR, lessons for CSR regulation can be learned from the financial sector.

18 In *Chapter Two*, CSR has been defined for the purpose and methodology of this thesis as 'private self-regulation'.[56] Deriving such a definition is necessary, because CSR as an "essentially contested concept"[57] has no universally agreed upon definition, but instead differs depending on the institutional setting.[58] The concept of private self-regulation bears the advantage of focusing on the relationship between CSR and the law,[59] and allows a more nuanced analysis of the nature of enforcement of social norms.[60] This is important, as the law is a central determinant of CSR.[61] In law and economics,[62] private self-regulation is defined as the (voluntary) provision of public goods, internalisation of externalities or private redistribution.[63] As a central commonality, it can be asserted that the aims of pay regulation in the financial sector —creditor externalities, financial stability as a public good—equal the aims

[54] Cp. Ferrarini & Ungureanu (2011), *supra* note 37.
[55] Bebchuk and Spamann argue that additional pay regulation can alleviate problems of information asymmetry between supervisory authorities and banks and could make direct regulation less tight, see Bebchuk & Spamann (2010), *supra* note 24.
[56] Cp. *Chapter Two*, at pp. 23-28.
[57] Sheehy (2015), *supra* note 5.
[58] S. Brammer, G. Jackson & D. Matten, 'Corporate Social Responsibility and Institutional Theory: New Perspectives on Private Governance', *Socio-Economic Review*, vol. 10(1), 2012, pp 3-28.
[59] Cp. J. Campbell, 'Why Would Corporations Behave in Socially Responsible Ways? An Institutional Theory of Corporate Social Responsibility', *Academy of Management Review*, vol. 32(3), 2007, pp. 946-67; G. Morgan & S. Quack, 'Law as a Governing Institution', in: G. Morgan et al. (eds.), *The Oxford Handbook of Comparative Institutional Analysis*, Oxford, Oxford University Press, 2010.
[60] J. Gond, N. Kang & J. Moon, 'The Government of Self-Regulation: On the Comparative Dynamics of Corporate Social Responsibility', *Economy and Society*, vol. 40(4), 2011, pp. 640-71.
[61] L. Renneboog & H. Liang, 'On the Foundations of Corporate Social Responsibility', *Journal of Finance*, vol. 72(2), 2017, pp. 853-910.
[62] Ogus & Carbonara (2017), *supra* note 6.
[63] The characteristic of externality internalisation has been added to the definition, as public goods and externalities overlap in their definitions and can be differentiated along the beneficiaries of the good and the way of consumption; for a more technical differentiation see S. Holtermann, 'Externalities and Public Goods', *Economica*, vol. 39(153), 1972, pp. 78-87.

of private self-regulation. There are three reasons, it is argued in this chapter, that financial regulation can and consequently ought to be analysed from the perspective of CSR.

19 First, whether a substantive social norm—e.g. stakeholder protection—is enforced by the law does not declassify it to be enforced via CSR as well. A social norm is detached from its mode of enforcement[64] and can also migrate between codification and non-codification and different forms of regulation.[65] The fact that a specific objective is pursued by public regulation thus does not automatically disqualify this objective to be CSR. This is expressed by the traditional understanding of CSR as going "beyond the law" as a marginal exceedance of the degree of care or effort required for compliance,[66] showing that CSR and the law can overlap in enforcing the same substantive social norm.

20 Secondly, pay regulation in the financial sector is a form of indirect regulation to protect creditors and financial stability. Bebchuk and Spamann explicitly juxtapose it with "direct", i.e. traditional prudential regulation and argue that pay regulation can serve as a complement.[67] It has been shown[68] that interpreting the 'voluntariness' of CSR as the absence of legal rules is an undue over-simplification of the institutional environment that determines the extent and nature of CSR engagement.[69] Instead, the law can take an active role in incentivising CSR by increasing either the benefits of engagement or the costs of non-engagement without directly restricting the discretion of businesses in their decision-making.[70] It has been argued that CSR can even be 'mandated' by law, leaving not the voluntariness in compliance (whether to engage at all), but the discretion of compliance (how to engage) up to corporations.[71] Pay regulation however does not generally entail mandatory stakeholder protection, instead it aims to steer compensation structures into the direction of more stakeholder-friendly incentives.

21 Thirdly, pay regulation in the financial sector is aimed at a specific group of stakeholders, i.e. creditors, and a specific type of public good, i.e. global financial stability. The challenge for an analysis of these rules from the perspective of CSR is to abstract their narrow objectives and

[64] Cp. S. Shavell, 'Law versus Morality as Regulators of Conduct', *American Law and Economics Review*, vol. 4(2), 2002, pp. 227-57.
[65] J. Eijsbouts, *Corporate Responsibility, beyond Voluntarism: Regulatory Options to Reinforce the Licence to Operate*, Maastricht, Maastricht University Press, 2011, available at https://doi.org/10.26481/spe.20111020je.
[66] Cp. European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions A Renewed EU strategy 2011-14 for Corporate Social Responsibility*, 2011, COM(2011) 681 final.
[67] Bebchuk and Spamann (2010), *supra* note 24.
[68] Cp. *Chapter Two*, at p. 18.
[69] Cp. J. Eijsbouts, 'Corporate Codes as Private Co-Regulatory Instruments in Corporate Governance and Responsibility and Their Enforcement', *Indiana Journal of Global Legal Studies*, vol. 42(1), 2017, pp. 181-205.
[70] Cp. D. McBarnet, 'Corporate Social Responsibility beyond Law, through Law, for Law', in: D. McBarnet, A. Voiculescu & T. Campbell (eds.), *The New Corporate Accountability – Corporate Social Responsibility and the Law*, Cambridge, Cambridge University Press, 2009; Gond et al. (2011), *supra* note 60; M. Cominetti & P. Seele, 'Hard Soft Law or Soft Hard Law? A Content Analysis of CSR Guidelines Typologized along Hybrid Legal Status', *uwf UmweltWirtschaftsForum*, vol. 24(2), 2016, pp. 127-40.
[71] As the example of Indian CSR regulation shows, see L. Gatti et al., 'Are We Moving Beyond Voluntary CSR? Exploring Theoretical and Managerial Implications of Mandatory CSR Resulting from the New Indian Companies Act', *Journal of Business Ethics*, 2018, available at https://doi.org/10.1007/s10551-018-3783-8.

identify whether and under which conditions these regulatory instruments work to incentivise CSR more broadly, or with regard to other corporate constituencies.

22 These reasons lead to the conclusion that it is feasible to analyse pay regulation in the financial sector as a legal incentive framework for CSR engagement. Such an approach nevertheless needs to account for the specific objectives of regulation, i.e. which corporate constituencies are aimed to be protected, and the underlying economic theories that have been explained above.[72] In order to derive lessons from pay regulation in the financial sector for legal incentivisation of CSR more generally, this context needs to be considered as well. Therefore, *Section 4* covers the peculiarities of the banking business, the details of bank governance briefly summarised above, and the interplay of pay regulation with traditional prudential regulation. To complete the overview of financial regulation and CSR, some more attention is paid to the nature of CSR in the financial sector, and what it means for how CSR is conceptualised in the analysis of *Section 3*.

2.3 The Practice of CSR in Finance

23 So far, the concept of externality internalisation and provision of public goods has only been treated abstractly for CSR and limited to the specific cases of creditors and financial stability for pay regulation. To gain a more coherent picture, it is useful to briefly sketch how CSR in the financial sector looks like. Based on this and the nature of risks and externalities, the concept of CSR employed in this analysis is expanded towards the dimensions of 'weak' and 'strong social performance'. Weak social performance refers to the causation of losses or harms to others; strong social performance is less clearly defined as "a firm's willingness to exceed expectations for social performance"[73] or "the preservation of gains".[74] The KLD Index compiles 'social strength' ratings from different forms of benefit provided to or active engagement with a set of stakeholders.[75] Here, weak social performance is understood as the causation of harms, i.e. negative externalities, and strong social performance as the provision of benefits, i.e. positive externalities. CSR aims to decrease weak social performance, i.e. the avoidance of harm, and to increase strong social performance, i.e. to sustain the provision of benefits. Comparing the areas of engagement and social norms of CSR in finance also helps to better understand how instruments of pay regulation may serve as incentives for private self-regulation more generally.

24 Business ethics, usually regarded as the core dimension of CSR,[76] is an important aspect in the financial industry as well. Its focus has mostly been on compliance with and beyond the law,

[72] *Supra*, para. 8 et seq.
[73] J. McGuire, S. Dow & K. Argheyd, 'CEO Incentives and Corporate Social Performance', *Journal of Business Ethics*, vol. 45(4), 2003, pp. 341-59.
[74] McGuire et al., 'Do Contracts Make Them Care? The Impact of CEO Compensation Design on Corporate Social Performance', *Journal of Business Ethics*, vol. 157(2), 2019, pp. 375-90.
[75] Cp. S. Waddok & S. Graves, 'The Corporate Social Performance-Financial Performance Link', *Strategic Management Journal*, vol. 18(4), 1997, pp. 303-19.
[76] According to Eijsbouts, "decent business" is the least codified dimension of substantive social norms, transitioning over self-regulation and soft law into more codified forms of hard law, see Eijsbouts (2011), *supra* note 65.

and on the avoidance of gross harm to society for private profit.[77] The complexity of the financial sector makes public supervision and enforcement substantially imperfect, and regulators as well as international bodies appeal to financial institutions for their cooperation by refraining from socially harmful activities.[78] For financial institutions, in turn, business ethics can be a way of securing public trust to protect their reputation in times of trouble,[79] which is important to uphold long-term legitimacy and the 'social licence' to operate.[80] The financial crisis sparked severe criticism[81] of lacking or dysfunctional ethics in the industry,[82] a dominance of pecuniary metrics for success and self-selection dynamics benefiting amoral decision-makers. It has been highlighted that high leverage exacerbates ethical problems in finance.[83] Next to an alleged lack of socially responsible behaviour though, this may also be interpreted as an indicator for the relevance of remuneration in setting incentives for behaviour that maximises social welfare. The more traditional category of 'business ethics' centres around the prevention of negative externalities, i.e. weak social performance, and is a complement to conventional regulation.

25 A different dimension of CSR in the financial sector is the field of socially responsible investment (SRI), investment decisions influenced or motivated by non-financial or 'ethical' considerations.[84] SRI has two important aspects: it provides the necessary capital for other businesses to undertake CSR activities, and it is a response to the non-financial preferences of retail investors for socially responsible investment opportunities. In its 'Sustainable Finance' policy approach covered in *Chapter Two*,[85] the European Commission addresses both of these

[77] Cp. G. Aragon, *Financial Ethics: A Positivist Analysis*, Oxford, Oxford University Press, 2011; for a concise, topical overview, see D. Melé, J. Rosanas & J. Fontrodona, 'Ethics in Finance and Accounting: Editorial Introduction', *Journal of Business Ethics*, vol. 140(4), 2017, pp. 609-13.
[78] In a speech on aligning financial incentives with societal objectives, then-IMF president Christine Lagarde stated: "[…] regulation alone cannot solve the problem. Whether something is right or wrong cannot be simply reduced to whether or not it is permissible under the law. What is needed is a culture that induces bankers to do the right thing even if nobody is watching.", Christine Lagarde, *Ethics and Finance*, speech at the Finance and Society Conference, 6 May 2015, available at https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp050615.
[79] Cp. K. Lins, H. Servaes & A. Tamayo, 'Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility during the Financial Crisis', *Journal of Finance*, vol. 72(4), 2017, pp. 1785-1824.
[80] As voiced by an Open Forum hosted by the Bank of England, see M. Angeli & S. Gitay, 'Bonus Regulation: Aligning Reward with Risk in the Banking Sector', *Bank of England Quarterly Bulletin*, vol. 2015(Q4), 2015, pp. 322-33. On the 'licence to operate' in CSR more generally, see N. Gunningham, R. Kagan & D. Thornton, 'Social License and Environmental Protection: Why Businesses Go Beyond Compliance', *Law & Social Inquiry*, vol. 29(2), 2004, pp. 307-41; E. Kurucz & B. Colbert, 'The Business Case for Corporate Social Responsibility', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.
[81] Zingales (2015), *supra* note 29.
[82] For a selected banking market, Kvalnes and Nordal show that financial managers actively neutralised moral dissonance over profitable, but unethical business decisions, see Ø. Kvalnes & S. Nordal, 'Normalization of Questionable Behavior: An Ethical Root of the Financial Crisis in Iceland', *Journal of Business Ethics*, vol. 159(3), 2019, pp. 761-75.
[83] E.g. R. Nielsen, 'High-Leverage Finance Capitalism, the Economic Crisis, Structurally Related Ethics Issues, and Potential Reforms', *Business Ethics Quarterly*, vol. 20(2), 2010, pp. 299-330.
[84] For an overview, see L. Kurtz, 'Socially Responsible Investment and Shareholder Activism', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.
[85] Cp. *Chapter Two*, at p. 30.

aspects by establishing uniform benchmarks and measures for the SRI market and by requiring the provision of information to clients on the ESG impact of their investment decisions.[86] Notably, the EC also aims to integrate environmental risks into prudential regulation on risk management,[87] linking it to the social dimension of finance mentioned above of harm prevention. SRI and 'sustainable finance' are therefore a form of CSR focusing on the provision of positive externalities, i.e. strong social performance, fostered by more recent, market-based regulatory initiatives.

26 CSR is primarily analysed through the lens of the tripartite categorisation of CSR activities developed in *Chapter Two*; it comprises (i) instrumental CSR, (ii) CSR as managerial rent extraction and (iii) CSR as delegated shareholder philanthropy. Instrumental CSR is the result of the 'business case' for CSR, meaning CSR activities that positively affect financial performance, and is determined by the availability of such opportunities and the institutionalisation of CSR.[88] CSR as managerial rent extraction refers to CSR activities that do not benefit the company, but individual managers; it essentially depends on either managerial discretion in decision-making or influence on the setting of performance targets. The benefits for managers can be material or immaterial,[89] the satisfaction of personal non-financial preferences[90] or a form of entrenchment.[91] CSR as delegated shareholder philanthropy refers to the imposition of shareholders' non-financial preferences on the corporation, it depends on preferences of investors[92] and their ability to influence decision-making, corporate objectives and the pay-setting process. These three categories are maintained for the analysis in this chapter as well.

27 These categories do not account for the dimensions of strong and weak social performance, however. As shown above, both dimensions are relevant in the financial sector—remuneration regulation instead focuses entirely on the prevention of negative externalities. The literature shows that strong and weak social performance react to different dynamics,[93] including executive compensation: weak social performance is more clearly associated with effects on

[86] European Commission, *Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment*, COM(2018) 353 final, 2018/0178 (COD); European Commission, *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks*, COM(2018) 355 final, 2018/0180 (COD); European Commission, *Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341*, COM(2018) 354 final, 2018/0179 (COD).
[87] European Commission, *Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341*, COM(2018) 354 final, 2018/0179 (COD).
[88] Cp. Kurucz & Colbert (2008), *supra* note 80.
[89] Cp. O. Williamson, 'Managerial Discretion and Business Behavior', *American Economic Review*, vol. 53(5), 1963, pp. 1032-57.
[90] Cp. R. Bénabou & J. Tirole, 'Individual and Corporate Social Responsibility', *Economica*, vol. 77(305), 2010, pp. 1-19.
[91] G. Cespa & G. Cestone, 'Corporate Social Responsibility and Managerial Entrenchment', *Journal of Economics & Management Strategy*, vol. 16(3), 2007, pp. 741-71; J. Surroca & J. Tribó, 'Managerial Entrenchment and Corporate Social Performance', *Journal of Business Finance & Accounting*, vol. 35(5)-(6), pp. 748-89.
[92] Cp. Bénabou & Tirole (2010), *supra* note 90.
[93] J. Mattingly & S. Berman, 'Measurement of Corporate Social Action: Discovering Taxonomy in the Kinder Lydenburg Domini Ratings Data', *Business & Society*, vol. 45(1), 2006, pp. 20-46.

financial performance, which is why markets react more strongly to it[94] and pay-performance sensitivity can effectively reduce it.[95] Effects of strong social performance on financial performance are less clear and it is found to be more strongly motivated by personal motivations, it may be disincentivised by high-powered financial incentives.[96] It is thus likely that pay regulation has significantly different effects on the dimensions of weak and strong social performance. The following analysis therefore does not only apply the three categories of CSR activities, but also the two dimensions of social performance.

Section 3: Bankers' Pay Regulation as a CSR Incentive Framework

28 This section conducts an analysis of the effects of EU bankers' pay regulation on CSR engagement. It explains the basic setup and context of European pay regulation in the financial sector, briefly compares its elements of governance prescriptions with those covered in *Chapter Three*, and then goes into detail on different forms of pay structure regulation and their effects on CSR engagement. This analysis of existing regulation is complemented by alternative regulatory propositions made in the academic literature, in critique of several shortcomings of the current regime. Staying within the framework of the financial sector and accounting for its peculiarities, the section concludes on the effects of EU pay regulation on CSR engagement.

3.1 Pay Regulation in the European Financial Sector

29 As demonstrated above, the case for pay regulation in the financial sector is based on the prevention of excessive risk-taking to protect creditors, taxpayers, and financial stability from negative externalities. It extends beyond the shareholder value paradigm of traditional 'good governance' and the issues of short-termism and managerial rent extraction. In the aftermath of the financial crisis, a significant number of new international guidelines, rules and principles has been produced; the development of current regulation is the result of an arguably complex and dynamic process, influenced by both new economic theories as well as the political and social ramifications of the crisis that have influenced public opinion and the legislative process.[97] A brief overview of the context, objectives and instruments of the EU regime on bankers' pay is thus necessary to understand its functioning.

30 In 2009, the Financial Stability Forum (FSF; today: FSB) published its 'Principles for Sound Compensation Practices', which were to become the basis for global pay regulation after the financial crisis.[98] These (three) principles were: effective compensation governance, alignment with prudent risk-taking, and supervisory oversight and stakeholder engagement. The

[94] D. Lange & N. Washburn, 'Understanding Attributions of Corporate Social Irresponsibility', *Academy of Management Review*, vol. 37(2), 2012, pp. 300-26.
[95] McGuire et al. (2003), *supra* note 73; McGuire et al. (2019), *supra* note 74.
[96] R. Bénabou & J. Tirole, 'Incentives and Prosocial Behavior', *American Economic Review*, vol. 96(5), 2006, pp. 1652-78.
[97] For an overview, see Ferrarini & Ungureanu (2011), *supra* note 37.
[98] Financial Stability Board (FSB), FSF Principles for Sound Compensation Practices, 2 April 2009 [herein: FSB Principles].

contribution of compensation to the crisis by incentivising short-termism and excessive risk-taking was stressed, but little emphasis was yet placed on the governance peculiarities of banks or shareholder interests. This was because the Principles were an international political compromise, needed to be kept general and flexible,[99] but also because excessive risk-taking and short-termism were still mostly regarded as problems of conventional 'bad governance'.[100] The G20 states agreed to endorse and implement the FSB Principles in April 2009.[101]

31 In Europe, the FSB Principles were quickly mirrored by the Committee of European Banking Supervisors (CEBS).[102] Early policy documents like the De Larosière Report[103] or the Commission Recommendation of 2009[104] show that European policymakers first adopted the 'bad governance' view as well. This changed, however, as the FSB's recommendation to avoid prescriptions on the design or level of individual compensation[105] was abandoned in favour of an in increasingly stringent approach.[106] This development can be attributed to mounting public pressure on politics as well as the stronger case for direct pay regulation instead of mere supervision and market discipline made in the literature.[107] Rules on pay were eventually introduced with the Third Capital Requirements Directive[108] (CRD III) of 2010, which was replaced by the Fourth Capital Requirements Directive[109] (CRD IV) in 2014. In 2019,

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[99] Ferrarini & Ungureanu (2018), *supra* note 3.

[100] E.g. G. Ferrarini & M. Ungureanu, 'Executive Pay at Ailing Banks and Beyond: A European Perspective', *Capital Markets Law Journal*, vol. 5(2), 2010, pp. 197-217; K. Murphy, 'Compensation Structure and Systemic Risk', *Marshall School of Business Working Paper Series*, Working Paper No. FBE 34-09, 2009.

[101] Group of 20, *Declaration on Strengthening the Financial System*, 2 April 2009, G20 London Summit 2009.

[102] Committee of European Banking Supervisors, *High-Level Principles for Remuneration Policies*, April 2009.

[103] The Report speaks of "high risk-taking" and "short-termism", stating that "it is primarily the latter issue which has an adverse impact on risk management and has thereby contributed to the crisis. […] It is extremely important to re-align compensation incentives with shareholder interests and long-term, firm-wide profitability." See High Level Group on Financial Supervision in the EU (De Larosière Group), *Report*, 25 February 2009, Brussels, pp. 30-31.

[104] The Commission stated that "there is a widespread consensus that inappropriate remuneration practices in the financial services industry also induced excessive risk-taking […]" and "tended to reward short-term profit." See European Commission, *Commission Recommendation of 30 April 2009 on remuneration policies in the financial sector*, 2009/384/EC, O.J. L 120/22, rec. 2, 3.

[105] FSB Principles, Introduction, p. 1.

[106] Cp. T. Dijkhuizen, 'The EU's Regulatory Approach to Banks' Executive Pay: From "Pay Governance" to Pay Design', *European Company Law*, vol 11(1), 2014, pp. 30-37.

[107] Cp. the contributions covered *supra*, para. 8 et seq.

[108] Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, O.J. L 329/3 [herein CRD III].

[109] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, O.J. L 176/338 [herein CRD IV].

amendments to CRD IV were made.[110] The following explanations concentrate on an overview of current rules under the amended CRD IV.[111]

32 Pay regulation in CRD IV aims to align compensation arrangements with risk management to prevent excessive risk-taking (rec. 62) and link remuneration to long-term performance (rec. 63). This is done in order to protect and foster European and global financial stability (rec. 67), which shows that excessive risk-taking is also understood from the perspective of externalities. As CRD IV also implements new international standards on capital and liquidity requirements,[112] governance and pay regulation are integrated as complements to prudential requirements.[113] These different motivations—improving bank governance, enhancing financial system resilience, and protecting creditors and taxpayers—explain why the regulatory instruments employed are a spectrum of governance prescriptions and pay structure interventions.

33 Governance prescriptions in CRD IV follow a pattern similar to those covered in *Chapter Three*: Art. 92(2)(a)[114] provides prescriptions on the remuneration policy that aim to align it with effective risk management and ensure that risk-taking does not exceed the level of tolerated risk of the institution. In principle, this aims at strengthening internal governance by raising responsibilities for the board. However, it needs to be considered that the perception and assessment of risks in corporate risk management functions is substantially shaped by regulatory requirements that also account for external risks.[115] Art. 95 furthermore requires 'significant institutions'[116] to establish a remuneration committee to support the supervisory body in its control function. In addition to the requirements of CRD IV, remuneration disclosure is covered by Art. 450 of the Capital Requirements Regulation.[117] It aims at enabling market forces and stakeholders to assess the incentive structure for risk-taking, thus imposing external discipline on the institution (rec. 97 CRR). Art. 93 lists additional rules for institutions profiting from exceptional government intervention and is only relevant for banks undergoing acute crisis.[118]

34 Art. 94 CRD IV, in turn, establishes an extensive regime of pay structure regulation that limits the use and design of specific instruments. Due to their arguably intrusive nature, these new

[110] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, O.J. L 150/253.
[111] For an overview of CRD III, see E. Ferran, 'New Regulation of Remuneration in the Financial Sector in the EU', *European Company and Financial Law Review*, vol. 9(1), 2012, pp. 1-34.
[112] Cp. BCBS, *Basel III: Finalising Post-Crisis Reform*, December 2017, Basel.
[113] As proposed by Bebchuk & Spamann (2010), *supra* note 24.
[114] Throughout this chapter, legal provisions or recitals that are referenced without a specified act refer to CRD IV.
[115] More on this *infra*, para. 102 et seq.
[116] The legal definition and an explanation of 'significant institutions' is provided *infra*, para. 45.
[117] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, O.J. L 176/1 [herein CRR].
[118] It is noteworthy however that the US 'Troubled Assets Relief Program' (TARP) that bailed out large banks was the first policy measure to introduce restrictions on bankers' pay that were later partially transposed into the Dodd-Frank Act. These restrictions already affected the whole banking sector and set new standards for remuneration even in institutions that were not receiving government support, see Ferrarini & Ungureanu (2010), *supra* note 100.

rules have been the focus of most attention as well as criticism in the literature.[119] Several measures aim at an overall alignment of individual variable compensation instruments and performance targets with the institution's financial performance. This also includes restrictions on guaranteed bonuses—a common practice before the crisis[120]— and severance payments, as well as mandatory malus and clawback provisions. A substantial portion of variable compensation needs to be paid in equity-linked instruments, and at least 40 percent of it needs to be deferred. The most prominent rule is the 'bonus cap', introduced upon initiative of the European Parliament,[121] which limits variable pay to 100 percent of fixed pay; the limit can be raised by shareholders to 200 percent.

35 Before going into detail on the rules it worth noting that the personal scope of pay regulation in CRD IV extends beyond executives and board members. As also the decisions of lower ranks of management and even junior employees in certain functions can bring an institution into distress,[122] CRD IV covers all "categories of staff whose professional activities have a material impact on the risk profile" (rec. 62). They are generally referred to as 'identified staff' or '(material) risk-takers'.[123] This raises caution about the explanatory capacity of the standard economic literature on compensation, which focuses almost exclusively on executives.[124]

36 CRD IV combines conventional governance improvements with restrictions on bankers' pay to contribute to the objectives of financial regulation. The general effects of governance prescriptions on incentives for CSR engagement have been elaborated at length in the previous chapter.[125] Here, the requirements for remuneration policies, committees and disclosure shall thus only briefly be compared with regulation for normal corporation to carve out the differences and discuss their implications for the results that had been reached so far (*Section 3.2*). The focus of this chapter will then be the elements of pay structure regulation under Art. 94 that are unique to the financial sector (*Section 3.3*).

3.2 Governance and Disclosure Prescriptions

37 As shown above, current EU rules on bankers' pay integrate elements of governance prescriptions and pay structure regulation with the aims of increasing sustainable long-term performance and preventing the externalities that results from excessive risk-taking. At the

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[119] Cp. K. Murphy, 'Regulating Banking Bonuses in the European Union: A Case Study in Unintended Consequences', *European Financial Management*, vol. 19(4), 2013, pp. 631-57; G. Ferrarini, 'CRD IV and the Mandatory Structure of Bankers' Pay', *ECGI Working Paper Series in Law*, Working Paper No. 294/2015, 2015.
[120] Ferrarini & Ungureanu (2010), *supra* note 100.
[121] Explained in greater detail *infra*, para 50.
[122] Cp. Mülbert (2009), *supra* note 7.
[123] Criteria on the identification of 'material risk-takers' have been provided by the EC, see Commission Delegated Regulation (EU) No 604/2014 of 4 March 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile.
[124] As noted by Zalewska (2016), *supra* note 21; for a notable exception, see S. Sepe & C. Whitehead, 'Paying for Risk: Bankers, Compensation, and Competition', *Cornell Law Review*, vol. 100(3), 2015, pp. 655-702.
[125] Cp. *Chapter Three*, at p. 65.

example of the SRD II,[126] governance prescription rules like remuneration policy, remuneration committee and disclosure requirements have been addressed in detail in the prior chapter.[127] This section therefore focuses on the differences between those elements of general corporate regulation and financial sector regulation, and the resulting deviations from the previous chapter. The analysis considers the relevant laws and the Guidelines on the implementation of Art. 92-95 CRD IV and Art. 450 CRR issued by the European Banking Authority (EBA).[128]

3.2.1 Remuneration Policy

38 Art. 92(2)(a) CRD IV prescribes that the remuneration policy shall be in line with the "business strategy, objectives, values and long-term interests of the institution". This roughly equals the Shareholder Rights Directive, which requires remuneration policies to contribute to the "business strategy and long-term interests and sustainability" of the company under Art. 9a(6) para. 1 SRD II. In both regimes, this is done by specifying the responsibilities of internal governance bodies like the management and supervisory board or remuneration committee.[129] Both SRD II and CRD IV furthermore oppose discretionary or guaranteed bonuses by requiring remuneration policies to specify performance, measurement and award criteria for variable compensation.[130] Variable pay also needs to be structurally separate from fixed compensation under Art. 9a(6) para. 1 SRD II and Art. 92(2)(g) CRD IV respectively. While SRD II mandates the introduction of say-on-pay votes, the EBA Guidelines explicitly allow both binding and advisory shareholder votes on the remuneration policy under CRD IV and set requirements for this process.[131] CRD IV mandates shareholder consent of at least two thirds to raise the 'bonus cap' from 100 percent to a maximum of 200 percent of fixed pay.

39 It emanates from this comparison of the main elements in CRD IV and SRD II on remuneration policy that they both employ similar means to improve internal governance in the sense of shareholder interests in sustainable, long-term financial performance. CRD IV makes use of the extent to which shareholders have an interest in preventing short-termism and excessive risk-taking as the results of badly designed pay structures and managerial rent-extraction.[132] The main difference is that CRD IV explicitly requires the alignment of the policy with sound risk management under Art. 92(2)(a) CRD IV. The prevalence of risks in the financial sector makes it necessary that such an internal alignment cannot be just an indirect consequence of

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[126] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, O.J. L 132/1 [herein: Second Shareholder Rights Directive, SRD II].

[127] Cp. *Chapter Three*, at p. 65.

[128] European Banking Authority (EBA), *Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013*, 27 June 2016, EBA/GL/2015/22 [herein: EBA Guidelines].

[129] For more details on the remuneration committee, see *infra* at para. 42-45.

[130] Art. 9a(1) para. 3 SRD requires remuneration policies to set "clear, comprehensive and varied criteria for the award of the variable remuneration" and to "indicate the financial and non-financial performance criteria. The EBA Guidelines require remuneration policies to "provide for an effective framework for performance measurement, risk adjustment and the linkages of performance to award" (§ 29).

[131] EBA Guidelines, §§ 38-41.

[132] Excessive risk-taking may happen because boards and shareholders themselves are insufficiently aware of risks or the implications of certain pay instruments, and thus harm their own interests as well as those of other corporate constituencies, see Bebchuk, Cohen & Spamann (2010), *supra* note 24.

well governed pay structures. Furthermore, one should also bear in mind that the definition and internalisation of risks in finance is heavily shaped by regulation as well.[133] *Section 4* covers any implications of the introduction of ESG criteria into financial risk management by the Sustainable Finance package.[134] Furthermore, the freedom of boards and shareholders to draft remuneration policies is directly limited by the restrictions of Art. 94 CRD IV covered below.

40 In *Chapter Three*, it has been concluded that remuneration policy regulation can promote type-(i) instrumental CSR, decrease type-(ii) rent-seeking CSR and—especially if coupled with say-on-pay—increase type-(iii) CSR as delegated shareholder philanthropy. The results depend on the prevalence of the 'business case for CSR'[135] and on the non-financial preferences of shareholders. It has been suggested[136] that the 'business case' is less prevalent in the financial sector than it is in other industries[137] and has only recently been gaining track because of stakeholder pressure and the integration of CSR criteria in risk management.[138] This shows that industry conditions influence the effectiveness of regulation in incentivising CSR. Ownership conditions are discussed below in *Section 4.1*.

41 There are two reasons why CSR engagement may be affected differently by remuneration policy requirements in CRD IV than those of SRD II. A key aspect is the application to 'identified staff': while in generic corporations the quality of pay governance can diffuse downwards to lower ranks of staff, the importance of material risk-takers in financial institutions precludes such an approach. The wider application of the remuneration policy renders regulatory control less centred on the role of executives and more operational. Secondly, the focus in CRD IV on alignment with risk management places emphasise for compensation on preventing harms rather than 'doing good'. Such a focus is thus likely to rather incentivise CSR in the form of curbing negative externalities than in providing positive externalities, especially given empirical evidence that CSR is an effective form of risk management in controversial industries.[139]

3.2.2 Remuneration Committees

42 Art. 95 para. 1 CRD IV requires significant institutions to establish a remuneration committee. The committee shall be able to exercise "competent and independent judgment". Requirements on its composition are specified by the EBA Guidelines, which prescribe that its member must be non-executive board members or members of the supervisory board respectively, depending on whether the institution has a one- or two-tier board system.[140] The committee chair and a majority of its members must qualify as 'independent';[141] EBA defines independence as having

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[133] The regulation of risk management is covered *infra*, para 104.
[134] Also cp. *Chapter Two*, at p. 30.
[135] Cp. Kurucz & Colbert (2008), *supra* note 80.
[136] I. Cherneva, *The Business Case for Sustainable Finance*, London, Routledge, 2012.
[137] See the elaborations in *Chapter Three*, at p. 84.
[138] O. Weber, M. Diaz & R. Schwegler, 'Corporate Social Responsibility of the Financial Sector – Strengths, Weaknesses and the Impact on Sustainable Development', *Sustainable Development*, vol. 22(5), 2014, pp. 321-35.
[139] H. Jo & H. Na, 'Does CSR Reduce Firm Risk? Evidence from Controversial Industry Sectors', *Journal of Business Ethics*, vol. 110(4), 2012, pp. 441-56.
[140] EBA Guidelines, § 49.
[141] Ibid.

no present or recent links to the institution or its management that could influence objective and balanced judgment and independent decision-making.[142]

43 The rules on remuneration committees covered in *Chapter Three* for corporations in general were based on an EC recommendation. This recommendation suggested to have an "appropriate balance" between managing and independent directors on the board and a "sufficient number" of independent directors on the remuneration committee to "play an effective role".[143] Independence is defined as having no business or personal relationship with the company, its management or a controlling shareholder, if such a relationship creates a conflict of interest for the director.[144] Realisation could vary significantly among member states, based on the pre-existence of other, substitutive governance elements.[145] While the concept of independence essentially does not differ, CRD IV imposes higher minimum requirements.

44 In *Chapter Three*, it has been elaborated that independent directors can increase type-(i) instrumental CSR and decrease type-(ii) CSR as rent-extraction, but also decrease type-(iii) delegated shareholder philanthropy. These results depend on two central factors: first, the gravity of the information asymmetry in corporate affairs from which non-executive directors suffer for not being involved in active management.[146] This disadvantage makes it more difficult for independent directors to impose CSR performance targets. Secondly, the ability of independent directors to fulfil a networking role and thus improve stakeholder relations. In the financial sector, both aspects constitute significant impediments. The crisis had demonstrated that the complexity of financial affairs was not properly understood by directors, who in turn were unable to control management.[147] Secondly, the financial sector is an unsuitable environment for stable stakeholder relations: as Zalewska argues, the inter-connectivity of the banking system means that relationships are frequently disrupted by the actions of others, making short-term gains more attractive compared to long-term relationships.[148]

45 While the requirements of CRD IV on independence may be stricter, the application of Art. 95 CRD IV is limited to 'significant institutions'. Pursuant to Art. 131(1), these are institutions identified by the member states to be important for the stability of the (global) financial system due to their size, organisation and nature of business, and thus require additional regulation. This shows that independent remuneration committees are primarily designed to prevent systemically excessive risk-taking; directors should thus also enjoy independence from shareholders. While CRD IV offers few new insights about the effects of independent remuneration committees on CSR engagement, the emphasis of regulators on more control and oversight[149] can pre-determine the mindset of independent directors to primarily understand themselves not as stakeholder networkers and advisors, but as supervisors, and in turn focus on

[142] EBA, *Joint ESMA an EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU*, 26 September 2017, EBA/GL/2017/12.
[143] European Commission, *Recommendation 2005/162/EC*, at para. 5.
[144] Ibid. at para. 13.1.
[145] Cp. *Chapter Three*, at p. 91.
[146] Cp. B. Baysinger & R. Hoskisson, 'The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy', *Academy of Management Review*, vol. 15(1), 1990, pp. 72-87.
[147] M. Murphy, 'Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension', *Delaware Journal of Corporate Law*, vol. 36(1), 2011, pp. 121-64.
[148] Zalewska (2016), *supra* note 21, at p. 330.
[149] Cp. EBA (2017), *supra* note 142.

the CSR dimension of preventing negative externalities instead of promoting strong CSR performance.

3.2.3 Disclosure Requirements in the Capital Requirements Regulation

46 Remuneration disclosure requirements are not covered by CRD IV, but in Art. 450 CRR, which was last overhauled in 2019 (CRR II).[150] Disclosure requirements are thus uniform across the EU.[151] While the remuneration governance process and qualitative specifications, e.g. the pay-for-performance link (Art. 450 para. 1 lit. b), the main characteristics of the remuneration system and measurement criteria (para. 1 lit. c), are also covered, a strong focus is laid on quantitative information. This especially refers to types of remuneration also covered by Art. 94 CRD IV, e.g. the maximum ratio of fixed and variable remuneration.[152] Aggregate quantitative information needs to be broken down by several detailed categories, special attention is paid to variable, deferred and any forms of guaranteed compensation. Art. 450(1)(i) CRR also requires the number of employees receiving EUR 1 million or more per year in total compensation to be disclosed, with an indication the broad pay span in which their total remuneration lies.

47 In *Chapter Three*, it was stated that qualitative information is crucial for shareholders, investors and other stakeholders to evaluate a company's compensation system.[153] That way, they may judge the pay-for-performance incentive framework, and influence it to increase type-(i) instrumental CSR and type-(iii) delegated shareholder philanthropy, and to decrease type-(ii) CSR as managerial rent extraction. It was concluded that especially the disclosure requirements of SRD II on the pay governance process, performance targets and the consideration of non-financial criteria are drivers of CSR engagement. The effects of remuneration disclosure on CSR engagement mentioned above furthermore depend upon complementary governance elements, like shareholder votes or remuneration committees.

48 CRR is remarkably different with its focus on the disclosure of the nature and amounts of certain pay instruments and total compensation. This way, it aims to raise pressure through transparency to improve compliance with the structural regulation of pay in Art. 94 CRD IV and steer institutions towards specific forms of remuneration, e.g. by reducing discretionary and guaranteed bonuses or increasing the use of deferred compensation.[154] This focus on pay instruments instead of pay targets and performance criteria however is less likely to improve CSR performance than the general rules of SRD II. Whether a combination of the two approaches is useful depends on the effectiveness of pay structure regulation in promoting CSR, which is covered in the subsequent part.

[150] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012, O.J. L 150/62 [herein: CRR II].
[151] The subjective scope of application of CRR is defined in Art. 4 CRR and not further discussed here.
[152] See *infra*, para. 49 et seq.
[153] Cp. *Chapter Three*, at p. 97.
[154] Cp. rec. 97 CRR.

3.3 Pay Structure Regulation: The Case of Variable Remuneration

49 Art. 94(1) CRD IV introduces different measures of pay structure regulation. For the purpose of this analyse, they are functionally divided into three group: the 'bonus cap' limiting the relative amount of variable compensation (*Section 3.3.1*), provisions to enforce the pay-for-performance principle and *ex-ante* risk alignment (*Section 3.3.2*), and rules on the structure of variable remuneration, deferral, malus and clawbacks as part of an *ex-post* risk alignment process (*Section 3.3.3*).

3.3.1 The Bonus Cap

50 Art. 94(1)(f) requires an 'appropriate balance' between fixed and variable compensation, with fixed compensation being high enough for the variable pay policy to be "fully flexible", i.e. recipients not being materially dependent on variable compensation. EBA has provided detailed criteria on the categorisation of instruments as either fixed or variable compensation.[155] Art. 92(2)(g) requires fixed remuneration to reflect the personal qualification of the employee and labour market conditions, and variable remuneration to reflect performance only. In addition to that vaguely held 'appropriate balance', Art. 94(1)(g)(i) imposes a strict cap on variable compensation of not more than 100 percent of fixed pay; this rule is usually referred to as "pay ratio cap"[156] or "bonus cap".[157] The cap can be extended toward 200 percent by a majority of at least two thirds of shareholders under procedures detailed in Art. 94(1)(g)(ii).

51 The cap was not yet part of the post-crisis pay regime of CRD III but was only introduced by its reform in 2014 with CRD IV. While countries like France and Germany had already pushed for a limitation of bonuses in the FSB Principles, this position was without a majority on the world stage.[158] It was instead introduced to the draft of CRD IV upon initiative of the European Parliament[159] and was supported by then EC Commissioner Michel Barnier.[160] The political justifications were curbing 'excessive levels of pay' that allegedly undermined incentives for prudential risk-taking and were financed by taxpayer monies through the bail-out of ailing institutions.[161] It was also expected to raise "transparency and honesty" of pay schemes and was regarded as a response to the inability of banks to "self-discipline" in rewards for *ex post*

[155] EBA Guidelines, § 117.
[156] Cp. Murphy (2013), *supra* note 119.
[157] Cp. Ferrarini & Ungureanu (2018), *supra* note 3.
[158] Cp. Ferran (2012), *supra* note 111.
[159] European Parliament, *EU Bank Capital Requirements Regulation and Directive – Parliament's key changes to the Commission proposal*, online press release, 15 April 2013, https://www.europarl.europa.eu/news/en/press-room/20130412BKG07195/eu-bank-capital-requirements-regulation-and-directive/13/parliament-s-key-changes-to-the-commission-proposal.
[160] M. Barnier, *Speech on Bonus Regulation*, Brussels, 30 January 2012, retrievable in French at https://europa.eu/rapid/press-release_SPEECH-12-48_fr.htm?locale=en.
[161] European Parliament, *MEPs Rein in Bankers*, online press release, 14 July 2010, available at http://www.europarl.europa.eu/sides/getDoc.do?language=en&type=IM-PRESS&reference=20100709STO78534.

failures.[162] The United Kingdom—whose banking sector hosts the most high earners[163]—strictly opposed the cap and brought proceedings against it before the ECJ, however dropped the case after the Opinion of the Advocate General had found the pleas ungrounded.[164]

52 The academic literature focuses mainly on the effects the bonus cap rule has on the structure of variable and fixed compensation as well as the levels of compensation, and the implications of these changes on risk-taking and financial performance. Proponents of the rule argue that it addresses the problem of managerial rent extraction in compensation[165] by preventing executives from hiding risks from institutional investors, boards and regulators and pushing shareholders towards more engagement and control.[166]

53 Criticism of the bonus cap is divided along the notion of whether pay regulation should address the type-III agency conflict between shareholders and creditors[167] or whether this should be entirely dealt with by prudential regulation, leaving it up to pay regulation to improve the governance and long-term orientation of remuneration.[168] Overall, the main points of theoretical criticism upon introduction of the rule were the following:[169] it would increase fixed remuneration, thus making banks more vulnerable to business cycles, and fail to decrease total pay. As remuneration is determined by the international labour market, it would decrease the ability of European banks to attract managerial talent and thus lead to a competitive disadvantage of the EU financial sector as a whole. Lastly, reducing variable pay would provide

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[162] European Parliament, *Tougher Rules Needed on Banker Bonuses – MEP Karas*, press release, 26 June 2012, available at http://www.europarl.europa.eu/pdfs/news/public/story/20120625STO47620/20120625STO47620_en.pdf.

[163] In 2013, 65.6 percent of all 'high earners' in the EU, i.e. employees receiving more than EUR 1 million as disclosed pursuant to Art. 450(1)(i) CRR, were located in the UK; the average ratio of variable to fixed remuneration for UK high earners at that time was at 410 percent; see EBA, *Benchmarking of Remuneration Practices at Union Level and Data on High Earners 2013*, at pp. 47, 53.

[164] Order of 9 December 2014, United Kingdom v Parliament and Council, C-507/13.

[165] Managerial rent-seeking in executive compensation was highlighted as a problem in the financial crisis by Bebchuk, Cohen & Spamann (2010), *supra* note 48; empirical evidence that pay schemes were excessive in the late of optimal contracting theory was provided by Efing et al. (2015), *supra* note 51. On the general problem of executive pay as a source of agency problems, see L. Bebchuk, J. Fried & D. Walker, 'Managerial power and rent extraction in the design of executive compensation', *University of Chicago Law Review*, vol. 69(3), 2002, pp. 751-846.

[166] A. Johnston, 'Preventing the Next Financial Crisis? Regulating Bankers' Pay in Europe', *Journal of Law and Society*, vol. 41(1), 2014, pp. 6-27; see also V. Acharya, M. Pagano & P. Volpin, 'Seeking Alpha: Excess Risk Taking and Competition for Managerial Talent', *Review of Financial Studies*, vol. 29(10), 2016, pp. 2565-99.

[167] E.g. Zalewska (2016), *supra* note 21; J. Thanassoulis & M. Tanaka, 'Optimal Pay Regulation for Too-Big-to-Fail Banks', *Journal of Financial Intermediation*, vol. 33(1), 2018, pp. 83-97; A. Kokkinis, 'Exploring the Effects of the 'Bonus Cap' Rule: the Impact of Remuneration Structure on Risk-Taking by Banker Managers', *Journal of Corporate Law Studies*, vol. 19(1), 2019, pp. 167-95.

[168] E.g. Ferrarini & Ungureanu (2011), *supra* note 37; Murphy (2013), *supra* note 119; R. Barontini et al., 'Directors Remuneration before and after the Crisis: Measuring the Impact of Reforms in Europe', in: M. Belcredi & G. Ferrarini (eds.), *Boards and Shareholders in European Listed Companies*, Cambridge, Cambridge University Press, 2013; P. Andres, R. Reig & E. Vallelado, 'European Banks' Executive Remuneration under the New European Union Regulation', *Journal of Economic Policy Reform*, vol. 22(3), 2019, pp. 208-25.

[169] As voiced by Murphy (2013), *supra* note 119; echoed by Ferrarini (2015), *supra* note 119; Ferrarini & Ungureanu (2018), *supra* note 3.

bankers with fewer incentives to exert effort in taking good risks and avoiding bad risks, worsening risk-adjusted financial performance.

54 The effects of the bonus cap rule have been the subjective of several studies. EBA reported that the ratio of variable to fixed compensation for identified staff dropped from 104.3 percent in 2013 to 65.5 percent in 2014,[170] indicating a significant effect of the 'bonus cap' on pay practices. In the literature, a primary observation has been that institutions with levels above the 1:1 threshold of variable to fixed pay have reacted with an increase of salaries to compensate this loss of variable pay.[171] Colonnello et al. thus find no evidence that banks lost their ability to retain skilled managerial talents.[172] This shows that a relative cap on variable pay has no effect on the managerial labour market, as employees anticipate expected total compensation. This, however, in turn means that the EU's dogmatic approach expressed in Art. 94(2)(g) of dividing remuneration into a fixed part to satisfy labour market demand for pay and a variable part to reflect performance is misguided. As a consequence of this substitution of variable by fixed pay, total compensation has been observed to drop.[173] This is due to two reasons: first, managers demand compensation for their expected pay, which is lower than the maximum potential value of variable pay under optimal conditions. Secondly, the risk premium demanded by risk-averse, undiversified managers for uncertain variable pay decreases.[174] Kokkinis provides an overview of variable-to-fixed-pay substitution rates at major UK banks for 2014 when CRD IV came into effect, showing that the decreases in variable remuneration were compensated by significantly lower amounts of fixed pay.[175]

55 In theory, the effects of the changed proportion of variable pay on risk-taking and exertion of effort are complex. On the one hand, the cap reduces the profit-dependency of payoffs under variable pay schemes and the value of owned shares, which is in line with the legislative intention of curbing (shareholder-induced) excessive risk-taking. On the other hand, the bonus cap also reduces the amount of variable compensation lost in case of distress and the amount of compensation that can be clawed back under *ex post* risk adjustments.[176] There are also the unintended consequences of regulatory intervention that need to be considered, resulting from institutions reacting to the discrepancy between legal requirements and market pressure.

56 So far, studies on the subject have found that the bonus cap has led to worse risk-adjusted financial performance and increased risk-taking,[177] as predicted by its critics. This can be explained by differentiating risk-taking into efforts to pursue 'good' and to shun 'bad risks'. While less variable pay leads to lower incentivisation to manage assets to their best use,[178] it also makes risk-takers less averse towards the losses resulting from bad decisions, a so-called

[170] EBA, *Benchmarking of Remuneration Practices at the European Union Level and Data on High Earners (Data as of End 2014)*, 30 March 2016, EBA-OP-2016-05, London.
[171] For an overview of the development of fixed and variable compensation in UK banks, see Angeli & Gitay (2015), *supra* note 80.
[172] S. Colonnello, M. Koetter & K. Wagner, 'Effectiveness and (In)Efficiencies of Compensation Regulation: Evidence from the EU Banker Bonus Cap', *IWH Discussion Papers No. 7*, 2018.
[173] Kokkinis (2019), *supra* note 167.
[174] Cp. A. Edmans, X. Gabaix & D. Jenter, 'Executive Compensation: A Survey of Theory and Evidence', *ECGI Working Paper Series in Finance*, Working Paper No. 514/2017, 2017, pp. 43-46.
[175] Kokkinis (2019), *supra* note 167, p. 186.
[176] Clawback and malus provisions are covered in greater detail *infra*, para 77.
[177] Colonnello et al (2018), *supra* note 173; Kokkinis (2019), *supra* note 167.
[178] Cp. D. Martinez-Miera & R. Repullo, 'Search for Yield', *Econometrica*, vol. 85(2), 2017, pp. 351-78.

'insurance effect'.[179] Colonnello et al. find that the cap has led to higher levels of stakeholder risks, systematic risk and systemic risk. A higher proportion of fixed pay furthermore entails higher operating leverage and less flexibility during times of distress, when banks would otherwise reduce the variable remuneration of their employees to ensure a sound capital base.[180] EBA nevertheless argues that the negative effects of the cap on cost flexibility are negligible.[181]

57 Furthermore, Kokkinis reports that as an immediate response to the bonus cap, UK banks started paying fixed pay allowance in the form of equity as a way of circumventing the bonus cap.[182] Such share-based allowances that are not dependent on any performance metrics lead to more alignment with shareholder interests than conventional variable remuneration, contrary to the intention of the legislator. While EBA has been strict on the legality of such practices,[183] the example highlights the necessity of accounting for unintended consequences in regulating pay structures. The role of shareholders has been regarded critically within the framework of Art. 94(1)(g). The bonus cap was received negatively by stock markets, indicating that shareholders disapprove of it.[184] Consequently, Kokkinis finds that all but one of the major UK banks successfully sought to expand the cap to 200 percent.[185] The role of shareholders as gatekeepers in ensuring appropriate levels of risk-taking incentives as devised by the law—arguably a political compromise—can thus be seen as misguided in light of the overall effort of reducing excessive risk-taking.

58 The effects of the bonus cap rule on pay and on performance can thus be summarised as the following: it reduces total pay, increases fixed compensation, and decreases bonus and equity pay. Consequently, risk-taking increases and risk-adjusted financial performance deteriorates. The empirical evidence suggests that the bonus cap has failed to achieve its objectives of reducing risk-taking and enhancing financial stability. The implications of these findings for CSR engagement are analysed separately along the tripartite categorisation of CSR activities and the dimensions of strong and weak CSR performance.[186]

59 Beginning with the categories of CSR activities, a rule like the bonus cap is likely to reduce type-(i) instrumental CSR due to the decreased pay-for-performance sensitivity of total remuneration and thus less incentivisation to identify and pursue CSR investment opportunities. Similarly, type-(iii) delegated shareholder philanthropy is likely to decrease, as this type of CSR depends on the availability of performance targets for variable pay and

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[179] M. Carlson & A. Lazrak, 'Leverage Choice and Credit Spreads when Managers Risk Shift', *Journal of Finance*, vol. 65(6), 2010, pp. 2323-62.
[180] M. Efing et al., 'Bank Bonus Pay as a Risk Sharing Contract', *Swiss Finance Institute Research Paper No. 18-72*, 2018.
[181] EBA (2016), *supra* note 170, at p. 36.
[182] Kokkinis (2019), *supra* note 167.
[183] See EBA, *Opinion of the European Banking Authority on the application of Directive 2013/36/EU (Capital Requirements Directive) regarding the principles on remuneration policies of credit institutions and investment firms and the use of allowances*, 15 October 2014, EBA/Op/2014/10. As of 2016, EBA reported that the use of non-cash instruments (shares and share-linked instruments) for fixed pay were still allowed and practiced, see EBA, *Benchmarking of Remuneration Practices at the European Union Level and Data on High Earners (Data as of End 2016),* 10 April 2018, at pp. 21-22.
[184] A. Kleymenova & I. Tuna, 'Regulation of Compensation and Systemic Risk: Evidence from the UK', *Chicago Booth Research Paper No. 16-07*, 2018.
[185] Kokkinis (2019), *supra* note 167.
[186] As explained *supra*, para. 26-27.

shareholder influence on the pay-setting process.[187] The fact that the proportion of variable pay decreases reduces the scope for compensation tied to performance targets *per se* and thus the influence boards and shareholders can exert on remuneration schemes. Type-(ii) managerial CSR may increase at least relatively to the other two categories. This is because the lower pay-for-performance sensitivity leads to more room for personal, non-monetary incentives in the managerial decision-making process, and thus CSR along the personal preferences of managers.[188] The reduced scope for performance targets also entails an increase in managerial discretion in CSR decision-making, which is linked to type-(ii) rent extraction.[189] These conclusion on how changing levels of variable pay affect CSR are reached *ceteris paribus* without yet considering the interaction of the 'bonus cap' with other elements of Art. 94, especially those affecting the performance sensitivity and structure of variable pay.

60 Then, there are the effects on the social performance dimension of CSR. Equity compensation has been demonstrated to disincentivise both weak and strong social performance.[190] The former is explained by the increased internalisation of avoiding the negative financial consequences of weak social performance.[191] The benefits of strong social performance, instead, are less certain and financially quantifiable, and thus less incentivised when sensitivity to financial performance is high. Consequently, a decrease in equity compensation as part of variable pay leads to an increase in weak as well as in strong social performance. Especially the rise of weak social performance is congruent with the results above that risk-taking has deteriorated under the pay ratio cap.[192] A less strict focus on financial performance instead may allow managers to pursue strong social performance policies as well. The effects of bonuses on CSR are rather ambiguous. While some evidence suggests that bonuses can also be drivers of CSR,[193] their short-term orientation on financial targets discourages CSR that is either weakly related to financial performance or whose material benefits only realise in the long term.[194] A decrease of bonus compensation should thus also lead to an increase in weak as well as in strong social performance. These effects might be offset by the extent to which bonuses are linked to non-financial performance targets;[195] the role of performance metrics in this is covered below in *Section 3.3.2*. It is important to notice that the bonus cap affects weak and

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[187] Cp. the elaborations on the imposition of non-financial shareholder preferences in *Chapter Three*, at p. 84.
[188] M. Fabrizi, C. Mallin & G. Michelon, 'The Role of CEO's Personal Incentives in Driving Corporate Social Responsibility', *Journal of Business Ethics*, vol. 124(2), 2014, pp. 311-26.
[189] M. Cho, S. Ibrahim & Y. Yan, 'The Use of Nonfinancial Performance Measures in CEO Bonus Compensation', *Corporate Governance: An International Review*, vol. 27(4), 2019, pp. 301-16; B. Hong, Z. Li & D. Minor, 'Corporate Governance and Executive Compensation for Corporate Social Responsibility', *Journal of Business Ethics*, vol. 136(1), 2016, pp. 199-213.
[190] McGuire et al. (2019), *supra* note 74; P. Berrone & L. Gomez-Mejia, 'Environmental Performance and Executive Compensation', *Academy of Management Journal*, vol. 52(1), 2009, pp. 103-26.
[191] Cp. R. Wiseman & L. Gomez-Mejia, 'A Behavioural Agency Model of Managerial Risk Taking', *Academy of Management Review*, vol. 23(1), 1998, pp. 133-53.
[192] Colonnello et al (2018), *supra* note 173; Kokkinis (2019), *supra* note 167.
[193] L. Mahoney & L. Thorne, 'An Examination of the Structure of Executive Compensation and Corporate Social Responsibility: A Canadian Investigation', *Journal of Business Ethics*, vol. 69(2), 2006, pp. 149-62.
[194] J. Deckop, K. Merriman & S. Gupta, 'The Effects of CEO Pay Structure on Corporate Social Performance', *Journal of Management*, vol. 32(3), 2006, pp. 329-42; Fabrizi et al. (2014), *supra* note 188.
[195] Hong, Li & Minor (2016), *supra* note 189; K. Maas, 'Do Corporate Social Performance Targets in Executive Compensation Contribute to Corporate Social Performance?', *Journal of Business Ethics*, vol. 148(3), 2018, pp. 573-85.

strong social performance differently, as it curbs direct incentives to reduce weak social performance and only removes disincentives for strong social performance. The extent to which the pay ratio cap thus leads to more strong social performance depends on the presence of positive incentives like personal managerial[196] or company characteristics.[197]

61 It can be summarised that on the level of drivers of CSR engagement, a rule like the 'bonus cap' in Art. 94(1)(g) leads to less instrumental CSR and delegated shareholder philanthropy, while increasing the scope for CSR as managerial rent extraction. Regarding the quality of CSR performance, a reduction of CSR is likely to materialise in the form of increased weak CSR performance; incentives to refrain from investing in strong CSR performance are reduced.

62 The bonus cap rule can thus not only be regarded as a failure to reach its actual objective of reducing excessive risk-taking in banks and enhancing financial stability, but also as an impediment to CSR engagement. What can nevertheless be learned from it is that it is equally important to consider different incentives to pursue good risks, i.e. to investment in strong CSR performance, and to avoid bad risks, i.e. to avoid weak CSR performance. The (relative) amount of variable and fixed pay is no viable object of regulation under economic considerations; the next sections look at the role of performance metrics and the structure of variable pay.

3.3.2 Mandating Pay-for-Performance

63 Art. 94(1) aims to ensure that variable pay adequately reflects —as is set out in Art. 92(2)(g) point (ii)— "a sustainable and risk adjusted performance". There are two strategies employed to ensure that variable pay reflects both performance and risks: on the one hand, prescriptions on the definition, measurement and evaluation of performance targets and criteria, including an *ex ante* adjustment for the risks undertaken, and secondly restrictions on the use of certain instruments. These instruments are considered inadequate by regulators to link variable compensation to performance and are thus entirely prohibited or restricted to exceptional situations only.

64 In a first step, Art. 94(1)(a) requires variable compensation to be based on a combined assessment of the performance of the individual employee, the business unit as well as the overall institution; performance cannot be measured entirely by financial criteria but needs to take into account non-financial criteria as well. Pursuant to Art. 94(1)(b), this performance assessment must furthermore be based on a multi-year framework to capture long-term performance in the long term. Subsequently, this performance assessment needs to be adjusted for "all types of current and future risks" pursuant to Art. 94(1)(j); this process is known as *ex*

[196] M. Manner, 'The Impact of CEO Characteristics on Corporate Social Performance', *Journal of Business Ethics*, vol. 93 supplement 1, 2010, pp. 53-72; M. Chin, D. Hambrick & L. Trevino, 'Political Ideologies of CEOs: The Influence of Executives' Values on Corporate Social Responsibility', *Administrative Science Quarterly*, vol. 58(2), 2013, pp. 197-232.

[197] Cp. A. McWilliams & D. Siegel, 'Corporate Social Responsibility: A Theory of the Firm Perspective', *Academy of Management Review*, vol. 26(1), 2001, pp. 117-27; R. Aguilera et al., 'Putting the S Back in Corporate Social Responsibility: A Multilevel Theory of Social Change in Organizations", *Academy of Management Review*, vol. 32(3), pp. 836-63.

ante risk adjustment.[198] The awarded variable compensation is thus determined by performance on different organisational levels and has been adjusted for the risks taken by the employee.

65 This *ex ante* risk adjustment process is complemented by an *ex post* process which ensures that no additional risks have materialised when deferred remuneration is vested and is covered below.[199] The measurement of performance and risks is based on quantitative and qualitative as well as absolute and relative criteria.[200] Qualitative criteria may include customer satisfaction, compliance with internal and external rules or personal characteristics like creativity, motivation and cooperation.[201] Despite their overall focus on financial risks and performance, the EBA Guidelines explicitly also encourage the use of "measures for risk alignment of remuneration where an exact quantification of the risk exposure is difficult, such as reputational […] risk."[202] Both quantitative and qualitative criteria for the assessment of risks and performance may include 'judgement'. This judgement does not amount to simple discretion, however, as a detailed procedure for judgemental approaches is set out that includes written policies, documentation and the involvement of and approval by control functions.[203] In a last step of the pay-setting process, performance criteria and risk adjustments are translated into actual remuneration awards. The set-up of a bonus pool is required to manage and control the award process of cash-based variable compensation.[204] The rules on performance measurement and *ex ante* risk assessment form a detailed prescription of the pay governance process and mandate the implementation of a strict pay-for-performance regime.

66 Several compensation instruments that are incompatible with the pay-for-performance principle are restricted in their use as variable remuneration. Art. 94(1)(d) generally prohibits all forms of guaranteed variable compensation. An exception is subsequently made under Art. 94(1)(e) for sign-on bonuses, which may be granted to new employees during their first year. Pursuant to Art. 94(1)(h), severance payments, also known as 'golden handshakes', need to adequately reflect prior performance and must not "reward failure". Art. 94(1)(i) states that also buyouts from previous contracts must be aligned with the institution's long-term interests and performance.

67 The practice of guaranteed bonuses received little to no attention until the crisis both in public and academia, which changed with the discussion on the contribution of pay practices to the crisis.[205] While short-term or mid-year hiring bonuses are unproblematic instruments to attract talent,[206] multi-year guaranteed bonuses are considered incompatible with the concept of pay-for-performance, as was already stressed in the FSB Principles.[207] This is because guaranteed bonuses shield risk-takers from the negative consequences of any losses their decisions may cause, while not limiting the benefits they receive from any gains.[208] Bebchuk et al. write that in failed banks before the crisis, "significant portions of an executive's performance-based

[198] EBA Guidelines, § 227.
[199] See *infra*, para. 76.
[200] EBA Guidelines, § 194.
[201] Ibid., § 210.
[202] Ibid., § 201.
[203] Ibid., § 195.
[204] Ibid., § 217-226.
[205] Cp. L. Bebchuk, 'Bonus Guarantees Can Fuel Risky Moves', *Wall Street Journal*, New York, 27 August 2009.
[206] Cp. Ferrarini & Ungureanu (2010), *supra* note 100.
[207] Cp. FSB Principles, p. 13.
[208] Cp. Ferrarini & Ungureanu (2011), *supra* note 37.

compensation are, in fact, salary and are expected to be paid even if performance is abysmal."[209] They were a widespread practice especially in the banking sector of the UK; where variable instruments dominated total remuneration, guarantees could be used to decrease uncertainty over payoffs for employees.[210] In sectors like investment banking, variable remuneration originated not as a form of incentive pay to achieve performance alignment, but as a way to keep labour costs more flexible in times of low profits.[211] They furthermore result from the traditional legal structure of variable compensation, which is a hybrid of superordinate discretion and contractual obligation: the case of Commerzbank, which was sued in 2009 by a group of their investment bankers for the payment of bonuses for performance targets they had met,[212] illustrates that bonus guarantees can also be the involuntary consequence of negligently designed pay schemes. Data provided by EBA show that the rule was effective in restricting the practice of guaranteed bonuses, with the number of such payments decreasing from ca. 2,000 in 2011/12 to 242 in 2013.[213]

68 Severance payments are a method for corporations to reach mutual agreement on the early termination of a contract ('golden handshake'). The EBA Guidelines restrict their amount to an "appropriate compensation" for this,[214] and entirely prohibit them if employees leave voluntarily or where "obvious failure" allows the unilateral cancellation of the employment contract.[215] These restrictions are justified by the link of severance payments to rent extraction and risk-taking incentives. Even though the empirical study of the subject has been limited in the past by the lack of available data,[216] optimal contracting theory postulates that *ex ante* contractually arranged severance payments can help to facilitate replacement[217] and prevent managerial entrenchment and misinformation.[218] On the other hand, however, it can work as an "insurance against being fired due to bad performance"[219] and increases risk-taking, as it cushions the negative financial consequences of dismissal. Empirical evidence confirms that it increases risk-taking.[220] The finding that *ex post* and discretionarily made severance payments regularly constitute a significantly larger amount than contractually pre-defined arrangements[221] further speaks against their efficiency.[222] Even though severance payments increase risk-taking and are in practice seldomly linked to actual performance, the strictness of

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[209] Bebchuk, Cohen & Spamann (2010), *supra* note 48, p. 273.
[210] Ferrarini & Ungureanu (2010), *supra* note 100.
[211] Murphy (2013), *supra* note 119.
[212] As covered in greater detail by Ferrarini & Ungureanu (2010), *supra* note 100, pp. 204-05.
[213] EBA (2016), *supra* note 170.
[214] EBA Guidelines, § 146.
[215] Ibid., §§ 147, 148.
[216] Edmans et al. (2017), *supra* note 174, p. 14.
[217] A. Almazan & J. Suarez, 'Entrenchment and Severance Pay in Optimal Governance Structures', *Journal of Finance*, vol. 58(2), 2003, pp. 519-48.
[218] R. Inderst & H. Mueller, 'CEO Replacement under Private Information', *Review of Financial Studies*, vol. 23(8), 2010, pp. 2935-69.
[219] L. Bebchuk & J. Fried, 'Executive Compensation as an Agency Problem', *Journal of Economic Perspectives*, vol. 17(3), 2003, pp. 71-92, at p. 81.
[220] N. Lu, H. Leland & L. Senbet, 'Options, Option Repricing in Managerial Compensation: Their Effects on Corporate Investment Risk', *Journal of Corporate Finance*, vol. 29(1), 2014, pp. 628-43.
[221] D. Yermack, 'Golden Handshakes: Separation Pay for Retired and Dismissed CEOs', *Journal of Accounting and Economics*, vol. 41(3), 2006, pp. 237-56; E. Goldman & P. Huang, 'Contractual vs. Actual Separation Pay following CEO Turnover', *Management Science*, vol. 61(5), 2015, pp. 1108-20.
[222] Edmans et al. (2017), *supra* note 174, pp. 66-67, 73.

their regulation can also be attributed to strong public resentment against their use during the crisis, as Ferrarini and Ungureanu argue.[223]

69 While pay-for-performance is the dominant contemporary paradigm on how to design compensation schemes,[224] the rules of CRD IV go beyond facilitating the shareholder orientation of pay governance and instead directly mandate variable compensation to be exclusively designed under the pay-for-performance principle. This includes negative financial sanctions for risks and losses, i.e. punishment for non-performance, as well as prohibitions on pay instruments that serve no incentive alignment purpose.

70 The rules on mandated pay-for-performance can be analysed regarding their effects on CSR engagement. Because they closely align managerial payoffs with long-term financial performance of the firm, they are likely to increase type-(i) instrumental CSR and decrease type-(ii) managerial rent extraction. Not considering instrument employed, e.g. cash bonuses or equity, the implementation of detailed performance targets, criteria and measurements for those instruments strengthens the focus on the implications of the individual's decisions for the firm. The prescriptions on risk adjustment explicitly include reputational risks, which can result from a lack of CSR engagement,[225] and customer satisfaction, which belongs to stakeholder management and is thus part of CSR as well.[226] They encourage the use of qualitative performance criteria that account for personal characteristics linked to better CSR performance, like compliance behaviour, creativity or cooperation.[227] Effects on type-(iii) delegated shareholder philanthropy are ambiguous. On the one hand, the rules structure the governance process—together with the prescriptions on the remuneration policy[228] under Art. 92—in a detailed and elaborate manner, and thus significantly facilitate the implementation of specific CSR performance targets, compared to a system of contractual and discretionary variable compensation. The use of CSR performance targets in compensation is an important driver of CSR engagement[229] and crucial for the steerage of CSR along the preferences of shareholders.[230] This is effect is countervailed though by the explicit prescriptions in Art. 94 on the nature of performance targets and risks with a clear focus on financial criteria. This prescription of targets, be it even just indirectly, lessens the discretion of boards to translate non-financial shareholder preferences into performance targets and corresponding remuneration incentives. Thus, while the procedural rules that require variable pay to be linked to performance targets are conducive to the imposition of non-financial shareholder preferences, the substantive rules on the nature of those performance targets focus on financial

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223 Ferrarini & Ungureanu (2010), *supra* note 100.
224 Cp. Kraakman et al. (2017), *supra* note 4, p. 36.
225 Cp. B. Husted, 'Risk Management, Real Options, and Corporate Social Responsibility', *Journal of Business Ethics*, vol. 60(2), 2005, pp. 175-83.
226 Cp. J. Harrison & R. Freeman, 'Stakeholders, Social Responsibility, and Performance: Empirical Evidence and Theoretical Perspectives', *Academy of Management Journal*, vol. 42(5), 1999, pp. 479-85.
227 Cp. Manner (2010), *supra* note 196; on the interaction of personal factors with firm-level characteristics more broadly, see McWilliams & Siegel (2001), *supra* note 197; Aguilera et al. (2007), *supra* note 197.
228 Cp. *supra*, para. 38 et seq.
229 Maas (2018), *supra* note 195.
230 Hong, Li & Minor (2016), *supra* note 189; A. Dyck et al., 'Do Institutional Investors Drive Corporate Social Responsibility? International Evidence', *Journal of Financial Economics*, vol. 131(3), 2019, pp. 693-714.

performance and risks and impede type-(iii) CSR. Exceptions in the form of qualitative performance criteria and non-financial risks however exist, as it has been shown.

71 Weak social performance is likely to decrease in response to these rules. This is mainly because the pay-for-performance requirements of Art. 94 force institutions to internalise a very broad range of risks into incentive schemes, which goes beyond direct financial risks and includes long-term consequences as well as non-financial risks like reputational, compliance or stakeholder risks. As all these risks are often the result of weak social performance, the rules strongly incentivise improvements in this regard. This effect is enforced by the strong pay-for-performance tie that lets risk-takers internalise the negative consequences of weak social performance through the *ex ante* risk adjustment. Effects on strong social performance are ambiguous. The encouraged use of qualitative performance criteria benefits strong social performance, which emanates from a more pro-active management of stakeholder interests and social compliance.[231] These forms of engagement are more closely linked to personal qualities than financial targets.[232] Overall, the rules aim at risk prevention and increasing pay-for-performance sensitivity though, which focuses the attention on the prevention of negative externalities.[233]

72 In summary, it can be said that rules on mandatory pay-for-performance in the form of performance alignment, *ex ante* risk adjustment and restrictions on the use of specific instruments, affect CSR in different ways. Instrumental CSR is increased, and managerial CSR decreased as a result of closer performance alignment. To the extent that the regulatory regimes prescribes performance targets and measurement criteria, delegated shareholder philanthropy is negatively affected. The focus on risk mitigation of the rules also decreases weak as well as strong social performance, even though the encouraged use of qualitative and non-financial performance criteria may positively affect strong social performance.

3.3.3 Structural Requirements on Variable Pay

73 This section looks at several provision under Art. 94 that address the structure of variable pay and impose specific instruments and conditions. Art. 94(1)(l) point (i) requires at least 50 percent of total variable pay to be paid in shares or share-linked instruments or—dependent on the legal structure—equivalent instruments. Originally, CRD IV only allowed non-listed institutions to employ share-linked instruments (e.g. synthetic shares or stock appreciation rights[234]) and required listed institutions to issue shares, which led to considerable administrative costs.[235] The reform of CRD IV in 2019[236] allowed also listed institutions to

[231] Cp. McGuire et al. (2003), *supra* note 73.
[232] Cp. C. Hartman & C. Beck-Dudley, 'Marketing Strategies and the Search for Virtue: A Case Analysis of the Body Shop, International', *Journal of Business Ethics*, vol. 20(3), 1999, pp. 249-63; K. Murphy, 'Performance Standards in Incentive Contracts', *Journal of Accounting & Economics*, vol. 30(3), 2000, pp. 245-78.
[233] McGuire et al. (2019), *supra* note 74.
[234] Cp. EBA Guidelines, § 252.
[235] Cp. European Commission, *Report of the Commission to the European Parliament and the Council – Assessment of the Remuneration Rules under Directive 2013/36/EU and Regulation (EU) No 575/2013*, 28 July 2016, COM(2016) 510 final.
[236] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial

employ share-linked instruments. Additionally, Art. 94(1)(l) point (ii) also allows "other instruments" in the form of additional tier 1, tier 2, non-cash debt or debt-linked instruments as set out by Artt. 52, 63 CRR to make up the 50 percent threshold, where such instruments are available. The Commission has released a Delegated Regulation setting out the regulatory technical standards (RTS) for such 'other instruments';[237] here, the focus shall be on shares and share-linked instruments of point (l)(ii). Debt-linked instruments are covered in *Section 3.4*.

74 Art. 94(1)(m) subsequently requires at least 40 percent of total variable compensation to be deferred over a period of at least four to five years (before 2019: three to five years). Both the deferred and non-deferred portion need to consist of at least 50 percent of equity and other instruments separately. For the management board and senior management of significant institutions, a minimum deferral period of five years applies. Deferral periods are intended to allow institutions to apply *ex post* risk adjustments to performance-based compensation to achieve a closer alignment of incentives with actual risks. They should be set by the institution in light of the risks undertaken by the staff member. Where the *ex ante* risk adjustment is based on multi-year accrual periods, *ex post* deferral periods may be shorter than would otherwise be appropriate (without violating the minimum requirements of four or five years respectively).[238] Where variable pay is particularly high,[239] at least 60 percent must be deferred. Vesting of deferred compensation needs to be structured on an annual *pro rata* basis.

75 Member states were allowed to issue waivers to smaller institutions regarding the application of the rules on pay-out in instruments and deferral under Art. 94(1)(l)-(m). This was justified by the principle of proportionality, because the administrative burden was regarded as unproportionate for banks whose activities have little or no effect on financial stability. EBA confirmed this legal practice in a 2016 review and called for harmonisation on a unionwide level,[240] which happened with the reform of CRD IV in 2019. Under current regulation, banks that do not meet the criteria of 'large institutions' under Art. 4(1) point (146) CRR[241] and have a balance sheet of less than EUR 5 billion are exempted from those provision. The same applies to employees in all institutions that receive less than EUR 50,000 in variable compensation.[242]

76 Art. 94(1)(n) subsequently requires institutions to undertake *ex post* risk adjustment, i.e. to evaluate whether the initial, *ex ante* risk assessment on which performance criteria were based was adequate, or whether risks have been omitted, underestimated, new risks were identified

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holding companies, remuneration, supervisory measures and powers and capital conservation measures, O.J. L 150/253.

[237] Commission Delegated Regulation (EU) No. 527/2014 of 12 March 2014 supplementing Directive (EU) No 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the classes of instruments that adequately reflect the credit quality of an institution as a going concern and are appropriate to be used for the purposes of variable remuneration, O.J. L 148/21.

[238] EBA Guidelines, § 239.

[239] National supervisory authorities have set thresholds that always qualify as particularly high amounts of variable pay, e.g. EUR 500,000 in Germany or GBP 500,000 in the UK. See Sect. 20 para. 3 sentence 2 German Remuneration Ordinance for Institutions (*Institutsvergütungsverordnung*); 19C.3.49 para. 6 UK BIPRU Remuneration Code.

[240] EBA, *Review of the Application of the Principle of Proportionality to the Remuneration Provisions in Directive 2013/36/EU*, 21 November 2016, EBA-OP-2016-20.

[241] For the purpose of this provision, these are institutions listed as 'globally' or 'other systemically important institutions, or where they belong to the three largest institutions by total asset value in the member state where they are established; see Art. 4(1) point 146(a)-(c) CRR as amended by CRR II.

[242] Art. 94(3) CRD IV as amended by Directive (EU) 2019/878.

or unexpected losses materialised.[243] Just like the *ex ante* risk assessment, the *ex post* assessment needs to account for "all types of current and future risks" pursuant to Art. 94(1)(k). Based on the *ex post* risk assessment, malus or clawback are applied where necessary. Malus refers to a reduction of deferred compensation before its vesting.[244] Clawback is a contractual provision that requires staff members to pay back variable compensation for which they have already gained ownership. Institution are required to contractually make 100 percent of variable compensation subject to either malus or clawback provisions. Clawbacks are intended for cases of significant losses caused by the employee, cases of fraud or severe negligent.[245] Clawback and malus provision are supposed to prevent 'rewarding failure'.[246] Additionally, Art. 94(1)(n) requires institutions to only award or vest variable remuneration if it is sustainable under the current financial situation.

77 The rules on the structure of variable pay instruments and on deferral, clawback and malus were a response to the contribution of remuneration to the crisis. Especially short-term, unrestricted bonuses were seen as a cause of incentives for risk-takers to focus on short-term financial targets instead of the sustainable, long-term value of the institution.[247] The empirical literature suggests that this problem was even more salient for junior employees in the trading and sales functions than senior management: data collected by UK financial authorities shows that cash bonuses made up the largest proportion of total pay and were linked to short-term accounting targets, usually net revenues of a single financial year.[248] The use of non-cash instruments instead is generally regarded as an improvement of long-term risk-alignment.[249] Even though this includes debt-based instruments, the prevalent form of non-cash pay in practice is clearly equity: with the exception of supervisory board members,[250] EBA data show that shares and share-linked instruments are the dominant form of non-cash variable remuneration.[251] This is not surprising, given that pay schemes are still designed on behalf of shareholders, whose primary interest is an alignment with firm value.[252] The use of other instruments, especially debt, to align the incentives of risk-takers with the interests of stakeholders in covered below in *Section 3.4*.

[243] EBA Guidelines, § 271.
[244] In legal terms, the "award" refers to the granting of variable remuneration without necessarily yet paying it, "vesting" means the effect by which the employee becomes the legal owner of the remuneration, see ibid., p. 9.
[245] Ibid., § 272.
[246] Cp. Bebchuk et al. (2010), *supra* note 48.
[247] Efing et al. (2015), *supra* note 51.
[248] Financial Services Authority, *Reforming Remuneration Practices in Financial Services*, Consultation Paper CP09/10, 2009.
[249] Angeli & Gitay (2015), *supra* note 80.
[250] The EBA Guidelines speak of "exceptional cases" in which supervisory board members are awarded variable compensation and require strict alignment exclusively with the assigned oversight, monitoring and control tasks. These restrictions speak against the regular use of equity compensation. See EBA GL §§ 172-73.
[251] In 2016, executive directors and management board members respectively received 57.9 percent of their variable remuneration in shares and share-linked instruments, 37.4 percent in cash and only 4.7 percent in other instruments. In other business functions, the use of other instruments was even less frequent. See EBA, *Report on Benchmarking of Remuneration Practices at the European Union Level and Data on High Earners (Data as of End 2016)*.
[252] D. De Angelis & Y. Grinstein, 'Performance Terms in CEO Compensation Contracts', *Review of Finance*, vol. 19(2), 2015, pp. 619-51; Zalewska (2016), *supra* note 21.

78 In addition to these requirements on non-cash instruments, the rules on deferral and clawback were introduced as a response to the short-term nature of variable remuneration pay-outs and the insufficient consideration of long-term risks.[253] The effect of deferral arrangements on managerial incentives is stronger for equity-based instruments than cash bonuses: while deferral of cash bonuses merely allows for *ex post* adjustments if new risks or losses materialise, share-linked instruments furthermore react to negative events by a decrease in their money value, which is linked to the financial performance of the institution via the share price. Evidence from the UK suggests that the increased use of deferral arrangements subsequent to the introduction of the legal requirement under CRD IV led to lower firm risk and was positively received by the stock markets, especially by institutional investors and pension funds.[254] This shows that the heterogeneity of investor time horizons remains an important aspect in the determinants of corporate risk profile and appetite, but also that before the introduction of deferral and clawback rules, excessive risk-taking went beyond the extent that could be explained by shareholder interests. This is consistent with empirical evidence showing that the amounts of variable compensation before the crisis were not explainable by optimal contracting theory.[255] The provision of Art. 94(1)(n) that makes the payment or vesting of variable compensation contingent upon a sustainable financial institution may reduce the adverse impact of the costs of remuneration on financial stability, but its effect is mitigated by two factors: first, the bonus cap rule of Art. 94(1)(g)(i) limits the relative amount of variable and thus reducible compensation. Secondly, this contingency of remuneration on the financial situation of the institution creates uncertainty for risk-takers, who in turn will demand a higher risk premium, which drives up both fixed and variable remuneration and thus administrative costs for the institution.

79 The rules covered in this section can be summarised as strengthening the alignment of risk-taker incentives with the long-term interests of the institution instead of short-term financial targets. This allows to adjust for risks that have *ex ante* not been recognised and to reduce variable remuneration for any losses caused. It thus imposes a rather strict regime of 'pay only for performance', which incentivises risk-takers to actively identify and mitigate further risks during the operational process than those originally captured in the remuneration scheme. Together with the provisions on *ex ante* risk-alignment (*Section 3.3.2*), they closely tie managerial payoffs to long-term performance and risks.

80 These rules have several implications for CSR engagement, first in the form of the tripartite categorisation. The alignment with long-term financial performance achieved by equity awards, deferral and clawback provisions strengthens type-(i) instrumental CSR and disincentivise type-(ii) managerial rent extraction, as decision-makers internalise much more strongly the financial consequences of their actions for the institution. Effects on type-(iii) delegated shareholder philanthropy are less clear: while especially Art. 94(1)(l)(i) aims to align managerial incentives with shareholder interests, these are purely proxied for by financial

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[253] Cp. A. Uhde, 'Risk-Taking Incentives through Excess Variable Compensation: Evidence from European Banks', *Quarterly Review of Economics and Finance*, vol. 60(1), 2016, pp. 12-28.
[254] Kleymenova & Tuna (2018), *supra* note 184.
[255] Efing et al. (2015), *supra* note 51.

performance, which precludes non-financial preferences.[256] The rules are thus likely to affect delegated shareholder philanthropy negatively.

81 It is also possible to differentiate along the effects on weak and strong social performance. Weak social performance is likely to decrease: the award of equity and other instruments lets decision-makers internalise the consequences of weak social performance more strongly. This effect is exacerbated by the long-term orientation of the pay-out process, which allows for unforeseen risks to affect payoffs, too. This especially affects non-financial risks that are more difficult to capture by risk management on accounting-based methods, e.g. reputational risks. As explained above, non-financial risks are often the consequence of weak social performance.[257] The *ex post* risk adjustment makes decision-makers more cautious about these unforeseen negative effects and incentivises them to identify and mitigate them. Effects on strong social performance are more ambiguous: as explained, a strong focus on financial targets—as achieved by equity awards just as bonuses—shifts attention from strong to weak social performance, as the material benefits of social performance are more opaque and uncertain *ex ante*.[258] While the long-term orientation of pay-outs may generally also incentivise attention towards strong social performance, the *ex post* risk-adjustment process is entirely structured along the negative dimension of unforeseen losses. It is thus no mechanism to alleviate the *ex ante* uncertainty of the payoffs of strong social performance, but instead favours the prevention of weak social performance. The overall effects on strong social performance are thus likely to be negative.

3.4 Alternative Policy Proposals: Debt

82 In the academic literature, the EU's approach to bankers' pay regulation has received substantial criticism. Some critics reject the use of pay regulation as a complement to prudential regulation at all, arguing that capital requirements and risk management regulation suffice to let shareholder-centric corporate governance internalise excessive risk-taking. Others instead merely criticise the regulatory instruments chosen as ineffective.[259] A common target in general is the 'bonus cap', which—as demonstrated above[260]—fails to achieve its desired effect. Here, attention shall be paid to alternative regulatory proposals. This accounts for the potential shortcomings of existing regulation and allows to gain additional insights on CSR incentivisation from the literature on pay regulation in the financial sector. This is done at the example of a recurrent proposal made in favour of mandated variable remuneration in debt-linked instruments.

83 As it has been elaborated above,[261] CRD IV currently allows certain forms of debt-based instrument to count as 'other instruments' pursuant to Art. 94(1)(l) point (ii). They therefore contribute to the minimum requirement on variable pay to consist of at least 50 percent of non-cash instruments. As EBA has noted, however, 'other instruments' are very rarely employed

[256] Cp. O. Hart & L. Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value', *Journal of Law, Finance, and Accounting*, vol. 2(2), 2017, pp. 247-74; Bénabou & Tirole (2010), *supra* note 90.
[257] *Supra*, para. 27.
[258] Deckop et al. (2006), *supra* note 194.
[259] On the academic discussion on the justifications for pay regulation, see *supra* para. 16.
[260] *Supra*, para. 58.
[261] *Supra*, para. 77.

with the exception of members of the supervisory board, whose payoffs are not linked to equity.[262] This is intuitive, as also Zalewska argues,[263] given the empirical evidence that corporations link remuneration targets to their own performance[264] and that shareholders are generally self-regarding when they have influence on compensation structures.[265] Correspondingly, Wei and Yermack also find that bond prices fall and share prices rise if disclosure reveals that CEOs are exposed to large amounts of inside debt.[266] Boards and shareholders have ostensibly little interest in the use of debt-based remuneration instruments.[267]

84 Nevertheless, the use of such instruments to curb the agency costs of debt[268] has already been proposed by Jensen and Meckling.[269] Several contributions have pointed out their benefits in preventing excessive risk-taking in financial institutions: unlike equity awards, whose value increases parallel to share prices, debt-based compensation is usually fixed and can at most be reduced in the future due to *ex post* risk adjustments.[270] As fixed claims, they also let managerial incentives resemble the payoffs of creditors, especially bondholders.[271] Bebchuk and Spamann argue in favour of tying variable compensation to a broader basket of equity and debt to internalise the interests of bondholders.[272] Edmans and Liu[273] specifically propose inside debt as compensation in the form of pensions to reduce excessive risk-taking; pension payments are fixed, “unsecured, unfunded obligation”[274] that are typically forgone if the institution defaults. Even though CRD IV addresses pension plans, it does so merely to ensure their inclusion in the overall remuneration system.[275] Kokkinis even argues in favour of plain long-term deferred cash bonuses instead of equity;[276] Brockman, Martin and Unlu show that also short-maturity debt can mitigate type-III agency problems.[277] Tung proposes the use of

262 See EBA, *Report on Benchmarking of Remuneration Practices at the European Union Level and Data on High Earners (Data as of End 2016)*; also see EBA Guidelines, §§ 172-73.
263 Zalewska (2016), *supra* note 21, p. 327.
264 De Angelis & Grinstein (2015), *supra* note 252.
265 V. Cuñat, M. Giné & M. Guadalupe, ‘Say Pays! Shareholder Voice and Firm Performance’, *Review of Finance*, vol. 20(5), 2016, pp. 1799-1834; K. Stathopoulos & G. Voulgaris, ‘The Importance of Shareholder Activism: The Case for Say-on-Pay’, *Corporate Governance: An International Review*, vol. 24(3), 2016, pp. 359-70; P. Iliev & S. Vitanova, ‘The Effect of the Say-on-Pay Vote in the United States’, *Management Science*, vol. 65(10), 2019, pp. 4505-21.
266 C. Wei & D. Yermack, ‘Investor Reactions to CEOs’ Inside Debt Incentives’, *Review of Financial Studies*, vol. 24(11), 2011, pp. 3813-40.
267 Bolton et al. (2015), *supra* note 25.
268 Cp. Mello & Parsons (1992), *supra* note 22; J. Brander & M. Poitevin, ‘Managerial Compensation and the Agency Cost of Debt Finance’, *Managerial and Decision Economics*, vol. 13(1), 1992, pp. 55-64.
269 Jensen & Meckling (1976), *supra* note 1.
270 Cp. Angeli & Gitay (2015), *supra* note 80, p. 324.
271 Ibid.
272 Bebchuk & Spamann (2010), *supra* note 24.
273 A. Edmans & Q. Liu, ‘Inside Debt’, *Review of Finance*, vol. 15(1), 2011, pp. 75-102.
274 Ibid., p. 76.
275 Pursuant to Art. 94(1)(o), pension plans need to be aligned with the overall strategy and long-term interests of the institutions, further restrictions on pay-out and instruments apply if the employee terminates the contract early. For an overview of the role of pensions in executive compensation, cp. L. Bebchuk & R. Jackson, ‘Executive Pensions’, *Journal of Corporation Law*, vol. 30(4), 2005, pp. 823-55.
276 Kokkinis (2019), *supra* note 167.
277 P. Brockman, X. Martin & E. Unlu, ‘Executive Compensation and the Maturity Structure of Corporate Debt’, *Journal of Finance*, vol. 65(3), 2010, pp. 1123-61.

publicly traded subordinated debt to make use of market mechanisms;[278] Bolton, Mehran and Shapiro similarly argue in favour of tying compensation to credit default swaps (CDS) spread.[279] Thanassoulis and Tanaka argue that pay-out in debt alone is insufficient to curb excessive risk-taking in a too-big-to-fail scenario and further propose linking compensation to debt interest rates together with deferral and clawback provisions.[280] The empirical literature supports the use of debt-based instruments to lower risk-taking and decrease creditor externalities.[281] It is noteworthy, however, that debt-based remuneration can be difficult and costly to implement and lacks transparency,[282] which is why it is also linked to the issue of managerial rent extraction.[283] Alces and Galle provide further critique by arguing that behavioural reasons bare decision-makers from fully responding to the incentives of debt-based pay.[284]

85 The common thread of the different proposals, be they remuneration in debt instruments or tying payoffs to debt-related market indicators and values, is that they seek to either directly align managerial incentives with the interests of creditors or let them face similar payoffs. This way, excessive risk-taking resulting from too short-sighted pay structures or shareholder interests can be reduced. While the academic literature makes a strong case for debt-based remuneration, regulators have so far mostly refrained from imposing mandatory pay structure requirements in this direction.[285]

86 Both theory and evidence support the efficacy of debt-based compensation. This is especially relevant for CSR, as creditors, whose interests are the focus of this approach, are the main stakeholders of banks. More abstractly, debt-based remuneration can be understood as an approach to tie managerial incentives to the payoffs of stakeholders who are negatively affected by corporate externalities. The case of mandatory remuneration in debt-based instruments is difficult to analyse from the perspective of CSR taken in this thesis, however: as it has been elaborated in *Section 2.1*, the role of creditors in the financial sector is unparalleled in other industries.[286] The tripartite categorisation developed in *Chapter Two* is explicitly based on shareholder primacy and the agency relationship between managers and owners that is the most relevant one in the generic corporation.[287] An increase in CSR as a consequence of legally

[278] F. Tung, 'Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation', *Northwestern University Law Review*, vol. 105(3), 2011, pp. 1205-52.
[279] Bolton et al. (2015), *supra* note 25.
[280] Thanassoulis & Tanaka (2018), *supra* note 167.
[281] Cp. R. Sundaram & D. Yermack, 'Pay Me Later: Inside Debt and Its Role in Managerial Compensation', *Journal of Finance*, vol. 62(4), 2007, pp. 1551-88; D. Anantharaman, V. Fang & G. Gong, 'Inside Debt and the Design of Corporate Debt Contracts', *Management Science*, vol 60(5), 2014, pp. 1260-80; F. Tung & X. Wang, 'Bank CEOs, Inside Debt Compensation, and the Global Financial Crisis', *Boston University School of Law Working Paper*, No. 11-49, 2012;
[282] Angeli & Gitay (2015), *supra* note 80.
[283] Bebchuk & Fried (2003), *supra* note 219; Bebchuk & Jackson (2005), *supra* note 275.
[284] K. Alces & B. Galle, 'The False Promise of Risk-Reducing Incentive Pay: Evidence from Executive Pensions and Deferred Compensation', *Journal of Corporation Law*, vol. 38(1), 2012, pp. 53-100.
[285] EBA explicitly states that the provisions of Art. 94(1)(l) on the use of non-cash instruments "should provide incentives for staff to act in the long-term interest of the institution." See EBA, *Final Draft Regulatory Technical Standards on classes of instruments that are appropriate to be used for the purposes of variable remuneration under Article 94(2) of Directive 2013/36/EU*, 19 February 2014, EBA/RTS/2014/2.
[286] *Supra*, para 8 et seq.
[287] Cp. *Chapter Two*, at p. 45.

mandated compensation in debt is neither instrumental to increasing financial performance,[288] nor in the interest of shareholders, nor to the private benefit of managers. It may thus be argued that from a dogmatic perspective, directly tying managerial compensation to the payoffs of stakeholders is a form of CSR mandated and not incentivised by law,[289] or even no CSR at all.[290] As explained in *Chapter Two*,[291] pay regulation is primarily understood as a legal incentive for CSR engagement. Several practical questions nevertheless arise for the subsequent analysis from this inquiry.

87 First, is it possible for the law to incentivise or at least facilitate the use of such instruments? Even though Art. 94(1)(l) point (ii) explicitly legalises debt-based remuneration, financial institutions mostly rely on the use of equity. Other legal options than mandating their integration into pay structure may be preferable, as governance prescriptions lead to fewer distortions than pay structure regulation.[292] The incentivisation of the use of debt-based instruments is also preferable from the perspective of CSR as self-regulation. Secondly, for which other types of stakeholders apart from creditors is such an approach viable? Debt is a basic form of financial capital and the contracting and information costs of integrating it into compensation schemes are low. This is demonstrated by the fact that even deferred cash bonuses can yield an alignment effect.[293] Debt thus is a straightforward method to tie managerial incentives to the material interests of certain stakeholders; comparable compensation schemes connected to the interests of other classes of stakeholders may be significantly more difficult to design. Thirdly, in which governance environments is such an approach viable? Banks, as multi-constituency organisations,[294] form an exception to the rule of shareholder primacy. Both the importance of the type-III agency conflict relative to the type-I conflict and the gravity of externalities justify this choice for pay structure regulation in the first place. The identification of potentially similar economic environments outside the financial sector to which such rules may be applied depends on a thorough understanding of the conditions under which these rules work there. The following section already elucidates several aspects of an answer to these questions, a final response however is given in the subsequent two chapters of the thesis.

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[288] Wei & Yermack (2011), *supra* note 266.
[289] On the classification of law-CSR relationship types, see *Chapter Two*, at p. 28; McBarnet (2009), *supra* note 70; Gond, Kang & Moon (2011), *supra* note 60.
[290] The concept of 'voluntariness' has been criticised as a central definitional characteristic of CSR but remains relevant in the adopted definition of CSR as private self-regulation, referring to the voluntary internalisation of externalities here. Based on the institutional CSR literature, this 'voluntariness' has been translated into the tripartite categorisation by basing it upon the decision-making authority of shareholders as owners and its delegation to corporate management in order to distinguish CSR from externally imposed regulation. On the notion of voluntariness, cp. *Chapter Two*, at p. 18; furthermore Brammer et al. (2012), *supra* note 58; Sheehy (2015), *supra* note 5. On the relevance of shareholders and delegated management, see Kraakman et al. (2017), *supra* note 4, pp. 11-15, 50 et seq.
[291] Cp. *Chapter Two*, at p. 23.
[292] Ferrarini & Ungureanu (2018), *supra* note 3.
[293] Cp. Kokkinis (2019), *supra* note 167.
[294] Becht et al. (2011), *supra* note 19.

3.5 Summary

88 The comparison of governance prescriptions under SRD and CRD IV/CRR in *Section 3.2* has shown that while the rules are remarkably similar, rules on the pay governance process and disclosure in the financial sector are adjusted to the peculiarities of the industry and to contribute to the objectives of pay structure regulation. Examples for this are the broader application of the remuneration policy not only to the management board and senior management as in SRD, but to all 'identified staff', which includes material risk-takers also in lower ranks of staff. The rules furthermore focus more on the prevention of excessive risk-taking; the requirement for independent directors in remuneration committee emphasises their role as controllers of the pay-setting process, not as advisors or stakeholder networkers.[295] Also, disclosure requirements under CRR focus significantly more on quantitative than qualitative disclosure, shifting attention away from the governance process towards compliance with regulation on the substance of remuneration schemes.[296] Notwithstanding the broader context of general governance regulation under CRD IV, rules on pay governance are designed to prevent excessive risk-taking and are integrated with the rules on pay structure as the regulatory core element.

89 This focus on preventing excessive risk-taking also runs as a red thread through the pay structure regime of CRD IV. It has been shown that the direct regulation of relative pay levels (indirectly affecting also absolute pay levels) at the example of the 'bonus cap' of Art. 94(1)(g) is a failed approach to decrease excessive risk-taking. Instead, it incentivises taking fewer risks with upside components and more risks with downside components.[297] Pay levels are thus no viable object of regulation, neither under general efficiency nor CSR considerations. Moreover, this finding is an argument against the *ex post* CSR view of executive pay, which treats executive compensation itself as a social concern and calls for its regulation along social and stakeholder expectations.[298] The *ex ante* view adopted in this thesis,[299] treating compensation 'merely' as an incentive for CSR engagement, can be harmonised with efficiency considerations in the compensation literature.

90 A mandatory pay-for-performance regime, as analysed in *Section 3.3.2*,[300] can increase instrumental CSR, depending on the prevalence of the 'business case', and decrease managerial CSR. The latter does not only depend on managers internalising the effects of CSR that negatively affects financial performance, but also the degree to which the rules on performance measurement and evaluation criteria curbs managerial discretion. Effects on delegated shareholder philanthropy depend on the regulatory details: while improvements of the governance process of setting pay-for-performance can increase it, the prescription of performance targets and measurements have a contrary effect. Mandatory pay-for-performance especially serves to reduce weak social performance; while pay-performance sensitivity generally decreases attention paid to strong social performance, the use of broader non-financial and qualitative metrics may also positively affect it. Prohibitions on the use of specific variable pay instruments that are incompatible with pay-for-performance, e.g. guaranteed

[295] Cp. C. Mallin, G. Michelon & D. Raggi, 'Monitoring Intensity and Stakeholders' Orientation: How Does Governance Affect Social and Environmental Disclosure?', *Journal of Business Ethics*, vol. 114(1), 2013, pp. 29-43; Kraakman et al. (2017), *supra* note 4, pp. 62-67.
[296] Cp. Armour et al. (2016), *supra* note 34, p. 384.
[297] Murphy (2013), *supra* note 119.
[298] Cp. *Chapter Three*, at p. 69.
[299] Cp. *Chapter One*, at p. 6.
[300] *Supra*, para. 63 et seq.

bonuses, strengthen overall pay-performance sensitivity, even though their primary objective is to prevent ‘pay for non-performance’ and thus managerial rent extraction.

91 Legally mandated risk adjustments can serve as a powerful instrument to make institutions more aware of potential negative externalities. The degree to which these externalities are internalised depends on their treatment in corporate risk management, which is covered below.[301] While *ex ante* risk adjustments are part of the pay-setting and award process and connected to the rules on performance targets and measurement, *ex post* risk adjustments depend on the structure of variable pay as well as deferral and clawback provisions.

92 The requirements on the structure of variable pay that limit the use of cash-based instruments entail a greater sensitivity to long-term financial performance, which affects instrumental CSR positively and CSR as managerial extraction negatively. This sensitivity to financial performance also decreases both weak and strong social performance. The use of non-equity instruments, which would lead to a stronger internalisation of stakeholder interests, finds no voluntary support among boards or shareholders. Notwithstanding the effects of any performance targets, a closer alignment of variable pay with corporate financial performance makes it more difficult for managers to respond to the non-financial preferences of shareholders. The rules on deferral, clawback, malus and retention lead to a more long-term orientation of pay. This increases instrumental CSR and decreases CSR as managerial rent extraction. It also decreases weak social performance; effects on strong social performance are ambiguous.

93 Alternative policy proposals in the form of debt-based variable remuneration make use of the extensive literature that has emerged on the role of remuneration in the financial sector and as a response to existing regulation. Debt-based instruments are an effective way to tie managerial incentives to the interests of creditors as the primary stakeholders of banks. From the perspective of CSR, the two questions arise of how the interests of other stakeholders could be translated into remuneration instruments, and how the law could facilitate or incentivise their use, where it serves the internalisation of externalities.

94 Contemporary pay regulation in the financial sector has several implications for CSR engagement. It shows that the regulation of pay levels has detrimental effects on CSR and should not be pursued. Using mandatory rules to strengthen pay-for-performance sensitivities can be a way of driving instrumental CSR and preventing weak social performance, this depends especially on the time horizon of performance targets. There is scope in the regulatory design to allow room for the imposition of non-financial shareholder preferences. Risk adjustments of performance-based compensation can further reinforce this orientation, even though they heavily shift attention to the avoidance of weak social performance to the detriment of strong social performance. Deferral, clawback and retention provisions have similar effects via a more long-term orientation, even though the negative effects on strong social performance are less severe. Where externalities are the result of badly designed, short-term pay schemes, interventions in the structure of pay by mandating the use of non-cash instruments can contribute to the prevention of negative externalities. In the same vein, the use of instruments tied to stakeholder interests requires further attention. Overall, the rules analysed in this chapter have a clear and strong focus on the avoidance of negative externalities, i.e. weak social performance. This is to the detriment of incentives that may encourage strong social performance, as well as the imposition of delegated shareholder philanthropy. As the agency

[301] *Infra*, para. 104.

conflict between shareholders and stakeholders contributes to these externalities, any empowerment of shareholders proves problematic in this context.[302]

Section 4: The Peculiar Conditions of Banking

95 The summary of the results in the previous section explains how different elements of pay regulation in the financial sector affect CSR engagement, differentiated along the tripartite categorisation of CSR activities, and the two dimensions of weak and strong social performance. The "exceptionalism"[303] of bank governance however prohibits any naïve generalisation of the results reached on the incentives of pay structure regulation for CSR engagement. Instead, it is necessary to account for the idiosyncrasies that make the financial sector exceptional and the conditions to which post-crisis pay regulation is tailored. This section thus pays attention to the most important aspects that formed the implicit assumptions of the preceding analysis. Focus is laid on the role of capital and ownership structure (*Section 4.1*), the regulatory environment (*Section 4.2*), the role of stakeholders (*Section 4.3*) and the nature of externalities (*Section 4.4*).

4.1 Capital and Ownership Structure

96 As explained in *Section 2.1*,[304] the capital structure of banks, specifically the financial leverage ratio between equity and debt, is a causal factor of shareholder interests in excessive risk-taking and negative externalities. In this section, the role of the capital structure as well as the effects of different forms of ownership on externalities and CSR receive more attention.

97 Because it is the very essence of the banking business to accept money from depositors and operate with that capital in lending it to borrowers, a high leverage ratio between equity and debt is inherent to financial institutions.[305] It has already been acknowledged by Jensen and Meckling that high leverage incentivises owners to engage in activities that promise high payoffs at low probabilities of success and to stop internalising potential losses when they exceed the owner's stake in the corporation.[306] This does not only entail more risky business strategies in general, but also more specific problems like underinvestment, i.e. the omission of profitable investments when the benefits are primarily reaped by creditors.[307] Another form of excessive risk-taking that particularly affects creditors is asset substitution, i.e. *ex post* risk shifting after a debt contract has been negotiated.[308] The role of creditors as stakeholders and

[302] In the words of Kraakman et al., to "mitigate […] the non-shareholder agency problems, a governance regime must necessarily constrain the power of the shareholder majority […].", see Kraakman et al. (2017), *supra* note 4, at p. 79.
[303] Armour et al. (2016), *supra* note 34, at p. 371.
[304] *Supra*, para. 8 et seq.
[305] Cp. Armour et al. (2016), *supra* note 34, at pp. 275-89.
[306] Jensen & Meckling (1976), *supra* note 1, at pp. 334 et seq.
[307] Kraakman et al. (2017), *supra* note 4, at p. 111.
[308] Mülbert (2009), *supra* note 7, at pp. 423-25.

the business characteristics of banking that facilitate asset substitution are covered below in *Sections 4.3* and *4.4* respectively.[309]

98 While every problem of negative externalities can be attributed to a lack of cost internalisation, the type of externalities covered here is caused by a limited financial involvement of owners. This relates to the more general issues of asset partitioning and limited liability: the owners of every corporation only bear losses up to their financial involvement, and the law regularly bars creditors from accessing the private property of shareholders.[310] A high financial leverage merely exacerbates this problem. Theoretically, the degree of shareholders' financial involvement in a company can thus also be an incentive for excessive risk-taking in other industries that entail large risks, like the energy or oil sectors that run large environmental risks.[311] The more shareholders are shielded from bearing the full losses of risks once they materialise, the more a regime of pay regulation that aims to disincentivise excessive risk-taking needs to restrict the role of shareholders in the pay-setting process. This does not only lead to a trade-off between remedies to the type-I or type-III agency conflict,[312] but also affects the CSR profile, as delegated shareholder philanthropy depends on shareholder empowerment.

99 Next to structure of capital, the nature of shareholders has implications for risk-taking and CSR as well. Erkens, Hung and Matos find evidence indicating that institutional owners were significant drivers of risk-taking before the crisis.[313] Institutional shareholders typically are activist shareholders and create pressure to increase financial performance.[314] It thus can be said that institutional shareholders can exacerbate the risk-taking problem, as they impose their interests more strongly.[315] This view is further reinforced by evidence that shareholder insulation led to better financial performance during the crisis.[316] The government as a shareholder has been found to lower default risk, but to increase operating risk, which is explained by the effect of governmental protection.[317] Other financial institutions as shareholders instead decrease credit and default risk, as they are directly affected by the externalities.[318] Even though the interconnectivity of financial institutions is strongly influenced by crossholding, it also entails a less severe shareholder interest in excessive risk-taking.

100 Next to crossholding, the patterns of ownership dispersion and portfolio diversification affect risk-taking. The more dispersed ownership of a financial institution is, the smaller is each

[309] *Infra*, para. 106-08, 109-10.
[310] Cp. Kraakman et al. (2017), *supra* note 4, p. 110.
[311] On the role of executive compensation in polluting industries, cp. Berrone & Gomez-Mejia (2009), *supra* note 190.
[312] Kraakman et al. (2017), *supra* note 4, at p. 79.
[313] D. Erkens, M. Hung & P. Matos, 'Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide', *Journal of Corporate Finance*, vol. 18(2), 2012, pp. 389-411.
[314] Cp. E. Rock, 'Institutional Investors in Corporate Governance', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[315] As proposed by Kokkinis (2019), *supra* note 167.
[316] D. Ferreira et al., 'Measuring Management Insulation from Shareholder Pressure', *ECGI Working Paper Series in Finance*, Working Paper No. 345/2013, 2013.
[317] G. Iannotta, G. Nocera & A. Sironi, 'The Impact of Government Ownership on Bank Risk', *Journal of Financial Intermediation*, vol. 22(2), 2013, pp. 152-76.
[318] T. Barry, L. Lepetit & A. Tarazi, 'Ownership Structure and Risk in Publicly Held and Privately Owned Banks', *Journal of Banking and Finance*, vol. 35(5), 2011, pp. 1327-40.

shareholder's financial stake in it. The risks borne by every owner are thus smaller, and dispersed shareholders have a stronger interest in excessive risk-taking contrary to blockholders, who hold a large stake.[319] This effect however conflicts with portfolio diversification: ownership in banks is typically not dispersed because shareholders are small retail investors, but because they hold a diversified portfolio: this diversification, in turn, means that shareholders also hold investments in other corporations that would be affected by any negative externalities, they therefore internalise risks to a greater extent.[320] Views whether the effects of dispersion or diversification dominate the effects on excessive risk-taking diverge.

101 The interests of shareholders in excessive risk-taking—in the different forms just elaborated—are the reason why the shareholder value orientation of corporate governance is far less present in finance. Where such ownership and business conditions prevail, executive pay regulation may contribute to the internalisation of risks and limit the imposition of shareholder preferences. This, however, creates a conflict with CSR: as shown in *Chapter Three*,[321] shareholder engagement can be harnessed as an important driver of CSR activities.[322] Thus, whether shareholder empowerment or restriction leads to more private self-regulation is a question that cannot be answered *per se* and requires further attention in the following chapters. An answer to this has crucial implications for the design of pay regulation, which can employ different instruments to pursue the one target or the other.

4.2 Regulatory Environment

102 Bebchuk and Spamann put forward that pay regulation in the financial sector can "complement and perhaps partially substitute for the traditional prudential regulation."[323] Due to the enormous complexity of the business of financial institution as well as the limited capacities and information of regulatory authorities, imperfections in financial regulation arise. These imperfections can be remedied by focusing regulation not on the business activities themselves, but the incentives to engage in them. Notably, the concept of CSR as self-regulation complementing and substituting for public regulation has already been put forward in *Chapter Two*,[324] where the example of human rights enforcement in multi-national enterprises and their supply chains is given.[325] Here, attention is paid to the specific forms of traditional regulation: capital requirements and risk management regulation. Liquidity requirements, which aim to

[319] Mülbert (2009), *supra* note 7.
[320] Armour & Gordon (2014), *supra* note 33; Armour et al. (2016), *supra* note 34, pp. 388-89.
[321] *Chapter Three*, at p. 104.
[322] Cp. L. Dam & B. Scholtens, 'Does Ownership Type Matter for Corporate Social Responsibility?', *Corporate Governance: An International Review*, vol. 20(3), 2012, pp. 233-52.
[323] Bebchuk & Spamann (2010), *supra* note 24.
[324] *Chapter Two*, at p. 23.
[325] Cp. R. Bismuth, 'Mapping a Responsibility of Corporations for Violations of International Humanitarian Law Sailing between International and Domestic Legal Orders', *Denver Journal of International Law and Policy*, vol. 38(2), 2010, pp. 203-26; A. Scherer & G. Palazzo, 'The New Political Role of Business in a Globalized World: a Review of a New Perspective on CSR and Its Implications for the Firm, Governance, and Democracy', *Journal of Management Studies*, vol. 48(4), 2011, pp. 899-931.

minimise the risks resulting from the unexpected withdrawal of short-term deposits, are not further discussed here.[326]

103 Capital requirements are the regulatory response to the problem that risky business decisions can lead to bank failure and harm the financial system and the economy, because banks hold too little equity to absorb realised losses. "The higher the level of the bank's capital […], the less the risk of balance sheet insolvency, because any losses the bank incurs on its assets will first fall on the shareholders."[327] The current system of rules on capital requirements is an elaborate system under the framework of Basel III, whose main elements are a risk-weighted asset basis and rules of different types of capital that can serve to fulfil any resulting minimum requirements. Additional requirements exist for 'systemically important institutions', which shows that capital requirements are a strategy to protect the stability of the financial system, not the survival of single institutions. Capital requirements however hinder banks in their business, because they impede their function of freely accepting deposits and lending to others. While pay regulation can decrease the need for strict prudential regulation, the same holds true vice versa. Any strategy to employ pay regulation to encourage the internalisation of negative externalities thus needs to be coordinated with other fields of law that have the same objective.

104 Risk management regulation also aims to prevent excessive risk-taking, but beyond that it directly influences the link between pay regulation and CSR. The task of the risk management function is to ensure the consistency of financial risks with overall corporate objectives by assessing and evaluating risks and providing an overview to senior management.[328] Failures in risk management have contributed to the crisis,[329] while in turn banks with strong and independent risk management functions were much less negatively affected by it.[330] The problems of risk management are the complexity of its tasks, including the integration of different types of risks, and the alignment of risk management with compensation schemes that provide strong incentives to maximise financial returns.[331] Consequently, risk management regulation under CRD IV imposes both procedural requirements, e.g. the independence of the risk management and control functions or the remuneration of control functions, and substantive regulation. The latter has specified by national authorities; taking Germany as an example, the German Financial Services Authority has published detailed guidelines on the identification, assessment and evaluation of counterparty and credit risks, market price risks, liquidity risks, and operational risks.[332] Risk management regulation thus helps to ensure that risks are adequately captured and integrated into the internal business decision-making processes. Beyond that, substantive risk management regulation heavily shapes variable remuneration in the financial sector by providing the basis for the *ex post* and *ex ante* risk adjustment of performance-based compensation under Art. 94. Regulators thus have an

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326 For an overview, see Armour et al. (2016), *supra* note 34, pp. 316-39.
327 Ibid., p. 290.
328 Cp. A. Santomero, 'Commercial Bank Risk Management: An Analysis of the Process', *Journal of Financial Services Research*, vol. 12(2), 1997, pp. 83-115.
329 Murphy (2011), *supra* note 147.
330 A. Ellul & V. Yarramilli, 'Stronger Risk Controls, Lower Risk: Evidence from US Bank Holding Companies', *Journal of Finance*, vol. 68(5), 2013, pp. 1757-1803.
331 Cp. Armour et al. (2016), *supra* note 34, p. 377-79.
332 German Financial Services Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*), Minimum Requirements for Risk Management (*Mindestanforderungen an das Risikomanagement*), circular 09/2017, 27 October 2017, English translation available at https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2018/meldung_181015_veroeffentlichung_marisk_englisch_en.html.

effective instrument at hand to shape the risk perception of corporations and draw their attention towards specific risks.

105 This is why the endeavour of European legislators to integrate ESG criteria into risk management regulation is important for the effects of pay regulation on CSR: the EC stated that "[i]ncluding environmental and social goals in financial decision-making aims to limit the financial impact of environmental and social risks",[333] and aimed to integrate "climate and other environmental factors in prudential regulation"[334] in the course of the 'Sustainable Finance' package. As explained in *Chapter Two*,[335] several legislative proposals have been developed to create a uniform taxonomy and benchmarking system of environmental risks for financial institutions to consider in their decision-making. This shows that a mandatory pay-for-performance regime that links performance-based compensation to *ex ante* and *ex post* risk adjustments can be actively steered in the direction of CSR-related externalities by complementary regulation.

4.3 Stakeholders

106 Another issue is the nature of the relevant stakeholders or external corporate constituencies. In the case of banks, the relevant group is contractually affiliated creditors, who bear the consequences of excessive risk-taking. Creditors are a peculiar constituency though: if a company defaults, creditors functionally become its owners.[336] The legal field of insolvency law generally deals with the rights of creditors in that situation and is not further discussed here.

107 A distinction is to be made between 'adjusting' and 'non-adjusting' creditors: adjusting creditor are able to alter their terms of affiliation with an entity in response to any changes in the risks they bear.[337] Non-adjusting creditors are unable, or only imperfectly able to do so. An important group of non-adjusting creditors are victims of corporate torts:[338] due to the involuntary nature of affiliation, tort victims are unable to react to excessive risk-taking. In tort law, the 'judgment proof' problem is well established, i.e. the inability of tortfeasors to compensate victims, because damage exceed their assets.[339] While creditors of banks can at least partially react to asset substitution and *ex post* risk shifting, other stakeholders may be less able to react to corporate externalities. These adjustments can be unilateral or may happen in the form of

[333] European Commission, *Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions – Action Plan: Financing Sustainable Growth*, Brussels, 8 March 2018, COM(2018) 97 final, p. 3.
[334] Ibid., p. 9.
[335] *Chapter Two*, at p. 30.
[336] Cp. P. Bolton, 'Corporate Finance, Incomplete Contracts, and Corporate Control', *Journal of Law, Economics & Organization*, vol. 30(1), 2014, pp. 64-81.
[337] The concept goes back to L. Bebchuk & J. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy', *Yale Law Journal*, vol. 105(4), 1996, pp. 857-934.
[338] Cp. Kraakman et al. (2017), *supra* note 4, pp. 115-16.
[339] Cp. S. Shavell, 'The Judgment Proof Problem', *International Review of Law and Economics*, vol. 6(1), 1986, pp. 45-58; S. Shavell, *Economic Analysis of Accident Law*, Harvard, Harvard University Press, 1987.

Coasean bargaining.[340] Pay regulation that aims to curb excessive risk-taking in other settings must therefore account for the nature of stakeholders, their ability to respond to risk exposure and the factors that determine the possibility of Coasean solutions to externality problems.

108 A second issue of stakeholder relations is the environment for relational contracts. These are "informal agreements sustained by the value of future relationships"[341] and essentially depend on trust and credibility to fill the contractual gaps of long-term interaction.[342] Zalewska has conjectured that due to the complex interconnectivity of actors in the financial industry, relationships are regularly disrupted by the actions of others and relational contracts thus disincentivised, favouring short-term gains over long-term cooperation.[343] Relational contracts are closely linked to stakeholder theory, which stipulates the active engagement with corporate constituencies and can be a strategy of long-term value maximisation.[344] Remuneration rules that reduce externalities arising from excessive risk-taking and impose a more long-term orientation on managers may thus have an additional effect on CSR engagement: by facilitating the sustainment of relational contracts, they enhance the potential for stakeholder management as a dimension of CSR. As relational contracting refers to cooperation and the reciprocal provision of benefits, this increases especially strong social performance, which has been defined as the provision of positive externalities and the "preservation of gains".[345]

4.4 Business Characteristics and Externalities

109 It is mentioned in *Section 2.1* that the complexity and opacity of the financial sector increase the costs of external and internal monitoring, agency problems are more severe and the problem of excessive risk-taking exacerbated.[346] The complexity and opacity are rooted in the nature of the business of financial institutions: banks function as informational intermediaries, as they specialise in the evaluation of risks in which they invest their deposits. This intermediary position and specialisation inherently create information asymmetries particularly between creditors and the institution and consequently facilitate the misuse of deposits.[347] Moral hazard in the form of excessive risk-taking because of *ex post* information asymmetries is a ubiquitous economic problem, however.[348] The problem of information asymmetries is thus encountered in virtually all areas of law, including corporate law with a specific focus on the protection of creditors.[349] Where despite legal intervention significant information asymmetries prevail—owed to the opacity and complexity of the specific business—rules on remuneration become

340 Cp. R. Coase, 'The Problem of Social Cost', *Journal of Law and Economics*, vol. 3(1), 1960, pp. 1-44.
341 G. Baker, R. Gibbons & K. Murphy, 'Relational Contracts and the Theory of the Firm', *The Quarterly Journal of Economics*, vol. 117(1), 2002, pp. 39-84, at p. 39.
342 R. Gibbons & R. Henderson, 'Relational Contracts and Organizational Capabilities', *Organization Science*, vol. 23(5), 2012, pp. 1350-64.
343 Zalewska (2016), *supra* note 21.
344 M. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function', *Business Ethics Quarterly*, vol. 12(2), 2002, pp. 235-56.
345 McGuire et al. (2003), *supra* note 73.
346 *Supra*, para. 13.
347 Cp. Armour et al. (2016), *supra* note 34, p. 276.
348 Cp. J. Stiglitz, 'The Contributions of the Economics of Information to Twentieth Century Economics', *Quarterly Journal of Economics*, vol. 115(4), 2000, pp. 1441-78.
349 S. Sepe, 'Directors' Duty to Creditors and the Debt Contract', *Journal of Business & Technology Law*, vol. 1(2), 2007, pp. 553-606; Kraakman et al. (2017), *supra* note 4, pp. 119 et seq.

more important as a complement to the costly regulation of business activities themselves. A central determinant of the viability of pay regulation to address the externality problem is thus not the severity of the externality, but the relative cost of direct regulation. This cost in turn depends on the complexity and opacity of the underlying business activity that remain despite general legal remedies.

110 The quality of externalities is an additional important characteristic. It is shown in *Section 2.3* that the financial sector provides both positive externalities and causes negative externalities;[350] the elements of pay regulation analysed in this chapter however focus entirely on the avoidance of negative externalities. As demonstrated, they affect negative and strong social performance very differently; this is because performance-sensitivity of pay and risk adjustments affect negative social performance more strongly,[351] while strong social performance is rather the result of non-financial personal incentives[352] and deliberate CSR performance targets.[353] Pay regulation thus needs to be precisely designed to the externalities that are prevalent in an industry.

Section 5: Conclusion

111 In the introduction to this chapter,[354] Mülbert is quoted hypothesising that "good corporate governance of banks" could show "the way forward for good corporate governance in general."[355] Banking however is a special industry because of the peculiarities of its business, regulatory and governance conditions. Therefore, Mülbert eventually concludes that "one may greatly doubt whether banks' corporate governance should indeed map the way forward for corporate governance in general. In particular, this holds true for the way forward to regulating bankers' pay."[356] It is virtually self-evident that any careless transplantation of governance rules from banks to other corporations is as counterproductive as the omission of these peculiarities has been in the design of bank governance regulation prior to the crisis.[357] This chapter thus aims to abstract insights from the use pay regulation to internalise externalities towards incentives for CSR as private self-regulation while accounting for the peculiar conditions of the financial sector. What lessons may be drawn from this approach?

112 The regulation of pay levels is no viable approach, as it potentially has even detrimental effects on CSR engagement. Enforcing pay-for-performance through the prescription of performance targets and measurement criteria as well as the establishment of a risk adjustment process can align CSR engagement with financial performance and encourage especially the reduction of

[350] *Supra*, para 23-25.
[351] Cp. McGuire et al. (2019), *supra* note 74.
[352] Bénabou & Tirole (2006), *supra* note 96.
[353] Maas (2018), *supra* note 195.
[354] *Supra*, para. 3.
[355] Mülbert (2009), *supra* note 7, p. 413.
[356] Ibid., p. 436.
[357] "In the period leading up to the financial crisis, the peculiarities of banks' balance sheets, their regulation, and the externalities they can create were thought not to necessitate any difference in the structure of bank governance from that of nonfinancial firms.", Armour et al. (2016), *supra* note 34, at p. 371.

weak social performance. Imposing requirements on the composition of variable pay can have positive effects on long-term orientation thus promote performance-related CSR, it also allows to tie managerial payoffs to the interests of stakeholders. However, delegated shareholder philanthropy is discouraged by too pervasive interventions into the pay-setting process, as they reduce the capability of boards and shareholders to impose specific non-financial preferences onto performance targets.

113 The role of shareholders is particularly ambiguous in the example of the financial sector: in *Chapter Three*, the conclusion is reached that shareholders can be a driver of CSR and their empowerment in the pay-setting process a form of governance regulation that can promote CSR engagement.[358] Where shareholders have a persistent interest in excessive risk-taking however, shareholder empowerment may be detrimental to social performance. The use of either governance prescriptions or pay structure regulation thus significantly depends on the capital structure and the role of shareholders.

114 Furthermore, pay regulation is not an isolated mechanism to incentivise the internalisation of externalities, but needs to be seen in the context of direct regulation. As both forms of regulation are complements, pay regulation—if employed—needs to be designed in balance with the marginal effectiveness of direct regulation. The role of stakeholders, particularly those affected by the externalities, and their ability to adjust their affiliation with the corporation needs to be considered as well. Lastly, the nature of the externalities, i.e. whether the avoidance of negative or provision of positive externalities is the more prevalent objective, has significant implications for the design of pay regulation. It can therefore be said that bankers' pay regulation—despite its objective of externality internalisation—is not a role model *per se* for CSR regulation. Instead, it elucidates the conditions under which different forms of pay structure regulation can affect certain forms of CSR engagement. The next chapter will bring together the insights from *Chapter Three* on the effects of pay governance prescriptions on CSR with the results from this chapter and derive principles for the integration of CSR into the objectives of executive pay regulation.

[358] *Chapter Three*, at p. 104.

Chapter Five
Regime Change? Towards New Principles of CSR-Oriented Pay Regulation

SUMMARY. This chapter aims to answer the question whether encouraging CSR engagement should be an objective of law and which legal areas are best suited to achieve it. It is argued that CSR is an activity that increases social welfare by remedying market failures, and that law has a role in supporting CSR if it fails to emerge. To explain why CSR sometimes fails to emerge, a transmission channel model of decision-making incentives is developed. This model is used to define three objectives for CSR legislation: providing an optimal amount of CSR, minimising the agency costs of CSR, and ensuring its market failure orientation.

The chapter argues that the integration of CSR into corporate law is no 'regime change', as it does not require abandoning the existing principles of corporate governance. The growing capacity of investors to enforce their interests has lessened the need for shareholder protection, causing a shift in the equilibrium of agency conflicts addressed by corporate law towards greater stakeholder protection. Due to its focus on decision-making incentives, executive pay regulation is the most suitable case to explore the inclusion of CSR into corporate law.

The integration of CSR into five main areas of pay regulation is discussed. Say-on-pay presents a possibility for more shareholder-driven CSR. Independent directors can find a new role as mediators of heterogeneous shareholder preferences in the pay-setting process to reduce the intra-shareholder agency costs of CSR. Compensation disclosure can contribute to all three objectives of CSR legislation and can integrate non-financial reporting into remuneration policies. Structural pay-for-performance requirements are a possibility of greater regulatory involvement of procedural regulations fails to increase CSR. Sustainability-linked bonds are a promising element of pay schemes in the future. The results are derived as principles for further discussions on the role of CSR in corporate law and regulatory design.

Section 1: Introduction

1 Corporate social responsibility (CSR) has permeated all areas of economic activity today and has become an institutionalised function in most large corporations. As a consequence, legislators are increasingly occupying themselves with CSR and have started integrating it into corporate law and economic regulation. This chapter deals with the question whether—and if yes, how—law should address CSR. The first research question of this thesis was what role law plays as a CSR determinant. Due to the importance of compensation as a key element in corporate decision-making incentives,[1] this has been answered in the previous two chapters at the example of executive pay regulation. It has been shown that both regulation of the pay-setting process[2] as well as structural regulation[3] have the potential to significantly affect and steer CSR engagement. Based on those insights, this chapter discusses the economic purpose of CSR and the supportive role of law in that.

2 Corporate law is occupied with the agency conflicts that govern corporations, which most prominently includes the protection of shareholder interests.[4] CSR, contrariwise, is about voluntary corporate engagement to the benefits of others.[5] The discrepancy between the two topics is self-evident, as any legislative effort to promote CSR engagement may easily come into conflicts with the goal of enforcing shareholders' interests in profit maximisation. Would the adoption of CSR as a new objective of corporate law thus constitute a regime change, abolishing the foundational rule set of how companies are organised and run today?[6] That question is aimed to be answered here. This chapter explores CSR not only as the result of agency relationships, but also a response to market failures that remain unaddressed by regulation and private law. In a globalised economy, jurisdictional boundaries raise the costs of solving cross-border externalities, and international supply chains and trade mean that more people are affected by the economic activities of others.[7] CSR, as a unilateral corporate activity, is a potential solution to some of these market failures.

3 What role then is to be assigned to the law after all? Just like any direct or indirect element of economic policy, CSR suffers from imperfections. It originates in the basic motivations of different corporate actors, which are transmitted into decision-making incentives depending on a firm's governance structure and the external environment in which it operates. Based on this understanding, this chapter develops a transmission channel model that helps to explain the failure of CSR emergence in certain settings, which is in turn the basis for legal corrections. Law may either directly attempt to remedy market failures, or it can try to enable CSR to do so and thus remedy it indirectly. From this basic approach, objectives for CSR legislation can be derived that include the optimal amount of CSR provision, its efficacy and market-failure-orientation, and its internal agency costs. Due to its focus on decision-making incentives, its role in corporate governance and the results yielded in the previous chapters, executive pay regulation is selected here as a primary area of corporate law to discuss the integration of these new CSR objectives. Several areas of pay regulation, addressing governance processes as well as compensation structures, are discussed regarding their potential to fulfil certain roles of CSR legislation.

4 *Section 1* forms the introduction. *Section 2* explains why CSR is a socially desirable solution to market failures, and which forms of CSR activities are, based on agency theory,

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[1] G. Ferrarini & M. Ungureanu, 'Executive Remuneration', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[2] *Chapter Three*, at p. 65.
[3] *Chapter Four*, at p. 107.
[4] Cp. M. Jensen & W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *Journal of Financial Economics*, vol. 3(4), 1976, pp. 305-60.
[5] On concepts of CSR, cp. *Chapter Two*, at p. 17.
[6] Cp. R. Gilson, 'From Corporate Law to Corporate Governance', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[7] Cp. A. Scherer & G. Palazzo, 'Globalization and Corporate Social Responsibility', in: A. Crane et al. (eds.), *The Oxford Handbook on Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.

economically sustainable. *Section 3* develops a transmission channel model to explain when CSR fails to emerge and what role law can play in solving this. *Section 4* discusses why executive pay regulation is the prominent area of corporate law for the integration of CSR and whether this is a divergence from the existing principles of corporate governance. *Section 5* analyses three elements of pay governance prescriptions—say-on-pay, independent remuneration committees, and disclosure—and how they could be adapted to accommodate CSR as a new regulatory objective. *Section 6* covers two areas of structural regulation, pay-for-performance and, as a specific example, remuneration in debt. *Section 7* concludes.

Section 2: The Social Welfare Implications of CSR

5 The claim that CSR should be an objective of executive pay regulation—or that any area of law should occupy itself with CSR at all—first requires a basic clarification of how CSR affects social welfare. From the perspective of welfare economics, *Section 2.1* explains how CSR, defined as a form of private self-regulation, serves as a mechanism of voluntary externality internalisation and public good provision. This makes it a remedy to market failures and as such an alternative to governmental regulation and Coasian internalisation strategies. Subsequently, *Section 2.2* reintroduces the agency perspective of CSR and differentiates the three main categories of CSR activities along their social welfare implications. It is argued that both instrumental CSR and delegated shareholder philanthropy increase social welfare, and that managerial CSR is an agency cost.

2.1 CSR as Self-Regulation and Market Failures

6 This chapter posits that CSR can serve as a remedy to market failures. To provide a theoretical foundation for this approach, recourse is necessary to the conceptual definition of CSR in *Chapter Two* as "a private form of self-regulation".[8] This definition has several advantages. Contrary to other concepts from managerial practice or business ethics, it captures both traditional discretionary philanthropy as well as modern institutionalised forms of CSR. Methodologically, it also lays greater focus on the determinants of CSR engagement, particularly its relationship with the law. Most importantly, it provides a link to the law and economics literature of self-regulation and economic theories of the function of CSR: according to Ogus and Carbonara, the purpose of 'CSR as self-regulation' is "the voluntary (private) provision of a public good",[9] a description widely adopted in the economic CSR literature as well.[10] Others, like Heal, have extended this with a focus on CSR on the firm level

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[8] *Chapter Two*, at pp. 23-28.

[9] A. Ogus & E. Carbonara, 'Self-Regulation', in: G. de Geest (ed.), *Encyclopedia of Law and Economics*, Cheltenham, Edward Elgar, 2017, at p. 244.

[10] E.g. T. Besley & M. Ghatak, 'Retailing Public Goods: The Economics of Corporate Social Responsibility', *Journal of Political Economy*, vol. 91(9), 2007, pp. 1645-63; F. Reinhardt, R. Stavins & R. Vietor, 'Corporate Social Responsibility Through an Economic Lens', *Review of Environmental Economics and Policy*, vol. 2(2), 2008, pp. 219-39; M. Kitzmueller & J. Shimshack, 'Economic Perspectives on Corporate Social Responsibility', *Journal of Economic Literature*, vol. 50(1), 2012, pp. 51-84.

towards "actions taken to reduce externalized costs or to avoid distributional conflicts."[11] The definition of 'CSR as self-regulation' adopted here includes both public good provision and externality internalisation as targets.[12] Despite being theoretically distinct concepts, public goods and externalities have similar implications for individual incentives and payoffs,[13] as corporations bear the costs of providing benefits to others. Thus, treating them jointly and deriving conclusions *mutatis mutandis*,[14] the following explores how the provision of public goods and externality internalisation through voluntary self-regulation, i.e. CSR, can be a systematic response to market failures.

7 The approach to CSR as a remedy to market failure outlined above has two basic implications: first, it is limited to market failures in the form of externalities and public goods, which constitutes an absolute restriction in scope. Secondly, CSR is a private and unilateral channel of corporations to address market failures 'voluntarily', i.e. in the absence of direct, both legal and contractual obligations to act. Within these limitations, it is posited, CSR can have positive effects on social welfare and be an economically efficient, socially desirable behaviour.[15] Intuitively, corporations are major producers of externalities themselves and thus in a superior informational and capacitive position to remedy this behaviour themselves—even more so in today's globalised, interconnected economy.[16] An assessment of the potential efficiency of CSR, however, must take into account its alternatives in economic policy and its precise form.

8 The conventional alternatives to CSR as a remedy to market failure are governmental intervention—particularly public regulation[17]—and private bargaining. Public regulation and private bargaining come with certain imperfection, from which the role of CSR can be delineated: the efficacy of public regulation depends on information, administration, and enforcement costs.[18] The activities of multi-national enterprises particularly demonstrate how the capacities of national regulatory authorities are limited by jurisdictional boundaries.[19] Private bargaining as a solution to market failure, as described by the Coase Theorem,[20] is limited by factors like information asymmetries, property rights allocation, coordination costs, collective action problems and most importantly transaction costs. Private law can partially alleviate this, e.g. by assigning property rights, incentivising information disclosure or generally minimising transaction costs. Situations persist in which bargaining remains inviable,

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[11] G. Heal, 'Corporate Social Responsibility? An Economic and Financial Framework', *Geneva Papers on Risk and Insurance: Issues and Practice*, vol. 30(3), 2005, pp. 387-409.
[12] In *Chapter Two*, CSR as a form of private self-regulation has been further defined as 'the voluntary provision of public goods, internalisation of externalities or private redistribution." See *Chapter Two*, at p. 27.
[13] Cp. S. Holtermann, 'Externalities and Public Goods', *Economica*, vol. 39(153), 1972, pp. 78-87.
[14] For a similar approach, cp. P. Crifo & V. Forget, 'The Economics of Corporate Social Responsibility: A Firm-Level Perspective Survey', *Journal of Economic Surveys*, vol. 29(1), 2015, pp. 112-30.
[15] Cp. Besley & Ghatak (2007), *supra* note 10; Kitzmueller & Shimshack (2012), *supra* note 10.
[16] Cp. Scherer & Palazzo (2008), *supra* note 7.
[17] On taxation, which unlike public regulation is not further discussed here, and CSR, cp. D. Matten & J. Moon, '"Implicit" and "Explicit" CSR: A Conceptual Framework for a Comparative Understanding of Corporate Social Responsibility', *Academy of Management Review*, vol. 33(2), 2008, pp. 404-24; on the regulatory role of taxation, cp. L. Kaplow & S. Shavell, 'On the Superiority of Corrective Taxes to Quantity Regulation', *American Law and Economics Review*, vol. 4(1), 2002, pp. 1-17.
[18] For an overview, cp. A. Ogus, *Regulation: Legal Form and Economic Theory*, Oxford, Clarendon Press, 1994.
[19] Scherer & Palazzo (2008), *supra* note 7.
[20] R. Coase, 'The Problem of Social Cost', *Journal of Law and Economics*, vol. 3(1), 1960, pp. 1-44.

something that is again exacerbated by the nature of multi-national enterprises and the geographical, legal, and informational complexity of their activities. Without delving into greater detail, it is eminent that even if public regulation and private legal orders are optimally designed, some market failures will remain unaddressed due to these imperfections. It is to these residual market failures, unsolved by conventional policy instruments, that CSR is considered an alternative solution.[21] This position in the CSR literature is derived from the economic theory on public goods, which posits that private provision of public goods is a second-best efficient solution if either public provision is inferior,[22] contracts are incomplete or transaction costs prohibitive.[23] CSR thus is a substitutive remedy to market failures, whose scope of application is delineated by the imperfections of existing mechanisms.

9 Despite its substitutive character, CSR also has innate advantages, because it works differently and depends on other conditions than conventional internalisation mechanisms. As a form of self-regulation—unlike public regulation—it does not depend on central governmental administration and enforcement.[24] Due to corporations' access to private information, relevant expertise and operational capacities,[25] CSR can also be enforced at lower costs and designed more targeted to specific situations.[26] Kitzmueller and Shimshack posit that "markets enjoy a comparative advantage in accommodating heterogeneous shareholder and stakeholder preferences at the cost of suboptimal public good levels."[27] This advantage particularly holds when externalities are linked to corporate activities and "when the public good is naturally bundled with the production of a private good."[28] On the other hand, CSR is a unilateral activity, which—contrary to contractual Coasian bargaining—makes it independent from transaction costs.[29] Self-regulatory and contractual remedies thus serve complementary purposes.[30] These advantages make CSR a viable substitutive remedy to market failures where conventional instruments fail and delineate the scope where it can be an efficient, social welfare enhancing activity.

10 Obviously, though, CSR has its own imperfections that narrow its scope of application. As CSR is a voluntary activity, the central question is: what incentives do firms have to internalise costs? Before turning in greater detail to the business environment and external factors necessary for CSR to arise, its firm-level determinants need to be discussed first. Any original incentive to engage in CSR arises from the intra-corporate agency relationship. The agency

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[21] "Only if governments fail to deliver optimal levels of public good will CSR be potentially efficient.", see Kitzmueller & Shimshack (2012), *supra* note 10, at p. 55.
[22] T. Bergstrom, L. Blume & H. Varian, 'On the Private Provision of Public Goods', *Journal of Public Economics*, vol. 29(1), 1986, pp. 25-49.
[23] T. Besley & M. Ghatak, 'Government versus Private Ownership of Public Goods', *Quarterly Journal of Economics*, vol. 116(4), 2001, pp. 1343-72; S. Grossman & O. Hart, 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration', *Journal of Political Economy*, vol. 94(4), 1986, pp. 691-719; O. Hart & J. Moore, 'Property Rights and the Nature of the Firm', *Journal of Political Economy*, vol. 98(6), 1990, pp. 1119-58.
[24] Cp. Ogus & Carbonara (2017), *supra* note 9; A. Ogus, 'Rethinking Self-Regulation', *Oxford Journal of Legal Studies*, vol. 15(1), 1995, pp. 97-108.
[25] Reinhardt et al. (2008), *supra* note 10.
[26] Besley & Ghatak (2007), *supra* note 10.
[27] Kitzmueller & Shimshack (2012), *supra* note 10, at p. 56.
[28] Besley & Ghatak (2007), *supra* note 10, at p. 1647.
[29] As also noted by R. Bénabou & J. Tirole, 'Individual and Corporate Social Responsibility', *Economica*, vol. 77(1), 2010, pp. 1-19.
[30] Ogus (1995), *supra* note 24, at pp. 100-02.

dimension of CSR thus needs to be considered to both delineate its role in public policymaking and further differentiate the social welfare implications of CSR activities.

2.2 CSR Activities and Agency Theory

11 CSR may, in principle, be a viable solution to market failures. Throughout this thesis, however, the point has been stressed that CSR is no monolithic phenomenon, but the complex outcome of a firm's underlying agency relationships.[31] Before discussing the economic, social and legal environment necessary for CSR engagement to thrive, its role in those agency relationships needs to be addressed first, as CSR not only affects social welfare through its role in solving market failures, but also its intra-corporate agency costs. The tripartite categorisation developed in *Chapter Two*, applied in the preceding two chapters as part of a positive analysis of the effects of pay regulation on CSR, provides a coherent framework of the different forms of CSR activities based on agency theory.[32] Here, those CSR categories are normatively assessed, weighing off the conflicting objectives of remedying market failures and minimising agency costs. It is argued that not all CSR activities are socially desirable, but only those that are aligned with financial performance or result from shareholders' non-financial preferences.

12 The conventional view in economics of the corporation is shareholder value theory. It posits that corporate activities should be organised with the sole aim of maximising financial returns to shareholders, based on the assumption that all other stakeholders are adequately protected through either law or contract.[33] This is best expressed in Shleifer and Vishny's understanding of corporate governance as "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment."[34] As explained above, however, CSR challenges the assumption of adequate contractual and regulatory stakeholder protection as well as that of profit maximisation as shareholders' sole interest.[35] These two issues make it necessary to discuss the role of agency problems, financial performance, and shareholder interests in CSR. The three categories of CSR activities developed in this thesis—(i) instrumental CSR, (ii) managerial CSR and (iii) delegated shareholder philanthropy—are structured around these aspects.

13 Type-(i) instrumental CSR encompasses all kinds of CSR activities motivated by the pursuit of long-term financial performance maximisation. It is defined widely as a spectrum of corporate engagement described by the 'business case' literature like risk management, reputational or social legitimacy theories of how CSR may eventually generate profits.[36] Instrumental CSR also posits that the non-financial preferences of stakeholders are internalised through conventional business activities and thus financial performance. This can happen indirectly, e.g. where stakeholder management facilitates a cooperative business environment leading to competitive advantages, or directly via the market mechanism, e.g. by meeting the

[31] This does not mean that CSR is *only* a topic of agency theory, but that agency theory is crucial to the understanding of firm-level incentives for CSR engagement.
[32] *Chapter Two*, at p. 45.
[33] Cp. R. Kraakman et al., *The Anatomy of Corporate Law A Comparative and Functional Approach*, Oxford, Oxford University Press, 2017, at pp. 22-24.
[34] A. Shleifer & R. Vishny, 'A Survey of Corporate Governance', *Journal of Finance*, vol. 52(2), 1997, pp. 737-83.
[35] Bénabou & Tirole (2010), *supra* note 29.
[36] *Chapter Two*, at p. 39.

demand of customers or investors for CSR engagement.[37] The essential characteristic shared by all activities is that they are incentivised by the traditional mechanisms of corporate governance, promoting (long-term) financial performance maximisation.

14 Because of this integration into the traditional corporate purpose of profit maximisation, type-(i) instrumental CSR constitutes no deviation from the shareholder value principle in corporate governance. As a remedy to market failures, instrumental CSR is Pareto-optimal: it improves the payoffs of those adversely affected by the market failure, the corporation's owners by generating financial returns and—depending on its specific realisation—potentially other stakeholders whose non-financial preferences are also satisfied. Instrumental CSR thus improves social welfare. It is also desirable from the perspective of dynamic efficiency: CSR scholars like Carroll[38] emphasise economic sustainability as the basis of CSR, because—as highlighted by Becker[39]—loss-making CSR practices bring about competitive disadvantages. These disadvantages increase the firm's risk of disappearing from the market, which thwarts the proliferation of CSR. A last point, raised by Jensen, is that maintaining financial performance maximisation as the primary corporate objective upholds managerial accountability and good governance, as it avoids conflicting targets that can exacerbate agency problems.[40] Overall, instrumental CSR thus is an uncontroversial, sustainable activity with positive net effects on social welfare.

15 Type-(ii) managerial CSR describes the conventional view of CSR as an agency cost, in which managers satisfy their material or non-financial self-interest at the expense of shareholders. Classically, that is the case of unrestrained corporate philanthropy at the expense of shareholder who have no say in it, described by Milton Friedman in 1970.[41] There are two additional theories that describe agency problems in modern, institutionalised CSR practices: the overinvestment hypothesis claims that managers with a mandate for CSR engagement may exceed instrumental cost-benefit equilibria of pre-determined CSR investments to gain psychological or strategical benefits.[42] A second view, the entrenchment hypothesis, posits that managers may abuse discretion in CSR to strategically invest in stakeholder support for their

[37] There is a clear conceptual distinction between such transactional instrumental CSR and Coasian bargaining. The Coase Theorem covers situations in which the producer of an externalities is contractually compensated for reducing the causal activity by those who are affected by it. Transactional instrumental CSR describes how corporations harness the non-financial preferences of contractual stakeholders, e.g. customers' higher willingness-to-pay for 'fair trade' products, by charging higher prices for internalising externalities that affect third parties, e.g. by ensuring compliance with ILO labour standards in their supply chains. While transaction and information costs thus may also play a role in CSR, they do so in a different way compared to Coasian bargaining.

[38] A. Carroll, 'The Pyramid of Corporate Social Responsibility: Towards the Moral Management of Organizational Stakeholders', *Business Horizons*, vol. 34, 1991, pp. 39-48.

[39] G. Becker, 'On Corporate Altruism', *The Becker-Posner Blog*, 2 February 2008, https://www.becker-posner-blog.com/2008/02/on-corporate-altruism-becker.html.

[40] M. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function', *Business Ethics Quarterly*, vol. 12(2), 2002, pp. 235-56.

[41] M. Friedman, 'The Social Responsibility of Business Is to Increase Its Profits', *New York Times Magazine*, 13 September 1970, pp. 122-26.

[42] A. Barnea & A. Rubin, 'Corporate Social Responsibility as a Conflict between Shareholders', *Journal of Business Ethics*, vol. 91(1), 2010, pp. 71-86.

person to protect against bord and shareholder control,[43] turning CSR into an instrument of managerial entrenchment.[44]

16 Type-(ii) managerial CSR is an agency cost—its social welfare implications, though, are ambiguous. Managerial CSR harms shareholder principals, which goes back to the core problem of separated ownership and control. Because corporate governance is conventionally designed to minimise these agency costs,[45] agency theory clearly suggests the avoidance of managerial CSR. However, as that remedy to market failures described above, CSR also has positive effects on third parties, whose payoffs may make it a Kaldor-Hicks efficient strategy from a public policy perspective. From the perspective of corporate law, managerial CSR is a dilemmatic trade-off of addressing the agency conflicts between either managers and shareholders or shareholders and stakeholders.[46] Even though corporate law traditionally upholds the shareholder value paradigm, proponents of 'radical stakeholder theory' in CSR scholarship advocate for the pursuit of stakeholder over shareholder welfare,[47] which in this terminology equates managerial CSR. Even though this makes it worth discussing, there are two main reasons why the argument of radical stakeholder theory is not adopted here: first, as Jensen corroborates, the primary contribution of firms to social welfare remains their actual course of business.[48] CSR that runs against a firm's original purpose is—as mentioned above—economically unsustainable and risks competitive disadvantages that also harm the proliferation of CSR by disappearing from the market. Secondly, the rejection of managerial CSR does not need to happen at the expense of stakeholders: as *Section 3.1* below lays out, different forms of CSR activities are substitutable depending on their underlying incentive schemes.[49] A rejection of managerial CSR need not *per se* translate into lower absolute levels of CSR engagement, but its substitution with other, more economically sustainable forms.

17 The last category, type-(iii) delegated shareholder philanthropy, describes CSR activities motivated by shareholders' pursuit to satisfy their non-financial preferences. Conventional corporate governance usually equates shareholder interests with long-term profit maximisation,[50] which makes this form of CSR engagement—in which shareholders are indifferent towards or even willing to sacrifice profits—problematic to evaluate. The desirability of type-(iii) CSR thus depends on whether corporate law should uphold profit maximisation as the firm's purpose and Shleifer and Vishny's understanding of corporate governance,[51] or whether shareholders should be empowered to 'sacrifice' profits.

18 As firm value does not equate shareholder welfare, Elhauge argues that a sole focus on profit maximisation harms shareholders with non-financial preferences, which is why the law should

[43] G. Cespa & G. Cestone, 'Corporate Social Responsibility and Managerial Entrenchment', *Journal of Economics & Management Strategy*, vol. 16(3), 2007, pp. 741-71.
[44] Cp. E. Fama, 'Agency Problems and the Theory of the Firm', *Journal of Political Economy*, vol. 88(2), 1980, pp. 288-307.
[45] Cp. Jensen & Meckling (1976), *supra* note 4.
[46] On stakeholder-shareholder agency conflicts, cp. Kraakman et al. (2017), *supra* note 33, at pp. 89 et seq.
[47] On radical—as opposed to instrumental—stakeholder theory, cp. T. Donaldson & L. Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications', *Academy of Management Review*, vol. 20(1), 1995, pp. 65-91.
[48] Jensen (2002), *supra* note 40.
[49] *Infra*, para. 21.
[50] Cp. Shleifer & Vishny (1997), *supra* note 34.
[51] Cp. *supra*, para. 12.

refrain from excessively restricting managerial discretion towards ‘profits-sacrificing’ CSR.[52] The central argument in favour of delegated shareholder philanthropy has been made by Hart and Zingales: they claim that corporations have the objective of maximising shareholder welfare, not market value, and should accommodate their owners’ non-financial preferences.[53] If shareholders are willing to forgo profits for an *ex ante* known cause, type-(iii) CSR is not only a Pareto-improvement of social welfare, but also economically sustainable.[54] Notwithstanding governance issues like heterogeneous preferences or *ex post* changes in CSR engagement that are discussed below,[55] delegated shareholder philanthropy is another viable form of addressing market failures.

19 While all forms of CSR are able to remedy market failures, not all of them are socially desirable. CSR is a Pareto-improvement of social welfare only if it is instrumental, i.e. aligned with financial performance, or qualifies as delegated shareholder philanthropy. Managerial CSR may be Kaldor-Hicks efficient from the perspective of public policy but is unsustainable and thus dynamically inefficient. This differentiation of CSR activities shows that much attention needs to be paid to the underlying incentives. The following section explains how these incentives interact with other conditions necessary for CSR to arise and which implications arise for the law in supporting and shaping CSR.

Section 3: The Need for Law in CSR

20 *Section 2* hast established that certain forms of CSR—those motivated by either maximising financial performance or satisfying shareholders’ non-financial preferences—can be socially desirable remedies to market failures. However, CSR may fail to emerge in these circumstances. This section develops a basic model to explain the emergence and failure of CSR and discusses the role of law in enabling CSR.

3.1 When Does CSR Fail?

21 So far, CSR has been discussed as a promising instrument to remedy market failures and substitute more conventional, imperfect public-policy measures like regulatory intervention or Coasian bargaining. However, just like any other instrument, CSR itself underlies inherent imperfections that limit its applicability. It is necessary to identify these imperfections to determine in which types of situations CSR is capable of solving market failures. A central prerequisite for any CSR engagement is the existence of the firm-level motivations discussed in the previous section. For those incentives to translate into corporate decision-making, though, further external and internal conditions are necessary. This section develops a transmission channel model to explain how CSR incentives are translated into actual

52 E. Elhauge, ‘Sacrificing Corporate Profits in the Public Interest’, *New York University Law Review*, vol. 80(3), 2005, pp. 733-869.

53 O. Hart & L. Zingales, ‘Companies Should Maximize Shareholder Welfare Not Market Value’, *Journal of Law, Finance, and Accounting*, vol. 2(2), 2017, pp. 247-74.

54 Cp. D. Baron, ‘Corporate Social Responsibility and Social Entrepreneurship’, *Journal of Economics & Management Strategy*, vol. 16(3), 2007, pp. 683-717.

55 Cp. *infra*, para. 33 et seq.

engagement. The model serves an approach to distinguish situation in which CSR emerges or fails to emerge. This allows to identify market failures that can be remedied with CSR and looks at how law can assist CSR.

22 What does the emergence of CSR depend upon, and why does it often fail to occur when it is warranted? Despite its ascent as an element of policymaking,[56] CSR remains a private and voluntary activity at its core. 'Voluntariness' describes the absence of any contractual or legal coercion, or, in Baron's words, CSR is "providing benefits beyond those generated by economic transactions […] or required by law."[57] Thus, next to the absence of enforcement by law, CSR also lacks any direct, transactional link to profit-making. Instead, it regularly relies on an agent's or stakeholder's altruism—a behaviour economists usually assume to be the exception, not the norm, in private markets.[58] That is why the imperfections of CSR as a problem solver appear to be more obvious and intuitive than not. Nevertheless, legislators struggle to identify the causes of CSR failure. Germany, as one example, eventually introduced legislation coercing multi-national enterprises to ensure human rights compliance in their supply chains in 2021, after a previous approach of encouraging voluntary self-regulation failed to induce any change in corporate behaviour.[59] Only by specifying the conditions needed to be met for CSR to function, situations where it is a viable policymaking alternative can be identified. Subsequently, this also allows the design of legal rules to facilitate CSR engagement. In situations where CSR may be warranted to solve a primary market failure, its under-provision by private parties represents another, secondary market failure. The prevention of a market failure in CSR provisions means ensuring the conditions of its emergence.

23 What, then, are the conditions necessary for CSR, i.e. whose absence consequently leads CSR emergence to fail? Their identification is already an extensively studied subject in CSR scholarship, albeit with insufficient consensus. That is primarily because CSR is treated as an essentially contested concept[60] and studies of the subject focus on specific situations or aspects of CSR: corporate governance scholarship as well as behavioural studies lay out the drivers and motivations of CSR.[61] Economic and legal theories, on the other hand, specify its self-regulatory purpose,[62] while the business case literature makes significant contributions in explaining how CSR can succeed in any specific setting.[63] As already shown in *Chapter Two*,[64] bringing together those different approaches is difficult, yet necessary: even noteworthy

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[56] Cp. *infra*, para. 70.
[57] D. Baron, 'Private Politics, Corporate Social Responsibility, and Integrated Strategy', *Journal of Economics & Management Strategy*, vol. 10(1), 2001, pp. 7-45, at p. 11; *Chapter Two*.
[58] Cp. H. Simon, 'Altruism and Economics', *American Economic Review*, vol. 83(2), 1993, pp. 156-61.
[59] Cp. German Ministry of Foreign Affairs, *The Due Diligence Act: Making Globalisation More Socially Just*, 3 March 2021, available at https://www.auswaertiges-amt.de/en/aussenpolitik/themen/aussenwirtschaft/wirtschaft-und-menschenrechte/-/2445576.
[60] Cp. J. Moon, A. Crane & D. Matten, 'Can Corporations Be Citizens? Corporate Citizenship as a Metaphor for Business Participation in Society', *Business Ethics Quarterly*, vol. 15(3), 2005, pp. 429-53.
[61] For one noteworthy contribution, cp. Bénabou & Tirole (2010), *supra* note 29.
[62] E.g. Heal (2005), *supra* note 11; J. Eijsbouts, 'Corporate Codes as Private Co-Regulatory Instruments in Corporate Governance and Responsibility and Their Enforcement', *Indiana Journal of Global Legal Studies*, vol. 24(1), 2017, pp. 181-205.
[63] E. Kurucz, B. Colbert & D. Wheeler, 'The Business Case for Corporate Social Responsibility', in: A. Crane et al. (eds.), *The Oxford Handbook of Corporate Social Responsibility*, Oxford, Oxford University Press, 2008.
[64] *Chapter Two*, at p. 15.

contributions that explicitly discuss the conditions of CSR emergence, like Reinhardt et al.,[65] do so by providing a non-exhaustive enumeration of internal and external factors that facilitate CSR, but do not differentiate necessary and sufficient conditions. Thus, a model is needed that connects the different dimensions of CSR emergence and explains how eventual corporate decision-making is determined.

24 To explain when CSR fails, it is necessary to cover the entire process of CSR emergence from its initial motivation to its eventual realisation. The transmission of those motivations into actual engagement happens through the influence of firm-internal and -external conditions that affect managerial decision-making incentives. As CSR has no single driver, its motivations are found in the tripartite categorisation: different forms of CSR emerge (i) because they are profitable, (ii) as agency costs, or (iii) as delegated shareholder philanthropy. The presence of any of these motivations is a necessary condition for CSR to arise. In order to materialise as decision-making incentives, however, corporate governance must function accordingly and the firm's business environment must be suitable for CSR. These are the internal and external sufficient conditions of CSR. Decision-making incentives, which determine the realisation of CSR engagement, are the result of motivations, internal, and external conditions. Taken together, they form a transmission channel of CSR emergence.

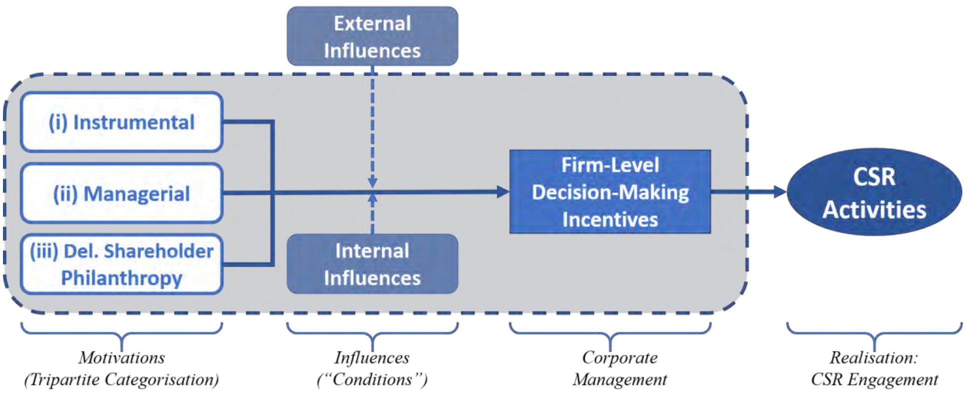

Figure 4: The transmission channel model as an explanation for CSR emergence.

25 As with any inquiry of CSR, the transmission channel model is not the sole explanation of CSR emergence and failure. Within the scope of this thesis, though, it offers two central advantages: first, its abstraction facilitates localising where along the transmission channel a reason for failure lies. The absence of interest in or awareness of CSR among shareholders and managers has different implications than poor governance or a lack of profitable business opportunities or societal pressure. The following sections use this approach to define the role of law in remedying CSR failure. Secondly, the approach uses agency theory and incentive analysis. This way, neither the way in which corporate decision-making functions, nor the influence of a firm's institutional environment are neglected.[66] As an answer to the question of 'when does CSR fail?', the transmission channel model connects the policymaking view of CSR as a

[65] Reinhardt et al. (2008), *supra* note 10.
[66] Cp. R. Aguilera et al., 'Putting the S Back in Corporate Social Responsibility: A Multilevel Theory of Social Change in Organizations', *Academy of Management Review*, vol. 32(3), 2007, pp. 836-63.

remedy to market failure with its complexity in corporate governance. Based on it, more nuanced, targeted, and efficacious legal responses can be drafted to facilitate CSR engagement.

3.2 The Role of Law in Enabling CSR

26 The limitations and imperfections of CSR that can be described through the transmission channel model may lead to situations where its effects are desirable to counter market failures, but it fails to arise. This secondary market failure, i.e. the failure of private parties to supply a socially optimal degree of voluntary self-regulation, lays the ground for the role of law in CSR. Instead of remedying the primary market failure, law could also address the secondary market failure instead and solve the primary one via CSR. Determining which of these strategies is preferable in any specific scenario always depends on case-based cost-benefit analysis. If the better alternative is to enable CSR, determining the most efficient legal strategies and instruments to do so is a more complicated endeavour, though. Here, it is argued that three objectives of CSR legislation are identifiable: providing the optimal amount of CSR engagement, minimising the agency costs that underlie CSR, and ensuring its efficacy and market-failure-orientation. These objectives and the centrality of decision-making incentives point towards a greater role of corporate governance regulation for CSR.

27 The view of law as a response to a secondary market failure in CSR provision differs from that assumed in the conventional CSR-law literature that is based on the legal theories of self-regulation.[67] As explained above,[68] market failures are usually addressed through regulatory intervention that targets any specific causal activity or behaviour. The law's role in CSR as self-regulation has instead primarily been understood as one of 'meta-regulation:'[69] rules that create an institutional environment conducive to CSR engagement and fall into a spectrum ranging from indirect, merely facilitative effects to direct, more coercive rules.[70] The law's influence varies in that self-regulation can be the result of autogenous emergence up to direct governmental delegation.[71] The key difference is that while 'meta-regulation' is restricted to a passive, supportive role for law, the secondary-market-failure view requires more targeted legal engagement that shapes CSR more actively. The different functions of the law in CSR are best explained by the corresponding framework developed in *Chapter Two*.[72]

28 Legal rules do more than merely encouraging CSR. Drawing from institutional, legal, and economic theory, the framework of *Chapter Two* maps three different forms of interconnection. Legal rules and CSR serve as substitutes in enforcing substantive social norms[73] (*CSR instead of the law*), legal rules can create or support CSR (*CSR because of the law*) or may also restrict

[67] On this literature, cp. *Chapter Two*, at p. 26.
[68] *Supra*, para. 8.
[69] Cp. C. Parker, 'Meta-Regulation: Legal Accountability for Corporate Social Responsibility?', in: D. McBarnet, A. Voiculescu & T. Campbell (eds.), *The New Corporate Accountability – Corporate Social Responsibility and the Law*, Cambridge, Cambridge University Press, 2009.
[70] Cp. J. Gond, N. Kang & J. Moon, 'The Government of Self-Regulation: On the Comparative Dynamics of Corporate Social Responsibility', *Economy and Society*, vol. 40(4), 2011, pp. 640-71; J. Black, 'Constitutionalising Self-Regulation', *Modern Law Review*, vol. 59(1), 1996, pp. 24-55.
[71] Cp. P. DeMarzo, M. Fishman & K. Hagerty, 'Self-Regulation and Government Oversight', *Review of Economic Studies*, vol. 72(3), 2005, pp. 687-706.
[72] *Chapter Two*, at pp. 28 et seq.
[73] Cp. J. Eijsbouts, *Corporate Responsibility, beyond Voluntarism: Regulatory Options to Reinforce the Licence to Operate*, Maastricht, Maastricht University Press, 2011.

CSR (*CSR against the law*). Their substitutive role is presented in the fact that either law or CSR can remedy a primary market failure. Unlike traditional meta-regulation posits, though, both the supportive and restrictive function of law are necessary elements of CSR legislation. As posited in *Section 2*,[74] managerial CSR is one form of CSR that is socially undesirable and should thus be discouraged. Law must thus simultaneously employ both restrictive and supportive instruments as a basis for efficient CSR provision.

29 Any design of restrictive or supportive legal rules, and the decision whether to employ law or CSR at all in remedying market failures, depends on the ultimate objectives of CSR legislation. From the perspective taken here, there are three objectives: first, law needs to ensure the provision of an adequate amount of CSR. Because CSR has the characteristics of a public good,[75] this usually means fixing under-provision. Apart from this quantitative goal, the qualitative efficacy of CSR needs to be ensured in that it actually focuses on remedying market failures. This entails discouraging practices of green washing or window dressing, or any other engagement without measurable impact. Thirdly, law must also minimise the agency costs of CSR: even when CSR engagement effectively solves market failures, costs on the firm level where CSR is determined need to be addressed as well. These three objectives—optimal provision, market failure orientation and minimising agency costs—are the basis of CSR legislation.

30 From the identification of those objectives, two questions ensue: which legal instruments are most suited? And how well does existing CSR legislation meet them? The European Union (EU), a frontrunner of CSR legislation,[76] pursues an approach of disclosure regulation that targets information asymmetries to strengthen private market forces for CSR engagement. This is the case for the Non-Financial Reporting Directive of 2014, which introduces CSR reporting obligations into accounting,[77] as well as the 'Sustainable Finance' package of 2018 that contains taxonomies, benchmarks, investment categorisations and disclosure duties for the financial sector.[78] The ostensible aim is to prevent 'green-washing' and enable private actors to make adequately informed decisions when they factor non-financial preferences into their transactions with corporations. Potentially, disclosure regulation can contribute to all three objectives of CSR legislation by informing and empowering the private actors involved in the determination of CSR.

31 It is doubtful, however, whether a disclosure-driven approach alone suffices to instrumentalise CSR as an element of economic policy. Information asymmetries are a core problem of CSR.[79] Both regulators and the private sector have thus been addressed them long since, and more recent developments indicate a trend of convergence and consolidation: while there have been

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[74] *Supra*, para. 11.
[75] Besley & Ghatak (2007), *supra* note 10.
[76] On CSR in Europe, cp. G. Jackson & A. Apostolakou, 'Corporate Social Responsibility in Western Europe: An Institutional Mirror or Substitute?', *Journal of Business Ethics*, vol. 94(3), 2010, pp. 371-94.
[77] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, 2014 O.J. L330/1 [herein: Non-Financial Reporting Directive, NFRD].
[78] EU High-Level Expert Group on Sustainable Finance, *Final Report 'Financing a Sustainable European Economy'*, 31 January 2018, available at https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf.
[79] Cp. M. Rhodes & T. Soobaroyen, 'Information Asymmetry and Socially Responsible Investment', *Journal of Business Ethics*, vol. 95(1), 2010, pp. 145-50.

approximately 360 ESG[80] reporting standards worldwide as of 2019, four of these are currently emerging as the dominant, generally accepted ones backed by both independent international organisations as well as the largest accounting firms.[81] At a fast pace, reliable CSR disclosure is increasingly being institutionalised as self-regulation in the private sector. This development and the legal infrastructure underpinning it are contrasted by consistent evidence that particularly stakeholder rhetoric that has surged is unaccompanied by equivalent corporate performance or consideration of stakeholder interests.[82] Similarly, *The Economist* reported that a comparable gap between self-portrayal and actual CSR performance persists in sustainable investing as of 2021.[83] Thus, much remains to be done to ensure the efficacy and optimal provision as well as reduction of agency costs in CSR.

32 This is not automatically an argument for more intrusive public regulation. The CSR transmission channel model, however, shows that current regulation focuses on the external and—to a lesser extent—the internal conditions of CSR emergence: disclosure addresses the informational imbalance between the firm and its affiliated outsiders, but does little to affect internal governance arrangement, basic interests in CSR or managerial incentives. This neglects the fact that CSR is the result of corporate decision-making and its underlying agency relationships. Any approach that aims to meet the three objectives of CSR legislation must address the entire process of CSR emergence throughout all tiers of corporate governance. While that is a vast field, one element that is particularly prone is executive compensation. As the following section lays out, that is for two reasons. First, as shown by the transmission channel, CSR is ultimately determined by decision-making incentives. Compensation is the central governance instrument to influence incentives,[84] and thus prone to steer CSR. Secondly, compensation cannot only affect the efficacy and quantity of CSR engagement, but also any agency costs. As is laid out below,[85] changes in corporate governance and the role of shareholders lead to a new balance of interests and a greater necessity of stakeholder protection in executive pay regulation.

Section 4: Pay Regulation and CSR in Corporate Law

33 Due to the imperfections of CSR, law is needed to provide a socially optimal amount of CSR, to ensure its efficacy in targeting market failures and to minimise the agency costs of CSR. This section lays out why particularly pay regulation is a suitable legal instrument to do so. Building upon the insights of the previous chapters, *Section 4.1* shows that pay regulation is

[80] 'ESG' stands for 'Environmental, Social and (Corporate) Governance' and generally refers to CSR-related performance in accounting terminology.
[81] These standards, which each have a varying focus, are issued by the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), the Task Force on Climate-related Financial Disclosures (TCFD) and the Carbon Disclosure Project (CDP). Cp. The Economist, *In the Soup: The Proliferation of Sustainability Accounting Standards Comes with Costs*, 3 October 2020.
[82] L. Bebchuk & R. Tallarita, 'The Illusory Promise of Stakeholder Governance', *Cornell Law Review*, vol. 106(1), 2020, pp. 91-178; L. Bebchuk, K. Kastiel & R. Tallarita, 'For Whom Corporate Leaders Bargain', *Southern California Law Review*, vol. 93, 2021, forthcoming.
[83] The Economist, *The Green Meme*, 22 May 2021, pp. 61-62.
[84] M. Jensen & K. Murphy, 'Performance Pay and Top Management Incentives', *Journal of Political Economy*, vol. 98(2), 1990, pp. 225-64.
[85] *Infra*, para. 39 et seq.

suitable to reach the objectives of CSR legislation just laid out. *Section 4.2* subsequently puts forward why the adoption of CSR as a goal of pay regulation is no divergence from conventional theories of corporate governance; instead, it fits into the broader development of corporate governance centred around the evolving role of shareholders.

4.1 Pay Regulation as a CSR Determinant

34 Out of the various fields of corporate law, none lends itself more to an analysis of its integration into CSR legislation than pay regulation. Compensation is the key element in corporate governance to shape managerial incentives;[86] the legal rules governing the pay-setting process and the structure of compensation affect corporate affairs on all tiers from basic agency relations up to operational decision-making.[87] That makes pay regulation a particularly predisposed venue to research the integration of CSR into corporate law along the three objectives defined in the last section. Based on the insights gathered in the preceding chapters, it is discussed here why the characteristics of pay regulation make it a natural next step in the progression of CSR legislation.

35 Compensation itself is a contractual instrument to align managerial with shareholder interests and reduce the agency costs that result from the separation of ownership and control.[88] Pay regulation supports the minimisation of agency costs by either lowering transaction costs to facilitate optimal contracting solutions[89] or interfering in the pay-setting process to prevent managerial rent extraction.[90] Additionally, a third objective of pay regulation can be the protection of non-shareholder constituencies. A present example of this is the financial sector, where pay regulation is designed to prevent excessive risk-taking, whose costs are largely borne by creditors.[91] To these ends, pay regulation employs two categories of instruments: governance prescriptions, which affect the pay-setting process, and structural regulation that directly alters compensation arrangements.[92] With these instruments, pay regulation can affect all stages of the CSR transmission channel and, as it is argued here, potentially contribute to all three objectives of CSR legislation.

36 The first objective—providing an optimal amount of CSR—can be reached through the quantitative effects of compensation on strategic and operational behaviour. By providing the right incentives through corresponding remuneration instruments[93] as well as performance targets,[94] pay regulation can directly affect and steer CSR towards optimal levels of engagement. Secondly, it can also affect the quality, i.e. orientation towards remedying market

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[86] Jensen & Meckling (1976), *supra* note 4.
[87] Cp. Ferrarini & Ungureanu (2018), *supra* note 1.
[88] Kraakman et al. (2017), *supra* note 33, at pp. 11-15, 49 et seq.; E. Fama & M. Jensen, 'Separation of Ownership and Control', *Journal of Law and Economics*, vol. 26(2), 1983, pp. 301-25.
[89] Ferrarini & Ungureanu (2018), *supra* note 1.
[90] Cp. L. Bebchuk, J. Fried & D. Walker, 'Managerial Power and Rent Extraction in the Design of Executive Compensation', *University of Chicago Law Review*, vol. 69(3), 2002, pp. 751-846.
[91] Cp. G. Ferrarini, 'CRD IV and the Mandatory Structure of Bankers' Pay', *ECGI Working Paper Series in Law*, Working Paper No. 294/2015, 2015.
[92] Ferrarini & Ungureanu (2018), *supra* note 1.
[93] J. McGuire et al., 'Do Contracts Make Them Care? The Impact of CEO Compensation Design on Corporate Social Performance', *Journal of Business Ethics*, vol. 157(2), 2019, pp. 375-90.
[94] K. Maas, 'Do Corporate Social Performance Targets in Executive Compensation Contribute to Corporate Social Performance?', *Journal of Business Ethics*, vol. 148(3), 2018, pp. 573-85.

failures, of CSR. Self-regulatory bodies and institutions like the UN PRI already provide public guidelines on the implementation of CSR performance targets.[95] Regulatory guidance of the pay-setting process can further complement this process to ensure the efficacy of CSR from a public policy perspective. Lastly, due to its original purpose, pay regulation can also address the underlying agency conflicts in CSR. Shareholder-value-oriented rules can not only minimise the agency costs of executive pay itself, but also design pay schemes to minimise the agency costs of CSR. Improved governance of the pay-setting process facilitates the conditions of CSR engagement[96] and, as it is discussed below,[97] by protecting or empowering shareholders, pay regulation can stipulate both instrumental CSR and delegated shareholder philanthropy. Based on the tripartite categorisation, these are the motivations of CSR that ensure economic sustainability.[98]

37 This versality of pay regulation is why it should be discussed first for the integration of CSR into corporate law. While significant potential lies in it to steer and support CSR engagement, there are limitations. Due to its partial roots in human altruism, CSR cannot be driven solely by material incentives. Executive pay generally cannot stipulate the creativity necessary for certain innovations and performance improvements.[99] Particularly with CSR, compensation can sometimes even be counterproductive if it crowds out intrinsic incentives that underly non-financial preferences.[100] Some dimensions of CSR may furthermore remain unrealisable even with regulatory support. These limitations and hindrances need to be acknowledged.

38 A final important distinction to be made is how pay regulation relates to the role of shareholders. The prior two chapters cover strikingly different sets of rules: *Chapter Three* discusses the provisions of general corporate law that are designed to maximise shareholder welfare by reducing shareholder-manager agency costs.[101] *Chapter Four* instead focuses on the financial sector, where pay regulation averts excessive risk-taking by restricting shareholders.[102] That is because in highly leveraged firms like financial institutions, shareholders hold a rational interest in excessive risk-taking, as high-stake losses are externalised to creditors.[103] Pay regulation accordingly limits shareholders' capacity to impose their interests on managerial incentives by regulating the pay-setting process and the use of incentive pay.[104] As on overview, the chapters reveal that pay regulation reacts to the role of shareholders in three different ways: it either protects, empowers, or restricts shareholders. Protective rules reduce agency costs by constraining or affecting the incentives of agents, e.g.

[95] Principles for Responsible Investment, *Integrating ESG issues into executive pay – Guidance for investors and companies*, June 2012, available at: https://www.unglobalcompact.org/docs/issues_doc/lead/ESG_Executive_Pay.pdf.
[96] B. Hong, Z. Li & D. Minor, 'Corporate Governance and Executive Compensation for Corporate Social Responsibility', *Journal of Business Ethics*, vol. 136(1), 2016, pp. 199-213.
[97] *Infra*, para. 39.
[98] Cp. *supra*, para. 11.
[99] B. Enke et al., 'Cognitive Biases: Mistakes or Missing Stakes?', *Review of Economics and Statistics*, 2021, forthcoming.
[100] R. Bénabou & J. Tirole, 'Incentives and Prosocial Behavior', *American Economic Review*, vol. 96(5), 2006, pp. 1652-78.
[101] *Chapter Three*, at p. 65.
[102] *Chapter Four*, at p. 107.
[103] P. Bolton, H. Mehran & J. Shapiro, 'Executive Compensation and Risk Taking', *Review of Finance*, vol. 19(6), 2015, pp. 2139-81.
[104] L. Bebchuk & H. Spamann, 'Regulating Bankers' Pay', *Georgetown Law Journal*, vol. 98(2), 2010, pp. 247-88.

through remuneration committee requirements.[105] Empowering rules enable shareholders to enforce interests themselves, e.g. through say-on-pay.[106] Restrictive rules, on the other hand, are employed where shareholder interests are deemed economically harmful.[107] The remainder of this section lays out why this matters for CSR and why the role of shareholders is the most crucial factor of regulatory design.

4.2 Corporate Law and the Centrality of Shareholders

39 Pay regulation is defined by shareholder centrality—the role, interests, and capacity of shareholders in corporate governance. Its legal rules either protect, empower, or restrict shareholders and are used depending on which of these functions is needed. Foremost, this has implications for CSR, which is affected differently by each of those functions. Beyond that, however, shareholder centrality also explains why the adoption of CSR as a regulatory objective in corporate law is no 'regime change' from its current purpose. Shareholders' development from a vulnerable, dispersed group into powerful institutional actors who can protect their own interests has made the necessity for legal solutions to the shareholder-manager agency conflict less acute. Instead, greater agency costs are borne today by other corporate constituencies, particularly stakeholders. The integration of CSR into corporate law is one strategy to accommodate this shift in agency conflicts.

40 The effects of protective, empowering and restricting rules on CSR vary. Particularly *Chapter Three* has laid out how pay regulation designed to protect shareholder interests can benefit instrumental CSR.[108] That is because to protect shareholder interests, the law first needs to define what those are; conventionally, profit maximisation is taken as a sole proxy.[109] This, however, can lead to rules that obviate the imposition of non-financial preferences by shareholders, as *Chapter Three* has argued for director independence to be the case.[110] Empowering rules, on the other hand, may promote both instrumental CSR as well as delegated shareholder philanthropy, depending on the shareholders' nature. Restrictive rules, as shown in *Chapter Four* at the example of the financial sector, can also induce more stakeholder-friendly corporate behaviour if shareholder interests are connected to negative externalities.[111] To conclude, any novel form of CSR-oriented pay regulation will be a composition of protecting, empowering, and restricting elements—depending on the role, nature, and interests of shareholders.

41 The centrality of shareholders is key to understanding pay regulation. Centrality does not equate shareholder centrism, though: the fact that pay regulation is designed along the role of shareholders in corporate governance does not *per se* entail the conclusion that shareholder interests should trump those of all other corporate constituencies. Notwithstanding this distinction, shareholder centrism is the current reality of both corporate law and executive pay

[105] Cp. Kraakman et al. (2017), *supra* note 33, at pp. 62-66.
[106] Ibid., at pp. 58 et seq.
[107] Cp. A. Zalewska, 'A New Look at Regulating Bankers' Remuneration', *Corporate Governance: An International Review*, vol. 24(3), 2016, pp. 322-33.
[108] Cp. *Chapter Three*, at p. 65.
[109] Cp. Hart & Zingales (2017), *supra* note 53.
[110] *Chapter Three*, at p. 90.
[111] *Chapter Four*, at p. 107.

regulation.[112] The financial sector is an exception to this observation, justified by the peculiarities of bank governance.[113] To make CSR an objective of pay regulation thus repudiates—at least partially—shareholder centrism and requires justification. It is argued here that such a justification can be found in the changing role of shareholders: their need for legal protection, their potential as drivers of CSR, and the necessity to restrict shareholder interests where appropriate.

42 The shareholder value paradigm, which prioritises shareholder welfare over the interests of other corporate constituencies, is no axiom of corporate governance. It emerged during the 1970s from the observation that dispersed shareholders suffer from agency, information and collective action costs and thus need legal protection from the actions of powerful management.[114] Under the assumption that stakeholders were protected by different bodies of law—employees by labour law, creditors by insolvency law, etc.—corporate law should focus solely on shareholders to maximise social welfare.[115] Over time, corporate governance systems globally converged and shareholder primacy has become the dominant model, having come to be seen as the final development stage of corporate law.[116] Eventually, its success led to the conclusion that "[…] the master problem of U.S. corporate law—the separation of ownership and control—has mostly been brought under control."[117] The success of shareholder primacy at remedying the shareholder-manager agency conflict does not render it obsolete though, and thus is no compelling argument to adopt CSR as a new objective. A major cause of this success, however, has not been corporate law, but the development of shareholders themselves. With the advent of shareholder activism and institutional investors, a form of corporate ownership has evolved with little resemblance of the 1970s dispersed retail investors.[118] With dwindling need for legal protection, as shareholders today actively participate in governance, the purpose and usefulness of current corporate law have been called into question again.[119] As this thesis argues, a justification for CSR legislation in corporate governance is found in the new role of shareholders as well as a necessary re-balancing of the agency conflicts corporate law addresses.

43 By actively engaging in corporate governance, large institutional investors defy the basic assumption of the old shareholder value model that they needed strong legal protection.[120] The

[112] E. Rock, 'Adapting to the New Shareholder-Centric Reality', *University of Pennsylvania Law Review*, vol. 161(7), 2013, pp. 1907-88.
[113] Cp. M. Becht, P. Bolton & A. Röell, 'Why Bank Governance Is Difference', *Oxford Review of Economic Policy*, vol. 27(3), 2011, pp. 437-63, at p. 438.
[114] Jensen & Meckling (1976), *supra* note 4. For historical background on the debate on whom corporations should serve, cp. A. Sommer, 'Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later', *Delaware Journal of Corporate Law*, vol. 16(1), 1991, pp. 33-56.
[115] Kraakman et al. (2017), *supra* note 33.
[116] H. Hansmann & R. Kraakman, 'The End of History for Corporate Law', *Georgetown Law Journal*, vol. 89(2), 2001, pp. 439-68; the applicability of shareholder primacy in different governance systems has also received criticism, see J. Gordon, 'Convergence and Persistence in Corporate Law and Governance', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[117] Rock (2013), *supra* note 112, at p. 1907.
[118] Cp. R. Gilson & J. Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights', *Columbia Law Review*, vol. 113(4), 2013, pp. 863-927.
[119] Z. Goshen & S. Hannes, 'The Death of Corporate Law', *New York University Law Review*, vol. 94(2), 2019, pp. 263-315; Gilson (2018), *supra* note 6.
[120] Gilson & Gordon (2013), *supra* note 118.

implications of the rise of institutional investors for corporate governance are extensively being debated. Empirical evidence indicates that institutional investors act as drivers of CSR by enforcing social norms[121] and improve governance quality, which facilitates CSR as well.[122] These positive effects could be reinforced by the law. On the other hand, institutional investors are complex organisations themselves and face idiosyncratic agency problems as intermediators between portfolio companies and beneficial owners.[123] Particularly index funds show too little stewardship and too much pro-managerialism in their engagements.[124] New developments in corporate governance like stewardship codes aim to oblige institutional investors to exert more responsibility.[125] As the importance of index funds is only to grow,[126] the new debate on the role of institutional investors in corporate governance shows that new restrictive rules or obligations may be necessary. Thus, also restrictive rules may become necessary to harmonise shareholder activism with CSR.

44 This rise of powerful shareholders urges a revaluation of the priorities of corporate law.[127] In general, there are three agency conflicts addressed by corporate law: between managers and shareholders, controlling and minority shareholders, as well as shareholders and stakeholders.[128] As the first agency conflict between managers and shareholders is attenuated, the relative importance of the other two grows. Particularly the agency conflict between shareholders and stakeholders has been called to receive greater attention in corporate law.[129] The globalisation of trade, supply chains and externalities has exacerbated the impact of modern multi-national enterprises and limits the capacity of national legal systems in remedying them. Private initiatives, despite the prominence of stakeholder rhetoric today, also remain toothless.[130] This justifies addressing them through corporate law. The financial sector has shown that pay regulation can effectively address the type-III agency conflict, so it is a potent instrument to do so here too. A revaluation of the agency conflicts balance in corporate law, it is argued here, may be achieved through CSR legislation.

45 The focus on shareholder protection in today's corporate law is becoming obsolete. While none of the current principles of corporate law should be abandoned, a recalibration of the agency conflicts addressed by it is necessary. There are two venues for this: on the one hand empowering shareholders and equipping them with new responsibilities in corporate governance where appropriate, and on the other one a shift towards greater legal protection of other corporate constituencies. CSR has been a private counterpart to these developments, and its integration into corporate law thus a possible solution. To this end, the protective, empowering, and restrictive elements of pay regulation can be employed. The following two

[121] A. Dyck et al., 'Do Institutional Investors Drive Corporate Social Responsibility? International Evidence', *Journal of Financial Economics*, vol. 131(3), 2019, pp. 693-714.
[122] A. Ferrell, H. Liang & L. Renneboog, 'Socially Responsible Firms', *Journal of Financial Economics*, vol. 122(3), 2016, pp. 585-606.
[123] Gilson & Gordon (2013), *supra* note 118.
[124] L. Bebchuk & S. Hirst, 'Index Funds and the Future of Corporate Governance', *Columbia Law Review*, vol. 119(8), 2019, pp. 2029-2146.
[125] L. Bebchuk, A. Cohen & S. Hirst, 'The Agency Problems of Institutional Investors', *Journal of Economic Perspectives*, vol. 31(3), 2017, pp. 89-112.
[126] L. Bebchuk & S. Hirst, 'The Specter of the Giant Three', *Boston University Law Review*, vol. 99(3), 2019, pp. 721-42.
[127] A claim made by Goshen & Hannes (2019), *supra* note 119; with different conclusions also by Gilson & Gordon (2013), *supra* note 118.
[128] Kraakman et al. (2017), *supra* note 33.
[129] Rock (2013), *supra* note 112.
[130] Bebchuk & Tallarita (2020), *supra* note 82; Bebchuk et al. (2021), *supra* note 82.

sections lay this out in greater detail for selected governance prescriptions (*Section 5*) and structural regulatory instruments (*Section 6*).

Section 5: Pay Governance Regulation

46 Governance prescriptions have been introduced in *Chapter Three*, where the three main types of rules are analysed. These are 'say-on-pay', remuneration committee independence, and disclosure. This section builds upon the results reached in *Chapter Three* and discusses how each of those three rules may be adjusted to contribute to CSR legislation.

5.1 Say-on-Pay

47 Say-on-pay is a form pay regulation that prescribes shareholder votes on a corporation's executive compensation. As a legal instrument that grants decision rights to shareholders, it falls into the category of empowering rules of pay regulation established in the previous section.[131] The rise of say-on-pay is linked to that of institutional investors; it aims to stipulate shareholder engagement to strengthen the pay-for-performance sensitivity and shareholder-orientation of executive compensation.[132] *Chapter Three* analyses how the variations of say-on-pay decision rights among different jurisdictions and governance systems are linked to shareholder sustainability activism and affect CSR.[133] This section builds upon those results to explore two questions: first, whether any of those legal variations in existing say-on-pay regimes yield larger effects on CSR than others. The second question is whether it is a viable strategy to expand say-on-pay by voting rights that are more directly linked to CSR.

5.1.1 Legal Variation

48 Activist investors increasingly engage with target firms to improve CSR performance.[134] One possibility to support this development is to strengthen those activist investors' bargaining power through stricter say-on-pay rules. The design, scope, and enforcement of say-on-pay decision rights vary significantly across jurisdictions, depending on each country's pre-existing governance arrangements. This section discusses which variations of the core elements of say-on-pay work best to support shareholder-initiated CSR engagement.

[131] *Supra*, para. 38.
[132] On the origins of say-on-pay, cp. R. Thomas, A. Palmiter & J. Cotter, 'Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?', *Cornell Law Review*, vol. 97(5), 2012, pp. 1213-66.
[133] *Chapter Three*, at pp. 82 et seq.
[134] E. Dimson, O. Karakaş & X. Li, 'Active Ownership', *Review of Financial Studies*, vol. 28(12), 2015, pp. 3225-68; A. Lafarre & C. Van der Elst, 'Corporate Sustainability and Shareholder Activism in the Netherlands', in: B. Sjåfell & C. Bruner (eds.), *The Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability*, Cambridge, Cambridge University Press, 2019.

49 The idea behind say-on-pay—shareholder approval rights on a firm's pay schemes as a deviation from the principle of delegated management—is simple. Its legal realisation is more complex, though. Based on the definition by Thomas and van der Elst adopted in *Chapter Three*,[135] several dimensions are identified that can be subjected to analysis: first, a shareholder can be either *ex ante* or *ex post*. An *ex ante* vote takes place on a firm's remuneration policy and thus future pay schemes; an *ex post* votes decides on a remuneration report that discloses past compensation. Secondly, a vote can be either mandatory or advisory: while advisory votes have a mere signalling function, mandatory say-on-pay makes shareholder approval necessary to adopt a remuneration policy in the case of an *ex ante* vote and to pay out of awarded remuneration in the case of an *ex post* vote. Lastly, each vote can differ in its legally prescribed minimum recurrence, affecting decision-making time horizons. As each of these rules has different effects on the engagement of shareholders, they also have different implications for CSR. Considering variations in governance environments, this section identifies those elements of say-on-pay that work best to incentivise shareholder-driven CSR.

50 The first element to consider is whether say-on-pay is *ex ante* or *ex post*. A remuneration policy, voted on *ex ante*, contains guidelines and procedural principles for future pay schemes. *Ex ante* votes thus allow shareholders to actively influence decision-making incentives and corporate objectives. Remuneration reports, voted on *ex post*, on other hand, reveal information on past compensation. *Ex post* votes are primarily intended to justify past pay practices[136] and allow shareholder to retrospectively monitor agents and reduce agency costs in compensation.[137] Noteworthily, a jurisdiction may prescribe both *ex ante* and *ex post* votes combined, as it is the case under EU law. Even though the empirical literature seldom includes legal comparisons to differentiate between different say-on-pay regimes,[138] it allows to draw conclusions on its functioning and implications for CSR: shareholder scrutiny as well as dissent are generally triggered by poor financial performance and high levels of total compensation.[139] However, weak CSR performance is also found to reduce support for existing pay schemes.[140] Say-on-pay is thus not only about pay, but also used as a general engagement mechanism to exert influence. Measurable effects of say-on-pay are higher pay-for-performance sensitivity through

[135] Say-on-pay is "(1) a recurring, mandatory, (2) binding or advisory shareholders' vote, (3) provided by law, that (4) directly or indirectly through the approval of the remuneration system, […] report or […] policy, (5) governs the individual or collective global remuneration package of the executives or managing directors of the corporation"; see R. Thomas & C. Van der Elst, 'Say on Pay around the World', *Washington University Law Review*, vol. 92(3), 2015, pp. 653-731.
[136] Cp. J. Gordon, 'Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"', *Journal of Corporation Law*, vol. 30(4), 2005, pp. 675-702.
[137] Cp. Thomas & Van der Elst (2015), *supra* note 135.
[138] Cp. J. Obermann & P. Velte, 'Determinants and Consequences of Executive Compensation-Related Shareholder Activism and Say-on-Pay Votes: A Literature Review and Research Agenda', *Journal of Accounting Literature*, vol. 40(1), 2018, pp. 116-51, at p. 133.
[139] J. Fisch, D. Palia & S. Solomon, 'Is Say on Pay All about Pay? The Impact of Firm Performance', *Harvard Business Law Review*, vol. 8(1), 2018, pp. 101-29.
[140] C. Cullinan, L. Mahoney & P. Roush, 'Are CSR Activities Associated with Shareholder Voting in Director Elections and Say-on-Pay Votes?', *Journal of Contemporary Accounting & Economics*, vol. 13(3), 2017, pp. 225-43.

higher incentive pay[141] as well as lower levels of short-term compensation,[142] both of which have positive effects on instrumental CSR.[143] Due to their use as bargaining instruments, both *ex ante* and *ex post* votes contribute to shareholder engagement. This contributes to CSR through improvements in corporate governance[144] and its strengthening of shareholder sustainability activism.[145] However, as control over performance targets is particularly important for shareholders to impose non-financial preferences,[146] it may be that *ex ante* votes have greater weight in negotiations. The relative importance of *ex ante* and *ex post* voting rights to shareholder bargaining power is still open to future empirical work.

51 The second dimension to consider is that both *ex ante* and *ex post* votes can be either binding or advisory. A binding *ex ante* vote, as is the default rule in the EU,[147] means that compensation may only be paid in accordance with a shareholder-approved remuneration policy. Binding *ex post* votes are rarer and are legally prescribed for example in France, where individual remuneration is to be withheld if shareholders disapproved of the remuneration report. In principle, binding votes in either case increase shareholders' bargaining power, as they entail legal consequences, while advisory votes have only signalling effects. As firms actively use say-on-pay to influence firms in their interests,[148] greater bargaining power would entail greater scope for shareholder-initiated CSR. Engagement, however, is more complex: for CSR, public as well as private engagement has become institutional investors' main strategy of voicing preferences.[149] Private engagement, or 'behind closed doors', is a much less disruptive channel for investors to voice their influence than public declarations or AGM votes.[150] It is preferred by long-term investors who rule out entry-or-exit decisions as an engagement method.[151] For CSR, this has two implications: for long-term investors, enforceable decision rights will primarily enhance bargaining power as punishment tools.[152] This means that the legal differences between *ex ante* and *ex post* votes matter only indirectly. Activist investors, on the other hand, are less reluctant to be confrontational in their engagement and use say-on-pay directly,[153] which means that legal design directly affects their interaction with target firms. As shareholders are generally more interested in the pay-setting process than micromanaging

[141] R. Correa & U. Lel, 'Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Valuation around the World', *Journal of Financial Economics*, vol. 122(3), 2016, pp. 500-20; D. Del Guercio, L. Seers & T. Woidtke, 'Do Boards Pay Attention When Institutional Activists Just Vote No?', *Journal of Financial Economics*, vol. 90(1), 2008, pp. 84-103.
[142] C. Van der Elst & A. Lafarre, 'Shareholder Voice on Executive Pay: A Decade of Dutch Say on Pay', *European Business Organization Law Review*, vol. 18(1), 2017, pp. 51-83; M. Grosse et al., 'Shareholder Say on Pay and CEO Compensation: Three Strikes and the Board Is Out', *Accounting & Finance*, vol. 53(3), 2017, pp. 701-25.
[143] McGuire et al. (2019), *supra* note 93.
[144] Hong et al. (2016), *supra* note 96.
[145] Cp. A. Lafarre & C. Van der Elst, 'Shareholder Sustainability Activism in the Netherlands', *ECGI Working Paper Series in Finance*, Working Paper No. 396/2018, 2018.
[146] On CSR performance targets, cp. Maas (2018), *supra* note 94.
[147] On say-on-pay in EU law and national implementation, cp. *Chapter Three*, at pp. 73 et seq.
[148] Y. Ertimur, F. Ferri & V. Muslu, 'Shareholder Activism and CEO Pay', *Review of Financial Studies*, vol. 24(2), 2011, pp. 535-92.
[149] Dyck et al. (2019), *supra* note 121.
[150] J. McCahery, Z. Sautner & L. Starks, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors', *Journal of Finance*, vol. 71(6), 2016, pp. 2905-32.
[151] Ibid.
[152] Cp. Fisch et al. (2018), *supra* note 139.
[153] Obermann & Velte (2018), *supra* note 138.

individual pay,[154] *ex ante* voting rights will be of greater importance to activists to affect future incentives, which are key to CSR. *Ex post* votes have mere disciplining effects and may even avert attention away from the remuneration policy. While mandatory *ex ante* votes are thus likely to have positive effects on CSR in any case, the usefulness of mandatory *ex post* votes is questionable and likely depends on the kind of shareholders present.

52 The third and last dimension to consider is minimum voting recurrence. In the EU, *ex ante* votes are to happen at least every four years or in cases of major changes to the remuneration policy; as a major exception, France requires annual votes; the US has no requirements, as *ex ante* say-on-pay is not prescribed by law. *Ex post* votes happen annually in the EU with every newly released remuneration report and at least every three years in the US.[155] As discussed above, *ex post* votes have little influence on incentives, tighter voting recurrence thus only allows shareholder to express dissent timelier over corporate performance. For *ex ante* votes, however, higher recurrence may be counterproductive: an important driver of CSR in compensation is long-term pay.[156] Frequent changes to the remuneration policy, e.g. because of annual say-on-pay votes, may discourage the use of long-term pay elements like deferred variable remuneration. Instead, rules like the EU standard of a vote every four years and in case of major changes is likely to better account for adequate investor time horizons, even though more empirical work on optimal time spans is still needed.

53 So far, it has been assumed that shareholders act as drivers of CSR. This assumption requires substantiation: indeed, a growing body of literature provides empirical evidence that institutional investors, by and large, promote CSR.[157] They do so to either pursue an instrumental, financial motivation,[158] or to transplant subjective social norms held within a corporate culture in general or by the deciding human actors within institutional investors in particular.[159] A group meriting special attention among them is that of asset managers. According to Bebchuk and Hirst, the three largest asset management firms cast a quarter of all votes in the US S&P 500 and are expected to increase this share to 40 % within the next two decades,[160] which makes them the largest force in institutional shareholding. Their effects on CSR happen through two channels: engagement and market forces. According to fund managers themselves most engagement happens 'behind closed doors' and not through official shareholder proposals.[161] It is thus difficult to evaluate any potential discrepancies between claims made in official engagement policies and actual behaviour.[162] Market forces affect CSR more openly: responding to public demand, asset managers offer specialised CSR-screened investment funds or pursue targeted divestment strategies, whose effects are better

[154] Ertimur et al. (2011), *supra* note 148.
[155] For a legal overview, cp. *Chapter Three*, at pp. 74-79.
[156] McGuire et al. (2019), *supra* note 93.
[157] Dimson et al. (2015), *supra* note 134; Dyck et al. (2019), *supra* note 121; T. Chen, H. Dong & C. Lin, 'Institutional Shareholders and Corporate Social Responsibility', *Journal of Financial Economics*, vol. 135(2), 2020, pp. 483-504.
[158] Dyck et al. (2019), *supra* note 121; L. Dam & B. Scholtens, 'Does Ownership Type Matter for Corporate Social Responsibility?', *Corporate Governance: An International Review*, vol. 20(3), 2012, pp. 233-52.
[159] Dyck et al. (2019), *supra* note 121.
[160] The three largest asset managers are BlackRock, Vanguard, and State Street; Bebchuk & Hirst (2019), *supra* note 126.
[161] B. Novick, '"The Goldilocks Dilemma": A Response to Lucian Bebchuk and Scott Hirst', *Columbia Law Review Forum*, vol. 120(3), 2019, pp. 80-108.
[162] Cp. Chen et al. (2020), *supra* note 157.

understood.[163] However, the intra-agency problems of asset management firms make them susceptible to a lack of shareholder activism, and public emphasis of engagement may be a reputationally driven response to this.[164] Dependence on the initiative of other activists[165] or proxy advisor recommendations[166] further complicate the matter. CSR engagement by institutional investors is thus the focal topic of *Chapter Six*.[167]

54 To conclude, the regulatory design of say-on-pay offers opportunity to stipulate shareholder-driven CSR. *Ex ante* say-on-pay plays a more important role in this than *ex post* due to its influence on incentive schemes; the effects of mandatory and advisory votes differ between long-term and activist investors. Voting recurrence should not be set at a frequency that is too high to obstruct long-term decision-making. It should be noted, however, that these results require further empirical work. Say-on-pay is also highly interconnected with other elements of executive pay regulation, particularly disclosure laws and remuneration policy requirements. Additionally, the path dependency of corporate governance systems needs to be considered, which for example makes binding *ex ante* votes more difficult to implement in co-determination two-tier governance systems like Germany than elsewhere.[168] Lastly, the role of shareholders as drivers of CSR requires further scrutiny.

5.1.2 Objective Scope

55 So far, this section has only addressed the differences in existing say-on-pay laws and their effect on CSR. Another possibility is to modify say-on-pay votes to directly affect CSR. Regulatory prescriptions on the topic of say-on-pay votes are nothing new: the remuneration policy as the topic of *ex ante* votes is subject to extensive procedural and substantive regulation in the EU, just as remuneration reports in the EU and CD&As in the US are subject to disclosure regulation.[169] Say-on-pay may thus be used to grant shareholder direct decision-rights over the pay-related aspects of CSR engagement. There are three possibilities for this: introducing requirements to address and consider the link between incentive pay and CSR performance in remuneration policies and reports; a separate vote on the contribution of pay schemes to CSR engagement; or making such a vote part of a comprehensive sustainability report.

56 Each of these alternatives has advantages. Steps towards explicit consideration of CSR in remuneration policies and reports already exist in the EU, where SRD II requires companies to "indicate […], where appropriate, criteria relating to corporate social responsibility" in the remuneration policy.[170] This makes it easier for firms to make CSR part of their voting decision

[163] Cp. Z. Li, S. Patel & S. Ramani, 'The Role of Mutual Funds in Corporate Social Responsibility', *Journal of Business Ethics*, 2020, available at https://doi.org/10.1007/s10551-020-04618-x.
[164] On stewardship issues of institutional investors, cp. Bebchuk et al. (2017), *supra* note 125.
[165] Gilson & Gordon (2013), *supra* note 118; Dimson et al. (2018), *supra* note 134.
[166] S. Choi, J. Fisch & M. Kahan, 'The Power of Proxy Advisors: Myth or Reality?', *Emory Law Journal*, vol. 59(4), 2010, pp. 869-918.
[167] *Chapter Six*, at p. 201.
[168] Cp. L. Bebchuk & M. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance', *Stanford Law Review*, vol. 52(1), 1999, 127-70; also see *Chapter Three*, at p. 90.
[169] Remuneration policy requirements are addressed in greater detail *infra*, para. 58 et seq.; disclosure requirements *infra*, para. 70 et seq.
[170] Art. 9a no. 6 of Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017 [herein: SRD II].

in say-on-pay. However, it allows no targeted activism at the role of CSR in compensation. This speaks in favour of the second possibility of a separate shareholder vote on the consideration of CSR or sustainability aspects in a firm's pay schemes. A separate vote allows for more nuanced interventions and activism. Its downside are substantial administrative costs for both firms and shareholders, who acquire voting information at significant costs and often outsource this task to professional proxy advisors.[171] A third option is integrating CSR-related pay issues into sustainability reports and subjecting those to shareholder votes. This would reduce administrative costs, as sustainability reporting has become an established practice,[172] and emphasises compensation in the context of a firm's CSR strategy. Criticism of extensive sustainability reports warns of disintegrating CSR issues too much from core business activities, along with issues of insufficiently harmonised accounting standards and lack of reliability.[173] A further general caveat is that too much regulatory exposure may overly sensitise firms to public pressure in controversial issues, causing disruption costs and hurting financial performance.[174] Even though they drive the quality of disclosure,[175] institutional investors' preference for tacit engagement may further dampen the efficacy of such approaches.[176]

57 This brief comparison shows that no single approach is superior to the others, although it points in two possible directions: either the greater inclusion of CSR considerations in remuneration policies to give CSR a greater role in say-on-pay, or the establishment of separate sustainability reports, including pay issues, to be voted on separately by shareholders. The direction say-on-pay will take depends on the development of complementary governance mechanisms, such as disclosure and regulation of the pay-setting process. Nevertheless, either of them points towards the integration of substantive CSR requirements and say-on-pay.

5.2 Remuneration Committee Requirements

58 A second important element of pay governance regulation concerns the role of remuneration committees and directors. Introduced in *Chapter Three*,[177] director independence requirements are part of the set of legal instruments to combat agency problems in executive compensation. Independence from executive management and controlling blockholders in concentrated ownership jurisdictions is an established strategy to prevent conflicted interests in the pay-setting process.[178] From the perspective of CSR legislation, this section argues for independent directors to assume a new role as mediators of heterogeneous shareholder non-financial preferences.

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[171] Y. Ertimur, F. Ferri & D. Oesch, 'Shareholder Votes and Proxy Advisors: Evidence from Say on Pay', *Journal of Accounting Research*, vol. 51(5), 2013, pp. 951-96.
[172] C. Searcy & R. Buslovich, 'Corporate Perspectives on the Development and Use of Sustainability Reports', *Journal of Business Ethics*, vol. 121(2), 2014, pp. 149-69.
[173] Cp. Rhodes & Soobaroyen (2010), *supra* note 79.
[174] Baron (2001), *supra* note 57.
[175] A. Bird & S. Karolyi, 'Do Institutional Investors Demand Public Disclosure?', *Review of Financial Studies*, vol. 29(12), 2016, pp. 3245-77.
[176] Novick (2019), *supra* note 161.
[177] *Chapter Three*, at p. 90.
[178] Cp. Kraakman et al. (2017), *supra* note 33, at pp. 62-66.

5.2.1 Directors as Stewards

59 Independent directors are "stewards",[179] i.e. agents who pursue the interests of their principals in the absence of conflicting incentives. Generally, these principals are shareholders, and corporate law stipulates director independence particularly for the area of pay-setting to avoid managerial rent-extraction.[180] This section discusses how director independence may contribute to CSR through changes in the legal understanding of their stewardship. As discussed in *Chapter Three*,[181] the current legal design and its focus on shareholder interests has failed to reduce agency costs by the intended extent and has questionable effects on CSR. This section takes shareholders' waning need for protection and calls in CSR scholarship for greater consideration of stakeholder interests as an occasion to discuss reform proposals of independent director stewardship. It is laid out that stakeholder interest protection should not be extended beyond their traditional relevance in the advisory and networking role of independent directors. Instead, following calls in corporate governance scholarship for greater minority shareholder protection,[182] it is argued that independent directors should assume a new role of mediators between heterogeneous shareholder preferences to reduce the intra-shareholding agency costs of CSR.

60 Legal understandings of the role of directors can vary. Corporate law usually defines independence as a lack of business ties with a company, particularly not being part of executive management, or any other form of personal stake that may compromise the director's ability to act as shareholder trustees.[183] Depending on the jurisdiction, these requirements may be extended to independence from a firm's majority shareholder as well. As pay-setting by the board falls into the category of self-dealing transactions[184] and is susceptible to managerial capture and rent-extraction,[185] remuneration committees are a primary target of statutory independence requirements. Personally, independent directors are expected to be qualified individuals with sufficient reputational incentives to improve corporate governance and to act as networkers among all corporate constituencies.[186] Co-determination even is a prominent example of legally mandated stakeholder-, in this case employee-appointed directors to protect the interests of these non-shareholder constituencies.[187]

61 The empirical literature shows that despite their ubiquity across jurisdictions today, current independence regulation fails to fully achieve its objectives.[188] The removal of conflicting incentives helps to combat agency problems and rent-seeking in compensation but does little to further optimal contracting solutions. That is why effects on governance quality are positive,

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[179] Ibid., at pp. 35-36.
[180] Ferrarini & Ungureanu (2018), *supra* note 1.
[181] *Chapter Three*, at pp. 91 et seq.
[182] Cp. *infra*, para. 63.
[183] Kraakman et al. (2017), *supra* note 33, at p. 35-37.
[184] K. Murphy, 'Executive Compensation: Where We Are, and How We Got There', in: G. Constantinides et al. (eds.), *Handbook of the Economics of Finance*, vol. 2A, Amsterdam, North Holland, 2013.
[185] Bebchuk et al. (2002), *supra* note 90.
[186] Fama & Jensen (1983), *supra* note 88.
[187] Germany is the most famous example of employee co-determination; cp. Kraakman et al. (2017), *supra* note 33, at pp. 90-91.
[188] R. Adams, B. Hermalin & M. Weisbach, 'The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey', *Journal of Economic Literature*, vol. 48(1), 2010, pp. 58-107.

but improvements of long-term financial performance have failed to materialise.[189] Another core issue is that independent directors are uninvolved in daily business and thus suffer from information asymmetries,[190] which impedes their ability to monitor and control.[191] This became particularly evident during the financial crisis, after independent directors failed to prevent excessive risk-taking due to an inability to fully understand high-risk, high-complexity activities in the banking sector.[192] The literature has thus come to emphasise that independence is no "panacea", but should only be a targeted instrument for specific governance solutions.[193] Based on these results, *Chapter Three* has critically reviewed the effects of independent remuneration committees in their current regulatory form on CSR.[194] It has concluded that—despite positive effects on CSR through governance improvements[195] and stakeholder networking effects[196]—information asymmetries can impede the imposition of operative non-financial performance targets.[197] Also, as a protective, not empowering, regulatory instrument, independence can hamper the imposition of delegated shareholder philanthropy. Both from the perspectives of conventional governance as well as CSR, possible reforms are being discussed.

62 One possibility that has been recurring in CSR scholarship is that of greater legal stakeholder orientation for directors.[198] Ultimately, this concept of stewardship goes back to the propositions of radical stakeholder theory and its repudiation of shareholder primacy.[199] Indeed, the literature discusses the influence of stakeholder-appointed directors on corporate governance, particularly creditors[200] and employees.[201] Here, however, an alternative is explored that does not require divergence from the shareholder value assumption of corporate law: more recent contributions have argued to expand the standard understanding of independence requirements towards greater protection of minority shareholders.[202] These proposals are efforts to provide more targeted tasks to independent directors and also a response

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[189] S. Bhagat & B. Black, 'The Non-Correlation between Board Independence and Long Term Firm Performance', *Journal of Corporation Law*, vol. 27(1), 2002, pp. 231 et seq.; Adams et al. (2010), *supra* note 188.
[190] B. Baysinger & R. Hoskisson, 'The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy', *Academy of Management Review*, vol. 15(1), 1990, pp. 72-87.
[191] R. Adams & D. Ferreira, 'A Theory of Friendly Boards', *Journal of Finance*, vol. 62(1), 2007, pp. 217-50.
[192] W. Ringe, 'Independent Directors: After the Crisis', *European Business Organization Law Review*, vol. 14(3), 2013, pp. 401-24.
[193] Ibid.
[194] *Chapter Three*, at pp. 93-97.
[195] Cp. Hong et al. (2016), *supra* note 96.
[196] Cp. C. Mallin, G. Michelon & D. Raggi, 'Monitoring Intensity and Stakeholders' Orientation: How Does Governance Affect Social and Environmental Disclosure?', *Journal of Business Ethics*, vol. 114(1), 2013, pp. 29-43.
[197] Cp. Maas (2018), *supra* note 94.
[198] Cp. J. Wang & H. Dewhirst, 'Boards of Directors and Stakeholder Orientation', *Journal of Business Ethics*, vol. 11(2), 1992, pp. 115-23.
[199] R. Freeman, *Strategic Management: A Stakeholder Approach*, Pitman, Boston, 1984; Donaldson & Preston (1995), *supra* note 47.
[200] J. Hilscher & E. Șişli-Ciamarra, 'Conflicts of Interests on Corporate Boards: The Effect of Creditor-Directors on Acquisitions', *Journal of Corporate Finance*, vol. 19, 2013, pp. 140-58; A. Marshall, L. McCann & P. McColgan, 'Do Banks Really Monitor? Evidence from CEO Succession Decisions', *Journal of Banking & Finance*, vol. 46, 2014, pp. 118-31.
[201] M. Gelter, 'Employee Participation in Corporate Governance and Corporate Social Responsibility', *ECGI Working Paper Series in Law*, Working Paper No. 322/2016, 2016.
[202] E.g. L. Bebchuk & A. Hamdani, 'Independent Directors and Controlling Shareholders', *University of Pennsylvania Law Review*, vol. 165(6), 2017, pp. 1271-1315.

to the growing capabilities of large institutional investors and the subsequent shift in agency conflicts.[203] In the following, this section picks up these proposals and discusses how independence regulation may be amended to also address the agency conflicts between shareholders in CSR that result from heterogeneous non-financial preferences.

5.2.2 Intra-Ownership Conflicts of Preferences

63 As concluded above,[204] delegated shareholder philanthropy can be a socially desirable source of CSR engagement, so increasing its provision to an optimal amount is one goal of CSR legislation. The classic corporate objective of profit maximisation bears little potential for shareholder dissent beyond the means to achieve that common goal—non-financial preferences, though, are much more heterogeneous, and conflicts of shareholder interests occur frequently. These conflicts become agency problems if some shareholders are able to exert control over corporate decision-making and thus enforce their interests over those of others. Director independence, as an instrument to protect disaggregate and minority owners, can be adjusted to better address these conflicts in CSR.

64 Delegated shareholder philanthropy is defined as CSR engagement that expresses shareholders' non-financial preferences. Primarily, non-financial preferences describe human individuals' inclinations to different forms of altruistic behaviour, which vary by personality traits, cultural background, and the influence of social norms.[205] Naturally, non-financial preferences and thus delegated shareholder philanthropy are heterogeneous.[206] Moreover, not only humans, but also corporations—particularly institutional investors—can display non-financial preferences: some entities like pension or government funds are regularly known to forego profit maximisation for political reasons.[207] With the growth of SRI, investment funds respond to the non-financial preferences of retail customers and translate those into market forces of demand for CSR. The CSR preferences of profit-oriented institutional investors vary mostly by investment time horizon,[208] indicating instrumental motivations, but also here non-financial characteristics like executives' political ideology[209] or cultural and social background affect CSR preferences.[210] Heterogeneous non-financial preferences are thus a ubiquitous force in shareholding, whose importance has grown with the institutionalisation of CSR. That is not an issue *per se*, as long as governance mechanisms succeed at accommodating shareholder interests, but it may turn into an agency cost in the presence of intra-shareholder agency conflicts.

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[203] M. Gutiérrez & M. Sáez, 'Deconstructing Independent Directors', *Journal of Corporate Law Studies*, vol. 23(1), 2013, pp. 63-94.
[204] *Supra*, para. 17.
[205] Cp. Bénabou & Tirole (2010), *supra* note 29.
[206] On altruism and CSR, cp. *Chapter Two*, at pp. 42 et seq.
[207] E.g., R. Johnson & D. Greening, 'The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance', *Academy of Management Journal*, vol. 42(5), 1999, pp. 564-76.
[208] H. Kim et al., 'Do Long-Term Institutional Investors Promote Corporate Social Responsibility Activities?', *Journal of Banking and Finance*, vol. 101(4), 2019, pp. 256-69.
[209] I. Kim, J. Ryou & R. Yang, 'The Color of Shareholders' Money: Institutional Shareholders' Political Values and Corporate Environmental Disclosure', *Journal of Corporate Finance*, vol. 64, 2020, Art. 101704.
[210] Dyck et al. (2019), *supra* note 121.

65 Generally, CSR is not an agency cost to shareholders if it is transparently disclosed to the market and thus *ex ante* known to any entrant investor.[211] Changes in CSR engagement and heterogeneous preferences are normally managed through the conventional governance mechanisms of shareholder participation, like voting and appointment rights. Problems arise, nevertheless, in the presence of two forms of intra-shareholder agency conflicts, associated with blockholders and opaque shareholder activism. A theory of CSR as an agency problem between shareholders has already been formulated by Barnea and Rubin, who model it is a conflict between insiders and outside investors.[212] Due to their closer association with the firm, inside investors gain excess utility from CSR engagement, which leads to overinvestment in it.[213] Notably, the reverse may also occur in that blockholders underinvest in CSR due to their personal preferences.[214] In either case, the non-financial preferences of minority shareholders are overridden. A different issue is 'behind closed doors' shareholder activism: as laid out above,[215] institutional investors regularly engage with firms in private to impose their preferences. This is another instance of potential intra-shareholder agency costs in which a group of owners imposes their preferences beyond the proportion of their share in the firm, bypassing conventional participation mechanisms.

66 Several conventional governance mechanisms deal with shareholder agency problems and are laid out in the literature.[216] Minority shareholder protection is a standard dimension of good governance, which also has a conducive effect on CSR.[217] More directly, independent directors stand out as an element of good governance as they touch upon the interests of both minority shareholders and non-shareholder constituencies.[218] From the different committees usually staffed with independent directors, remuneration committees merit special attention as they are the closest to corporate strategy and decision-making.

67 To address the issue of blockholders' benefits of control first, there is ample support in the literature for strengthening director accountability to minority shareholders in current regulation.[219] Currently, independent directors in most jurisdiction lack the incentives, legal mandate, and capabilities to adequately protect minority shareholders.[220] A general first step to prevent intra-shareholder agency conflicts in CSR thus is to improve the regulatory design of director independence and rid it of its existing inefficiencies. Noteworthy proposals in this direction like more substantive personal independence criteria and accountability to minority investors have been made by Ringe[221] or Bebchuk and Hamdani.[222] Regarding the intra-shareholder conflicts of CSR, the duties of independent directors—especially on remuneration committees—should include duties to manage shareholder relations, identify non-financial preferences and monitor the process of incorporating them into the firm's objectives. This can either be achieved through substantive requirements for independent directors, or procedural

[211] Kitzmueller & Shimshack (2012), *supra* note 10.
[212] Barnea & Rubin (2010), *supra* note 42.
[213] Ibid.
[214] As found by Dam & Scholtens (2013), *supra* note 158.
[215] *Supra*, para. 51.
[216] For an overview, see Kraakman et al. (2017), *supra* note 33, at pp. 79 et seq.
[217] H. Jo & M. Harjoto, 'The Causal Effect of Corporate Governance on Corporate Social Responsibility', *Journal of Business Ethics*, vol. 106(1), 2012, pp. 53-72.
[218] Cp. ibid., at pp. 85-86.
[219] Cp. Bebchuk & Hamdani (2017), *supra* note 202.
[220] As argued by Gutiérrez & Sáez (2013), *supra* note 203.
[221] Ringe (2013), *supra* note 192.
[222] Bebchuk & Hamdani (2017), *supra* note 202.

regulation of the pay-setting process. It is important for the process to be transparent and well documented to ensure that results are proportionate to shareholders' interests and stakes in the firm. The efficacy of such an approach depends upon the success of the reforms of director independence towards more accountability and substantive independence.

68 The second issue of 'behind closed doors' investor activism is more complicated. That is because shareholder empowerment is often targeted specifically at institutional investors due to their engagement capabilities,[223] which may exacerbate the issue of opaque preference imposition. In principle, institutional investors' engagement is desirable due to its positive effect on long-term financial performance and CSR.[224] This only becomes an issue if CSR preferences are imposed outside of conventional governance channels; thus, one option is to inhibit 'behind closed doors' engagement with regard to CSR. Existing evidence shows that directors appointed by institutional investors improve long-term performance but not disclosure, as investors value withholding information to gain insider benefits.[225] Restricting 'behind closed doors' activism, however, is both hard to achieve and would risk the net positive effects it brings.[226] Similarly, strengthening the board *vis-à-vis* activist investors may promote managerial-driven CSR, which can exacerbate agency problems and hinder delegated shareholder philanthropy. A preferable option may thus be a greater degree of institutionalisation of the process through which shareholders bring in non-financial preferences. This may include disclosure obligations on the way in which shareholder preferences have influenced corporate objectives and compensation performance targets, similar to how SRD II currently requires a simple disclosure of CSR consideration in this process. It may furthermore be accompanied by higher transparency obligations for institutional investors on the role of CSR in their engagement, a topic explored in *Chapter Six*.[227] This way, useful engagement opportunities can be retained without creating distortions in delegated shareholder philanthropy.

69 To conclude, independent directors can—in the wake of upcoming reforms—find a senseful purpose in managing shareholders' non-financial preferences. That task is important, given that shareholder conflicts of interests are a recurrent argument against 'philanthropic' CSR.[228] Defining the role of independent directors in this way can bring them towards a concretely defined, productive purpose. It also does not stand in the way of traditional monitoring and control functions, because it complements the trend of more engagement by investors.

5.3 Compensation Disclosure

70 A third and last regulatory instrument covered in this section is compensation disclosure. Disclosure has been a longstanding element of pay regulation to remedy information asymmetries between the firm and its shareholders and stakeholders and thus enable more efficient pay schemes. CSR legislation—especially in Europe—on the other hand, is equally disclosure-driven to provide reliable information on CSR performance to investors and the

[223] Cp. ibid.
[224] Dyck et al. (2019), *supra* note 121.
[225] G. Jiang & C. Liu, 'Getting on Board: The Monitoring Effect of Institutional Directors', *Journal of Corporate Finance*, vol. 67, 2021, Art. 101865.
[226] Cp. McCahery et al. (2016), *supra* note 150.
[227] *Chapter Six*, at p. 201.
[228] On these arguments, cp. Hart & Zingales (2017), *supra* note 53.

public. This section discusses how CSR can be integrated into pay disclosure to bridge the remaining gap between conventional CSR legislation, with its focus on CSR performance, and compensation disclosure, with its focus on steering the improvement of incentive schemes. A currently ongoing reform of CSR regulation in the EU is an opportunity to introduce new rules into compensation disclosure that allow investors and stakeholders to use reliable and comparable CSR information to increase CSR engagement at target firms.

5.3.1 Disclosure in Pay and CSR Regulation

71 So far, this chapter has discussed the integration of CSR into corporate law mostly separate from any existing approaches of CSR legislation. Disclosure regulation, however, is a pivotal point in which these two areas overlap. The purpose of current CSR legislation is to ensure the provision of reliable and comparable information on CSR performance, so market forces can effectively demand adequate levels of CSR engagement. Compensation disclosure, in turn, aims to empower shareholders and stakeholders to monitor and control the pay-setting process in their interest to minimise agency costs in the creation of incentive schemes. To connect these two areas means to enable these actors to translate disclosed information on CSR engagement into corresponding compensation instruments, performance targets, and remuneration policy objectives. This way, investors could voice non-financial preferences and stakeholders their interests actively as part of the governance process, and not just passively through supply and demand on capital and product markets. This section discusses and compares the basics of those two areas to define precise objectives for CSR-oriented compensation disclosure.

72 Conventional compensation disclosure pursues several objectives. It addresses the information asymmetry between corporate insiders and outsiders and is a key instrument of corporate law to reduce agency costs, as it lets non-controlling shareholders make better informed affiliation and voting decisions, e.g. on board appointments or say-on-pay.[229] Similarly, outside investors gain better knowledge, which improves external governance and the crucial influence of financial markets on the firm.[230] Disclosure also lets other contractual stakeholders voice their interests at lower information costs in negotiations, and firms can be held accountable more easily for their performance if compensation details are laid out and justified.[231] It is often characterised as a non-intrusive form of regulatory intervention *sui generis*, separate from the categories of governance prescriptions and procedural regulation.[232] Nevertheless, it can significantly affect both the pay-setting process as well as the structure of compensation. Current regulatory approaches in the EU and the US are largely similar, as they combine quantitative data on compensation with explanatory information on the link between pay and corporate performance.[233] A key objective has been to improve pay-for-performance sensitivity and empower investors.[234] Depending on its design, disclosure can set guidelines for the entire

[229] Kraakman et al. (2017), *supra* note 33, at pp. 38-39.
[230] Ferrarini Ungureanu (2018), *supra* note 1.
[231] J. Gordon, 'Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"', *Journal of Corporation Law*, vol. 30(4), 2005, pp. 675-702.
[232] Ferrarini and Ungureanu call disclosure "a more limited form of intervention in governance" and "traditionally associated with minimal regulatory intervention"; Ferrarini & Ungureanu (2018), *supra* note 1, at p. 345.
[233] For more details, see *Chapter Three*, at pp. 99 et seq.
[234] Murphy (2013), *supra* note 184.

pay-setting process and the design of remuneration policies or direct market forces towards either stipulating or inhibiting the use of certain pay instruments. Quantitative as well as qualitative disclosure are thus central to any regulatory approach, as information costs are reduced through both 'more' and 'better' information,[235] and despite little invasiveness, disclosure requirements can significantly affect a firm's compensation arrangements.

73 The key instrument of CSR legislation in the EU is the Non-Financial Reporting Directive of 2014.[236] As the name suggests, it introduces disclosure obligations to provide a minimum of information necessary to understand a corporation's extent of CSR engagement, including on relevant corporate policies, the use of KPIs, and due diligence processes. It has been the result of the European Commission's CSR Strategy of 2011 that had the aim of integrating CSR considerations into all tiers of corporate decision-making, a response to the trend of institutionalisation of CSR at that time.[237] The background of the EU's CSR policies is elaborated in greater detail in *Chapter Two*.[238] While the NFRD introduced no coercive requirements on CSR except for comply-or-explain provisions where firms did not take CSR concerns into consideration, it was a basic first step towards the integration of CSR and conventional accounting disclosure. Follow-up guidelines on climate-related disclosure were issued by the EC in 2019.[239] A similar further step was SRD II, which requires corporations to disclose any CSR-related performance criteria and their contribution to the firm's objectives in its remuneration policy.[240]

74 In 2019, the EC announced its 'European Green New Deal', a regulatory and investment plan to achieve greater sustainability for the EU economy.[241] In the wake of this policy undertaking, a review and subsequent reform of the Non-Financial Reporting Directive were announced, as several regulatory and market failures were identified: the NFRD requirements were not detailed enough, difficult to enforce, leaving too much discretion, and created insufficient market pressure for adequate voluntary disclosure.[242] A corresponding draft for a Corporate Sustainability Reporting Directive was published in April 2021 that would push non-financial reporting away from international soft law towards legally codified standards.

75 These developments form the outset for the integration of CSR into compensation disclosure. Designed correctly, disclosure could enable investors and stakeholders to translate new

[235] Cp. B. Hermalin & M. Weisbach, 'Information Disclosure and Corporate Governance', *Journal of Finance*, vol. 67(1), 2012, pp. 195-233.
[236] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, 2014 O.J. L330/1 [herein: Non-Financial Reporting Directive, NFRD].
[237] European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions A Renewed EU strategy 2011-14 for Corporate Social Responsibility*, 2011, COM(2011) 681 final.
[238] *Chapter Two*, at pp. 20-22.
[239] European Commission, *Communication from the Commission — Guidelines on non-financial reporting: Supplement on reporting climate-related information*, 20.06.2019, C/2019/4490, OJ C 209, pp. 1-30.
[240] Art. 9a VI subpara. 3 SRD II.
[241] European Commission, *Communication from the Commission: The European Green Deal*, COM(2019) 640 final, 11.12.2019, pp. 16-17.
[242] European Commission, *Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting*, 2021, COM(2021) 189 final.

information on CSR performance into demand for corporate objectives and decision-making incentives, for which compensation remain the central instrument. The remainder of this section lays out how correctly designed quantitative and qualitative compensation disclosure can contribute to the objectives of CSR legislation.

5.3.2 CSR-Oriented Compensation Disclosure

76 If compensation disclosure is to form an effective entry point for conventional CSR disclosure into executive pay regulation, regulatory design is crucial. Foremost, this requires the definition of precise regulatory objectives. As it is argued here, pay disclosure can contribute to all three objectives of CSR legislation due to its complementary nature. Two aspects are crucial for CSR-oriented compensation disclosure rules to succeed at that: first, the interests and capabilities of the regulatory addressees—shareholder, stakeholders, as well as the general public. Secondly, an efficient combination of quantitative and qualitative disclosure prescriptions that address both pay governance and pay structure. This section argues that the introduction of such new disclosure rules is an important complement to both the developments of CSR legislation reform and the roles of shareholders and stakeholders in corporate governance.

77 As defined in *Section 3*,[243] CSR legislation has three objectives: providing a socially optimal amount of CSR engagement, minimising the agency costs of CSR, and ensuring the efficacy of CSR, i.e. its focus on remedying market failures. Due to its fundamental role as the basis for effective governance,[244] disclosure can contribute to all three of these objectives. First, the focus of existing CSR legislation on non-financial reporting obligations shows that disclosure can increase the quantity of CSR. This is achieved through market forces, as disclosure increases the capability of not only investors, but also stakeholders to demand CSR engagement from firms. Secondly, disclosure also reduces primary agency costs by altering affiliation terms and lowering monitoring and control costs for investors.[245] Particularly the latter makes it easier for shareholders to influence corporate decision-making in their interest and impose non-financial preferences, which reduces managerially driven and thus potentially agency cost-loaden CSR, e.g. as disguised earnings management.[246] Lastly, the correct design of disclosure rules also contributes to the efficacy of CSR: a core problem of CSR is that of 'green-washing', i.e. companies that abuse information asymmetries to portrait their CSR engagement in a more benevolent light than reality would allow.[247] An equally important issue is political influencing disguised under the label of CSR, which is also unrelated to market failures.[248] The proliferation of reliable reporting standards, endorsed by private organisations as well as

[243] *Supra*, para. 26 et seq.

[244] "[E]ffective governance, in dispersed and blockholding ownership companies, […] depends on effective disclosure." Ferrarini & Ungureanu (2005), *supra* note 1, at p. 311.

[245] Cp. Kraakman et al. (2017), *supra*, note 33, at p. 38.

[246] Z. Li & C. Thibodeau, 'CSR-Contingent Executive Compensation Incentive and Earnings Management', *Sustainability*, vol. 11(12), 2019, 3420.

[247] On greenwashing and CSR, cp. P. Seele & L. Gatti, 'Greenwashing Revisited: In Search of a Typology and Accusation-Based Definition Incorporating Legitimacy Strategies', *Business Strategy and the Environment*, vol. 26(2), 2017, pp. 239-52.

[248] On political influencing and CSR, cp. M. Bertrand et al., 'Hall of Mirrors: Philanthropy and Strategic Advocacy', *Quarterly Journal of Economics*, 2021, forthcoming; M. Bertrand et al., 'Tax-Exempt Lobbying: Corporate Philanthropy as a Tool for Political Influence', *American Economic Review*, vol. 110(7), 2020, pp. 2065-2102.

regulators, is an important step towards the elimination of such inefficient CSR practices. This overview shows that disclosure—unlike other governance mechanisms, e.g. independent directors[249]—is no targeted instrument for one specific problem, but a complementary tool to improve overall governance and contribute to all three objectives of CSR legislation.

78 To ensure its efficacy and to avoid potential goal conflicts,[250] disclosure regulation must be designed according to the interests and capabilities of its addressees. These addressees are shareholders, stakeholders, as well as the general public. Shareholders, as the primary target group, have two main interests in disclosure: first, it is part of the affiliation terms, i.e. the conditions based on which entry-or-exit decisions are made, and thus important for the external governance of capital markets.[251] Secondly, disclosure decreases monitoring and control costs, which facilitates the use internal decision rights, e.g. say-on-pay, but also informal engagement for investors. Stakeholders, on the other hand, benefit from lower information costs as part of their negotiations with the firm, thus resulting in lower transaction costs, in which they express their interests.[252] The general public comprises everybody who does not hold a stake, but an opinion on a company. This opinion forms part of the company's reputational concerns as well as non-shareholder activists who use public pressure to enforce changes in corporate behaviour; both affect CSR engagement via the channel of financial performance.[253] Thus, even though disclosure decreases information costs for all corporate constituencies, these cost reductions materialise in different effects on CSR depending on each actor's affiliation terms, interests, and capabilities to enforce these.[254] This must be taken into account for the design of substantive disclosure rules.

79 Good disclosure must enable shareholders to make better informed affiliation decisions and play a more active role in governance and lower transaction costs for stakeholders. It adequately informs the general public so reputational concerns incentivise the firm where appropriate, but unsubstantiated outrage is avoided.[255] To achieve this, pay regulation must provide sufficient explanatory information to assess the relationship between incentive schemes and CSR performance and the quality of the pay-setting governance process.[256] Assuming that parallel non-financial reporting requirements provide a comprehensive overview of a firm's CSR engagement, this begins with basic quantitative disclosure. This should include requirements to disclose the amount of variable remuneration linked to CSR performance targets, differentiated by total, department, and individual levels. Further specifications should require firms to distinguish between actual CSR performance targets and non-financial performance targets that are unrelated to CSR as understood here to prevent

[249] Cp. *Supra*, para. 59-62.
[250] For example, compensation disclosure targeting only stakeholders and the public can sometimes impede firms' ability to set optimal pay schemes in the interests of shareholders, as it is a recurrent criticism of pay regulation; cp. K. Murphy & M. Jensen, 'The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation', *Journal of Law, Finance, and Accounting*, vol. 3(2), 2018, pp. 189-242.
[251] Kraakman et al. (2017), *supra* note 33, at pp. 71-72.
[252] Notably, this only holds for contractual stakeholders. Non-contractual constituencies benefit only indirectly from disclosure regulation—e.g. where it lowers the costs for tort victims to enforce their claims via the judicial system—and through reputational effects as part of the general public.
[253] Cp. Baron (2001), *supra* note 57.
[254] On competitive effects of disclosure, also cp. Hermalin & Weisbach (2012), *supra* note 235.
[255] On remuneration disclosure design and public outrage, cp. Gordon (2005), *supra* note 231.
[256] Ferrarini & Ungureanu (2018), *supra* note 1, at p. 345.

greenwashing.[257] Furthermore, variable compensation linked to CSR should be differentiated by instrument, e.g. cash bonuses or equity pay, restricted or unrestricted pay, which allows conclusions about the time horizon[258] and risk-taking incentives[259] of variable pay.

80 These quantitative data need to be accompanied by qualitative information that lays out the link between incentive pay and CSR engagement. First, this includes an explanatory report in which the firm lays out how performance targets that are defined in the remuneration policy and individual compensation arrangements provide to its CSR objectives. Maintaining the close connection with non-financial reporting, it should also be laid out whether or not quantitative CSR performance targets are used and, if that is the case, why qualitative targets have been preferred instead.[260] Next to performance targets, it should also be explained how the compensation structure, i.e. the choice of pay instruments, contributes to CSR objectives. A lesson from the financial sector is that it should also be explained how CSR-related pay fits into the overall remuneration policy and whether the firm has taken any precautions to avoid that unrelated performance targets or incentives interfere with its CSR objectives.[261] Another takeaway that may find its way into CSR-oriented pay disclosure is 'pay-for-non-performance', i.e. firms should state whether incentive pay also includes malus provisions for the realisation of pre-defined CSR risks and whether arrangements include clawback provisions for the realisation of long-term risks after compensation has been awarded.[262] Retrospectively, a report should include how past compensation practices have contributed to previous CSR targets and, consequently, how CSR engagement has affected the pay-out of compensation.

81 While disclosure is a detailed area of regulation, these brief outlines sketch a possible direction compensation disclosure may take to react to the developments in non-financial reporting and the needs of CSR legislation. Not simply 'more', but better disclosure is a way to stipulate more targeted, shareholder- and stakeholder-driven CSR engagement. Disclosure is also a less invasive and costly form of regulation than some potential alternatives that may affect corporate behaviour directly. CSR-oriented pay disclosure thus fits well into both the existing approaches of CSR legislation and conventional corporate governance regulation.

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[257] Even though 'non-financial performance targets' are often understood as synonymous to CSR, they may also include e.g. customer or subordinate employee satisfaction, which can be directly attributed to a firm's course of business and are unrelated to any market failure.
[258] Cp. D. Walker, 'The Challenge of Improving the Long-Term Focus of Executive Pay', *Boston College Law Review*, vol. 51(2), 2010, pp. 435-72.
[259] E.g. K. Shue & R. Townsend, 'How Do Quasi-Random Option Grants Affect CEO Risk-Taking?', *Journal of Finance*, vol. 72(6), 2017, pp. 2551-88.
[260] Quantitative performance targets show better effects at improving CSR engagement than qualitative targets, see Maas (2018), *supra* note 94.
[261] In EU financial sector pay regulation, where a key objective is to avoid excessive risk-taking, remuneration policies must be fully integrated with the risk management function and ensure that no remuneration incentives interfere with risk management targets; more on that in *Chapter Four*, at p. 123.
[262] On malus and clawback provisions, cp. A. Edmans, X. Gabaix & D. Jenter, 'Executive Compensation: A Survey of Theory and Evidence', *ECGI Working Paper Series in Finance*, Working Paper No. 514/2017, 2017, at pp. 97 et seq.

Section 6: Structural Pay Regulation

82 A second form of pay regulation not yet addressed is structural regulation. As opposed to governance prescriptions and disclosure, structural regulation is not used to adjust the pay-setting process and governance, but to directly alter compensation structures and remuneration policies. This makes it a more coercive form of regulation[263] that is only applied if boards and shareholders fail—even under perfect governance conditions—to set optimal incentive schemes. In this section, two types of regulatory intervention are discussed as alternatives if governance prescriptions fail as elements of CSR legislation: 'pay-for-performance' regulation and, as a specific instrument, the use of debt-based pay.

6.1 Pay-for-Performance

83 A significant body of existing structural regulation can be subsumed under the term 'pay-for-performance'. Its purpose is to promote certain pay structures that increase performance sensitivity, in other words the efficacy of variable compensation at functioning as incentive pay. This section discusses the application of pay-for-performance regulation to CSR. Based on existing approaches, it derives principles for how it can strengthen the CSR orientation of pay schemes.

6.1.1 Coercive Pay Regulation and CSR

84 'Pay-for-performance' has become an important element of executive pay regulation; its differences in application compared to governance prescriptions make it a possible complement in CSR legislation to the instruments covered so far. In private governance, 'pay-for-performance' is a plain description of the rationale of incentive pay, i.e. non-discretionary variable compensation whose award is linked to performance.[264] In a legal context, the term's meaning is slightly different, as it describes legislative efforts to improve these performance-inducing effects of compensation. In doing so, regulation pursues two objectives: first, to curb shareholder-manager agency costs by discouraging or eliminating "excessive pay", i.e. economically unjustified compensation.[265] Secondly, regulation also furthers optimal contracting solutions—not by lowering transaction and information costs as governance prescriptions do, but by directly promoting the use of efficient pay instruments. This more invasive strategy of directly promoting specific principles and practices in executive pay is why 'pay-for-performance' rules are considered structural regulation.[266] There are insights to gain for CSR legislation: even though convention 'pay-for-performance' regulation explicitly targets financial performance maximisation, its principles may be applied to pay practices that promote CSR engagement. 'Pay-for-performance' regulation is thus a potential strategy for CSR legislation if governance prescriptions and the empowerment of market forces fail to induce optimal levels of CSR.

[263] Ferrarini & Ungureanu (2018), *supra* note 1.
[264] Cp. Jensen & Murphy (1990), *supra* note 84.
[265] On the economic concept of excessive pay, cp. R. Posner, 'Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?', *Duke Law Journal*, vol. 58(6), 2009, pp. 1013-70.
[266] Cp. Ferrarini & Ungureanu (2018), *supra* note 1.

85 As laid out in *Section 3*, CSR is a highly imperfect remedy to market failures because of its dependence on certain conditions to emerge.[267] The transmission channel model shows that the two primary objectives of CSR legislation are to ensure the internal conditions of CSR emergence by correcting corporate governance and its external conditions by enabling market forces. This approach may fail, though: if shareholders and boards lack any original—financial or non-financial—motivations for CSR, governance corrections are of little help. Additionally, in many settings even regulation cannot ensure the external conditions by empowering stakeholders or creating business environments sufficiently conducive to CSR. Due to the altruistic nature of CSR, this problem occurs regularly in its application to market failures. If governance prescriptions fail as elements of CSR legislation, the alternative may not yet be regression to direct regulation of the relevant economic activity, however, but structural pay regulation: if even optimal governance results in the provision of suboptimal CSR incentives to corporate decision-making, a possible solution is the legal provision of these incentives along the principles of 'pay-for-performance'. Two examples illustrate its functioning.

86 SRD II is a prominent and recent example for the application of 'pay-for-performance' regulation. While its primary purpose is to strengthen the role of shareholders in governance, including via say-on-pay,[268] it also includes regulatory specifications that aim to push compensation towards greater sensitivity to financial performance. These rules are embedded in disclosure requirements on the remuneration policy and contain structural impositions: by requiring the use of qualified awarding criteria, SRD II discourages discretionary compensation and instead promotes the use of performance targets.[269] Furthermore, it requires companies to explain and justify the use of equity pay and endorses the use of vesting periods and retention in it.[270] These rules are not coercive, because they do not mandate any pay instruments, as SRD II recognises that pay-setting falls "within the competence of the company."[271] However, they address the structure of compensation instead of its governance process by encouraging or discouraging the use of certain pay instruments through disclosure or comply-or-explain approaches.

87 There are also more coercive rules: in the financial sector, pay regulation prohibits the use of certain instruments and imposes direct requirements on the structure of compensation. This harsh intervention in incentive schemes is based on the peculiarities of bank governance: in financial institutions, creditors instead of shareholders are the main suppliers of capital,[272] exacerbating the 'agency costs of debt.'[273] Due to their limited involved, shareholder bear losses only to a small extent but fully internalise profits, leading to an interest to engage in excessive risk-taking that is also translated into corresponding managerial incentives.[274] While the complexities of bank governance receive more attention in *Chapter Four*,[275] the basic rationale is that due to the peculiarities of financial institutions, standard governance solutions are insufficient, as the interests of shareholders *per se* do not coincide with social welfare maximisation. Bankers' pay regulation thus reacts by directly restricting shareholders in their

[267] *Supra*, para. 21.
[268] For more on this, see *Chapter Three*, at p. 76.
[269] Art. 9a para. 6 subpara. 3 SRD II.
[270] Art. 9a para. 6 subpara. 4 SRD II.
[271] Rec. 28 SRD II.
[272] Becht et al. (2011), *supra* note 113, at p. 438.
[273] A. Mello & J. Parsons, 'Measuring the Agency Cost of Debt', *Journal of Finance*, vol. 47(5), 1992, pp. 1887-1904.
[274] Bolton et al. (2015), *supra* note 103.
[275] *Chapter Four*, at pp. 109 et seq.

capability to impose incentives that could lead to excessive risk-taking.[276] In the EU, this is achieved by prescribing the composition of variable pay, prohibiting the use of certain instruments and mandating certain practices like retention periods and clawbacks.[277] Furthermore, the integration of a bank's risk management function—which is equally the target of regulation to ensure the internalisation of all potential risks—into the pay-setting process is required. Conclusions from the financial sector for 'pay-for-performance' are twofold: first, if shareholder interests oppose social welfare, market forces fail and direct regulation proves costly, then shareholder primacy in pay regulation may be abandoned in favour of restrictive structural rules. Secondly, pay governance regulation can be further complemented by the integration of other relevant corporate functions into the pay-setting process can complement regulation of instruments and performance targets.

88 Based on these two examples, how can 'pay-for-performance' be integrated into CSR legislation? Conventional regulation promotes the use of certain pay practices, performance targets, and the integration of other relevant corporate functions. The examples show that this can happen across a wide spectrum of enforcement, ranging from endorsing or signalling to coercive requirements. This can be applied to CSR as well: if market-driven approaches fail, i.e. shareholders lack motivations or motivations cannot be translated into CSR incentives, law may directly promote these incentives instead.

6.1.2 'Pay-for-Sustainable-Performance'

89 These insights on the functioning of 'pay-for-performance' regulation can be applied to CSR legislation in three steps. First, the relevant kind of 'performance' must be defined: conventional regulation simply targets financial performance as a proxy for shareholder interests or, in banking, socially optimal risk-taking. Here, a measurable concept of CSR performance must be found. Secondly, the way in which law can endorse compensation practices that contribute to this kind of CSR performance needs to be identified. Lastly, enforcement is discussed, which can vary on a spectrum of market-driven up to legally coercive approaches.

90 The target of CSR legislation is CSR engagement as it is defined in *Section 2*: the private, self-regulatory remedying of market failures.[278] Unlike financial performance, though, this concept is much harder to specify. Non-financial reporting is not yet sufficiently developed to provide KPIs necessary for measurement and benchmarking or reliable disclosure to eliminate outsider information asymmetries.[279] Another issue, introduced in *Chapter Four*,[280] is that CSR performance—or 'CSP'—can be differentiated into two forms: avoiding negative and providing positive externalities, in the CSR literature also termed the 'avoidance of poor' and 'provision of strong social performance'.[281] While the avoidance of weak social performance is linked to risk management and more easily measurable, the benefits of strong social performance are difficult to quantify. Consequently, weak CSP triggers stronger market

[276] Bebchuk & Spamann (2010), *supra* note 104.
[277] For an overview of EU financial regulation under CRD IV, see *Chapter Four*, at p. 132.
[278] Cp. *supra*, para. 6 et seq.
[279] As discussed above for ongoing non-financial disclosure reforms in the EU, see *supra*, para. 71-75.
[280] *Chapter Four*, at pp. 116-19.
[281] Cp. J. Mattingly & S. Berman, 'Measurement of Corporate Social Action: Discovering Taxonomy in the Kinder Lydenburg Domini Ratings Data', *Business & Society*, vol. 45(1), 2006, pp. 20-46.

reactions[282] and is itself sensible to pecuniary incentives;[283] strong CSP rather relies on non-financial and personal drivers and may even be crowded out by material incentives.[284] These caveats must be considered in regulatory design, for which two conclusions can be made: first, firms' competence in the pay-setting process should be respected due to their informational advantage at operationalising CSR objectives. While the empirical literature provides a solid understanding of which elements of executive compensation drive CSR,[285] regulation should pursue their endorsement through market-based enforcement instead of legal coercion. Secondly, pay regulation may further support the CSR-compensation link by driving the integration of corporate CSR functions into the pay-setting process.

91 The elements of compensation relevant for CSR are instruments and performance targets. Instruments, i.e. salary, cash bonuses and equity, themselves constitute incentives.[286] While the relationship between CSR and compensation has troubled empirics due to its complexity and endogeneity,[287] three assertions are possible: first, incentive pay promotes instrumental CSR due to its effects on financial performance.[288] Secondly, this effect becomes stronger with the long-term-orientation of pay schemes.[289] Thirdly, depending on the industry, CSR is part of risk management,[290] making it susceptible to the effects of pay instruments on risk-taking.[291] To a significant extent, conventional 'pay-for-performance' regulation already endorses these pay practices.[292] CSR legislation can thus play an additional, complementary role to existing regulation through corrective interventions. To provide an example, one such approach may be to legally require firms to ensure that pay structures do not obstructs their CSR engagement, e.g. through excessive short-term orientation or excessive risk-taking. A stricter alternative is to require firms to actively ensure that pay structures adequately represent their own corporate CSR objectives or "impacts on society", which is how the EC as a policymaker defines CSR.[293] Either of these approaches allows for a market-driven comply-or-explain enforcement through remuneration policies and reports.[294] Further rules may target the avoidance of 'pay-for-no-performance',[295] i.e. rewarding failures or not discounting negative CSR performance from variable compensation, which could be achieved through malus, retention or clawback

[282] D. Lange & N. Washburn, 'Understanding Attributions of Corporate Social Irresponsibility', *Academy of Management Review*, vol. 37(2), 2012, pp. 300-26.
[283] McGuire et al. (2019), *supra* note 93.
[284] Bénabou & Tirole (2006), *supra* note 100.
[285] For a literature review, see *Chapter Two*, at pp. 55 et seq.
[286] There are more. For an exhaustive overview of executive pay, cp. Edmans et al. (2017), *supra* note 262.
[287] S. Callan & J. Thomas, 'Executive Compensation, Corporate Social Responsibility, and Corporate Financial Performance: A Multi-Equation Framework', *Corporate Social Responsibility and Environmental Management*, vol. 18(6), 2011, pp. 332-51.
[288] McGuire et al. (2019), *supra* note 93.
[289] J. Deckop, K. Merriman & S. Gupta, 'The Effects of CEO Pay Structure on Corporate Social Performance', *Journal of Management*, vol. 32(3), 2006, pp. 329-42.
[290] P. Berrone & L. Gomez-Mejia, 'Environmental Performance and Executive Compensation: An Integrated Agency-Institutional Perspective', *Academy of Management Journal*, vol. 52(1), 2009, pp. 103-26.
[291] McGuire et al. (2019), *supra* note 93.
[292] As discussed in *Chapter Three*, at p. 104; *Chapter Four*, at p. 152.
[293] European Commission (2011), *supra* note 237, at p. 6.
[294] Cp. Gordon (2005), *supra* note 231.
[295] Cp. Bebchuk & et al. (2002), *supra* note 90.

provisions.[296] Any of these suggestions would need to be subject to a cost-benefit analysis of regulatory design.

92 Performance targets, on the other hand, can be employed to directly pursue pre-determined CSR objectives; this makes them drivers of not only instrumental CSR, but also delegated shareholder philanthropy. Ostensibly, CSR legislation should endorse the proliferation of CSR performance targets in compensation schemes and remuneration policies. More importantly, though, it can help to ensure their efficacy, which depends on measurability and comparability. Even though this varies across industries,[297] quantitative performance targets and the use of KPIs are more effective at promoting CSR and preventing 'greenwashing' than soft qualitative targets.[298] The fact that external non-financial reporting assurance has been an important driver of CSR performance targets underlines this.[299] Current legislation only requires firms to disclose under SRD II whether they employ CSR performance targets at all.[300] A next step may be to require the 'appropriate use' of CSR performance targets in relation to corporate CSR objectives, overall strategy, or the firm's impact on society. Furthermore, 'adequate involvement' of the corporate CSR function or responsible directors could be required for the translation of CSR objectives into performance targets during the pay-setting process. While terms like 'appropriateness' or 'adequacy' are vague, they avoid one-size-fits-all pitfalls; instead, they allow firms the freedom to apply those rules as general principles of CSR legislation to their own respective context. In fact, a similar approach is already pursued in banking, where supervisory authorities and public auditors are charged with ensuring compliance.[301] Where there is no such pre-existing supervisory infrastructure, CSR legislation can instead be enforced through comply-or-explain approaches that integrate rules such as the ones suggested here into existing regulation on remuneration policies and reports, and leave enforcement to market forces.

93 Current legislative endeavours already shift into this direction: in February 2022, the European Commission published a proposal for a directive on supply chain due diligence with the aim of improving human rights protection among international suppliers and integrating climate change into business strategies.[302] Among other measures, the EC intends to achieve this by requiring the design of variable remuneration schemes to be in accordance with the climate- and human-rights-aligned business strategy, sustainability, and long-term interests. European legislators intend to employ the channels described in this section to push for further integration of CSR in remuneration schemes and other internal governance channels. For the future, it remains to be seen whether this approach will continue to rely on market-based enforcement or lead to stricter rules on the design of pay schemes and policies that reduce corporate discretion.

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[296] On the functioning of malus, retention or clawbacks, cp. Edmans et al. (2017), *supra* note 262.
[297] A. Ikram, Z. Li & D. Minor, 'CSR-Contingent Executive Compensation Contracts', *Journal of Banking & Finance*, 2019, available at: https://doi.org/10.1016/j.jbankfin.2019.105655.
[298] Maas (2018), *supra* note 94.
[299] H. Al-Sheer & M. Zaman, 'CEO Compensation and Sustainability Reporting Assurance: Evidence from the UK', *Journal of Business Ethics*, vol. 158(1), 2019, pp. 233-52.
[300] Art. 9a para. 6 subpara. 3 SRD II.
[301] Art. 92 para. 2 CRD IV requires supervisory authorities to ensure that financial institutions "comply with the following principles in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities: […]" in drafting remuneration policies.
[302] European Commission, COM(2022) 71 final, 2022/0051 (COD).

94 A complementary observation to this development is that new legislation may not always seem necessary for more coercive rules: after the global financial crisis of 2009, Germany introduced a rule that required executives' remuneration structure to be aligned with "sustainable business development", as laid down in Sect. 87 of the Stock Corporation Act.[303] Unambiguously, this change in the law was intended to combat managerial short-termism, especially in pay scheme incentives, that had contributed to the crisis.[304] 'Sustainable business development' thus referred to the economic dimension of long-term profit maximisation. Nevertheless, a debate ensued whether the wording of 'sustainability' could also be extended to include social or ecological criteria.[305] Legal scholarship and jurisprudence faced the potential to push the integration of CSR into pay regulation. The implementation of SRD II offered an opportunity for legislators to remove any ambiguity that had arisen in legal practice in 2019. While SRD II merely mentions the possibility for remuneration policies to "include, where appropriate, criteria relating to corporate social responsibility",[306] the German implementation is more coercive: the new version of Sect. 87 now requires pay schemes to be aligned with "sustainable and long-term development of the company", explicitly differentiating between economic long-term interests and ecological and social sustainability.[307] While the interpretation of adequate consideration of sustainability criteria is left to business practice, the German example shows how academic and jurisprudential developments can equally act as drivers of CSR-oriented, coercive pay regulation next to legislators.

95 'Pay-for-sustainable-performance' is a potential solution to the problem that even under perfect governance conditions, a lack of necessary interests sometimes causes under-provision of CSR incentives. Because 'CSR performance' is difficult to define, however, it is unviable to pursue a coercive approach in which any other actor than companies themselves hold the decisive competencies of pay-setting. Thus, despite qualifying as structural regulation, 'pay-for-sustainable-performance' needs to be built on principles instead of detailed rules, whose enforcement is left to market forces. These principles must ensure that pay structures are conducive to CSR, CSR performance targets are employed effectively, and that corporate CSR functions are involved in the pay-setting process. This approach should not constitute a deviation from existing regulation but complement it and harness the growing reliability of non-financial reporting in the private sector in the future.

6.2 Remuneration in Debt

96 A final element of pay regulation discussed in this chapter is the use of debt. While the previous section on 'pay-for-performance' lays out the general rationale of structural pay regulation and CSR, this section selects a single pay element and discusses its effects on CSR. It investigates the conditions under which debt as a pay instrument can lower risk-taking externalities and discusses a recent trend of 'sustainability-linked bonds' and their potential role in CSR legislation.

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[303] Sect. 87 para. 1 sentence 2 German Stock Corporation Act, old version of 05.08.2009.
[304] Cp. *Chapter Four*, at p. 114.
[305] Cp. N. Röttgen & H. Kluge, 'Nachhaltigkeit bei Vorstandsvergütungen', *Neue Juristische Wochenschrift*, vol. 13/2013, 2013, pp. 900-04.
[306] Cp. *Chapter Three*, at p. 101.
[307] Cp. C. Arnold, J. Herzberg & R. Zeh, 'Vorstandsvergütung und Nachhaltigkeit', *Die Aktiengesellschaft*, vol. 66(4), 2021, pp. 141-47.

6.2.1 Debt as a Stakeholder Proxy

97 Debt as an element of compensation has been discussed extensively in the literature for the financial sector, a debate already introduced in *Chapter Four*.[308] Its core rationale is that debt can align managerial incentives with the interests of creditors, thus reduce shareholder-creditor agency costs and by extension also risk exposure for other stakeholder constituencies. Key questions from the perspective of this chapter are whether debt-based compensation also functions outside the financial sector, whether it has measurable effects on CSR in general, and if it can be a useful instrument of CSR legislation.

98 In the financial sector, the debate on debt has arisen because of the special externalities faced by bank creditors as the main suppliers of capital, caused by shareholders' interests in excessive risk-taking.[309] Remuneration in debt, as the basic rationale goes, aligns the incentives of decision-makers with creditor interests and brings risk-taking closer to socially optimal levels, as it does not account for future gains, but is *ex post* adjustable and forgone in case of default.[310] While in the context of capital, 'debt' usually just refers to bonds or deposits, its understanding in compensation includes all unsecured, fixed long-term claims such as pensions, deferred cash bonuses and any other market-based debt security. The empirical literature offers support for the proposed use of debt in compensation. It finds that bond prices fall and share prices rise if high exposure to inside debt is disclosed,[311] and provides clear evidence that debt-based pay, including even short-term maturity debt,[312] lowers both risk-taking and creditor externalities.[313] Several key propositions on implementation have been made, such as the use of pensions as inside debt,[314] plain long-term deferred cash bonuses as a replacement for equity,[315] publicly traded subordinated debt to utilise market mechanisms[316] or linking compensation to debt interest rates with deferral and clawback provisions.[317] Because shareholders even outside the financial sector rationally lack interests in the use of debt-based pay and prefer equity,[318] its endorsement through structural pay regulation has been proposed.

99 Debt-based pay may also be an instrument to improve CSR. It is a strategy to reduce negative stakeholder externalities—or weak social performance—that are caused by excessive risk-

[308] *Chapter Four*, at pp. 140 et seq.
[309] Cp. *supra*, para. 87.
[310] Cp. M. Angeli & S. Gitay, 'Bonus Regulation: Aligning Reward with Risk in the Banking Sector', *Bank of England Quarterly Bulletin*, vol. 2015(Q4), 2015, pp. 322-33.
[311] C. Wei & D. Yermack, 'Investor Reactions to CEOs' Inside Debt Incentives', *Review of Financial Studies*, vol. 24(11), 2011, pp. 3813-40.
[312] P. Brockman, X. Martin & E. Unlu, 'Executive Compensation and the Maturity Structure of Corporate Debt', *Journal of Finance*, vol. 65(3), 2010, pp. 1123-61.
[313] R. Sundaram & D. Yermack, 'Pay Me Later: Inside Debt and Its Role in Managerial Compensation', *Journal of Finance*, vol. 62(4), 2007, pp. 1551-88; for more studies on this, cp. *Chapter Four*, at p. 141.
[314] A. Edmans & Q. Liu, 'Inside Debt', *Review of Finance*, vol. 15(1), 2011, pp. 75-102.
[315] A. Kokkinis, 'Exploring the Effects of the 'Bonus Cap' Rule: The Impact of Remuneration Structure on Risk-Taking by Banker Managers', *Journal of Corporate Law Studies*, vol. 19(1), 2019, pp. 167-95.
[316] F. Tung, 'Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation', *Northwestern University Law Review*, vol. 105(3), 2011, pp. 1205-52.
[317] J. Thanassoulis & M. Tanaka, 'Optimal Pay Regulation for Too-Big-to-Fail Banks', *Journal of Financial Intermediation*, vol. 33(1), 2018, pp. 83-97.
[318] Cp. Bolton et al. (2015), *supra* note 103; V. Cuñat, M. Giné & M. Guadalupe, 'Say Pays! Shareholder Voice and Firm Performance', *Review of Finance*, vol. 20(5), 2016, pp. 1799-1834.

taking, resulting from the capability to externalise realised losses. *Chapter Four* has discussed the general conditions under which these insights can be generalised for CSR and corporate governance.[319] A key requirement is that adjustments in risk-taking incentives can improve CSR engagement, which is especially the case for externalisable or long-term risks that are difficult to measure. Another question is whether creditors can stand *pars pro toto* for other stakeholders. As suppliers of capital, creditors hold a peculiar role in governance according to agency theory;[320] however, most contractual constituencies hold fixed claims, which is also the case for some non-contractual stakeholders like tort victims. There is very little empirical research on this topic, though one recent study of 2020 finds robust positive effects of debt-based compensation on CSR engagement, speaking in favour of this hypothesis.[321]

100 The use of debt-based compensation remains a possibility for structural regulation in CSR legislation, depending on a more solid empirical understanding of its functioning and circumstances. As it has been noted in the literature, though, inside debt is complex and often opaque, which is why Bebchuk and Fried have listed pensions and deferred cash as standard instruments of 'camouflaging' excessive pay and managerial rent extraction.[322] Any regulatory approach to endorse debt-based compensation should thus be coupled with sufficient transparency disclosure and quality assurance of the pay-setting process. Moreover, it is important to look beyond plain inside debt. Rather, a CSR-oriented approach may be to couple long-term deferred cash compensation, tied to CSR performance targets, with clawback and malus provisions to account for additional, pre-defined *ex post* risk adjustments. Such instruments could be mixed with equity to provide balanced incentives to maximise financial performance while accounting for risk externalities. Another possibility is the use of bonds or other tradable debt securities, as proposed in the literature,[323] to harness market forces. A promising example of such tools are sustainability-linked bonds that are considered in the remainder of this section.

6.2.2 Sustainability-Linked Debt

101 Debt-based compensation can be a strategy to adjust risk-taking incentives. A further refinement is the use of market-based instruments, which allows tying managerial payoffs to market valuations in a way comparable to equity pay. A young, notable trend in capital markets may even allow to directly connect this to CSR: sustainability-linked bonds have emerged within the last few years as a special type of debt whose value directly depends on CSR performance. Integrating such instruments into compensation structures may allow to combine the effects of both debt-based pay and market-driven CSR valuations.

102 Sustainable finance is nothing new, as SRI—i.e. investment selection along ESG criteria—has become an established practice and the EU has pushed for a greater integration of CSR and

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[319] *Chapter Four*, at pp. 146 et seq.
[320] Cp. Jensen & Meckling (1976), *supra* note 4.
[321] S. Boubaker, K. Chebbi & J. Grira, 'Top Management Inside Debt and Corporate Social Responsibility? Evidence from the US', *Quarterly Review of Economics and Finance*, vol. 78(C), 2020, pp. 97-115.
[322] Cp. L. Bebchuk & J. Fried, 'Pay Without Performance: Overview of the Issues', *Academy of Management Perspectives*, vol. 20(1), 2006, pp. 5-24.
[323] Tung (2011), *supra* note 310; Bolton et al. (2015), *supra* note 103.

capital markets with its ‘Green Finance’ regulatory initiative.[324] Developments in bond markets that tie traditional refinancing methods to CSR can be interpreted as a response to both these investor demands and regulatory drive. One category of such developments is that of ‘green bonds’ or ‘social bonds’, which simply are conventional bonds issued to finance investments in certain areas of CSR engagement.[325] That is to be differentiated from ‘sustainability-linked bonds’ (SLB), which are loans with changing terms depending on CSR performance: based on contractually pre-determined CSR performance targets, interest payments will fall if those targets are met by the issuer and vice versa if missed. Figures and estimates vary. In 2020, according to data by *The Economist*, sustainability-linked debt made up approximately one quarter of the entire sustainable debt market,[326] which BloombergNEF reported had passed the threshold of a total volume of USD 3 trillion in 2021 in an ongoing phase of exponential growth.[327] One reason for this steep development has been their spread from corporate to sovereign debt markets and the need for largescale social investments in 2020 and 2021.[328] Becoming an established securities type, SLBs are a peculiar strategy to instrumentalise CSR, as successful CSR engagement allows to reduce the cost of debt, while also satisfying investor demands. Regarding compensation, SLBs are of interest for combining the incentive characteristics of debt, influence of market forces, and direct metrics of CSR performance.

103 The use of sustainability-linked debt in pay schemes could have several advantages. First, it would have the benefits of conventional debt elaborated on above.[329] The particular advantage of tradable bonds over inside debt is that the latter risks being abused as a managerial hedging mechanism against equity incentives.[330] To avoid this form of rent extraction and pose correct incentives, the instrument must retain actual debt characteristics, which is more easily attained by publicly traded securities.[331] Secondly, this also includes the influence of market forces on incentives, which are more sensible to *ex post* risk adjustments.[332] Most importantly, though, it combines this with long-term CSR incentives, as payoffs are directly affected by CSR performance. A central obstacle that exists to SLBs, though, is reliable measurement. While the International Capital Markets Association (ICMA) has already published standards on their issuance,[333] much remains open in the definition, measurement, and assessment of CSR performance. Before industry practices have matured on the selection of reliable KPIs, definition of CSR targets and reporting, it is doubtful whether SLBs could be part of any strategy in CSR-oriented, structural pay regulation. However, depending on the developments

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[324] For more on this, cp. *Chapter Two*, at p. 30.

[325] Related terms are ‘environmental bonds’ or simply ‘sustainability bonds.’ On green bonds and corporate governance, cp. D. Tang & Y. Zhang, ‘Do Shareholders Benefit from Green Bonds?’, *Journal of Corporate Finance*, vol. 61, 2020, 101427.

[326] The Economist, *Green Paper*, 15 February 2020, p. 60.

[327] BloombergNEF, *Sustainable Debt Hits $3 Trillion Threshold*, 10 June 2021, available at https://about.bnef.com/blog/sustainable-debt-issuance-hits-3-trillion-threshold/.

[328] J. Giráldez & S. Fontana, ‘Sustainability-Linked Bonds: The Next Frontier in Sovereign Financing’, *SSRN Electronic Journal*, 2021, available at https://ssrn.com/abstract=3829946.

[329] *Supra*, para. 97-100.

[330] B. Galle & K. Alces, ‘The False Promise of Risk-Reducing Incentive Pay: Evidence from Executive Pensions and Deferred Compensation’, *Journal of Corporation Law*, vol. 38(1), 2012, pp. 53-100.

[331] D. Anantharaman, V. Fang & G. Gong, ‘Inside Debt and the Design of Corporate Debt Contracts’, *Management Science,* vol. 60(5), 2014, pp. 1260-80.

[332] Tung (2011), *supra* note 316.

[333] International Capital Markets Association, Sustainability-Linked Bonds Principles, June 2020, available at https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2020/Sustainability-Linked-Bond-Principles-June-2020-171120.pdf.

in 'green' capital markets and the use of alternative compensation instruments, it may be a promising option of future regulatory initiatives.

Section 7: Conclusion

104 Would it constitute a regime change in corporate law to adopt CSR as a new regulatory objective? This chapter discusses the different purposes of CSR and its relationship with the law to answer that question. The approach to CSR and the delineation of the role of law in it developed here are built on agency theory, justified by welfare economics, and do not reject the conventional understanding of shareholder primacy. Instead, CSR is understood as the result of intra-corporate agency relationships as well as a contribution to social welfare as an instrument to solve market failures. This chapter provides an approach to outline the purpose of CSR, and its place in corporate law where the latter can support it.

105 CSR, as a form of private self-regulation, is about the voluntary provision of public goods and internalisation of externalities. As such, it remedies market failures and, due to its nature, has certain competitive advantages over other strategies like governmental regulation or Coasian bargaining in doing so. The agency perspective of CSR further introduces a more nuanced perspective in that only some forms—instrumental CSR and delegated shareholder philanthropy—are economically sustainable, while managerial CSR is an agency cost.

106 While it is commonplace that CSR cannot solve all issues, approaches to determine why and when CSR fails to emerge vary. With the transmission channel model, this chapter provides a comprehensive framework to localise at which point of the transmission channel from original motivations to the eventual realisation of CSR engagement the cause for any potential failure lies. This allows a more targeted regulatory response to CSR failure, and opens the path to cost-benefit analysis whether the law should either directly solve any market failure or enable CSR to do so instead. Based on this model, agency theory and welfare economics, three objectives have been defined for CSR legislation: providing a socially optimal amount of CSR, minimising the agency costs of CSR, and ensuring the efficacy, i.e. orientation towards remedying market failures of CSR.

107 From all areas of corporate law, executive pay regulation is the most prominent field for an inquiry into the introduction of CSR as a new regulatory objective. That is for two reasons: executive pay is the central element of corporate governance to affect corporate decision-making, and as such it can be used to intervene at all stages of the CSR transmission channel. Secondly, it can potentially contribute to all three objectives of CSR legislation. This chapter thus discusses the integration of CSR into pay regulation *pars pro toto* for corporate law in general.

108 This presents no regime change: pay regulation is best understood through shareholder centrality—its rules either empower, protect, or restrict shareholders, based on the regulatory objectives. Shareholder centrality is different from shareholder primacy, however, and existing corporate law regularly deviates from the latter. The integration of CSR into pay regulation is aligned with the principles of shareholder centrality and, where applicable, provides justifications for the rebuttal of shareholder primacy. It is also part of a response in corporate law to the real-world developments of increasingly powerful shareholders who enforce their own interests, lessening the necessity for their protection by law. Instead, other agency conflicts, particularly those with stakeholders, gain greater relevance. CSR is one possible strategy to react to these developments.

109 The integration of CSR into executive pay regulation is discussed using five examples taken from the previous chapters.[334] There are three elements of governance prescriptions and two forms of structural regulation. Say-on-pay is an opportunity to empower shareholders to impose their non-financial preferences on corporate decision-making. This requires stricter say-on-pay laws, with a focus on *ex ante* votes for their influence on remuneration policies. Depending on future developments, decision rights may be combined with either greater emphasis on CSR in remuneration policies, or the creation of decision rights on sustainability reports that also address compensation. Independent directors, which have disappointed in historical legislative endeavours, may find a better purpose in managing heterogeneous shareholder preferences and their inclusion in the pay-setting process. This would complement calls for greater minority shareholder protection, as it reduces intra-shareholder agency costs in CSR. Compensation disclosure is a key element of pay regulation, it is an opportunity to integrate existing non-financial reporting in the wake of its reform in the EU. It is an important step to let shareholders, stakeholders, as well as the general public exert greater influence on firms towards more and better CSR engagement. 'Pay-for-performance' regulation is an alternative solution to endorse CSR where governance prescriptions fail to result in optimal CSR incentives. Debt-based pay, particularly in the form of SLBs, remains a possible venue of future regulatory initiatives, depending on developments in capital markets and non-financial reporting.

110 The core argument of this chapter is one for the integration of CSR into corporate law. As a first step into that direction, new principles for CSR-oriented pay regulation are developed. Pay regulation is taken as an example because of its centrality in corporate decision-making incentives and connections to other areas of corporate governance. Arguably, this inquiry is far from exhaustive, as different areas of corporate law require attention as well from the perspective established here. For those areas already discussed, the derived principles should be discussed in greater detail, particularly regarding regulatory cost-benefit analysis, legal comparison, and empirical validation. This chapter has the clear intention to endorse future research in this direction. One key area of research touched upon insufficiently in this chapter are the conditions under which the intended effects of pay regulation translate into actual CSR engagement. Out of those conditions—which have been identified in *Chapter Four*[335]—this chapter has highlighted the importance of shareholders, on whose interests the entire design of pay regulation depends.[336] The next chapter thus concludes this thesis with a case study of the role of institutional investors in CSR engagement.

[334] *Chapter Three*, at p. 65; *Chapter Four*, at p. 107.
[335] *Chapter Four*, at p. 146.
[336] *Supra*, para. 39-45.

Chapter Six
Ownership and Sustainability: Index Funds and Conflicting Incentives for CSR Activism

SUMMARY. This chapter discusses index funds' incentives for CSR shareholder activism and their implications for the design of CSR-oriented pay regulation. Shareholders are the most important factor to consider for implementing the principles of CSR-oriented pay regulation. Index funds—a type of passive mutual funds—are rapidly centralising corporate ownership and have moved to the centre stage of corporate governance debates. The existing literature has shown that while they are reticent to engage in conventional governance, they also exhibit vocal CSR activism driven by competition for the assets of clients with non-financial preferences.

A case study is thus conducted to understand how those conflicting incentives interact as drivers of CSR engagement in portfolio companies. Drawing from stewardship policies, engagement reports, and data on client preferences and capital market forces, the chapter elucidates how index funds' incentives affect CSR engagement.

Instrumental, i.e. financially motivated, CSR forms the baseline of index funds' CSR shareholder activism driven by conventional governance incentives. As competitive strategies, some index funds further focus on certain areas of CSR in which they promote heightened, altruistically motivated engagement to attract assets of potential clients who value the social or environmental impact of their investments. The effect of these strategies on actual CSR engagement are mitigated by information asymmetries and the risks of green-washing and pro-managerialism. CSR-oriented pay regulation can both harness index funds as drivers of CSR and, together with complementary legislation, should address the identified shortcomings.

Section 1: Introduction

1 Corporate social responsibility (CSR), the practice of private self-regulation by businesses to solve market failures, is increasingly being relied upon by policymakers to address public issues. Simultaneously, legislators assume a more active role in driving and shaping corporate self-regulation through adaptations in corporate law.[1] The economic purpose of CSR seems clear—to contribute to social welfare maximisation where private actors are more apt to do so than governments. The basics of the role of law in CSR are laid out as well. Implementing this approach in practice and tailoring it to the fast-changing actuality of corporate governance, however, remains an ongoing concern in practice and academia.

[1] Cp. *infra*, para. 87.

2 The key actors that stand at the core of corporate governance are shareholders.[2] As owners, they determine the purpose of the corporation; corporate law is occupied with minimising the agency costs that emerge from the separation of ownership and control.[3] The same holds true for CSR: it occurs either in relation to its integration with financial performance and as part of the shareholder-manager agency relationship, or as a deliberate imposition of non-financial preferences by shareholders. That is why, when it comes to the implementation of legislation that aims to shape or drive CSR towards specified regulatory objectives, shareholders merit special attention. This particularly applies to index funds. They are the fastest growing type of institutional investors and already control a quarter of all voting shares in the US S&P 500.[4] Due to this sheer size, they hold an enormous influence in governance.

3 The business model of index funds, however, consists of passively accumulating assets and tracking market indices; they aim to maximise assets under management, not financial performance. That is why the literature already points out that index funds lack incentives to properly engage in stewardship, i.e. the pursuit of their beneficiary owners' best interest in portfolio companies. They are reticent to engage in governance matters, which implicitly also extends to CSR. A recent inquiry by Barzuza et al.,[5] however, has shown that contrary to this assumption, there is vocal CSR activism by index funds in practice. The authors argue that index funds are driven by the competition for the assets of a younger millennial generation that heavily values the social and environmental impact of their investment decisions.

4 Thus, there seem to be conflicting incentives for index funds to engage for CSR. As a key shareholder group, their attitude is crucial for the design of CSR-oriented corporate law. That is why this chapter conducts a case study that inquires the incentives of the largest three index funds—BlackRock, State Street Global Advisors, and Vanguard—based on stewardship policies, engagement reports and market data. It attempts to disentangle their different, interacting governance incentives by employing the tripartite categorisation of CSR activities developed in this thesis and provide more nuanced conclusions for CSR legislation, whose design depends on the role of shareholders. Its results are relevant for pay regulation in particular, but also stewardship and non-financial disclosure regulation.

5 Following this introduction, *Section 2* introduces the conditions for implementing the principles of CSR-oriented pay regulation and explains the relevance of shareholder preferences among them. *Section 3* shows the special importance of index funds as shareholders and summarises the existing literature on their conflicting incentives for CSR governance engagement. *Section 4* is a case study of the Big Three index funds' incentives for CSR shareholder activism. *Section 5* discusses regulatory implications of the results; *Section 6* concludes.

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[2] M. Jensen & W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *Journal of Financial Economics*, vol. 3(4), 1976, pp. 305-60.
[3] E. Fama & M. Jensen, 'Separation of Ownership and Control', *Journal of Law and Economics*, vol. 26(2), 1983, pp. 301-25.
[4] L. Bebchuk & S. Hirst, 'Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy', *Columbia Law Review*, vol. 119(8), 2019, pp. 2029-2146.
[5] M. Barzuza, Q. Curtis & D. Webber, 'Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance', *Southern California Law Review*, vol. 93(6), 2021, pp. 1243-1322.

Section 2: Shareholder Attitudes and CSR Legislation

6 The principles of CSR-oriented pay regulation derived in the previous chapter can be implemented into practice only by being adjusted to certain conditions. Among those conditions, the role of shareholders and ownership structure stands out due to its centrality in corporate governance. This section explains how shareholders determine the design of pay regulation and how their preferences shape CSR.

2.1 Applying the Principles of CSR-Oriented Pay Regulation

7 Shareholders occupy a special role in governance, CSR, and pay regulation. The general principles of CSR-oriented pay regulation developed in *Chapter Five* are formulated to provide guidance for future legislation to integrate CSR and corporate law.[6] Applying those principles in practice, however, requires detailed regulatory cost-benefit analysis that needs to consider the real-world context in which firms operate and CSR engagement happens. A basic framework for the application of CSR-oriented pay regulation can be taken from *Chapter Four*. There, the financial sector is analysed to derive insights on the relationship between CSR and coercive pay regulation.[7] Because the financial sector is uniquely exceptional in its characteristics,[8] conditions are identified based on which insights from there may be extrapolated to other industries. These conditions are generalisable to determine the relevant main influencing factors in any industry. Among them, which are briefly recapitulated in the following, ownership and shareholders stand out as unique.

8 Pay regulation is an instrument to steer incentives for managerial decision-makers. These incentives, however, must not be taken out of the real-world context in which they are embedded. At the example of the financial sector, the four main elements to consider for the functioning of pay regulation have been developed in *Chapter Four*. First, there is the regulatory environment: CSR is a substitute for governmental regulation in enforcing substantive social norms.[9] Thus, existing regulation defines the very scope within which CSR engagement is possible at all,[10] and serves as an alternative to promoting instrumental CSR. Secondly, stakeholders influence CSR: Their capability to protect their own interests and transaction costs decide whether externalities are better left to market forces or regulation.[11] Also, the legal nature of their affiliation with the firm determines which area of law or regulation applies. Thirdly, CSR is determined by business characteristics and externalities. In different industries, CSR takes vastly different forms, governmental regulation may be more costly due to the complexity of business activities and public-private information asymmetries,[12] and the prevalence of either positive or negative externalities may require different CSR incentive schemes. Lastly, there are shareholders: as core providers of capital,

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[6] *Chapter Five*, at p. 198.
[7] *Chapter Four*, at p. 107.
[8] Cp. J. Armour et al., *Principles of Financial Regulation*, Oxford, Oxford University Press, 2016.
[9] J. Eijsbouts, *Corporate Responsibility, beyond Voluntarism: Regulatory Options to Reinforce the Licence to Operate*, Maastricht, Maastricht University Press, 2011.
[10] Cp. J. Gond, N. Kang & J. Moon, 'The Government of Self-Regulation: On the Comparative Dynamics of Corporate Social Responsibility', *Economy and Society*, vol. 40(4), 2011, pp. 640-71.
[11] Cp. R. Coase, 'The Problem of Social Cost', *Journal of Law and Economics*, vol. 3(1), 1960, pp. 1-44.
[12] For the financial sector, this argument is brought forward by L. Bebchuk & H. Spamann, 'Regulating Bankers' Pay', *Georgetown Law Journal*, vol. 98(2), 2010, pp. 247-88.

the involvement of shareholders is decisive for any type of corporate agency conflict.[13] Ownership structure, whether concentrated or dispersed, decides how much control is directly exerted by shareholders and, most importantly, the subjective preferences of shareholders determine corporate objectives.[14]

9 While all elements in this brief overview need to be considered for the proper implementation of CSR legislation in any setting, shareholders stand out for two reasons. First, patterns of ownership and shareholder preferences span across industries, meaning insights on their relevance for CSR are potentially applicable to all areas of corporate law. More importantly, however, the role of shareholders is the key determinant of the design of pay regulation. While other corporate constituencies are protected by different bodies of law, shareholders protection has long stood at the core of corporate law and has become central to its design.[15] Thus, as an initial inquiry into the application of CSR-oriented pay regulation, this chapter focuses on the role and preferences of shareholders in CSR engagement. The following lays out how shareholder centrality particularly materialises in the area of pay regulation.

2.2 The Role of Shareholder Preferences

10 Shareholders merit special attention due to their central role in corporate governance across industries, economic environments, and jurisdictions. As corporate owners, shareholders are a key driver of CSR, because they not only determine the corporate agency relationships that underlie CSR engagement, but also because they impose non-financial preferences on corporate objectives. Shareholders also determine regulatory objectives: depending on their capacities and whether their interests coincide with or diverge from social welfare maximisation, pay regulation either protects, empowers, or restricts shareholders' ability to set corporate decision-making incentives. A key group of shareholders driving development have been institutional investors due to their capacities and expertise to monitor corporate agents, influence objects and engage in governance. Their preferences and attitudes towards CSR, however, remain subject to debate. For these reasons, shareholder attitudes towards CSR are researched in this chapter.

11 How do shareholders affect CSR? Throughout the thesis, it has continuously been emphasised that CSR should not be seen as a monolith, but instead be addressed through the lens of methodological individualism[16] and corporate agency theory. This approach has yielded the central insight that shareholders' interests in CSR are simultaneously driven by both profit maximisation and non-financial preferences:[17] Primarily, they hold an interest in instrumental CSR activities that increase corporate financial performance. From the perspective of agency theory, this includes most forms of stakeholder interaction, non-financial risk management, or

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[13] R. Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Oxford, Oxford University Press, 2017.
[14] E.g. A. Dyck et al., 'Do Institutional Investors Drive Corporate Social Responsibility? International Evidence', *Journal of Financial Economics*, vol. 131(3), 2019, pp. 693-714.
[15] Cp. A. Shleifer & R. Vishny, 'A Survey of Corporate Governance', *Journal of Finance*, vol. 52(2), 1997, pp. 737-83.
[16] Cp. K. Arrow, 'Methodological Individualism and Social Knowledge', *American Economic Review*, vol. 84(2), 1994, pp. 1-9.
[17] Cp. *Chapter Two*, at p. 45.

regulatory pre-emption all summarised in the 'business case' literature.[18] Conversely, shareholders are also interested in actively reducing CSR engagement where it is an undesirable waste of financial resources, for example by a CEO who solely wants to boost their own social reputation.[19] While these two forms of instrumental and managerial CSR are subsumed under conventional profit maximisation, shareholders may also pursue non-financial preferences, i.e. voluntarily 'sacrificing' profits to reach any social objective they deem best addressed by corporate engagement.[20] Their influence on CSR thus happens simultaneously through different channels, which each need to be considered separately and are affected by the nature of shareholders' interests and their capabilities to enforce these.

12 Pay regulation is similarly defined by shareholder centrality. Conventional pay regulation has the objective of maximising shareholder welfare.[21] This happens by either facilitating the creation of optimal incentive schemes[22] or by preventing managerial rent-extraction through excessive pay.[23] For the purpose of this inquiry, regulatory strategies to achieve that can be categorised in two ways: either by using law to protect shareholder interests, e.g. through the employment of independent directors,[24] or by directly empowering shareholders, e.g. through say-on-pay.[25] The choice of means again depends on the capabilities of shareholders to enforce their own interests. Additionally, however, pay regulation may also deviate from shareholder primacy if shareholder interests systematically diverge from social welfare and direct regulation of economic activities is unattainable; in these cases, pay regulation is designed to restrict shareholder interests.[26] The design of pay regulation thus entirely depends on the interests and capabilities of shareholders.

13 Shareholder centrality in CSR and pay regulation naturally converge in CSR-oriented pay regulation: its rules either empower, protect, or restrict shareholders. Its goal is to maximise social welfare by ensuring the emergence of the correct incentives to provide a socially optimal amount of CSR, to ensure its efficacy at solving market failures, and to minimise the agency costs of CSR.[27] The key question that needs to be answered to implement the principles of CSR-oriented pay regulation is which of those functions—empowering, protecting or restricting shareholders—are necessary in which circumstances. Two epistemic obstacles

[18] A. Carroll & K. Shabana, 'The Business Case for Corporate Social Responsibility: A Review of Concepts, Research and Practice', *International Journal of Management Reviews*, vol. 12(1), 2010, pp. 85-105.
[19] Cp. G. Cespa & G. Cestone, 'Corporate Social Responsibility and Managerial Entrenchment', *Journal of Economics & Management Strategy*, vol. 16(3), 2007, pp. 741-71.
[20] R. Bénabou & J. Tirole, 'Individual and Corporate Social Responsibility', *Economica*, vol. 77(1), 2010, pp. 1-19.
[21] G. Ferrarini & M. Ungureanu, 'Executive Remuneration', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[22] M. Jensen & K. Murphy, 'Performance Pay and Top Management Incentives', *Journal of Political Economy*, vol. 98(2), 1990, pp. 225-64.
[23] L. Bebchuk, J. Fried & D. Walker, 'Managerial Power and Rent Extraction in the Design of Executive Compensation', *University of Chicago Law Review*, vol. 69(3), 2002, pp. 751-846.
[24] Cp. J. Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices', *Stanford Law Review*, vol. 59(6), 2007, pp. 1465-1568.
[25] Cp. R. Thomas & C. Van der Elst, 'Say on Pay around the World', *Washington University Law Review*, vol. 92(3), 2015, pp. 653-731.
[26] Ferrarini & Ungureanu (2018), *supra* note 21.
[27] Cp. *Chapter Five*, at p. 166.

persist to this: the role of institutional investors in governance and the nature of shareholder preferences.

14 Institutional investors are the main driver of shareholder engagement in corporate governance. In the US, professional, large investment companies like insurers, pension funds, hedge funds or mutual funds have gradually replaced retail investors throughout the late 20th century and are the largest group of shareholders today.[28] Naturally, this has made them the focus of recent corporate governance reforms. What makes institutional investors special is that they possess the resources and expertise to actively engage with companies, and that their growing share of overall ownership makes them an increasingly influential force. However, much remains unknown about the details of how institutional investors interact with portfolio companies.[29] A peculiar case currently discussed is that of mutual funds—whose importance has grown over-proportionally—due to internal complexities that make engagement difficult and are addressed in the following section.[30]

15 The second core issue is preferences. Engagement mechanisms themselves are partially obscure and it still not perfectly understood what objectives are even pursued by institutional investors. While internal agency problems impede the pursuit of financial performance maximisation, institutional investors are also found to be drivers of CSR engagement.[31] Notably, this not only holds for instrumental CSR, but also non-financial preferences.[32] Despite being corporate entities themselves, institutional investors thus appear to also transplant moral, political, or cultural values. Particularly the attitude of index funds, given their size and importance, towards CSR has barely been touched upon in the literature so far and merits special attention.[33]

Section 3: Index Funds and CSR

16 Corporate ownership across industrialised nations is increasingly concentrated in the hands of institutional investors. At the forefront of this development stand index funds: passively management investment funds that automatically track share indices instead of relying on human decisionmakers. This organisational model comes with issues, most notably a lack of stewardship, i.e. engagement with portfolio companies, that has moved to the centre stage of current corporate scholarship. This theorised idleness stands in sharp contrasted to the observation of index funds engaging in loud social activism. From this apparent conundrum of a lack of conventional governance involvement but keen CSR engagement, the basis of a case

[28] Cp. E. Rock, 'Institutional Investors in Corporate Governance', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[29] Cp. J. McCahery, Z. Sautner & L. Starks, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors', *Journal of Finance*, vol. 71(6), 2016, pp. 2905-32.
[30] *Infra*, para. 17 et seq.
[31] Cp. S. Graves & S. Waddock, 'Institutional Owners and Corporate Social Performance, *Academy of Management Journal*, vol. 37(4), 1994, pp. 1034-46; R. Johnson & D. Greening, 'The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance', *Academy of Management Journal*, vol. 42(5), 1999, pp. 564-76.
[32] A. Dyck et al., 'Do Institutional Investors Drive Corporate Social Responsibility? International Evidence', *Journal of Financial Economics*, vol. 131(3), 2019, pp. 693-714.
[33] Cp. *infra*, para. 24-29.

study is developed to understand the role of index funds as shareholders for CSR and governance regulation.

3.1 Idle Stewards but Social Activists?

17 Institutional investors may look back at an impressing impact of shaping the basic discourse of corporate scholarship. Going back all the way to Berle and Means,[34] corporate law has understood shareholders as dispersed human owner-investors, culminating in the introduction of agency theory and the paradigm of shareholder value protection with the work of Meckling and Jensen.[35] Today, this is no more: in 2000, Hansmann and Kraakman benignly argued that corporate law had simply succeeded at solving the shareholder-manager agency conflict.[36] In 2013, Ronald Gilson and Jeffrey Gordon acknowledged that shareholder dispersion had waned in favour of emerging intermediary investors who concentrated direct ownership in their hands.[37] In a system they term 'agency capitalism', these institutional investors fall into two groups: activists who specialise in portfolio monitoring and executing interventionist campaigns, and passive mutual funds that simply maximise assets under management.[38] Mutual funds, in turn, fall into two categories: actively managed funds with managers who try to 'beat the market' and passive index funds that mechanically track markets.

18 Index funds have documented a spectacular ascent and concentration process. Today, there are three key players: BlackRock, Vanguard, and State Street. Together, these 'Big Three' control 25 percent of all voting shares in the American S&P 500, a figure projected to grow to over 40 percent over the next two decades.[39] Within the last ten years, 80 percent of all assets that have flowed into investment funds went to these three companies.[40] The selling propositions of index funds to retail investors are straightforward: they promise solid returns—given the lack of evidence that attempting to beat markets were a better strategy for the majority of investors than simply following them[41]—and operate at negligible costs due to algorithmic automation, while offering opportunities to diversify even small portfolios. Due to this dominance, it is crucial to understand how index funds' interpretate their role as corporate owners and stewards.

19 Exercising a quarter of all voting rights as owners of the S&P 500, one might suspect that index funds have massive resources and expertise to influence managerial decision-making. The Big Three, however, employ a total of fewer than one hundred individuals in charge of corporate governance.[42] They also virtually never initiate shareholder proposals or director nominations[43]

[34] A. Berle & G. Means, *The Modern Corporation and Private Property*, New York, Macmillan, 1932.
[35] Meckling & Jensen (1976), *supra* note 2.
[36] H. Hansmann & R. Kraakman, 'The End of History for Corporate Law', *Georgetown Law Journal*, vol. 89(2), 2001, pp. 439-68.
[37] R. Gilson & J. Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights', *Columbia Law Review*, vol. 113(4), 2013, pp. 863-927.
[38] Ibid.
[39] Bebchuk & Hirst (2019a), *supra* note 4.
[40] L. Bebchuk & S. Hirst, 'The Specter of the Giant Three', *Boston University Law Review*, vol. 99(3), 2019, pp. 721-42.
[41] E. Fama & K. French, 'Luck versus Skill in the Cross-Section of Mutual Fund Returns', *Journal of Finance*, vol. 65(5), 2010, pp. 1915-47.
[42] Bebchuk & Hirst (2019a), *supra* note 4.
[43] Ibid.

and are bad at monitoring.[44] This observation dashes hopes for institutional investor empowerment to be the solution to the shareholder-manager agency conflict and justifies concerns for the future of corporate governance.[45] Nevertheless, it is the understandable result of index funds' underlying organisation and economic incentives.

20 The business model of mutual funds is to pool assets from individual investors and in turn invest those assets into shares of publicly traded companies. Naturally, their clients have a presumable interest in maximising profits. Mutual funds, as Janus-faced agents of those beneficiary owners on the one hand and shareholder principals in their portfolio companies on the other, however, lack the incentives to engage accordingly in corporate governance. The first and most obvious reason for this is diversification. Mutual funds—as this is part of their competitive advantage—pool resources to invest in a large array of companies; governance engagement will thus reap only a tiny proportion of the advantages while bearing its full costs.[46] What is more, portfolio companies are usually shared among competitors, meaning the latter will also benefit: both these issues reinforce a central free-riding problem in the distribution of costs and benefits of governance engagements.

21 Secondly, the business model of mutual funds does not endorse shareholder activism. Active as well as passively managed funds charge fees as a percentage of assets under management, unlike, e.g., hedge funds that profit from performance improvements. The key incentive for funds managers thus is to maximise assets, not portfolio companies' financial performance. Active funds, the literature assumes, may at least have in interest in doing so because superior financial performance is a competitive advantage for them, but they still face the free-riding problems elaborated above.[47] Index funds, however, only sell average market performance and have no incentives to improve performance or governance.[48]

22 Lastly, practical agency problems deter funds managers from governance involvement: in the US, many companies direct large 401(k) pension assets that are lucrative business opportunities for fund managers.[49] Governance activism can risk alienating corporate executives in charge of those assets and thus spoil these opportunities.

23 There are some sources of governance activism for index funds. Most obviously, they have fiduciary duties towards retail investors that oblige them to pursue and exercise voting rights in their interests. This may be also regarded as a strategy of pre-empting governmental regulation, given more recent pushes towards greater stewardship regulation.[50] Index funds

[44] D. Heath et al., 'Do Index Funds Monitor?', *ECGI Working Paper Series in Finance*, Working Paper No. 638/2019, 2019.
[45] Cp. L. Bebchuk, A. Cohen & S. Hirst, 'The Agency Problems of Institutional Investors', *Journal of Economic Perspectives*, vol. 31(3), 2017, pp. 89-112.
[46] Gilson & Gordon (2013), *supra* note 37.
[47] Cp. S. Griffith & D. Lund, 'Conflicted Mutual Fund Voting in Corporate Law', *Boston University Law Review*, vol. 99(3), 2019, pp. 1151-92.
[48] Disagreeing, Fisch et al. argue that index funds compete with actively managed funds on the industry levels and thus have at least some incentives to improve performance, see J. Fisch, A. Hamdani & S. Solomon, 'The New Titans of Wall Street: A Theoretical Framework for Passive Investors', *University of Pennsylvania Law Review*, vol. 168(1), 2019, pp. 17-72.
[49] R. Ashraf, N. Jayaraman & H. Ryan, 'Do Pension-Related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation', *Journal of Financial and Quantitative Analysis*, vol. 47(3), 2012, pp. 567-88.
[50] Cp. J. Hill, 'Good Activist/Bad Activist: The Rise of International Stewardship Codes', *Seattle University Law Review*, vol. 41(2), 2018, pp. 497-524.

indeed usually vote in AGMs, but they have outsourced the decision-making process to specialised proxy advisors and mostly follow their voting guidelines.[51] Nevertheless, these different drivers do not seem to overcome the systematic underlying lack of incentives for governance involvement faced by index funds.

24 From this outline, one may assume that index funds' reticence to get involved in governance also extends to the realm of CSR engagement. An opposing theory, however, has recently been published by Barzuza, Curtis and Webber (BCW).[52] BCW show that in a stark contrast, the Big Three actively engage in CSR activism, which they argue is due to competition for the assets of a young generation with strong non-financial preferences in their investment decisions.[53] Their central proposition—that index funds had few incentives to engage in conventional governance, but strongly did so in CSR—presents the key conundrum of this chapter: unravelling this apparent paradox is necessary to understand the role of shareholders for CSR legislation.

25 In 2017, State Street conducted a stunning PR campaign called 'Fearless Girl'. It was accompanied by the introduction of a comply-or-explain approach to demand justification from companies with all-male boards that was soon intensified towards withholding votes to the nomination committee members if no progress were made. Shortly thereafter, BlackRock responded by requiring companies to have at least two female directors; Vanguard also took a pro-diversity approach and threatened to withhold votes.[54] Regarding climate change, BlackRock started urging investors in 2015 to consider the long-term effects of climate change in their portfolio decision-making and in 2019 announced divestments amounting to USD 1.8 trillion from companies linked to the coal industry.[55]

26 Notably, index funds have shown real engagement in these areas and surpassed the stance of proxy advisors, who are otherwise known for their aggressive stance on conventional governance issues,[56] and are highly confrontational towards management. BCW offer an explanation for this phenomenon: they argue that since index funds cannot compete on financial performance and hardly on price,[57] they have discovered the social impact of their clients' investments as a distinguishing competitive advantage.[58] The authors cite evidence that the millennial generation—roughly those born between 1980 and 2000—holds far greater non-financial preferences than any other age-based demographic segment and places 'improving society' over 'generating profits' as the primary purpose of business.[59] This demographic segment is not only amassing savings itself, but will also watch over an inherited wealth transfer of 12 to 30 trillion dollars from their parental generation in the decades to come.[60] CSR

[51] D. Lund, 'The Case Against Passive Shareholder Voting', *Journal of Corporation Law*, vol. 43(3), 2018, pp. 493-536.
[52] Barzuza et al. (2021), *supra* note 5.
[53] Ibid.
[54] Ibid.
[55] On the details of index funds' CSR engagement policies, cp. *infra*, para. 36 et seq.
[56] On the influence of proxy advisors, cp. N. Malenko & Y. Shen, 'The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design', *Review of Financial Studies*, vol. 29(12), 2016, pp. 3394-3427.
[57] Cp. *supra*, para. 21.
[58] Barzuza et al. (2021), *supra* note 5.
[59] Ibid., at p. 1285.
[60] Ibid.

engagement by index funds may thus be a response to those non-financial preferences in order to compete for these asset volumes.

27 BCW emphasise that “[i]ndex fund social activism may be about branding, but it is not cynical or superficial. Rather, it is a response to a complex, but robust, set of economic incentives.”[61] Nevertheless, this kind of engagement comes with problems. Their basic incentives are not to engage in areas where CSR has the highest impact, but where it is subjectively most highly valued by their investors. This not only means that they are not incentivised to consider the impact of CSR on financial performance but may also exhibit pro-managerial tendencies in choosing areas with less board resistance.[62] These aspects form a complex picture of index fund CSR activism.

28 Another contribution on the topic is made by Ringe, who explores the potential of institutional investors as drivers of pro-CSR governance activism.[63] Providing arguments in a similar line to those of BCW, he argues that due to the supply side effects of competition for assets by index funds, demand by millennial investors with non-financial preferences, and common ownership effects, institutional investors were a key force for more CSR engagement. The author concludes that regulators should enact fewer prescriptive rules and instead focus on enabling investors to exert influence on firms, including through better disclosure regulation, the removal of barriers to and facilitation of platforms for investor collaboration.[64] The outlined benefits of investor activism and—more importantly—its regulatory implications show that if harnessed right, index funds can play a key role in fostering CSR engagement. To avoid any pitfalls resulting from shortcomings like governance activism reticence or greenwashing, investor incentives and behaviour need to be closely inspected.

29 Index funds are undoubtably a central force in corporate ownership whose importance will only grow in the future. Their lack of incentives for corporate governance engagement, however, has worried scholars over the design of corporate law and stewardship regulation. This reticence stands in stark contrast to their active engagement for social causes, which can be attributed to the non-financial preferences of the investors for whose assets they compete. A better understanding of the interplay of CSR and conventional governance incentives is thus needed to know what role CSR legislation may play in it.

3.2 Case Study Outset

30 BCW show that—contrary to the situation in conventional corporate governance—index funds can be activist shareholders when it comes to CSR engagement. Notwithstanding the extensive inquiry, however, it is but the beginning of further research into this direction as the authors

[61] Ibid., at p. 1305.
[62] BCW argue that portfolio themselves can hardly oppose pro-diversity shareholder initiatives due to the impending public backlash. Ibid., at p. 1306.
[63] W. Ringe, ‘Investor-Led Sustainability in Corporate Governance’, *ECGI Working Paper Series in Law*, Working Paper No. 615/2021, 2021.
[64] Ibid., at pp. 32-44.

themselves concede.[65] Many questions about index funds' influence on CSR remain unaddressed, especially regarding the role of shareholders for CSR-oriented pay regulation.

31 Several issues arising from how index funds approach CSR activism are already highlighted by BCW: the insufficient consideration of financial performance, incentives driven by marketing and differentiation strategies, and the avoidance of resource-intensive involvement.[66] Thus, there is the necessity for more research on the links between index funds and CSR. Moreover, BCW have merely opened the door to separating CSR incentives from conventional governance incentives and there are two venues that remain under-addressed and deserve further attention: first, while they juxtapose governance and CSR incentives to emphasise that the former cannot simply be applied to the latter, more attention needs to be payed to their interplay and the influence of governance incentives on CSR. This is closely linked to the second issue: a lack of differentiation between CSR activities. While BCW indeed acknowledge that incentives affect index funds' choice of areas for CSR engagement, they do not differentiate much between the drivers and effects of CSR activities.[67] Applying any differentiation—such as the tripartite categorisation developed in this thesis[68]—may derive more precise results.

32 The issues of index fund behaviour have real consequences for how the principles of CSR-oriented pay regulation developed in the previous chapter[69] may be implemented in practice. The interplay of CSR and governance incentives can affect the drivers of CSR engagement: if index funds are reluctant to engage in governance activism and are often even found to exhibit pro-managerialism in their decisions,[70] they might fail to pursue instrumental CSR and instead prefer managerial CSR, exacerbating the agency costs of CSR. If the main purpose of CSR engagement is marketing to retail investors, the efficacy of CSR, i.e. its success at solving actual market failures, might be at stake, as indicated by evidence that index funds fail to curb political influencing disguised as CSR.[71] Index funds are particularly silent on pay issues,[72] posing a challenge to the approach of making pay regulation a legislative driver of CSR engagement. To understand the role of shareholders for CSR legislation means to better understand the incentives of index funds to engage in CSR.

33 To fill this theoretical gap in CSR and corporate scholarship, this chapter follows up with a brief case study that addresses those issues left open by the BCW study. Case studies are a method of inductive theory development[73] that can help developing a better understanding of index funds' incentives, based on which hypotheses can be derived. A practice-oriented case study bears the advantage of facilitating the construction of theories in complex settings such

[65] "In integrating the phenomenon of index fund social activism into the larger debate over index funds as shareholders, we hope to begin the conversation regarding this new era in corporate governance." Ibid, at pp. 1320-21.
[66] Ibid.
[67] Ibid.
[68] *Chapter Two*, at p. 45.
[69] *Chapter Five*, at p. 155.
[70] Bebchuk & Hirst (2019a), *supra* note 4.
[71] L. Strine, 'Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending', *Washington University Law Review*, vol. 97(4), 2020, pp. 1007-45.
[72] Ashraf et al. (2012), *supra* note 49.
[73] K. Eisenhardt & M. Graebner, 'Theory Building from Cases: Opportunities and Challenges', *Academy of Management Journal*, vol. 50(1), 2007, pp. 25-32.

as this one, where incentives are difficult to disentangle.[74] The research question to answer in it is: what are the incentives for index funds, from conventional corporate governance as well as social activism, to engage in the different forms of CSR activities as defined by the tripartite categorisation? Shedding light on this question will help to define how pay regulation needs to be designed to contribute to the objectives of CSR legislation.

34 To distinguish how internal organisation, competition, preferences, and legislation affect index funds' incentives for CSR activism, the three largest funds—BlackRock, State Street Global Advisors (SSGA) and Vanguard—are selected. This allows for comparisons to identify possible differences in policies, business strategies, and economic environment. In two separate steps, following this comparative approach, the funds' stewardship policies and engagement reports are analysed. They are used to discern how index funds themselves display their incentives—bearing in mind the relevance this has for the competition for the assets of investors with non-financial preferences—and how their actual engagement looks like. This is complemented by data on client non-financial preferences and the market for sustainable investments. From the policies and corresponding reports—which also present subjective information but are the closest available qualitative information on index fund engagement—insights on incentives are derived. The key approach is to use existing knowledge on the relationship between stewardship and conventional governance engagement and identify differences in the relationship for CSR engagement as shareholders.

Section 4: The Big Three and CSR Shareholder Activism – A Case Study

35 To understand the role of index funds as drivers or inhibitors of CSR, this case study attempts to disentangle incentives for conventional governance engagement and incentives derived from competition for the assets of investors with non-financial preferences. A comparison of the Big Three's stewardship policies is conducted with special attention paid to self-identified priorities and attitudes towards CSR, which are then matched with known empirical insights on investor preferences. In a second step, actual engagement taken from stewardship reports is analysed to identify discrepancies to policies and derive conclusions on index funds' incentives to engage in different forms of CSR.

4.1 Engagement Policies and Investor Preferences

36 BlackRock, Vanguard, and State Street each have engagement policies that detail how CSR characteristics play into their investment and governance affiliation decisions. The principles laid out in these policy documents can be used as a first step to approach index funds' framing and understanding of CSR, both from the perspective of self-regulatorily imposed stewardship rules and how engagement is presented to clients and the public.

[74] K. Eisenhardt, 'Building Theories from Case Study Research', *Academy of Management Review*, vol. 14(4), 1989, pp. 532-50.

4.1.1 Policies

37 This section provides an overview and comparison of the Big Three index funds' engagement policies as the institutional baseline for the stewardship activities. The aim is to understand how they perceive and publicly communicate the issue of CSR. This is done with an eye to differentiation of CSR activities: while conventional scholarship posits that index funds are disincentivised to engage in governance, BCW theorise that they instead compete for socially minded clients by engaging in CSR shareholder activism. As the understanding of CSR promulgated in this thesis emphasises the interplay of both conventional and idiosyncratic incentives,[75] it is crucial to understand which forms of CSR are dominated by either conventional governance or marketing-driven activism incentives.

38 To understand how index funds approach CSR, it is wise to begin with both the largest one among the Big Three and the most vocal one on ESG issues: BlackRock manages a total asset volume of ca. USD 9.5 trillion, and its CEO Larry Fink publishes an annual letter in which he describes what he sees as the currently most pressing issues for portfolio companies. In 2021, this letter centred on climate and sustainability issues with bold strokes. It reiterates BlackRock's prior appeal to portfolio companies to "create enduring, sustainable value for all of [their] stakeholders", rejecting a narrowly defined idea of shareholder primacy, and highlights the key proposition that "climate risk is investment risk."[76] In 2020, BlackRock already announced divestments from high sustainability-related risk sectors.[77] This was followed upon in 2021 by a verbal commitment to "support" a transition of the global economy towards net-carbon neutrality 2050.[78] While this transition is framed as a necessity for human society in general to cope with climate change, implications for individual companies are phrased through a financial lens: the letter emphasises that "companies that are not quickly preparing themselves will see their businesses and valuations suffer," while "within industries […] companies with better ESG profiles are performing better than their peers, enjoying a 'sustainability premium.'"[79] Notably, reference is also made to "customers and talent, especially as young people increasingly expect companies to reflect their values."[80] Social issues, which are also mentioned in the context of the covid-19 pandemic, are addressed less precisely in the language of a general stakeholder management approach. Instead, reference is made to the 2018 letter, which had stated that "[c]ompanies must benefit all of their stakeholders", as they would otherwise "lose the license to operate from key stakeholders."[81] Overall, the self-portrayal of BlackRock is that of a driver of sustainability in portfolio companies—through both expertise and data analytics—motivated by both the long-term financial prospects of spearheading that transition and a vague sense of societal purpose.

39 This general impression is also incorporated into BlackRock's engagement policies. In its 'Investment Stewardship Global Principles', the asset management company lays out the basics of how it interacts with portfolio companies. Regarding CSR, the main approach is to require

[75] Cp. *Chapter Two*, at p. 45.
[76] L. Fink, *Larry Fink's 2021 Letter to CEOs*, 2021, available at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.
[77] L. Fink, *Annual Letter to CEOs – A Fundamental Reshaping of Finance*, 2020, available at https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceo-letter.
[78] Fink (2021), *supra* note 76.
[79] Ibid.
[80] Ibid.
[81] L. Fink, *Larry Fink's 2018 Letter to CEOs – A Sense of Purpose*, available at https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter.

non-financial disclosure and reports of CSR engagement along international reporting standards to promote “sustainable long-term value creation.”[82] Where reporting is inadequate, BlackRock claims to “engage with a company and/or use our vote to encourage a change in practice.”[83] While corporate governance is understood to include “appropriate risk oversight of environmental and social […] considerations”,[84] CSR is not directly mentioned with regard to compensation schemes and policies.

40 Two areas of CSR engagement—climate change and stakeholders—are addressed separately and offer insights on differentiated approaches to CSR: climate change is simultaneously framed as a social as well as a financial issue, with BlackRock acknowledging that “[t]he public and private sectors have roles to play […] to curb the worst effects of climate change”,[85] but specifying expectations towards portfolio companies as an awareness of the impact of “climate-related risk and opportunities”[86] on business and strategy. Regarding stakeholders, however, non-financial motivations are entirely absent and stakeholder relations management is purely described as an issue of “long-term shareholders’ interest” and “long-term value creation”.[87]

41 A final noteworthy object of inquiry at BlackRock are regional proxy voting guidelines. While diversity in the boardroom had been marketed extensively,[88] the requirement for at least two female directors on the board only extends to the US, Canada, Latin America, and Europe. This is justified with a focus “on the quality of the board” and the claim that “pertinent diversity characteristics may differ across markets.”[89]

42 The engagement policies of SSGA, with a total asset volume of ca. USD 4 trillion, lend itself to a close comparison with BlackRock. In its own annual letter to portfolio company CEOs, SSGA defined “the systemic risks associated with climate change and a lack of racial and ethnic diversity”[90] as its stewardship priorities, thus highlighting CSR as a key issue in its engagement. Unlike BlackRock, however, who combine language of CSR as both a financial and social concern, SSGA pursues a more stringent approach of framing their engagement as driven primarily by investment risk considerations. They cite evidence that “companies with strong ESG characteristics experienced less negative stock returns during the market collapse”[91] of the initial covid-19 economic shocks and phrase particularly climate change as an issue for “long-term value.”[92] SSGA lists communications and voting as their methods of engagement and demand proper non-financial disclosure using international frameworks as well as improvement strategies from companies ranking the lowest in a proprietary ESG

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[82] BlackRock, *BlackRock Investment Stewardship – Global Principles*, January 2021, at p. 3, available at https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-engprinciples-global.pdf.
[83] Ibid.
[84] Ibid., at p. 9.
[85] Ibid.
[86] Ibid.
[87] Ibid., at p. 10.
[88] Cp. *supra*, para. 24-29.
[89] BlackRock, *Our Approach to Engagement on Board Diversity*, March 2021, available at https://www.blackrock.com/corporate/literature/publication/blk-commentary-engaging-on-diversity.pdf.
[90] State Street Global Advisors, *CEO’s Letter on Our 2021 Proxy Voting Agenda*, 11 January 2021, available at https://www.ssga.com/library-content/pdfs/asset-stewardship/combined-proxy-guidance-letters.pdf.
[91] Ibid., at p. 1.
[92] Ibid.

scoring system.[93] The purely instrumental language of CSR is only interrupted with regard to the social issues of racial and gender diversity: here, SSGA claims that "[w]hen it comes to racial and ethnic diversity […] we all have work to do. That includes us at State Street."[94] Referencing its own 'Fearless Girl' campaigns on gender diversity and the Black Lives Matter protests in the US, a notable commitment is made to vote against nomination committee chairs who fail to appoint "at least 1 director from an underrepresented community"[95] as of 2022.

43 Further specifications on how these publicised attitudes are translated into precise stewardship engagement are included in SSGA's global ESG engagement and voting guidelines. There, all CSR stewardship is subsumed under the "fiduciary obligation to our clients […] to maximize the long-term returns of their investments."[96] This includes as a minimum adequate non-financial disclosure, while SSGA is open to "support" actual CSR integration.[97] Engagement with firms is driven by screening systems to identify ESG industry outliers and annual thematic prioritisation of certain issues. Notably, SSGA further specifies that it will not support shareholder proposals on CSR issues, even if those are deemed 'material', as long as either general CSR performance or non-financial disclosure are considered sufficient.[98] Regionally, SSGA's commitment to approve only ethnically and gender diverse boards is limited to the US and UK, while gender diverse boards are also expected in Canada, Japan, and Europe.[99] Like at BlackRock, no links between compensation and CSR are discussed.

44 Lastly, Vanguard—with ca. USD 7 trillion assets under management—pursues the most tacit approach to CSR stewardship. In its Responsible Investment Policy for, it merely mentions non-financial "ESG risk as part of an overall independent risk assessment" in its investment decisions.[100] "[E]ffective management of environmental and social risks" is promoted as part of conventional good governance, and corresponding engagement characterised as "quiet diplomacy focused on results".[101] In its US proxy voting guidelines, no active engagement in favour of CSR is described, except for the commitment to vote against nomination committee chairs "where there is a lack of sufficient progress on board diversity and board diversity disclosure."[102]

45 Vanguard commits to vote in favour of CSR shareholder proposals only in cases of disclosure of how climate change risks are incorporated into strategy, capital allocation and business

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[93] Ibid.
[94] Ibid., at p. 3.
[95] Ibid., at p. 3.
[96] State Street Global Advisors, *Global Proxy Voting and Engagement Guidelines for Environmental and Social Issues*, March 2021, available at https://www.ssga.com/library-content/pdfs/ic/proxy-voting-and-engagement-guidelines-principle.pdf.
[97] Ibid., at p. 3.
[98] Ibid., at p. 4.
[99] State Street Global Advisors, *Summary of Material Changes to State Street Global Advisors' 2021 Proxy Voting and Engagement Guidelines*, March 2021, available at https://www.ssga.com/library-content/pdfs/global/proxy-voting-and-engagement-guidelines.pdf.
[100] Vanguard Funds, *Responsible Investment Policy*, available at https://about.vanguard.com/investment-stewardship/principles-policies/.
[101] Ibid.
[102] Vanguard Funds, *Summary of the Proxy Voting Policy for U.S. Portfolio Companies*, 1 April 2021, at p. 3., available at https://about.vanguard.com/investment-stewardship/portfolio-company-resources/2020_proxy_voting_summary.pdf.

impact assessments, or where they request "reasonable" disclosure of diversity-related workforce demographics or minority protection.[103]

46 From a comparison of the Big Three's engagement policies, first insights can be gained on how they present and view CSR. All of the three investment firms mention CSR as an integrated part of their stewardship approaches, signalling that they view CSR as an institutionalised practice in business and part of good corporate governance. Primarily, this is driven by instrumental language: CSR is foremost characterised as a form of financial and non-financial risk management, especially in the case of the ecological, regulatory, and reputational consequences of climate change. This is complemented by a positive dimension of instrumental CSR according to which strong non-financial performance offers competitive advantages in embracing future technologies and markets more quickly as well as operating in more conducive stakeholder environments. A purely instrumental understanding of CSR, subsumed under the index funds' primary fiduciary duty of 'long-term value creation', would indicate that incentives for CSR activism did not diverge from the ones for conventional governance, as methods of engagement remained largely the same.

47 Notably, however, the proclaimed push for deeper CSR integration in portfolio firms remains shallow in the governance dimension. None of the Big Three, for example, explicitly requires an alignment of remuneration policies with CSR strategies or the adoption of non-financial performance targets as central steering devices. Instead, their approach centres on disclosure and reporting: they all require certain levels of non-financial reporting, relying on international standards such as the Sustainability Accounting Standard Board's (SASB) Industry Standards or the Taskforce on Climate-related Financial Disclosures (TCFD) Framework.[104] Through the vaguely defined use of communicative engagement and voting, poor disclosure is supposed to be discouraged and used to identify outliers with particularly weak CSR performance. Disclosure is a strategy to manage corporate affiliation terms that usually addresses outsiders,[105] which indicates that index funds prefer using the influence of market forces on firms over actual engagement. This also matches their reluctance to specify criteria for the integration of CSR into corporate governance and is affirmed by their reliance on quantitative CSR metrics for large-scale, low-cost non-financial performance evaluation. Additionally, all Big Three appear reluctant to endorse CSR activist shareholder proposals and detail the limited circumstances, such as the improvement of inadequate disclosure and reporting,[106] under which they may do so. Index funds thus convey an instrumental view of CSR, focusing on associated investments risks, that favours the use of market mechanisms over individual corporate engagement. This speaks in favour of a strong prevalence of conventional governance incentives in their attitudes towards CSR.

48 Next to these commonalities, there are also remarkable differences in the engagement policies. Most obviously, it is the space dedicated to CSR. Both BlackRock and SSGA do not only address CSR in individual sections in their general engagement policies, but have proceeded to publish separate, distinct ESG stewardship policies that elicit their CSR attitudes in detail. Vanguard, in contrast, pursues no such differentiated approach and instead appears to only incorporate CSR to the extent that it is part of a financially adequate long-term investment policy.

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[103] Ibid., at pp. 11-12.
[104] On internationally accepted non-financial reporting standards, cp. *Chapter Five*, at p. 168.
[105] Kraakman et al. (2017), *supra* note 13, at pp. 38-39.
[106] *Supra*, para. 43.

49 This observation is connected to a more striking difference: the baseline presentation of CSR as an instrumental issue is interrupted at SSGA and BlackRock by altruistic language referring to social welfare and non-financial preferences. At BlackRock, this is the case with climate change, described as a societal challenge, while SSGA focuses on the social issue of ethnic and gender diversity. For each issue respectively, the two funds explicitly go beyond instrumental language in the description of their approach. Applying BCW's theory of CSR shareholder activism as competition for clients with non-financial preferences, it may be conjectured that instead of broadly promoting CSR, index funds pursue more targeted marketing strategies of focusing on a specific CSR issue in which they claim a leading competitive advantage. BlackRock underpins their climate change activism with large divestment announcements, SSGA aims to promote gender and ethnic diversity by threatening to withhold proxy votes.

50 A comparison of engagement policies thus yields the result that index funds primarily regard CSR as a contribution to long-term firm value. To this form of engagement for type-(i) instrumental CSR, conventional corporate governance incentives apply with the according free-riding issues elaborated on in *Section 3*.[107] Beyond that, however, some index funds also pursue targeted strategies that focus on a specific area of CSR, in which they market the pursuit of non-financial preferences to compete for clients who want to satisfy non-financial preferences in their investment decisions. Incentives for activism in favour of these forms of CSR—that can be classified as type-(iii) delegated shareholder philanthropy—are instead determined by those competitive forces on the asset markets and the efficacy of marketing strategies. A differentiation of CSR activities is thus necessary to adequately specify these results.

51 There are two problems with the feasibility of this insight. First, the separation into instrumental CSR, activism for which is governed by conventional governance incentives, and delegated shareholder philanthropy as the targeted pursuit of what index funds assume are client preferences, depends on actual client preferences. A second core issue is greenwashing, i.e. the ability of index funds to omit translating their stewardship positions into actual engagement, because their behaviour is too costly to observe. Beginning with the first problem, this section proceeds to examine whether actual client preferences match index funds' policy priorities.

4.1.2 Investor Non-Financial Preferences

52 The Big Three's rhetoric in their respective engagement policies hints at a differentiated understanding of instrumental and profit-sacrificing CSR activities. Instrumental CSR, which simply entails sustainability as a contribution to long-term investment value, is driven by conventional governance incentives as a part of performance maximisation. Activism for profit-sacrificing CSR by index funds, instead, can be rationalised as a targeted strategy to attract clients who hold non-financial preferences. A first check whether this simple distinction holds is to compare index funds rhetoric with actual client preferences and to evaluate data on the latter's willingness to sacrifice profits.

53 In their study, BCW focus on the generation of millennials as one with distinct social values from those of the previous one, citing evidence of higher willingness to consider social and environmental impacts in their investment decisions and higher rates of participation in socially

[107] *Supra*, para. 20.

responsible investing.[108] Data gathered by Morgan Stanley in 2019 indeed show that millennials are overwhelmingly supportive of SRI, with 95 % "interesting in sustainable investing"; this, however, is up from a baseline of 85 % among all investors.[109] This shows that SRI is not a singular generational issue, but spans all investor categories. The empirical literature confirms that sustainability has become a recurrent criterion for mainstream investors.[110] The inclusion of CSR characteristics in their engagement policies thus seems necessary for index funds to satisfy general investor expectations of how fiduciary duties are exercised.

54 BlackRock and SSGA focus their language of non-financial investment criteria on certain limited areas. For BlackRock, this is climate change, while SSGA highlights ethnic and gender diversity. In these areas, extensive commitments to withhold votes or even divest are made if portfolio companies do not meet expectations.[111] Surveys show that both climate change and diversity rank among the CSR topics to which investors assign the highest priority in their interests. This supports BCW's claim that index funds highlight engagement in these specific areas driven by non-financial motivations as a positioning strategy to carve out competitive advantages.

55 Lastly, the most important question is whether investors are actually willing to forego financial performance to satisfy non-financial preferences. If this were not the case, a differentiation between instrumental and profit-sacrificing CSR engagement strategies would not hold. As SRI has only entered mainstream investing rather recently, the empirical evidence is incomplete. One notable study finds that investors' utility derived from sustainable investments is stronger when returns are positive, which indicates a preferences for instrumental sustainability over profit-sacrificing.[112] Other empirical studies though find that there are inherent non-pecuniary benefits derived from SRI,[113] a conclusion supported by both natural[114] and field experiments.[115] While the financial and philanthropic dimensions of SRI thus unsurprisingly seem cognitively connected by investors, the willingness to trade off profits with social or environmental impact exists to a positive extent that however cannot yet be quantified. Marketing non-financially motivated shareholder engagement in certain focal areas thus appears to be a plausible strategy for index funds to compete for certain investor target groups as clients.

56 A brief overview of investor preferences shows that both an interest in CSR generally and the willingness to either combine or even forego profits to reach certain social or environmental targets are prevalent to a certain extent. Millennials, whom BCW claim to be the core driver of

[108] Barzuza et al. (2021), *supra* note 5, at pp. 1291 et seq.
[109] Morgan Stanley Institute for Sustainable Investing, *Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice*, 2019, available at https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf.
[110] S. Hartzmark & A. Sussman, 'Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows', *Journal of Finance*, vol. 74(6), 2019, pp. 2789-2837.
[111] *Supra*, para. 40.
[112] N. Bollen, 'Mutual Fund Attributes and Investor Behavior', *Journal of Financial and Quantitative Analysis*, vol. 42(3), 2007, pp. 683-708.
[113] B. Barber, A. Morse & A. Yasuda, 'Impact Investing', *Journal of Financial Economics*, forthcoming.
[114] Hartzmark & Sussman (2019), *supra* note 108.
[115] R. Bauer, T. Ruof & P. Smeets, 'Get Real! Individuals Prefer More Sustainable Investments', *Review of Financial Studies*, vol. 34(8), 2021, pp. 3976-4043.

this phenomenon,[116] show only slightly higher interests in CSR issues than average investors in the most recent surveys. The nearly ubiquitous importance attributed to sustainability considerations in investment decisions indicates that index funds respond to client demands by integrating instrumental CSR as a baseline into all its engagements. Beyond that, a targeted pursuit of *ex ante* specified non-financial objectives driven by 'social' motivations may be a viable strategy to compete for the assets of clients who value those objectives. Given the evidence on engagement policies and client preferences, index funds' CSR engagement is concurrently directed by both conventional financial incentives as well as market forces for the activist pursuit of non-financial objectives. The key question that remains is whether client demand for altruistic engagement is exhausted in mere rhetoric—given that index funds are already criticised for their general reticence in governance—or also translated into action.

4.2 Governance Activism and Market Forces

57 Actions speak louder than words and allow more resilient inferences on motivations and incentives. The look at the Big Three's engagement policies offered useful first insights on how they frame their stance on CSR, which is especially important given BCW's hypothesis that their CSR activism is driven by competition for non-financial investor preferences and hence successful marketing. This part of the case study compares actual shareholder engagement taken from stewardship reports with the policies and furthermore discusses the issue of substitutive market forces.

4.2.1 Governance Activism

58 From their stewardship policies, the insight is derived that index funds have a broad interest in instrumental CSR as well as a specific interest in altruistic CSR engagement in selected areas. While shareholder engagement for instrumental CSR—as a contribution to long-term financial performance—is driven by well understood conventional governance incentives, altruistic CSR activism is entirely the result of competition for assets of investors with non-financial preferences. Private retail investors, however, are often not qualified to monitor their funds' actual stewardship engagement, which creates scope for greenwashing the impact of their investments. As a consequence, incentives for index funds to support CSR shareholder activism only exist to the extent to which the resulting engagement is observable and can be marketed as a competitive advantage in the market for assets. This raises the urgent question whether discrepancies between index funds' stewardship policies and their engagement exist.

59 Due to the novelty of the issue, reliable data on index fund CSR shareholder activism is still difficult to gather or verify. The Big Three themselves publish comprehensive annual reports including quantitative data and often selective qualitative case studies of their engagement. This information is arguably subjective. From existing reliable data on the role of index funds as conventional financial stewards, however, the relationship between policies, engagement, and incentives is already known partially.[117] These insights allow a basic interpretation of engagement reports issued by index funds themselves that can be extended to CSR engagement. Comparing the relationship between the Big Three's policies and reported

[116] Barzuza et al. (2021), *supra* note 5.
[117] E.g. Heath et al. (2019), *supra* note 44.

engagement for both conventional and CSR stewardship can thus yield further insights on the funds' CSR activism. To identify differences in CSR incentives from conventional governance incentives, special attention is paid to the volume of engagements, their content, and shareholder proposals.

60 BlackRock conducted 9,270 engagements with portfolio companies in the proxy year 2020/21,[118] which presents a 49 % increase to the prior period.[119] Out of those, 2,330 dealt with "climate and natural capital" and 1,350 with "company impacts on people", which means that approximately 40 % of all of BlackRock's engagements dealt with environmental or social issues in the broader sense of CSR.[120] This presents a steep increase to just 316 engagements on environmental and 353 ones on social issues two years prior.[121] More resources appear to be invested into stewardship engagements; also, CSR-related engagements have grown disproportionately and this growth has been focused in the environmental sector.

61 Voting decisions are used as a 'hard' instrument to voice dissent with companies that significantly diverge from what the fund considers adequate consideration of sustainability criteria, or which are unable to reliably promise improvements. For 2020, available data shows that BlackRock took action against 22 % of a total of 244 companies it considered making insufficient progress on climate change.[122] For 2021, that scope—called 'Climate Focus Universe'—was extended to approximately 1,000 companies representing 90 % of CO_2 emissions in BlackRock's investment portfolio, whose handling of climate change is assessed.[123] In 2021, BlackRock claims to have voted against 255 directors and 319 of those companies directly "for climate-related concerns that could negatively affect long-term shareholder value."[124] While those numbers appear significant in relation to companies 'monitored', climate-related performance poses a negligible reason for the total of 6,560 directors against whose appointment BlackRock had voted. However, 'board-related diversity' was the second most common reason for such a negative vote after 'lack of independence'.[125] In America, a lack of ethnic or gender diversity on the board or disclosure thereof even was the most common reason, typically directed at members of the nomination committees. A twofold approach regarding environmental and social issues is thus discernible: for the complex task of integrating climate change into long-term corporate strategies, engagement and assessments are preferred with voting as a measure of strong disapproval. Diversity, which is easier to monitor through reporting and disclosure, is addressed primarily with voting pressure.

62 Lastly, shareholder proposals as a key item of shareholder activism merit attention. Like most index funds, BlackRock has initiated none. Support for shareholder activism has increased, however: while in 2019/20, it only supported 15 or 6 % of all shareholder-initiated proposals

[118] BlackRock, *Pursuing Long-Term Value for Our Clients: A Look Into the 2020-2021 Proxy Voting Year*, July 2021, available at https://www.blackrock.com/corporate/literature/publication/2021-voting-spotlight-full-report.pdf.
[119] Ibid.
[120] Ibid.
[121] Ibid.
[122] BlackRock, *Our Approach to Sustainability*, July 2020, at p. 4, available at https://www.blackrock.com/corporate/literature/publication/our-commitment-to-sustainability-full-report.pdf.
[123] BlackRock, *Climate Focus Universe*, 2020, available at https://www.blackrock.com/corporate/literature/publication/blk-climate-focus-universe.pdf.
[124] BlackRock (2021), *supra* note 118, at p. 14.
[125] Ibid., at p. 9.

on environmental or social issues,[126] this rose to 81 proposals or 47 % in 2020/21.[127] This notable shift had followed changes in the stewardship policy towards a greater emphasis on shareholder proposals as a driver of sustainability-related issues.

63 SSGA, having published an annual report for the calendar year 2020, conducted a total of 1721 engagements with portfolio companies within this time period.[128] This is a slight increase of 12 % within two years, i.e. compared to 2018.[129] In 2020, 851 specific engagements targeted R-factor scores, SSGA's proprietary system of measuring, comparing and assessing a company's ESG performance, which thus can be broadly equated with CSR-focused engagements.[130] SSGA's introduction of systematic R-factor ratings in 2019 with no comprehensive data on engagements yet render an inter-periodical comparison difficult. The 2018/19 stewardship report lists 443 cumulative engagements on SSGA's primary "core campaign focus" of gender diversity, 89 engagements on the secondary focus of climate change and a total of 153 engagements on "sustainability and long-term strategy."[131] SSGA's CSR stewardship is thus becoming more transparent with improved disclosure. For the first half of 2021, 555 engagements are reported; of these, three quarters covered governance issues, while environmental issues were raised in approximately 29 % and social issues in 49 %.[132] While these data allow no conclusion on quantitative trends, they show that unlike BlackRock, SSGA focus more on social issues in accordance with their 'Fearless Girl' main policy of promoting gender diversity explained above.[133]

64 Voting behaviour appears to be a less integral instrument of SSGA's engagement policy. Its support of proposals has remained stable over the last few years, with overall opposition to management positions in 15.5% of management-initiated proposals and 11.4 % of shareholder-initiated proposals in 2020.[134] BlackRock, in contrast, actively increased its support of shareholder-initiated proposals from 17 % to 35 % from 2019/20 to 2020/21.[135] In its Q2 2021 report, however, SSGA reports an increase in support of shareholder-initiated proposals on climate matters from 14 % in 2019 to 35 % in 2020 to 46 % in the first half of 2021.[136] At a first glance, SSGA appears to follow the adoption of shareholder proposals as an easily publicisable strategy of CSR engagement. Data reveals, however, that support for climate-related shareholder activism is mostly driven by proposals on 'say-on-climate', i.e. governance decision rights for shareholders on climate matters, and "climate-related lobbying", which entails membership in dedicated trade associations or political contributions.[137] Proposals related to the transition to renewable energies or operational changes in response to climate change received the least support or even none at all. SSGA thus appears to pursue a strategy

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[126] BlackRock (2020), *supra* note 122, at p. 17.
[127] BlackRock (2021), *supra* note 117, at p. 15.
[128] State Street Global Advisors, *Stewardship Report 2020*, March 2021, available at https://www.ssga.com/library-content/pdfs/asset-stewardship/asset-stewardship-report-2020.pdf.
[129] State Street Global Advisors, *Stewardship Report 2018-19*, August 2019, available at https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf.
[130] State Street Global Advisors (2021), *supra* note 128.
[131] Ibid., at pp. 16-17.
[132] State Street Global Advisors, *Stewardship Activity Report Q2 2021*, 2021, available at https://www.ssga.com/library-content/products/esg/asset-stewardship-activity-q2-2021.pdf.
[133] Cp. *supra*, para. 42-43.
[134] State Street Global Advisors (2021), *supra* note 128.
[135] BlackRock (2021), *supra* note 118, at p. 16.
[136] State Street Global Advisors (2021), *supra* note 128.
[137] Ibid., at p. 3.

of supporting CSR shareholder activism only where it remains on an abstract or symbolic governance level while avoiding operational interventions that may be more costly to pursue or create greater disruptions in relation to corporate management. These indications speak in favour of index funds showing pro-managerial tendencies highlighted by the literature as well as greenwashing concerns.

65 Lastly, Vanguard's stewardship report for 2020 offers insights on its approach to CSR activism. Its engagement records show a change of policy: while Vanguard engaged with 793 companies in 2020—a decrease of 9 % compared to the previous year[138]—this spiked to 734 within just the first half of 2021.[139] Except for an increase in 'diversity-related engagements' from 71 in the first half of 2020 to 305 in the same period of 2021,[140] disclosure of how environmental or social issues are addressed during engagement is less systematic at Vanguard, who follow a more tacit policy of CSR integration as explained above.[141]

66 Instead, voting behaviour is well documented—Vanguard is eager to document its greater adoption of CSR-oriented policies in several areas: it claims to have increased support for diversity-related proposals—whether initiated by management or shareholders—from 17 % to 50 % in 2021.[142] Support for environmental proposals was at 37 %, a trend however that is again driven by a support of 83 % for 'say on climate' provisions that have no direct effect on a company's environmental performance, but just strengthen shareholder decision rights.[143] Overall proxy voting data show that even though Vanguard has increased its support of CSR-related proposals, it is still far from joining shareholder activism: while in 2019 and 2020, it supported a mere 6 % of all shareholder-initiated environmental or social proposals,[144] this increased to a mere 20 % in the first half of 2021, which is still by far the lowest level of support for any category of proposals.[145] However, it supported all of 17 management-initiated E&S proposals, a small fraction in contrast to 227 shareholder-initiated ones.[146] Overall, despite changes in engagement and voting behaviour towards a greater emphasis on CSR topics, Vanguard's approach is still in line with its policies of not supporting activism with significant operational or disruptive effects.

67 Overall, engagement at the Big Three is in dynamic development. First, index funds appear to react to the notion gaining recognition in academia that they were bad stewards[147] by increasing their total engagement, integrating CSR with long-term financial performance in most areas of corporate strategy, and exhibiting a more adversarial voting behaviour towards management. These trends appear, to different degrees, at all Big Three funds and could also be an attempt to pre-empt stricter stewardship regulation. Secondly, index funds' engagement appears to be consistent with the focal points highlighted in their policies on certain areas of CSR. BlackRock

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[138] Vanguard, *Investment Stewardship 2020 Annual Report*, 2020, available at https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2021_investment_stewardship_annual_report.pdf.
[139] Vanguard, *Investment Stewardship 2021 Semiannual Report*, 2021, available at https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/inv_stew_2021_semiannual_report.pdf.
[140] Ibid.
[141] Cp. *supra*, para. 42-43.
[142] Ibid.
[143] Ibid. For more details on 'say on climate', cp. *infra*, para. 80.
[144] Vanguard (2020), *supra* note 138, at p. 44.
[145] Vanguard (2021), *supra* note 139, at p. 28.
[146] Ibid.
[147] Cp. *supra*, para. 19-23.

shows overproportionate growth in climate-related engagement, while SSGA's engagement is concentrated on social and diversity matters.[148] This is congruent with the marketing theory of competition for the assets of non-financially motivated investors. Lastly, due to the centrality of marketing in these incentive schemes, greenwashing can be an issue: all investors vocally claim high rates of approval for CSR-related shareholder proposals—at least relative to previous periods. The data published by two of the Big Three, however, shows that this is mostly concentrated in the area of 'say on climate' shareholder decision rights and other shallow governance-related areas, while support for proposals is the lowest where any actual operative impact could be expected.

68 What do these observations say about incentives for instrumental and altruistic CSR shareholder engagement? Primarily, the limited information available on engagement seems to confirm the existence of concurrent incentives for instrumental CSR as part of conventional governance and altruistic CSR in limited areas where it attracts accordingly minded investors. One large issue is the implication of greenwashing: if the effects of costly, profit-sacrificing CSR engagement are unobservable to investors, index funds can wrongfully project generic, instrumental CSR as the result of shareholder activism or simply suggest a greater social impact of their stewardship than what is factual. The existence of incentives for profit-sacrificing CSR thus depends on not only marketability, but also observability. A second, yet unaddressed problem is that instead of costly shareholder engagement, index funds may simply rely on market forces to create social impact by offering passive 'responsible investment funds.' This substitution of stewardship by investment screening needs to be addressed as well to adequately gauge governance incentives.

4.2.2 Socially Responsible Investing

69 There are two ways in which index funds can attract clients with non-financial preferences by promising an impact to their investments: either by using their position of ownership to enforce more CSR at a portfolio company, or simply by relying on market forces and offering ESG-screened passive investment opportunities. Based on ESG disclosure metrics or even simpler criteria, funds are offered that either negatively screen by excluding companies with poor CSR ratings or positively screen by focusing on certain selected investments with a predefined social impact. While this form of delegated socially responsible investing also creates pressure on companies to improve CSR performance by restricting or easing capital supply, it may function as a substitute to governance engagement. Offering ESG-screened investment vehicles can be a less costly alternative for index funds to individual engagement at single companies. This potential substitution is important to discuss as it may dilute the incentives posed by client preferences to engage in CSR shareholder activism by instead satisfying them passively through market forces. This, in turn, would have consequences for the design of CSR-oriented governance regulation.

70 ESG-screening has been a fast-growing trend in the area of SRI for the last years. BlackRock, the first of the Big Three to publish a Sustainability Report, reports a volume of USD 200 billion in dedicated sustainable investments and USD 616 billion in screened investments,

[148] Cp. *supra*, para. 38-43.

making up roughly nine percent of its total assets under management.[149] With some analysts projecting ESG investments to continue growing and to make up a third of global assets under management by 2025,[150] the relevance of this investment category is likely to expand even further.

71 Empirical data shows that investment firms consider ESG criteria in their decisions primarily because of their effect on financial performance and client demand.[151] Accordingly, ESG-screened investments are usually marketed as an improvement in returns, a possibility for investors to express non-financial preferences and values, or both. Offering screened passive investment funds is also closer to the conventional core business of index funds than governance activism, which suggests that scale economies may further facilitate this positioning strategy. What particularly speaks in favour of the Big Three relying on market forces to drive CSR is that their engagement policies, as laid out above, strongly focus on improved CSR disclosure for portfolio companies.[152] As disclosure is an instrument traditionally directed at market participants and not affiliated shareholders,[153] this may be another indicator that index funds prefer to driver CSR through capital supply instead of governance engagement.

72 The relationship between CSR shareholder activism and ESG investing is still insufficiently well researched. While it is possible that funds use screened investments to shirk on governance engagement and still produce CSR effects, clients may also be incentivised through SRI to pay more attention to governance engagement and monitor their funds' stewardship activities more vigilantly. The relationship between shareholder activism and market forces thus requires more empirical research in order to be conclusive.

Section 5: Theory Development and Regulatory Implications

73 In *Section 4*, an attempt is made at better understanding index funds' approach to and strategic integration of shareholder CSR engagement. As some of the largest institutional investors, their attitudes and incentives matter to determine how governance regulation needs to be designed to use shareholder engagement as a driver of socially optimal levels of CSR. Here, both the insights from the case study are discussed as well as conclusions that can be drawn for regulatory design and the implementation of the principles of CSR-oriented pay regulation developed the previous chapter.[154]

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[149] BlackRock, *2020 Sustainability Disclosure*, 2021, available at https://www.blackrock.com/corporate/literature/continuous-disclosure-and-important-information/blackrock-2020-sasb-disclosure.pdf.
[150] Bloomberg, *ESG Assets May Hit $53 Trillion by 2025, a Third of Global AUM*, 23 February 2021, available at https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/.
[151] A. Amir-Zadeh & G. Serafeim, 'Why and How Investors Use ESG Information: Evidence from a Global Survey', *Financial Analysts Journal*, vol. 74(3), 2018, pp. 87-103.
[152] Cp. *supra*, para. 46.
[153] Kraakman et al. (2017), *supra* note 13.
[154] *Chapter Five*, at p. 155.

5.1 Performance versus Preferences? Preliminary Insights

74 The brief case study conducted in this chapter can partially confirm, refine, and repudiate elements of BCW's theory on conventional governance and CSR activism incentives for index funds. To begin, the case study indicates that instrumental CSR—as a perceived contribution to 'long-term value creation' or financial performance—serves as a baseline of how index funds approach CSR and include it in the exercise of their primary fiduciary duties. In addition, some index funds selectively pursue an approach of CSR as delegated shareholder philanthropy to satisfy certain non-financial preferences. This is supported by client preferences: the vast majority of investors considers CSR concerns part of diligent decision-making, but some groups hold specific, 'profit-sacrificing' attitudes that can be served through targeted marketing and positioning campaigns. For BlackRock, this is climate change, while SSGA focuses on gender and ethnic diversity as an area in which their engagement is a competitive advantage. There is thus an interplay of conventional governance and market-driven incentives for index funds to engage in CSR shareholder activism. Additionally, it is possible that regulatory pre-emption and reputational concerns about stewardship quality, driven by the proliferated notion in scholarship that index funds lack incentives to be good stewards, drive engagement: total stewardship engagement by index funds has increased over the last years, while CSR stewardship makes up a growing proportion of that. It remains to be seen whether index funds pursue a strategy of assigning further priority to social and sustainability concerns in their stewardship concepts.

75 A core issue that is identified with regard to shareholder sustainability activism is greenwashing: index funds have incentives to shirk on investing in governance, do not directly benefit from financial improvements through instrumental CSR and are only driven by investors' subjective perspective of social impact. The efficacy of CSR thus is in question. The case study shows that index funds neglect deep governance elements, such as compensation structures, and refuse to support activist proposals with operative impact. Instead, they mostly focus on disclosure, a market-oriented instrument, and shallow governance such as 'say on climate' shareholder decision rights that have no direct impact on CSR. That focus on disclosure as well as their business model further indicate that index funds rely on market forces as a substitute to governance engagement to exert CSR pressure on portfolio companies.

76 On index funds' incentives to engage in CSR activism, the following picture emerges: instrumental CSR serves as a baseline, incentives for which are those of conventional governance to maximise long-term financial performance. They originate from the funds' fiduciary duties and suffer from the issues of free-riding and incongruous business models with corresponding pay structures explained in *Section 3*.[155] Simultaneously, index funds are incentivised to invest in non-financially motivated CSR by the competition for the assets of investors with non-financial preferences. These incentives—which can be strong, as the priority index funds allocate to CSR in their policies indicates—are diluted by information asymmetries, i.e. investors' inability to monitor the effects of the funds' engagement and the latter's ability to overstate their activism and impact. This greenwashing, in turn, may have two results: either simply a lack of measurable engagement in CSR at all, or the substitution of heightened, profit-sacrificing CSR by generic instrumental CSR. The prevalence, intensity, and consequences of these incentives remain subject to further theory development and empirical research.

[155] *Supra*, para. 17 et seq.

77 For CSR legislation, three main problems ensue: first, selection of relevant topics in which funds engage is not driven by any measurable economic impact of CSR, but financial performance considerations and subjective investor preferences. Consequently, it may be necessary to ensure the efficacy and right focus of CSR. Secondly, pro-managerialism and a tendency to shirk on any form of resource-intensive or disruptive engagement persist. This may raise the agency costs of CSR and is a source of greenwashing. Lastly, the substitution of governance activism by market forces—which can still be marketed as impact to clients—may foster CSR but is at least an issue for governance regulation that needs to be taken into account.

5.2 Regulatory Design

78 To regress to the main topic of this thesis, implications for governance regulation from these insights need to be discussed. CSR legislation pursues three objectives: to provide the socially optimal amount of CSR engagement, to ensure its efficacy in focusing on remedying market failures and preventing greenwashing, and to minimise the corporate agency costs of CSR. Index funds' incentives to engage in CSR shareholder activism have an important effect on how regulation needs to be designed to utilise and direct the role of shareholders as CSR drivers. This directly holds for pay regulation, whose design empowers, protects, or restricts shareholders, but also additional regulation that can influence shareholder incentives.

5.2.1 Pay Regulation

79 In *Chapter Five*, conclusions are reached on how the main elements of executive pay regulation—say-on-pay, disclosure, the role of directors in the pay-setting process, and structural regulation—could be adapted to contribute to the objectives of CSR legislation. The insights on the role of index funds as shareholders and drivers of CSR gained here provide valuable guidance for an effective regulatory design. Ideally, they allow CSR-oriented pay regulation to harness index funds' incentives for CSR activism and circumvent or alleviate their shortcomings, such as reticence, greenwashing, pro-managerialism, or shallowness. As already noted in the literature, index funds also display no tendency for short-termism, which has been a recurrent feature especially in EU pay regulation.[156] Regarding the latter, two basic strategies are viable: either the attempt to coerce index funds into a more active and efficacious role as CSR drivers, through pay and accompanying regulation, or to accept and circumvent inherent drawbacks and instead rely on other actors in corporate governance.

80 As argued in *Chapter Five*, say-on-pay—i.e., shareholder decision rights on the design of a company's remuneration policy and the pay-outs disclosed in a remuneration report—can facilitate the imposition of non-financial preferences and drive delegated shareholder philanthropy.[157] This can be achieved through strengthened *ex ante* decision rights on incentive schemes and rules that increase the importance of CSR in the remuneration policy. The case study conducted here shows that index funds have market-based incentives to pursue non-financial preferences in their engagements that can be exploited. The connection between CSR and remuneration policies, however, remains unaddressed in stewardship policies and

[156] G. Strampelli, 'Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing', *San Diego Law Review*, vol. 55(4), 2018, pp. 803-52.
[157] *Chapter Five*, at pp. 174 et seq.

neglected in engagements and voting decisions. Index funds appear to prefer 'say on climate' votes, which are modelled after say-on-pay, but merely introduce advisory shareholder votes on a company's "climate transition action plan" that have no direct effect on corporate operations or incentive schemes.[158] Thus, regulation may push index funds to pay greater attention to compensation design as a CSR incentive. Their reluctance towards disruptive or operative engagement may be addressed through a stronger mandatory consideration of CSR in remuneration policies, the proliferation of best practices of sustainability-linked incentive schemes that lower engagement costs, or adapted disclosure rules that are discussed next.

81 Pay disclosure informs shareholders, stakeholders, and the general public about the quality of CSR incentives at a company and thus is central to combatting information asymmetries and greenwashing about a company's commitment to CSR targets. As such, disclosure on compensation is closely complemented by disclosure on CSR performance, which is necessary to verify performance metrics of CSR-linked pay and also forms a core element of index funds' CSR engagement approach. As a market-oriented instrument, disclosure primarily serves to inform market forces and unaffiliated actors. Quantifiable disclosure of the CSR-incentive link in companies may thus serve as a data basis to be integrated into ESG scores, on which also index funds heavily rely for offering screened investments, but also in their engagements. By lowering information costs, it may make it easier for funds to integrate deep governance matters like compensation into their CSR stewardship approaches.

82 A third element of pay governance regulation is independent directors. Using their prominent role in the pay-setting process, independent directors can focus on lowering the agency costs of CSR by managing heterogeneous shareholder non-financial preferences. As this chapter has shown that also index funds pursue varying non-financial preferences to compete for assets, such a regulatory strategy may be necessary to reduce the organisational costs of pay-setting if index funds start paying greater attention to compensation.

83 Lastly, structural regulation remains as a substitutive instrument if governance prescriptions fail to bring about adequate incentives for CSR engagement. Index funds still display several shortcomings in their role as CSR activist shareholders that have been laid out. Regulation of the pay-setting process may be accordingly adapted to account for these shortcomings, such as sketched out here, or they may be addressed by supportive regulation that is discussed below.[159] Only if these approaches fail, structural and more coercive rules may be considered. This includes mandatory CSR performance targets, CSR-linked instruments such as sustainability-linked bonds, or the discouragement of pay instruments that negatively affect CSR due to their time horizon or risk profile.

84 Overall, the complexity of index funds' CSR activism incentives results in what can be summarised as a dual approach of pay regulation functionality: where index funds have incentives to foster CSR, pay regulation should empower them to do so—and additional regulation, discussed below, may help to optimise these incentives. Where funds have suboptimal incentives, e.g. where their CSR engagement risks becoming pro-managerial, i.e. an agency cost for investors, or greenwashing, restrictive rules may be employed. This can be stronger independent directors or, if other approaches fail, also structural regulation. A precise design of CSR-oriented pay regulation can be further developed on this basis with additional

[158] Introduced by a climate activist hedge fund, the concept of 'say on climate' has been readily adopted by other institutional investors as a low-cost, high-publicity instrument. Any measurable impact on CSR still remains to be quantified, though.
[159] *Infra*, para. 85 et seq.

empirical insights and under considerations of the other relevant conditions enumerated in *Section 2.1*.[160]

5.2.2 Stewardship and Supportive Regulation

85 Implications for the design of CSR-oriented pay regulation and—by extension, corporate law more generally—taken from how index funds behave as shareholders must be seen in the context of complementary legislation. Primarily, there are two relevant areas: stewardship regulation that affects the way in which institutional shareholders are expected to exercise their ownership rights, and CSR legislation, especially the area of non-financial reporting rules.

86 The adoption of stewardship codes proliferated rapidly within the decade following the financial crisis, beginning in the United Kingdom, to develop standards for how investors should contribute to long-term value creation.[161] As a soft law instrument, stewardship codes have little direct impact on economic incentives, but are suited to manage financial market and portfolio company expectations and thus steer behaviour. In Europe, SRD II has been the first step towards supranational codification of stewardship norms, although doing so minimally due to still heterogeneous national regimes, a current lack of market demand for harmonisation and the flexibility of bottom-up approaches.[162] Given convergence trends in corporate governance, it is thus likely that more EU stewardship regulation can be expected in the future. This may be an opportunity to account for the observable shift in the understanding of institutional investors themselves documented in this chapter and define the purpose and expectations of stewardship in a way that support and steer the role of shareholders as drivers of socially desirable forms of CSR. One contribution on how this form of newly defined stewardship may look like is made by Gordon:[163] his concept of 'systematic stewardship' posits that large institutional investors should not pursue firm-specific, but instead aim to mitigate systematic risks like climate change, social or financial stability, which they are predicated to pursue due to their asset and client structure. Depending on the evolving behaviour of index funds and more empirical evidence, more concepts on CSR stewardship will develop soon.

87 Non-financial reporting, on the other hand, forms the basis of any CSR legislation and determine investors' ability to assess portfolio companies' engagement. While the US-based Big Three still rely primarily on institutional reporting standards, such as those of the SASB or TFCD, the EU is developing towards codified CSR reporting. The Non-Financial Reporting Directive (NFRD) of 2014 was the first to introduce harmonised minimum standards for large corporations to disclose certain non-financial information.[164] The Sustainable Finance Disclosure Regulation (SFDR) of 2019 regulates, among other things, CSR categorisations and ratings for exchange-traded funds and is thus relevant for how index funds drive market forces

[160] *Supra*, para. 7.
[161] For an overview, cp. Hill (2018), *supra* note 50.
[162] D. Katelouzou & K. Sergakis, 'When Harmonization is Not Enough: Shareholder Stewardship in the European Union', *European Business Organization Law Review*, vol. 22(2), 2021, pp. 203-40.
[163] J. Gordon, 'Systematic Stewardship', *ECGI Working Paper Series in Law*, Working Paper No. 566/2021, 2021.
[164] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, 2014 O.J. L 330/1 [herein: NFRD].

for CSR.[165] In 2021, a Corporate Sustainable Reporting Directive (CSRD) proposal was published by the Commission to amend the NFRD and develop—for the first time—harmonised non-financial reporting standards.[166] The EU is thus moving away from self-regulatory or soft law reporting standards towards legally endorsed and uniform rules. These new CSR reporting standards are under development to first be applied in the financial year of 2023 and will draw from existing reporting frameworks. They are projected to increase the quantity of CSR reporting and aim to improve its quality—i.e., explanatory power and comparability—as well. This is likely to strengthen the influence capital market forces have on CSR and lower the costs of broad-scale engagement with portfolio companies, meaning the role of index funds will gain further importance in the future.

Section 6: Conclusion

88 Shareholders are the protagonists of corporate law—be it as wards to be protected, actors to be empowered, or egoists to be restrained. This chapter provides some clarification on which of these roles index funds—who hold growing influence in governance affairs—assume with regard to CSR in portfolio companies. Its results are a step towards formulating rules for pay regulation that encourage economically efficient and socially desirable forms of CSR.

89 Sequentially, this thesis has mapped the relationship between law, CSR, and corporate governance and shown how current norms of corporate law affect CSR incentives at the example of pay regulation. It has derived principles for how pay regulation can be designed to make CSR more efficient. Implementing those abstract principles in regulatory practice requires consideration of the economic conditions in a jurisdiction or specific industry. Among those conditions, shareholders are especially important due to their centrality in governance. Index funds, who are rapidly centralising corporate ownership in their hands, have inherent incentives to remain reticent in conventional governance but simultaneously appear to activists in some area of CSR. This conflict of incentives has significant implications for the design of pay regulation, whose design is determined by the role of shareholders. With its case study, this chapter is an attempt to disentangle index funds' incentives for CSR and derive implications for the design of CSR-oriented pay regulation.

90 The case study indicates that instrumental, i.e. financially motivated, CSR forms the baseline of index funds' CSR stewardship. It is driven by the same conventional incentives to engage in governance for long-term value maximisation that are also ground for concerns about reticence and pro-managerialism. Simultaneously, some index funds pursue targeted engagement in certain areas of CSR, like BlackRock who focus on climate change or SSGA on gender diversity. In these areas, engagement is framed as going beyond financial motivations to—as BCW have already argued[167]—compete for the assets of investors with

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[165] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, 2019 O.J. L 317/1 [herein: SFDR].
[166] European Commission, *Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting,* COM(2021) 189 final, 2021/0104(COD).
[167] Barzuza et al. (2021), *supra* note 5.

corresponding non-financial preferences. This additional form shareholder activism, in which incentives are determined by market forces and CSR engagement becomes an instrument of marketing, may drive CSR but comes with two issues: first, it is not driven by the efficacy of CSR at solving market failures, but subjective perception. Secondly, it is susceptible to information asymmetries. As private investors are imperfect monitors of index fund engagement, this can lead to both greenwashing and pro-managerialism, entailing less CSR and higher agency costs. While index funds as shareholders may thus act as drivers of CSR, this comes with disadvantages that may be addressed through regulation.

91 Partially, pay regulation may account for these shortcomings. Its different instruments, whose effects on CSR have been analysed throughout the previous chapters, build upon shareholders' role in the process of setting pay schemes, corporate objectives and performance targets and can mitigate the shortcomings of index funds. Concurrently, stewardship regulation and non-financial disclosure are important to make capital markets a greater and more targeted driver of CSR.

92 What implications do these insights have for stewardship and the changing role of shareholders more generally? Formulating basic scepticism of the direction corporate governance regulation has taken in Europe, Edward Rock comments:

> "[…] one gets the distinct impression that shareholders who act too much like shareholders, with single-minded focus on maximizing shareholder value today, are *not* what is sought. […] Rather, the EU seems to be searching for a very different sort of shareholder, a shareholder more like a rich uncle who, while demanding, is ultimately focused on doing what is best for the family as a whole, one who 'can be encouraged to take an interest in sustainable returns and longer term performance' even at the costs of lower returns."[168]

It appears that 'real shareholders' increasingly diverge from the academic ideal of plain, single-minded profit maximisers. Instead, modern institutional investors' interests are mixed and as complex as their underlying agency structures and market forces. Non-financial preferences cannot, as Rock fears, be seen as an imposition by overly idealistic legislators and thus a divergence from economic rationale. Instead, as Ringe rightly argues,[169] institutional investors themselves are the drivers of this development; their empowerment, though, is limited by their own shortcomings. More attention thus needs to be paid to how legal rules and regulation can contribute towards ensuring that those non-financial preferences result in socially desirable forms of CSR. Where shareholders act as drivers of CSR, incentives can be reinforced and guided towards efficacy and economic efficiency. Negative and harmful impacts may be discouraged. In the future, this will require more empirical research on the quantifiable effects of index funds engagement to ensure better regulatory design of CSR-oriented pay regulation.

[168] Rock (2018), *supra* note 28, at p. 473.
[169] Ringe (2021), *supra* note 63.

Chapter Seven
Conclusion: Towards a Synthesis of Legal Rules, Governance, and Private Self-Regulation

SUMMARY. This final chapter concludes the thesis. It presents the results in a concise summary, lists limitations of the methodological approach of the research project, discusses policy implications and directions for future research, and offers final remarks on the topic.

Section 1: Introduction

1 This thesis is an attempt to clarify the influence of pay regulation—as an important element of corporate law—on corporate social responsibility (CSR) and whether its legal rules should be designed to endorse CSR. The research project connects the legal perspectives of public regulation with compensation as an incentive mechanism in private governance and CSR as a form of voluntary private self-regulation. It argues that as law is an important institutional determinant of CSR and compensation governs managerial decision-making, pay regulation is a direct way for corporate law to affect incentives for CSR engagement. That, in turn, makes it a channel for legislators to consider in their endeavours of driving and shaping CSR as an element of economic policy. The thesis aims to both contribute to our understanding of when and why CSR emerges as well as to provide input and guidance on how law can improve its contributions to social welfare maximisation.

2 CSR describes how private actors unilaterally remedy market failures. Simply taken as a form of corporate behaviour, it is the result of external just as internal decision-making incentives. This makes it susceptible to economic analysis. Corporations, as complex legal entities, are best understood through agency theory, which addresses the separation of ownership and control, allocation of decision rights, and interests of contractual and non-contractual stakeholders. Within the shareholder-manager agency relationship, incentives are primarily shaped by compensation, whose structure, composition, and governance are addressed in corporate law by the area of pay regulation.

3 The thesis combines a descriptive, explorative approach to CSR with the established analytical toolset of agency theory in corporate governance. It brings together insights on law as an institutional determinant of CSR and legal framework for self-regulation with empirically tested knowledge of how compensation affects CSR engagement and applies both to the area of pay regulation. This approach provides insights on how pay regulation can steer CSR. Simultaneously, it raises the question whether pay regulation should recognise and make use of these effects, which in turn depends on the economic purpose of CSR and any possible conflicts it might cause with the conventional objectives of corporate law.

4 These issues are distilled into two main research questions: first, how pay regulation affects CSR engagement incentives. This is a descriptive question that is answered through a positive

analysis of different areas of pay regulation that each pursue varying objectives and employ different legal instruments. The second research question is whether pay regulation should adopt CSR engagement as an objective and, if so, how its design should accordingly be adjusted. This normative follow-up inquiry requires a delineation of the economic purpose of CSR, principles for a regulatory design that does not conflict with conventional objectives, and guidelines for their implementation in legal practice. Together, these two research questions form a comprehensive overview of the relationship between CSR and pay regulation, enhance its knowledge base, and provide recommendations for scholarship and practice.

5 In this chapter, *Section 2* provides an overview of the results of this thesis, the content of each chapter, and explains how the research questions have been answered. *Section 3* discusses the limitations to this research project. In *Section 4*, implications for both the directions of future research as well as policymaking are suggested. *Section 5* offers final concluding remarks.

Section 2: Research Findings

6 The thesis is structured into five content chapters in total. *Chapter Two* constructs the research framework and develops the methodologies based on the different discipline relevant for the issue at hand, merging them into a coherent approach. *Chapters Three* and *Four* address the first research question and cover the two main areas of pay regulation in practice: shareholder-value-oriented pay regulation in generic corporate law and the more restrictive rules of pay regulation in the financial sector. Together, they offer a comprehensive picture of the forms and purposes of pay regulation and illustrate its functioning. *Chapter Five* opens research question number two, defines objectives for CSR regulation and develops new principles for the integration of CSR into pay regulation. These principles receive concretion in *Chapter Six*, where a case study is conducted to inquire how the incentives of index funds—an especially important type of shareholders—affect the design of CSR-oriented pay regulation.

7 *Chapter Two* begins to outline a research framework by providing a definition of CSR. CSR is an essentially contested concept,[1] i.e. it lacks a set of defining core characteristics and thus requires a conceptual definition that fits the situation in which it is to be applied. The concept developed in the thesis understands CSR as a 'form of voluntary private self-regulation', which has several advantages: first, it captures both older forms of discretionary business philanthropy as well as the modern institutionalised forms of CSR that are embedded in international frameworks, reporting standards, and legal rules. Particularly, it gives a universal, theoretical foundation to the more operational modern approach like ESG that surged in business practice and debate thanks to the proliferation of CSR principles. It also points out the economic purpose of CSR in remedying market failures, shows its connection to law and economics, and accordingly allows for an analysis of its internal and external determinants. This is important for its link to pay regulation, which affects both firm level incentives as well as the institutional legal environment. For corporate governance, a tripartite categorisation of CSR activities within the shareholder-manager agency relationship is developed: CSR is often related to financial performance, in which case it is either a type-(i) instrumental improvement, or a type-(ii) managerial agency cost. It can also, however, be unrelated to the goal of making profits and

[1] B. Sheehy, 'Defining CSR: Problems and Solutions', *Journal of Business Ethics*, vol. 131(3), 2015, pp. 625-48, at p. 640.

instead result from the deliberate imposition of shareholder non-financial preferences as type-(iii) delegated shareholder philanthropy. These categories help explain the complexity of various incentives that can underlie the different forms of CSR.

8 On the institutional level, law is a key determinant of CSR.[2] This may surprise, as CSR was often understood as voluntary engagement 'beyond the law' and thus outside the scope of any legal analysis. CSR and law, however, are alternatives in enforcing "substantive social norms",[3] meaning that law delineates the scope for the existence of CSR. Beyond this baseline, *Chapter Two* proceed to show how legal rules directly influence CSR: CSR may actively be incentivised through supportive regulation or legal coercion (*CSR because of the law*), it may be relied upon as a substitute for legal intervention because of cost-benefit comparison (*CSR instead of the law*), and it may be restricted by laws, e.g. in the case of managerial fiduciary duties (*CSR against the law*).

9 Lastly, *Chapter Two* shows how compensation, as a private contractual mechanism, affects CSR: variable compensation is used as an instrument in lieu of monitoring and control to reduce agency costs by aligning managerial payoffs with pre-defined metrics of shareholder value.[4] As firm value or financial performance are the main variables of incentive pay, especially equity pay, this induces an alignment of CSR with financial performance. The use of performance targets to which payoffs are linked is an important window for shareholders to impose specific non-financial objectives. Lastly, also the effects of compensation on risk appetite, time horizon, and managerial discretion and creativity all affect CSR incentives. Overall, the research framework of *Chapter Two* can be used to single out different CSR incentives, analyse the influence of legal rules on it, and localise it within corporate governance.

10 From that outset, *Chapter Three* addresses the first research question and analyses how pay regulation affects incentives for CSR engagement. The economic rationale behind standard pay regulation is maximising shareholder welfare; this is derived from corporate law's occupation with the intra-corporate agency conflicts. It does so in two ways: by minimising the costs for private actors to set optimal pay schemes and by preventing managerial rent-extraction through excessive pay.[5] The preferred regulatory strategy to achieve this is through governance prescriptions that alter the pay-setting process, but do not directly interfere with its outcomes. *Chapter Three* shows that the changes in the pay-setting process and compensation schemes brought about by regulation affect CSR incentives. It does so by identifying and studying the three most important instruments of shareholder-value-oriented pay regulation.

11 These instruments cover the entirety of the pay-setting process and deal with the role of shareholders, boards, and outsiders in it: 'say-on-pay' rules allocate decision rights in pay-setting to shareholders, director independence aims to prevent conflicts of interests, and compensation disclosure remedies information asymmetries between the company and its outside investors, capital markets, and other stakeholders. Employing the tripartite

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[2] H. Liang & L. Renneboog, 'On the Foundations of Corporate Social Responsibility', *Journal of Finance*, vol. 72(2), 2017, pp. 853-910.
[3] J. Eijsbouts, *Corporate Responsibility, beyond Voluntarism: Regulatory Options to Reinforce the Licence to Operate*, Maastricht, Maastricht University Press, 2011.
[4] Cp. G. Ferrarini & M. Ungureanu, 'Executive Remuneration', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018.
[5] L. Bebchuk, J. Fried & D. Walker, 'Managerial Power and Rent Extraction in the Design of Executive Compensation", *University of Chicago Law Review*, vol. 69(3), 2002, pp. 751-846.

categorisation of CSR activities of *Chapter Two* to differentiate incentives, *Chapter Three* finds that all these shareholder-value-oriented rules tend to promote an alignment of CSR with financial performance. Their effects on delegated shareholder philanthropy, however, are ambiguous: 'say-on-pay' gives shareholders more influence on the design of remuneration policies. While this originally increases pay-performance sensitivity, it also gives shareholders greater bargaining power to impose non-financial performance targets. Director independence has ambivalent effects: while it is conventionally intended to ensure financial performance alignment, independent directors suffer from information asymmetries that hamper their ability to monitor and control. Despite positive effects on stakeholder management, this may obfuscate the remuneration committee's ability to translate CSR objectives into performance targets and thus raise the costs of deliberate CSR incentivisation. Clarification of these effects requires targeted empirical work. As many jurisdictions define independence as equal distance to shareholders, the current legal design may furthermore have negative effects on delegated shareholder philanthropy. Lastly, disclosure is a key complementary mechanism to reduce information asymmetries about compensation systems and lowers the costs for both stakeholders and shareholders to exert influence on the pay-setting process. Pay disclosure is thus important for both financially aligned CSR as well as delegated shareholder philanthropy. In total, *Chapter Three* shows that the standard instruments of pay regulation affect CSR incentives by pushing towards an alignment with financial performance. Depending on whether they empower or protect shareholders and how shareholder interests are defined by the law, they can lead to either more or less delegated shareholder philanthropy.

12 Forms of pay regulation that do not have the sole objective of shareholder welfare maximisation are addressed in *Chapter Four*. Such rules are found in the banking sector, where pay regulation is designed to prevent incentives for excessive risk-taking. Due to the leveraged capital structure of banks and other governance peculiarities, losses are mostly born by creditors and taxpayers, while shareholders fully internalise gains.[6] Shareholders thus have a systematic interest in excessive risk-taking which they translate into corresponding compensation schemes. Pay regulation is employed to prevent the imposition of such incentives, as direct regulation of activities or shareholder interests proves to be imperfect.[7] This makes bankers' pay regulation a peculiar study and potential role model for CSR legislation, because its purpose—internalising externalities that harm stakeholders and the general public—closely aligns with the function of CSR.

13 *Chapter Four* focuses on EU rules. These mostly rely on structural intervention, complement the governance prescriptions covered in *Chapter Three* and provide a comprehensive overview of the instruments available to pay regulation. Its rules aim to prevent the use of variable compensation components and performance targets that encourage excessive risk-taking and instead—in conjunction with other elements of financial regulation—ensure that payoffs are aligned with long-term financial performance and risks. As CSR itself is linked to non-financial risk management and long-term financial performance, these rules provide perspectives on potential direct incentivisation of CSR engagement through pay regulation. More closely inspected, the regulatory instruments reveal different effects: the most prominent rule, a 'bonus cap' that limits variable compensation in a ratio to fixed pay, has problematic effects: it does not reduce overall risk-taking but distorts incentives towards greater loss indifference. Regulating absolute or relative pay levels thus is no viable option for CSR, as it already fails

[6] M. Becht, P. Bolton & A. Röell, 'Why Bank Governance Is Difference', *Oxford Review of Economic Policy*, vol. 27(3), 2011, pp. 437-63.
[7] L. Bebchuk & H. Spamann, 'Regulating Bankers' Pay', *Georgetown Law Journal*, vol. 98(2), 2010, pp. 247-88.

to be efficient in banks. Rules on the contractual design and qualitative structure of compensation prove to be more effective: mandatory pay-for-performance requirements succeed in aligning incentives with long-term financial performance while accounting for potential risks. Structural requirements on pay instruments are invasive but ensure a balanced composition with corrective effects on risk-taking and time horizon. Lastly, compensation in debt is also explored, which is currently not mandated but called for in the literature for its effect of directly linking managerial payoffs to creditor interests.[8] Creditors are a special type of stakeholders, but debt-based pay can protect the interests of other fixed-claim corporate constituencies as well, which makes it a potential venue for CSR-incentivising compensation and future regulation. Overall, banking offers a good example of pay regulation that achieves externality internalisation. Its rules are more invasive than governance prescriptions but also show that other regulatory objectives than shareholder welfare maximisation can be viable and economically efficient. Its highly restrictive rules, however, disable shareholders to act as drivers of CSR, limiting its applicability to scenarios where shareholder interests are detrimental to CSR.

14 Lastly, *Chapter Four* also discusses the conditions under which the specific results reached for the banking sector can be extrapolated to other industries or generalised for standard corporate law. As noted, financial regulation exclusively responds to the peculiarities of bank governance. In total, four conditions are abstracted that determine this peculiarity: capital and ownership structure, the regulatory environment, the role of stakeholders, and business characteristics and externalities. More generally, an analysis of these four conditions in an industry is necessary to judge the viability of CSR-oriented pay regulation in it and can help tailor such regulation to the specific requirements of that industry.

15 With the effects of existing forms of pay regulation on CSR covered in the previous two chapters, *Chapter Five* proceeds to answer the second research questions and discusses whether and—if so—how pay regulation should be ideally designed to encourage CSR engagement. CSR, as a form of private self-regulation, can increase social welfare by unilaterally remedying market failures. As it differs from government intervention or private bargaining, there are situations in which CSR is a more cost-efficient method to do so. Incentivising CSR engagement is thus one channel through which corporate law can contribute to social welfare maximisation. This extends to both instrumental CSR, which is financially Pareto-efficient, and delegated shareholder philanthropy, as a corporation's owners are entitled to allow 'profit-sacrificing' engagements. Managerial CSR, however, constitutes an agency cost, which makes it economically unsustainable. To specify how law can optimise CSR provision, *Chapter Five* develops a transmission channel model that covers the entirety of CSR emergence and helps localise failures in it that the law can address. Based on this model, three objectives for CSR legislation are derived: to provide the socially optimal amount of CSR, to ensure its functional efficacy at solving market failures, and to minimise the intra-corporate agency costs of CSR. While potentially all areas of corporate law can contribute to these objectives, pay regulation stands out for its potential to directly alter decision-making incentives.

16 Based on this framework, *Chapter Five* proceeds to lay out new principles of CSR-oriented pay regulation for the five main instruments covered throughout the prior two chapters. They consider the existing functional purposes of pay regulation, define a way in which they can contribute to the objectives of CSR legislation, and discuss regulatory implementation. Say-

[8] E.g. A. Edmans & Q. Liu, 'Inside Debt', *Review of Finance*, vol. 15(1), 2011, pp. 75-102; R. Sundaram & D. Yermack, 'Pay Me Later: Inside Debt and Its Role in Managerial Compensation', *Journal of Finance*, vol. 62(4), 2007, pp. 1551-88.

on-pay rights empower investors to impose non-financial preferences and should focus on *ex ante* remuneration policies to influence decision-making incentives. This can be further reinforced through a greater integration of CSR in remuneration policies and shareholder decision rights on CSR performance. Independent directors are not ideal at monitoring and controlling, the need for which has also waned with the rise of powerful institutional investors. Instead, building upon their networking and advisory role, independent directors may be assigned a guiding role in the pay-setting process to accommodate heterogeneous shareholder preferences and mitigate intra-shareholder CSR agency conflicts. Disclosure is already a vital element of both existing CSR legislation and pay regulation. Future initiatives need to integrate these still disparate areas to enable investors, stakeholders, and the generable public to directly evaluate the influence of pay scheme incentives on non-financial performance. Structural regulation of the composition of pay instruments and contractual design is a substitutive device to endorse CSR if the governance prescriptions mentioned so far fail to induce optimal levels of CSR and shareholder interests oppose CSR. Especially sustainability-linked bonds pose a promising development in capital markets for the introduction of CSR-linked pay instruments through structural regulation. With these principles, *Chapter Five* endorses the notion that adopting CSR as a regulatory objective in pay regulation does not constitute a 'regime change', as it is consistent with the goal of social welfare maximisation and is founded in agency theory and shareholder centrism.

17 As the last content chapter, *Chapter Six* sheds some final light on the implementation of the principles derived in *Chapter Five*. The conditions for comparing the effects of pay regulation on CSR in different legal and economic environments developed in *Chapter Four* serve as a framework for this. Among those conditions, shareholders and ownership stand out due to special role in both corporate governance and pay regulation, which is why *Chapter Six* focuses on the role of shareholders for CSR-oriented pay regulation. Index funds are an especially prone research subject, as their reticent behaviour in conventional governance stewardship[9] and vocal sustainability activism[10] offer conflicting indications about attitudes towards CSR.

18 Thus, *Chapter Six* conducts a case study of the three largest index funds to clarify their incentives to engage in pro-CSR shareholder activism, using policy and reporting information and supplementary empirical data. It finds that, as a baseline approach, index funds have fully integrated instrumental CSR into their financial stewardship. Additionally, some index funds further delineate certain specific areas of CSR engagement in which they promote the pursuit of non-financial objectives. This is done to gain a competitive advantage in the market for assets, where clients who factor non-financial preferences into their investment decisions are increasingly present. The case study shows the complexity of incentives that institutional investors have regarding CSR: while they act as drivers of CSR, their engagement also risks suffering from potential reticence, pro-managerialism, greenwashing, and a lack of efficacy. CSR legislation can respond by exploiting index funds activism as a source of CSR engagement where it exists while remedying its identified shortcomings. Particularly, engagement driven by subjective client preferences should directed towards areas of CSR where it unfolds the highest efficacy while preventing pro-managerialism and shirking on resource-intensive engagements. An important factor to account for are market dynamics and sustainable investment vehicles, which may act as substitutes for institutional investors' CSR shareholder

[9] Cp. L. Bebchuk & S. Hirst, 'Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy', *Columbia Law Review*, vol. 119(8), 2019, pp. 2029-2146.
[10] Cp. M. Barzuza, Q. Curtis & D. Webber, 'Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance', *Southern California Law Review*, vol. 93(6), 2021, pp. 1243-1322.

activism. Overall, *Chapter Six* demonstrates the importance of the role of shareholders in CSR and is an example of how to consider the conditions and complexity under which CSR emerges when designing regulation.

19 Among the insights gained in this thesis, three results overarch the topic of CSR and pay regulation and thus deserve closer attention. First, there is the tripartite categorisation developed in *Chapter Two* and applied throughout the analytical chapters of the entire thesis. The tripartite categorisation, it is advocated here, presents a novel and original concept developed in this research project that is of broader scientific use. It is derived from a merger of agency and institutional theory—branching sociological, legal, and managerial CSR scholarship—and demonstrates its applicability to the CSR-law relationship. It is one possible way of differentiating CSR activities, whose advantage lies in its focus on incentivisation and the different drivers of CSR that each impact the firm differently, paying adequate tribute to the complexity of the topic. It can be used for thorough theory development, but also serve as a fundament for empirical testing. For these reasons, the tripartite categorisation can contribute value to CSR scholarship beyond this thesis and find application to other issues in the discipline as well.

20 A second contribution to be highlighted is the theoretical definition of CSR derived in this thesis as a form of private self-regulation, directed at the unilateral remediation of market failures. As CSR is an essentially contested concept, this definition is derived for the purpose and scope of this research project and just one of many possible conceptualisations. Nevertheless, it is sufficiently abstract and general to also be applicable to CSR in other settings, while still delineating practices that fall under its scope from others that do not. The approach of this thesis is thus also a useful addition to other conceptualisations, including the topic of ESG that currently dominates the centre stage of the CSR debate: the rise of ESG is owed to the successful institutionalisation of CSR and, consequently, a greater need for operationalisation and measurability of CSR activities by investors and managements. ESG is an approach to CSR that separates activities by areas of corporate engagement—environmental, social, or governance—with a focus on granularity and the development of KPIs and other forms of quantitative or qualitative CSR measurement. The concept of CSR as private self-regulation and a remedy to market failures pursued in this thesis provides a further dimension to ESG approaches by focusing on economic functionality, agency conflicts, and incentivisation. It is applicable to the ESG debate just as well as it has been to the dominant themes of sustainability and social responsibility before it and, due to its sound theoretical foundation, can also serve future CSR developments. Instead of focusing on specific, single issues of CSR, this thesis has pursued a deliberately general and basic approach to provide a flexible analytical framework to be applied in CSR scholarship and practice.

21 Lastly, the role of pay regulation requires elucidation. The thesis focuses on this area of corporate governance regulation for several reasons: its close connection to incentives, its own inherent characteristic as an issue of social interest, and its potential for future CSR legislation. The results reached in the analytical chapters provide clear insights on the ways in which the different legal instruments of pay regulation affect incentives for CSR engagement and can be employed as elements of CSR legislation. A broader question, however, is these results bear any generalisability—more specifically: do any of their insights still hold if remuneration is taken out of the equation? The thesis makes basic indications about how corporate law influences CSR. While the effects of say-on-pay, for example, as a rule governing shareholder participation in the process of determining remuneration policies on CSR are analysed and evaluated, they may hold broader implications for shareholder decision rights in general. The results of this thesis thus provide important ground for further research on basic CSR-law relationship to be discussed in the next section.

22 Together, the chapters of this thesis make a small contribution to our understanding of how CSR, law, and private governance interact. They demonstrate that pay regulation is an important determinant of CSR within its institutional and legal environment. It goes beyond merely affecting managerial decision-making incentives but is entwined with other elements of corporate governance: pay regulation cannot be seen apart from and in turn affects itself the relationship between shareholders and managers, the allocation of decision rights, information flows, and stakeholder influences. In pointing out the specificities of how pay regulation determines CSR, the thesis also highlights the importance of considering firms' broader institutional environment for the design of corporate law. The second research question—whether and how pay regulation should actively promote and endorse CSR—follows from that. CSR is more than voluntary corporate discretion; it systematically serves an economic purpose in solving market failures, at which it sometimes holds a competitive advantage over conventional internalisation mechanisms. Law can promote this function to improve social welfare. The adoption of CSR as a regulatory objective is consistent with the existing rationale of corporate law and thus endorsed; the principles derived for CSR-oriented pay regulation are advances to showcase venues of how this can be realised. The subsequent case study exemplifies the circumstances of practical implementation, but also demonstrates that legal CSR endorsement conflicts less with shareholder primacy than often assumed by conventional corporate governance scholarship. The answers and conclusions given here are intended to provide clarifications and ground for more future research in this direction.

Section 3: Limitations

23 This thesis claims that law—particularly, among the many areas of corporate law, pay regulation—matters for CSR as a determinant. It can be employed as an instrument by legislators to drive CSR into a desirable direction of efficiency and social welfare maximisation. For that purpose, a very specific research framework has been constructed, drawing from different methodologies for the partially disparate areas of inquiry. This is owed to both the interdisciplinarity of law and economics as well as a functional approach to the essentially contested concept of CSR. Particularly for the economic analysis of law, however, Calabresi and Melamed have rightfully noted that framework and model building come with the problem "that models can be mistaken for the total view of phenomena, like legal relationships, which are too complex to be painted in any one picture."[11] This thesis makes no claims beyond those directly addressed by the research questions, acknowledges the importance of other approaches, and recognises certain caveats.

24 Foremost, its contribution is a theoretical one and does not provide original empirical evidence. Its analysis focuses on translating existing economic insights into legal conclusions, connecting disparate research topics, and draws from and builds upon existing empirical knowledge wherever available. For the field of CSR, which has long been neglected as a distant topic 'beyond compliance' by legal scholarship, this has filled a research gap. The thesis does not,

[11] G. Calabresi & D. Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral', *Harvard Law Review*, vol. 85(6), 1972, pp. 1089-1128, at p. 1128.

however, quantify any effects or rule out rivalling hypotheses. Its focus is a framework that accounts for the complexity of CSR, proves its susceptibility to law and economics analysis, and can be used as a basis for future empirical testing of subsequent hypotheses.

25 Likewise, the normative conclusions derived in answering the second research question are equally restricted to the conceptual level. A theoretical justification is provided for how CSR contributes to social welfare and how law can support this function. The principles of CSR-oriented pay regulation derived in *Chapter Five* exemplify how the adoption of CSR as an objective in one area of corporate law is consistent with its existing rationale. They cannot be directly applied as direct policy recommendations, which would require greater consideration of the conditions that influence the CSR-law relationship—as shown in *Chapter Six*—and, again, more empirical evidence. Ongoing developments in non-financial disclosure regulation, other areas of CSR legislation, and business practice will further affect the conclusions reached until this point.

Section 4: Policy Implications and Future Research

26 What could follow from the insights that have been learned in this thesis? Foremost, its normative conclusions can serve as input for policymaking. It is shown that CSR engagement is a socially desirable objective of legislation and that its pursuit is reconcilable with the conventional structure and objectives of corporate law. Primarily, this implies that lawmakers should move towards the adoption of CSR-oriented pay regulation. More broadly, the thesis sketches out the prospect of a general integration of CSR—as both a remedy to market failures and a solution to shareholder-stakeholder agency conflicts—into corporate law. Such a recommendation is consistent with the direction legislation has recently taken towards a greater involvement in CSR, reinforcing its self-regulatory character as something that stands between direct legal coercion and managerial discretion. The conclusions reached in this thesis are purposefully designed as general principles that are to be specified dependent on the relevant regulatory setting.

27 Likewise, the thesis also argues that current CSR legislation ought to pay greater attention to internal corporate governance. Most of it still focuses on external issues, notably non-financial disclosure regulation. While disclosure is a necessary baseline for market forces to affect CSR, an obvious next step is to progress towards considering the effects of internal governance mechanisms on CSR. Likewise, future stewardship regulation for institutional investors can play a significant role in strengthening the internal role of shareholders as CSR drivers in governance.

28 Academically, the thesis attempts to point out directions of future research in the relevant disciplines. Most directly, this pertains to the empirical work of quantifying the effects of pay regulation on CSR laid out theoretically under the first research question. While the thesis makes use of the existing literature on the causal link between compensation and CSR, the evidence in this direction remains incomplete. More importantly, the direct connection between pay regulation and CSR is yet unaddressed. In the thesis, much emphasis is put on disentangling the complexity of CSR and highlighting the shortcomings of existing approaches that oversimplify the issue by reducing CSR to a singular dimension. Thus, the corresponding frameworks are also developed to serve as guidance for more detailed empirical research.

29 Accompanying the policy implications, future research is also invited to address the implementation and design of CSR-oriented pay regulation. *Chapter Six* is exemplary for how economic and institutional conditions need to be considered to draft effective legal rules for CSR endorsement in corporate governance. Research in this field may particularly cover the conditions of certain industries, different jurisdictions, or the influence of stakeholder constituencies on CSR.

30 Additionally, more work on the integration of CSR and corporate law in general is endorsed. The thesis chooses pay regulation as its focus due to the centrality for decision-making incentives. However, the frameworks of CSR activities in agency theory, the CSR-law relationship, or the transmission channel model are equally applicable to other areas of corporate law. Research in this direction may provide further insights on how promoting CSR can be reconciled with conventional regulatory objectives.

Section 5: Final Remarks

31 As an opener to the thesis, anecdotal evidence is cited on how people often perceive the connection between executive pay and social responsibilities to centre on issues of distributive justice, an *ex-post* sense of justified earnings, or wage equality.[12] This stands in sharp contrast to how scholarship treats compensation as an *ex-ante* incentive. Pay regulation is of interest to this thesis not only because of its role in governance, but also its inherent social dimensions; by uncovering how CSR-oriented pay regulation can contribute to social welfare maximisation beyond shareholder value, the thesis also underscores the importance of framing the link between compensation and social responsibilities as one of incentives.

32 Much of modern law and economics can be traced back to the Coase theorem, which posits that not only governmental intervention, but also private bargaining can remedy market failures.[13] This whole research project rests on the initial, naïve observation that sometimes, corporations internalise externalities even when they are neither legally coerced nor contractually obliged to. Instead, they do so in a way that is usually understood as ‘voluntary’. What is more, that behaviour has become so recurrent that private institutions and legislators have started to rely on it systematically. The thesis is designed to start as an unbiased inquiry into the causes of CSR within its legal environment and an inquisition of how this knowledge may help us to improve social welfare by better remedying market failures.

33 This makes it an attempt to achieve two things at which law and economics usually excels: first, it is an interdisciplinary study. It brings together different legal areas, the economics of private organisations and markets, institutional and behavioural theory. In doing so, it provides new insights that remain unattainable if one restricts themselves to the approach of a single discipline. Secondly, it also challenges pre-conceived notions: explaining how modern corporate governance has evolved out of corporate law, Ronald Gilson writes that “[i]n the end, corporate governance is messy, complicated and contextual because that is the character of

[12] *Chapter One*, at p. 1.
[13] R. Coase, ‘The Problem of Social Cost’, *Journal of Law and Economics*, vol. 3(1), 1960, pp. 1-44.

dynamic markets."[14] Law and economics has tended to long disregard CSR as an issue 'beyond the law.' This thesis attempts to show that legal rules play a crucial role in this area that has become so important to today's business practice. The everchanging dynamics that underlie corporate governance—its market forces, agency conflicts, and rules—are moving towards a greater emphasis on externalities and stakeholder conflicts in the face of less need for shareholder protection. Corporate law's constant need to adapt is exemplified in this research project by pay regulation, whose effects on CSR demonstrate how corporate law can incentivise private self-regulation and remedying market failures.

[14] R. Gilson, 'From Corporate Law to Corporate Governance', in: J. Gordon & W. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance*, Oxford, Oxford University Press, 2018, at p. 30.

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Anreize, Nachhaltigkeit und Recht:

Die Beziehung zwischen der Regulierung von Vorstandsvergütung und der gesellschaftlichen Verantwortung von Unternehmen

Laurenz Goldhahn

Zusammenfassung

In welcher Beziehung stehen Managergehälter zur gesellschaftlichen Verantwortung von Unternehmen (Corporate Social Responsibility, CSR)? Eine weit verbreitete Meinung ist die *ex-post*-Ansicht, dass Vorstandsvergütung lediglich ein Thema von Verteilungsgerechtigkeit, Angemessenheit und öffentlicher Empörung sei. Dies steht im Widerspruch zum ursprünglichen wissenschaftlichen Verständnis der Vergütung als privatwirtschaftlichem Instrument zur Steuerung unternehmerischer Entscheidungsanreize und Reduktion von Prinzipal-Agenten-Kosten. Aktuell bezieht weder die ökonomische Vergütungsforschung CSR ausreichend ein, noch wird Vergütungsregulierung als potenzieller Bestandteil des wachsenden Instrumentariums der CSR-Gesetzgebung erwogen. Durch die erfolgreiche Etablierung von CSR in der Unternehmenspraxis sowie die Aufmerksamkeit, die politische Entscheidungsträger und Gesetzgeber dem Thema mittlerweile zollen, ist die Beantwortung dieser Fragen jedoch umso wichtiger geworden. Dieser blinde Fleck der Corporate Governance – die Beziehung zwischen Vergütung, CSR und Recht – ist daher das Thema der vorliegenden Arbeit.

Die Dissertation nähert sich diesen Problemen in zwei aufeinander folgenden Forschungsfragen: Zuerst wird die Rolle der Vergütungsregulierung als institutioneller Bestimmungsfaktor von CSR-Engagement identifiziert. Dazu wird ein Analyserahmen entwickelt, der eine theoretische Basis liefert und die verschiedenen Forschungsdisziplinen vereint, die zur Erklärung der Beziehung zwischen CSR und Recht heranzuziehen sind. In der Folge werden die verschiedenen Bereiche der Vergütungsregulierung hinsichtlich ihrer Auswirkungen auf CSR analysiert. Aus dem Ergebnis leitet sich die zweite Forschungsfrage ab: Sollten Gesetzgeber CSR-Engagement fördern und – wenn ja – wie? In diesem Teil definiert die Arbeit den volkswirtschaftlichen Zweck von CSR, identifiziert dessen Defizite, die Rolle des Rechts dabei, diese zu beheben, und erforscht das Potenzial von Vergütungsregulierung als Instrument hierzu. Zuletzt wird eine Fallstudie durchgeführt, um zu erörtern, wie der Einfluss von Indexfonds als wichtigen CSR-Treibern der Corporate Governance in der CSR-Gesetzgebung berücksichtigt werden sollte.

Das Forschungsprojekt zeigt, dass Vergütungsregulierung Teil der institutionellen Bestimmungsfaktoren von CSR ist und, abhängig von ihrer Ausgestaltung, verschiedene Formen von CSR-Engagement fördern oder diesen entgegenwirken kann. Als eine Form privater Selbstregulierung ist CSR eng mit gesetzlichen Regelungen verwoben und das Resultat komplexer, zugrundeliegender Faktoren innerhalb und außerhalb des Unternehmens. Die Arbeit entwirft eine Differenzierung von CSR-Aktivitäten, um diese Komplexität abzubilden, und die in einer folgenden Analyse von Vergütungsregulierung im allgemeinen Unternehmensrecht sowie den besonderen Regeln des Finanzsektors angewandt wird. Zusammen ergeben diese Studien ein umfassendes Bild der Art und Weise, auf die Vergütungsregulierung Anreize für CSR-Engagement setzt.

Ursprünglich kaum mehr als Geschäftsethik, stellt moderne CSR eine unilaterale Antwort von Unternehmen auf Formen von Marktversagen dar, die im Zuge der Globalisierung nicht mehr durch nationale Regierungen allein behoben werden können. CSR ist jedoch selbst kein perfektes Instrument. Nachdem aufgezeigt wurde, wie gesetzliche Regelungen für CSR-Anreize und -Steuerung sorgen, legt die Arbeit dar, wie Vergütungsregulierung angepasst werden kann, um zum Ziel eines gesamtgesellschaftlich optimalen Niveaus an CSR-Engagement beizutragen. Es wird gezeigt, dass CSR-orientierte Vergütungsregulierung mit den konventionellen Zielen der Corporate Governance vereinbar ist und schließlich ein Vorbild für die Integrierung von CSR als Gesetzgebungsziel ins allgemeine Unternehmensrecht geliefert.

Incentives, Sustainability and Law:

The relationship between executive pay regulation and corporate social responsibility

Laurenz Goldhahn

Summary

What is the relationship between executive pay regulation and corporate social responsibility (CSR)? A prevalent notion is the *ex post* view that compensation is just an issue of distributional justice, adequacy, and ensuing public outrage. This is contrasted by its original academic understanding as an instrument to steer managerial decision-making incentives and reduce agency costs. Currently, CSR is neither sufficiently included in economic research on executive pay, nor is pay regulation considered as a potential instrument in the growing body of CSR legislation. The successful proliferation of CSR in business practice and the attention policymakers and legislators now pay to it, however, have raised the importance of answering these questions. Thus, this blind spot in corporate governance—the relationship between compensation, CSR, and law—is the topic of this thesis.

The dissertation approaches these issues in two subsequent research question: first, the role of executive pay regulation as an institutional determinant of CSR engagement is identified. To this end, an analytical framework is developed that provides a theoretical foundation and merges the disparate academic disciplines necessary to fully explain the CSR-law relationship. Subsequently, the different areas of pay regulation are then analysed for their effects on CSR. From the results, the second research question arises: should legislators promote CSR engagement and—if so—how? In this part, the thesis defines the economic purpose of CSR, identifies its shortcomings, the role of law in remedying these, and explores the potential of pay regulation as an instrument for that. Lastly, a case study is conducted to map how the influence of index funds as an important driver of CSR in corporate governance should be accommodated in the design of CSR legislation.

The research project shows that pay regulation is part of the institutional determinants of CSR and, depending on its design, can incentivise or discourage different forms of CSR engagement. As a form of private self-regulation, CSR is closely interconnected with legal rules and the result of complex underlying drivers inside and outside the firm. The study develops a differentiation of CSR activities to accommodate this complexity, which is applied in an analysis of pay regulation in general corporate law and the specific rules of the financial sector. Together, these inquiries form a comprehensive picture of the ways in which pay regulation sets incentives for CSR engagement.

Originally little more than business ethics, modern CSR has emerged as the unilateral response of businesses to the market failures of today’s globalised economy that national governments alone could not properly address. CSR itself, however, is an imperfect remedy. Having shown how legal rules can incentivise and steer CSR, the thesis proceeds to lay out how existing pay regulation can be adjusted to accommodate the objective of contributing to socially optimal levels of CSR engagement. It shows how CSR-oriented pay regulation is consistent with the conventional goals of corporate governance and eventually provides a prospect for the integration of CSR and corporate law in general

Stimulansen, duurzaamheid en recht:

De relatie tussen de regulering van de beloning van bestuurders en maatschappelijk verantwoord ondernemen

Laurenz Goldhahn

Samenvatting

Wat is de relatie tussen executive beloningsbeleid en maatschappelijk verantwoord ondernemen (MVO)? Een heersend begrip is de ex post mening dat beloning enkel een kwestie is van distributieve rechtvaardigheid, geschiktheid en daaruit voortvloeiende publieke verontwaardiging. Dit contrasteert met het oorspronkelijke academische begrip daarvan als een instrument voor aansturing van besluitvormingsprikkels van managers en verlaging van vertegenwoordigingskosten. Momenteel wordt MVO onvoldoende opgenomen in economisch onderzoek naar executive beloning en wordt beloningsbeleid ook niet aangemerkt als potentieel instrument in de groeiende hoeveelheid MVO-wetgeving. De succesvolle uitbreiding van MVO in bedrijfspraktijken en de aandacht die beleidsmakers en wetgevers er thans aan besteden, hebben echter het belang vergroot om deze vragen te beantwoorden. Deze blinde vlek in deugdelijk bestuur - de relatie tussen beloning, MVO en de wet - is dus het onderwerp van deze thesis.

De dissertatie benadert deze punten in twee verdere onderzoeksvragen: ten eerste wordt de rol van executive beloningsbeleid als een institutionele determinant van MVO-betrokkenheid vastgesteld. Daartoe wordt een analytisch kader ontwikkeld, dat een theoretische basis biedt en de onvergelijkbare academische disciplines verenigt, die noodzakelijk zijn voor het volledig verklaren van de MVO-wetgevingsrelatie. Vervolgens worden de verschillende terreinen van beloningsbeleid geanalyseerd op hun effecten op MVO. Uit de resultaten vloeit de tweede onderzoeksvraag voort: moeten wetgevers MVO-betrokkenheid bevorderen en – zo ja - hoe? De thesis definieert in dit deel het economische doel van MVO en stelt de tekortkomingen daarvan vast, alsook de rol van de wet om deze te herstellen, en onderzoekt het potentieel van beloningsbeleid als instrument daarvoor. Tot slot wordt een casestudy uitgevoerd om in kaart te brengen hoe de invloed van indexfondsen als een belangrijke drijfveer van MVO in deugdelijk bestuur moet worden ingebed in het ontwerp van MVO-wetgeving.

Het onderzoeksproject toont dat beloningsbeleid onderdeel is van de institutionele determinanten van MVO en, afhankelijk van het ontwerp daarvan, verschillende vormen van MVO-betrokkenheid kan stimuleren of ontmoedigen. Als een vorm van private zelfregulering is MVO nauw verbonden met wettelijke regels en het resultaat van complexe onderliggende drijfveren binnen en buiten het bedrijf. Voor het inbedden van deze complexiteit ontwikkelt het onderzoek een differentiatie van MVO-activiteiten, die wordt toegepast in een analyse van beloningsbeleid in het algemene ondernemingsrecht en de specifieke regels van de financiële sector. Samen geven deze onderzoeksvragen een uitgebreid beeld van de manieren waarop beloningsbeleid prikkels geeft voor MVO-betrokkenheid.

Oorspronkelijk niet veel meer dan bedrijfsethiek, blijkt het moderne MVO het unilaterale antwoord te zijn van bedrijven op de markttekortkomingen van de hedendaagse geglobaliseerde economie, die de nationale overheden zelf niet op de juiste wijze zouden kunnen aanpakken. MVO zelf is echter een gebrekkig rechtsmiddel. Door te tonen hoe wettelijke regels MVO

kunnen stimuleren en aansturen, gaat de thesis over tot een uiteenzetting over hoe bestaand beloningsbeleid kan worden aangepast voor het inbedden van de doelstelling van het bijdragen aan sociaal optimale niveaus van MVO-betrokkenheid. Getoond wordt hoe MVO-georiënteerd beloningsbeleid samenhangt met de conventionele doeleinden van deugdelijk bestuur en uiteindelijk een mogelijkheid biedt voor de integratie van MVO en het algemene ondernemingsrecht.

Curriculum Vitae

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Short biography

Management consultant in the area of banking and compliance with a focus on regulatory compliance and ESG. Trained in business law and law & economics. He has professional experience in the fields of regulatory compliance and risk management, corporate governance, EU and German financial supervisory law, especially sustainable finance regulation, supply chain due diligence, remuneration regulation, and licencing and contract management. He holds a Ph.D. in law & economics, a Master of Laws (LL.M.) in law & economics, and a Bachelor of Laws (LL.B.) in international business law. Next to speaking to German, he has certified language skills in English, French, Spanish and Dutch.

Education

2023	**Doctorate degree** / European Doctorate in Law & Economics (Ph.D / Dr. iur.) University of Hamburg, Erasmus University Rotterdam, University of Bologna
2016	**Master of Laws** / European Master in Law and Economics (LL.M.) University of Hamburg, Erasmus University Rotterdam
2015	**Bachelor of Laws** / International Business Law and Business Management (LL.B.) Westfälische Hochschule, Recklinghausen
2012	**Abitur** Ernst-Barlach-Gymnasium, Castrop-Rauxel

Work Experience

2022–	**Consultant** / Management consulting, banking and compliance 4C GROUP AG, Düsseldorf
2017	**Intern** / Advisory services, licence and contract management Ernst & Young, Düsseldorf

2016–2017	**Intern** / Auditing and advisory services, financial supervisory law Ernst & Young, Frankfurt am Main

Prizes and awards

2016	Wissenschaftsförderpreis endowed award (bachelor thesis), Sparkasse Vest Recklinghausen
2014	Honorable Mention Delegation Award, National Model United Nations, New York
2012–2015	Deutschlandstipendium scholarship, Westfälische Hochschule

Publications

2022	"ESG in Remuneration and Corporate Governance", *Tijdschrift voor Compliance*, vol. 2022(4), 2022.
2015	„Wirtschaftliche Auswirkungen und rechtliche Grenzen der EZB-Krisenpolitik", in: *Recklinghäuser Beiträge zu Recht und Wirtschaft*, Nr. 30/2015, Hrsg.: B. Bergmans, R.-M. Marquardt, ISSN 2191-866X.

European Doctorate in Law & Economics

EDLE PhD Portfolio

Name PhD student : Laurenz Goldhahn
PhD-period : 2017-2022
Promoters : Prof. Dr. Wolf-Georg Ringe, Prof. Dr. Sharon Oded
Co-promoter : Dr. Alessandro Pomelli

PhD training

Bologna courses	***year***
Introduction to Statistics	2017
Experimental Economics	2017-18
Modelling Private Law	2017-18
Microeconomics III	2018
Game Theory, Behaviour and the Law	2018
Behavioural Law and Economics – Law Enforcement	2018
Property Law and Economics	2018
Specific courses	***year***
Seminar 'How to write a PhD', Hamburg	2018
Academic Writing Skills for PhD students, Rotterdam	2018
Empirical Legal Studies Seminar Series, Hamburg	2018
Topics in Corruption Research Seminar Series, Hamburg	2018
International Law and Relations Seminar Series, Hamburg	2018
The Transformation of Global Environmental Politics Seminar Series, Hamburg	2018
Hamburg Lectures in Law & Economics Seminar Series, Hamburg	2018-19
Advanced Empirical Legal Studies, Rotterdam	2019
Preventing Scientific Misconduct Seminar, Rotterdam	2019
Advanced Empirical Methods: Research Design Theory & Applied, Rotterdam	2019
Seminars and workshops	***year***
Bologna EDLE November seminar, attendance	2017
Behavioural Approaches to Contract and Tort (BACT) seminar series, attendance, Rotterdam	2018-19

Erasmus Graduate School of Law (EGSL) lunch seminars, attendance, Rotterdam	2018-19
Joint Seminar 'The Future of Law and Economics', attendance, Rotterdam	2018
Rotterdam Fall seminar series, peer feedback, Rotterdam	2018
Rotterdam Winter seminar series, peer feedback, Rotterdam	2018-19
John Hopkins University SAIS Bologna open guest lectures and seminars, Bologna, attendance	2018
University of Bologna, Department of Economics (DSE) weekly seminar series, attendance, Bologna	2018-19
Presentations	***year***
Bologna EDLE March seminar, Bologna	2018
Hamburg EDLE June seminar, Hamburg	2018
Rotterdam Fall seminar series, Rotterdam	2018
Rotterdam Winter seminar series, Rotterdam	2019
Joint Seminar 'The Future of Law and Economics', Maastricht	2020
Bologna November seminar, Bologna	2020
Attendance (international) conferences	***year***
Italian Society of Law and Economics/Società Italiana di Diritto ed Economia (ISLE/SIDE) Annual Conference, Rome	2018
Erasmus Initiative Conference, The Dynamics of Inclusive Prosperity, Rotterdam	2018