Mutual Funds, ESG and Gatekeeper Responsibility: Challenges and Resolution of Agency Conflicts

ONYEKA OSUJI & MOHAMMED KHAIR ALSHALEEL*

Abstract

This paper considers the extent, and resolution, of agency conflicts in applying the Environment, Social and Governance (ESG) criteria and associated gatekeeping expectations to mutual funds. Drawing on the agency theory, the paper demonstrates that the manifestation of principal-agent and principal-principal-agent conflicts can erode mutual funds' gatekeeping role encapsulated in ESG. Agency conflicts can be resolved by clear definitions of ESG in investment objectives, chief sustainability officer roles, investment diversification and categorisation, credible assurance services and investor education.

Keywords

Agency problem, corporate social responsibility, ESG, gatekeeper, mutual funds, responsible investment

1. Introduction

This paper proposes solutions to agency conflicts in applying Environment, Social and Governance (ESG) criteria to mutual funds which, in contrast to hedge funds,[1] are less likely to engage with investee companies on ESG issues.[2] As a broad term for investment strategies underlining the governance structures of businesses and environmental and social impacts of their products or practices,[3] ESG refers to '*impact*

---

* Professor Onyeka Osuji is a Professor of law at the University of Essex, UK (o.k.osuji@essex.ac.uk).

Dr Mohammed Khair Alshaleel is a Senior Lecturer in law at the University of Essex, UK (mkalsh@essex.ac.uk).

[1] Mark R. DesJardine & Rodolphe Durand, *Disentangling the Effects of Hedge Fund Activism on Firm Financial and Social Performance* 41 Strateg. Manag. J, 1054, 1070 (2020); Albert M. Ahn & Margarethe F. Wiersema. *Activist Hedge Funds: Beware the New Titans* 35 Academy of Management Perspectives, 96,102 (2021).

[2] Angela Morgan et al, *Mutual Funds as Monitors: Evidence from Mutual Fund Voting* 17 J. Corp. Finance 914, 918 (2011); Zhichuan Frank Li, Saurin Patel & Srikanth Ramani, *The Role of Mutual Funds in Corporate Social Responsibility* 174 J. Bus. Ethics, 715, 727(2021).

[3] Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee* 72 Stan. L. Rev, 381, 400 (2020); Iain MacNeil

Osuji, Onyeka & Khair Alshaleel, Mohammed, 'Mutual Funds, ESG and Gatekeeper Responsibility: Challenges and Resolution of Agency Conflicts'. *European Business Law Review* 36, no. 1 (2025): 75-102.

investing, sustainability investing and community investing, among other nomenclatures, [that] support the environmental issues, human rights, fair labour practices, sustainable consumption and community involvement'.[4] In striving to align financial interests with non-financial and ethical considerations, ESG reflects the investor perspective of corporate social responsibility (CSR),[5] a broader umbrella term.[6] Like CSR, ESG embeds gatekeeper responsibility of '*private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers*'.[7] The leverage-based gatekeeper responsibility '*arises from an organisation's ability to influence the actions of other actors through its relationships, regardless of whether the impacts of those other actors' actions can be traced to the organization'*. [8]As institutional investors, mutual funds are not disconnected from CSR expectations whether they are "sustainable funds" or "conventional funds" in Nofsinger and Varma's classification.[9]

Nonetheless, pluralistic ownership, governance and operational structures involving complexities of stakeholder relationships and expectations (see Figure 1) are particularly challenging to mutual funds' integration of ESG. As a common pool of money for investment by professional management,[10] mutual funds are susceptible to varying stakeholder interests and potential agency conflicts. Conflicts may arise between investors' ESG interests and mutual funds' value maximization goals.[11]

Regulation-related agency conflicts are not farfetched. Since linkages exist between regulatory backgrounds and the agency problem, the growing, uncoordinated, regulatory attention on ESG can create or aggravate conflicts.[12] In the UK, for example, ESG-related provisions for mutual funds in the Companies Act 2006, Stewardship Code, Principles for Responsible Investment and Corporate Governance Code can be

---

& Irene marié Esser, *From a Financial to an Entity Model of ESG* 23 European Business Organization Law Review, 9, 12 (2022).

[4] Mark Anthony Camilleri, *The Market for Socially Responsible Investing: A Review of The Developments* 17 Social Responsibility Journal 412, 418 (2020).

[5] Pushpika Vishwanathan et al, *Strategic CSR: A Concept Building Meta-Analysis* 57 Journal of Management Studies, 314, 340 (2020).

[6] Archie Carroll, *Corporate Social Responsibility: Perspectives on the CSR Construct's Development and Future* 60 Business and Society 1258, 1265 (2021).

[7] Reinier Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strateg*y 2 Journal of Law, Economics, and Organization 53, 55 (1986).

[8] Stepan Wood, *The Case for Leverage-Based Corporate Human Rights Responsibility* 22 Business Ethics Quarterly 63, 67 (2012).

[9] Li, Patel & Ramani, *supra.* n. 2; John R. Nofsinger & Abhishek Varma, *Keeping Promises? Mutual Funds' Investment Objectives and Impact of Carbon Risk Disclosures* 187 Journal of Business Ethics 493, 500 (2023).

[10] Mohammed Alshaleel, *Money Market Funds Reforms in the US and the EU: The Quest for Financial Stability* 31 European Business Law Review 303, 320 (2020).

[11] Samuel M. Hartzmark & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows* 74 The Journal of Finance 2789, 2800 (2019).

[12] Annelies Renders & Ann Gaeremynck, *Corporate Governance, Principal-Principal Agency Conflicts, and Firm Value in European Listed Companies* 20 Corporate Governance: An International Review 125, 130 (2012).

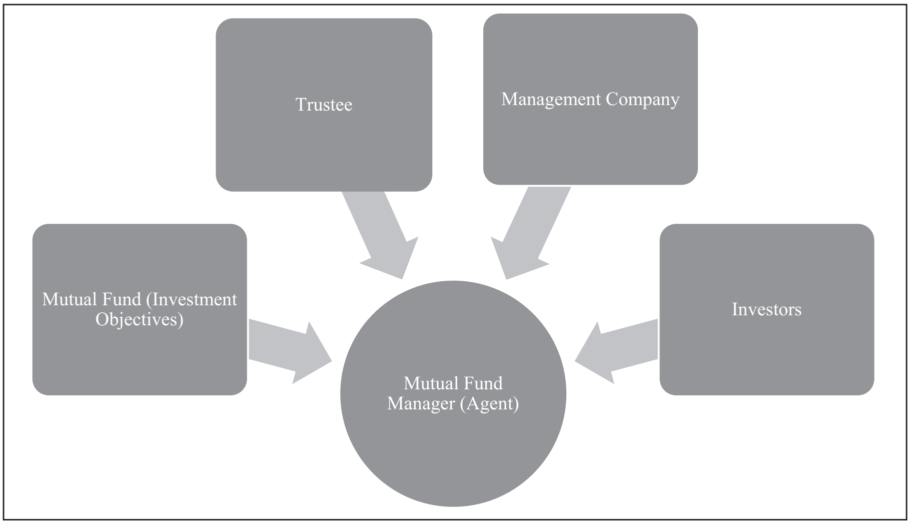

Figure 1. Mutual Funds' Principals-Agent

more polarising than clear. Similarly, specific directions in the 'Guiding Principles on design, delivery and disclosure of ESG and sustainable investment funds' apply alongside the Principles for Businesses, Open-Ended Investment Company Regulations, Collective Investment Schemes Sourcebook and Senior Management Arrangements, Systems and Controls.[13]

EU regulations are another example of ESG-related agency conflicts as shown by the Sustainability-Related Disclosure Regulation (SFDR) 2019, Taxonomy Regulation 2020 and, more specifically, Undertakings for Collective Investment in Transferable Securities (UCITS) Commission Delegated Directive 2021 drafted in collaboration with European Securities and Markets Authority. While identifying conflicts of interests is a goal of UCITS Commission Directive 2010/43 as amended by the UCITS Commission Delegated Directive 2021, neither instrument provides satisfactory solutions to the agency problem in integrating ESG in mutual funds' investment processes. In going further than the SFDR's disclosure approach by requiring fund managers to incorporate principal adverse impacts in due diligence processes, the Delegated Directive[14] raises questions about how this interacts with asset managers' duty to act in clients' best interest. Given their fiduciary duties, fund

[13] FCA, *Guiding Principles on Design, Delivery and Disclosure of ESG and Sustainable Investment Funds* (2021), https://www.fca.org.uk/news/news-stories/guiding-principles-on-design-delivery-disclosure-esg-sustainable-investment-funds.

[14] Commission Delegated Directive (EU) 2021/1270 of 21 April 2021 amending Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS) [2021] OIL L 277/141 (Delegated Directive 2021) Art. 5a (7).

managers need to invest assets in ways they believe will achieve the investment objectives but if sustainability or ESG criteria are not specified in investment policies, best interests may be associated with financial best interest.

While these regulatory developments are welcome, potential agency problems in integrating ESG have not been addressed. There is also the question of clarity of the meanings and contents of ESG factors since the mutual funds' capability to effectively undertake ESG-related gatekeeping roles may depend on their stakeholders' understanding and expectations which may, in turn, be influenced by those stakeholders' pluralist institutional environments and values. For example, investors' avoidance of managers with 'foreign-sounding names'[15] can be due to deliberate or unconscious attribution and differentiation of values. Are primary investors' "social preferences" easily followed by mutual funds?[16] Is the exclusion of certain sectors and insistence on certain norms agreeable to all investors? If ESG-orientated activist investors are "governance intermediaries"[17] and "sustainable capitalists"[18] and, as Figure 1 shows, mutual funds are confronted by variegated layers of stakeholders (principals) in multiple jurisdictions who adhere to diverse values, their understanding of ESG-related gatekeeping roles may be laboured. As indicated in the paragraph below, answers to questions surrounding mutual funds' understanding of ESG may depend on viewpoints shaped by their stakeholders' legal, cultural and institutional environment and agency conflicts may ensue.

Given that "E" in ESG refers to impacts on, and interaction with, the natural environment, what are the standards for classifying economic activities as environmentally sustainable? Must activities, for instance, contribute to climate change mitigation or pollution prevention and control? Are businesses expected to address physical risks such as biodiversity loss and extreme weather events and does their responsibility include risks linked to transitioning to a low-carbon economy such as shifting to new technologies that reduce renewable energy prices and demand for fossil fuels?[19] Furthermore, as "S" in ESG indicates social factors such as risks to society from economic activities and contributions of economic actors, from whose perspective is the relevant "society" determined? If "S-related risks" include, for example, violations of stakeholders' human rights, gender or ethnicity-based discrimination in recruiting or promoting employees or failing to monitor payment of living wages by suppliers

---

[15] Alok Kumar et al, *What's in A Name? Mutual Fund Flows When Managers Have Foreign-Sounding Names* 28 Review of Financial Studies, 2281, 2300 (2015).

[16] Arno Riedl & Paul Smeets, *Why Do Investors Hold Socially Responsible Mutual Funds?* 72 Journal of Finance, 2505, 2540 (2017).

[17] Abhijith Acharya et al, *Socially Oriented Shareholder Activism Targets: Explaining Activists' Corporate Target Selection Using Corporate Opportunity Structures* 178 Journal of Business Ethics, 307, 317 (2022).

[18] Anna Christie, *The Agency Costs of Sustainable Capitalism* 55 UC Davis Law Review, 875, 912 (2021).

[19] Technical Expert Group on Sustainable Finance (TEGSF), *Taxonomy: Final Report of the Technical Expert Group on Sustainable Finance* (2020), https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf.

and contractors,[20] on what basis can businesses assess the existence of applicable standards? Would contributions to society's objectives include investments on tackling inequality and fostering social cohesion, social integration and labour relations?[21] Finally, if "G" in ESG concerns investments in businesses with sound management structures, tax compliance, staff remuneration and employee relations, are good corporate governance practices easy to determine knowing, for example, that such structures and stakeholder viewpoints may be context-specific.[22]

While these questions are arguably not peculiar and may apply, for example, to transnational businesses across sectors, the interplay of stakeholder relationships and governance and operational structures in mutual funds presents unique difficulties. The UK Supreme Court's description of ESG-based investment ("ethical investment") as '*an investment made not, or not entirely, for commercial reasons but in the belief that social, environmental, political or moral considerations make it, or also make it, appropriate*'[23] for example, defined neither the holder of the "belief" nor the grounds for and "appropriateness" of non-commercial "considerations". Moreover, is "investment" the first level investment in mutual funds or subsequent investments by those funds in other businesses? To what extent should mutual fund managers have regard to the first-level investors' beliefs and non-commercial considerations or the managers' own values system? These are budding foundations of agency conflicts.

The lack of a universally inclusive and investor sensitive definition of ESG and its principles is particularly problematic in profit-maximising mutual funds with multiple principals and a set of agents interfacing between the corporate entity and investors. In the circumstances, agency conflicts triggered by pluralism can arise firstly from the perspective of institutional investors as corporate entities furthering CSR through ESG.[24] Institutional investors are meant to deliver profits to their own investors and, in doing so, may need to diversify investments across sectors and jurisdictions with potentially multiple values systems and interpretations of ESG criteria. Retail investors in mutual funds and other institutional investors may have their own personal values underpinned by cultural, religious and other orientations in their jurisdictions of residence or origin which, in relation to integration of ESG, suggest that retail investors can constitute heterogenous principals with divergent interests.

This paper's distinct contributions to scholarship therefore include conceptual clarifications to strengthen ESG as a theoretical construct with practical consequences. We consider how "resonance dilemma" described in human rights literature as '*ideas and practice need to resonate with existing value systems in order to be*

---

[20] Ibid.

[21] Technical Expert Group on Sustainable Finance, *Taxonomy Technical Report* (2019), https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-taxonomy_en.pdf.

[22] TEGSG, *supra* n.19.

[23] *R (Palestine Solidarity Campaign Ltd) v Secretary of State for Communities and Local Government* [2020] UKSC 16, [1].

[24] Philipp Krueger et al, *The Importance of Climate Risks for Institutional Investors* 33 The Review of Financial Studies, 1067, 1100 (2020).

accepted' exists in transposition of ESG to mutual funds.[25] Methodologically, we draw on the agency theory to link ESG to the principal-agent (PAP) and principal-principal-agent (PPAP) conflicts and thereby extend the traditional financial interest focused analysis. While research has been undertaken on PPAP between shareholders and debenture holders, dominant and minority shareholders, and insurance companies' shareholders and policyholders and banks' dual role as creditors and shareholders,[26] we are unaware of works on ESG-related agency problems in mutual funds. Expanding on existing solutions for addressing the agency problem internally including through boards of directors and monitoring by large shareholders and externally including by facilitating market competition in products and services, we show that fiduciary duties and chief sustainability officers (CSOs) are relevant internal corporate governance mechanisms in mutual funds while external assurance services can bridge information asymmetries between fund managers as agents and investors as principals.[27]

This paper continues by tracing the origin of ESG and demonstrating how it presents a resonance dilemma. It utilizes the agency theory for conceptualising challenges arising from mutual funds' ownership and operational structures and primacy of financial returns in investment objectives. It shows that traditional PAP is presented in the integration of ESG in mutual funds' investment processes, their engagement with investee companies and operationalization of their managers' fiduciary duties while PPAP is particularly possible in ESG-related investor activism. Before concluding, the paper demonstrates that agency conflicts can be resolved by providing clear definitions of ESG in investment objectives, creating CSO roles, diversifying and categorising investments, and improving assurance services and investor education.

2. ESG, Resonance Dilemma and Agency Problem

Financial interest is a motivation for investment in mutual funds. Reflecting a mutual relationship between investors and professionally managed financial institutions, "mutual fund" enables small investors to participate in the recent rapid growth of capital markets.[28] The basis is pooling money from large numbers of investors to be managed and invested according to the investment objectives by an external

---

[25] Sally Merry & Peggy Levitt, *Remaking Women's Human Rights in The Vernacular: The Resonance Dilemma* in Lars Engberg-Pedersen, Adam Fejerskov & Singe M. Cold-Ravnkilde (eds.), *Rethinking Gender Equality in Global Governance: The Delusion of Norm Diffusion*, 145 (Palgrave Macmillan 2019).

[26] Rafael La Porta et al, *Agency Problems and Dividend Policies Around the World* 55 Journal of Finance, 1, 6 (2000).

[27] Michael Young et al, *Corporate Governance in Emerging Economies: A Review of The Principal-Principal Perspective* 45 Journal of Management Studies, 196, 200 (2008).

[28] Mohammed K Alshaleel, *Regulation and Governance of Mutual Funds: United Kingdom and United States of America Perspectives on Investor Protection,* 18 (Routledge, 2022).

professional management with the expertise, resources and experience.[29] Managers invest the fund's assets according to its objectives, which the investors accept upon buying shares/units.[30]

Diversification, which mitigates investment risks by spreading them over several investments and across markets, demonstrates the preeminent role of financial considerations in mutual funds' establishment and attractiveness to investors. To diversify portfolios, mutual funds generally invest in equities, bonds, derivatives, deposits and near-cash assets, short-term money market instruments, or a mix of these investments.[31] Diversified portfolios limit risks for investors by ensuring that sudden changes in any sector do not substantially alter the fund's financial security and worth.[32] Mutual funds offer liquidity, by standing ready to redeem their shares at net asset value and are usually subject to extensive regulations due to the mostly retail investor profile.[33] Mutual funds distinctively combine these benefits in one vehicle for investors in comparison to financial institutions such as hedge funds and pension funds.

While some funds aim to increase the value of invested amounts (growth funds), others provide investors with regular income through dividends (fixed-income funds).[34] Investors consider how their personal goals are matched by the fundamental aims in the funds' investment objectives which indicate the type of assets forming the main part of the investment portfolio.[35] For instance, money market funds managers invest in short-term debt securities such as commercial paper and treasury bills and cannot purchase long-term maturity instruments in breach of the objectives.[36]

As both a pool of funds by (primary) investors and (second-level) investors in their own right in other businesses, mutual funds are a type of institutional investors that are increasingly expected to integrate ESG although not originally targeted by the notion.[37] The emergence of ESG can be traced to the conceptualisation of socially responsible investment (SRI) which in turn originated from "ethical investment"

---

[29] Alshaleel, *supra* n.10.

[30] Collective Investment Schemes Sourcebook (2021), COLL 4.2.5.

[31] John Haslem, *Mutual Funds: Portfolio Structures, Analysis, Management, and Stewardship,* 8 (John Wiley & Sons, 2009).

[32] Alshaleel, *supra* n.28, 24.

[33] Paul Mahoney, *Manager-Investor Conflicts in Mutual Funds* 18 Journal of Economic Perspectives 161, 164 (2004); John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance And Fee Litigation Don't Work in Mutual Funds* 120 Yale Law Journal, 84–100 (2010).

[34] Elton Edwin & Martin J. Gruber, *A Review of the Performance Measurement of Long-Term Mutual Funds* 76 Financial Analysts Journal, 22, 27 (2020).

[35] Collective Investment Schemes Sourcebook (2021), COLL 4.2.5; Tara Van Ho & Mohammed Khair Alshaleel, *The Mutual Fund Industry and the Protection of Human Rights* 18 Human Rights Law Review, 1, 15 (2018).

[36] Halil Kiymaz, H Kent Baker & Greg Filbeck, *Mutual Funds and Exchange-Traded Funds Building Blocks to Wealth*, 270 (Oxford University Press, 2015).

[37] Natixis Investment Managers, (2021) https://www.im.natixis.com/uk/resources/natixis-investment-managers-esg-survey-doc.

although all three are used interchangeably.[38] SRI, rebranded as ESG when corporate governance factors were added in the late 1990s and early 2000s, reflects investors' intention to conciliate personal ethics and investment against the backdrop of a range of social, environmental and economic issues.[39] Its definitions commonly emphasise on integrating investors' financial needs with social responsibilities. Globally, SRI gained prominence through the *Principles for Responsible Investment* formulated by the UN Environment Programme and UN Global Compact. Although initially designed for institutional investors and asset management companies, other entities, including mutual funds, can commit to the principles.

Nonetheless, ESG factors and financial returns are not necessarily in alignment thereby potentially triggering conflicts between market participants. Like human rights which need to be 'translated, redefined and adapted to the new circumstances'[40] in a '*process [that] may lead to a departure from the original intended meaning*',[41] the integration of ESG in mutual funds is far from clear and causes a resonance dilemma. As shown above, mutual funds' stakeholders include their primary individual and institutional investors, fund managers and second-level investee businesses, potentially creating mutually exclusive tripartite levels of interaction that are not easily ignored. Even within each stakeholder class, particularly primary investors and investee businesses, disparities may exist in understanding of the meaning and content of ESG factors. What options are then available to mutual funds as gatekeepers? How can ESG enable financial goals for which mutual funds are primarily established? Do investors signal interest in ESG by investing, and continuing to invest, in mutual funds? Is ESG consistent with the fund managers' fiduciary duties? Are the managers competent to integrate ESG considerations in investment decisions?

Foie gras[42] illustrates the pertinence of these questions as a meat production and consumption issue in the wider sustainability discourse that includes ESG.[43] While foie gras is an ESG issue for some investors[44] other market participants, including fund managers, may have different views even when animal welfare[45] concerns exist. Consumption alongside the associated food systems is increasingly being linked to climate change and environmental sustainability with debates around necessities and

[38] *R (Palestine Solidarity Campaign Ltd) v Secretary of State for Communities and Local Government* [2020] UKSC 16, [1].

[39] Tadahiro Nakajima, *ESG Investment* in Tadahiro Nakajima et al (eds), *ESG Investment in the Global Economy* (Springer, 2021).

[40] Merry & Levitt, 146 *supra* n.25.

[41] Marisa McVey, John Ferguson & François-Régis Puyou, *Traduttore, Traditore? Translating Human Rights into the Corporate Context* 182 Journal of Business Ethics, 573, 586 (2023).

[42] *Commission of European Communities v French Republi*c Case C-184/96 (1998).

[43] Oliver Lazarus, Sonali McDermid & Jennifer Jacquet, *The Climate Responsibilities of Industrial Meat and Dairy Producers* 165 Climatic Change 1, 4 (2021).

[44] E.g., *Lovenheim v Iroquois Brands Ltd* 618 F. Supp. 554 (D.D.C. 1985).

[45] European Convention for the Protection of Animals kept for Farming Purposes (ETS No. 087); Council Directive 98/58/EC of 20 July 1998 concerning the protection of animals kept for farming purposes; *National Pork Producers Council v Ross* 6 F.4th 1021 (9th Cir. 2021).

luxuries captured as '*objective needs versus subjective desires*'.[46] In this context, foie gras is challenging since '[m]eat has gained vast cultural, ideological, and emotional significance over time' and '*has satisfied needs well beyond nutrition across cultures…, to perform activities valuable to oneself (e.g., cooking meals containing meat for the family); and … to be part of a community, (e.g., involving social food traditions or social eating where meat plays a central role)*'.[47] Foie gras is therefore a particularly emotive issue that cannot be separated from its consumption's sociocultural context.[48]

This presents a resonance dilemma, perhaps captured below by Vivek Ramaswamy, Strive Asset Management's executive chairman:

> If you're an owner of capital and you want, with your money, to tell companies to pursue environmental agendas or social agendas, it is a free country and you are certainly free to invest your money accordingly. But the problem that I see is a different one. Where large asset managers… are using the money of everyday citizens to vote their shares and advocate for policies in corporate… boardrooms that most of those owners of capital did not want to advance with their money.[49]

This statement hints at an "agency problem" in integrating ESG in mutual funds' investment processes due to the separation of "ownership" and "management". Broadly, an agency problem arises when the wellbeing of a party ("principal") depends on the actions of another ("agent").[50] The classical agency theory – developed by Jensen and Meckling – argues that the agent's decisions are expected to further the principal's interests. PAP lies in encouraging the agent to act in the principal's interest rather than in the agent's own interest. As PAP is a feature of corporate entities with diversified ownership and independent management, its relevance to mutual funds and implications for integrating ESG are undeniable.[51]

Generally, the main organizational structures are the corporate form, where mutual funds are separate entities, and the contractual form or trust structure, where they are

---

[46] Alan Mathios et al, *Journal of Consumer Policy's 40th Anniversary Conference: A Forward Looking Consumer Policy Research Agenda* 43 Journal of Consumer Policy, 1, 3 (2020); Doris Fuchs et al, *A Corridors And Power-Oriented Perspective On Energy-Service Demand And Needs Satisfaction* 17 Sustainability: Science, Practice and Policy 162, 167 (2021).

[47] Minna Kanerva, *Consumption Corridors and the Case of Meat* 45 Journal of Consumer Policy 619, 622 (2022).

[48] Rafi Youatt, Power, *Pain, and the Interspecies Politics of Foie Gras* 65 Political Research Quarterly 346, 350 (2012).

[49] Noah Sheildlower, *Are ESG ETFs a Gimmick? The Debate Surrounding the Transparency and Social Agendas of Sustainable Investing* (2022), https://www.cnbc.com/2022/10/08/esg-etf-investing-raises-concerns-about-transparency-social-agendas.html.

[50] Stephen Ross, *The Economic Theory of Agency: The Principal's Problem* 63 American Economic Review 134, 137 (1973).

[51] Alshaleel, *supra* n.28, 134.

established as trusts managed by trustees for investors' benefit.[52] In the UK, mutual funds are typically open-ended vehicles either as Unit Trust of the trust form or Open-Ended Investment Company (OEIC) of the corporate form. While these vehicles are collective investment schemes, a wider term that also includes investment trusts, they are regarded as mutual funds (Figure 2).[53] In Unit Trusts, unitholders are the owners of the deposited property[54] and the manager and trustee are fiduciaries. Due to their separate legal personality, OEICs' shareholders are not the owners of the property forming the fund's subject matter. Constituted under instruments of incorporation,[55] OEICs are operated by an authorized corporate director (ACD), or board of directors, that makes investment decisions and a depositary in a similar role to unit trust trustee (supervision of fund manager). In USA,[56] where mutual funds are structured as corporate entities with boards of directors that supervise their operations and review contracts of investment advisers and other service providers. Like UK funds, US mutual funds do not employ managers, directors and other workers, alongside external service providers.[57] Rather, they are externally managed by investment advisers contracted to operate their investments. Mutual funds' organizational structures can therefore trigger agency conflicts and, for ESG, these are twofold: PAP and PPAP.

2.1. PAP

The separation of ownership and management/control existing in unit trusts and OEIC schemes can create conflicts of interest between the management and investors. As Figure 2 shows, the manager/ACD and the trustee/depositary must be separate corporate bodies from the fund and from each other.[58] Consequently, mutual funds use only external service providers as fund managers. The managers owe duties to the fund and to their own corporate entity and may seek to acquire the highest possible earnings for the latter.[59] How does this work in the integration of ESG?

2.1.1. ESG Integration

ESG can be a factor for mutual funds at the point of initial investment and as a continuing concern throughout the life of that and subsequent investments in investee companies. Integration is the systematic and explicit inclusion of ESG opportunities and risks in investment analysis and decisions. It is the recognition in investment

---

[52] Anna Sergeeva, *Collective Investment Schemes Regulations* 1 3a Scientific journal NRU ITMO 1, 3 (2009).

[53] Ibid.

[54] *Charles v. Federal Commission of Taxation* (1954) 90 C.L.R. 598 at 609.

[55] Tom Cornick, *UK Introduces Open-Ended Investment Companies* 29 Int'l Fin. L. Rev 29, 31(1997).

[56] Investment Company Act of 1940, s.7 (a) and s.10 (a).

[57] Mohammed K Alshaleel, *Undertakings for the Collective Investment in Transferable Securities Directive V: Increased Protection for Investors* 13 European Company Law 14, 16 (2016).

[58] UK Financial Services and Markets Act 2000, sections 243 (4), (5)(a), (b) and (7)).

[59] Haslem, 43 *supra*. n. 31.

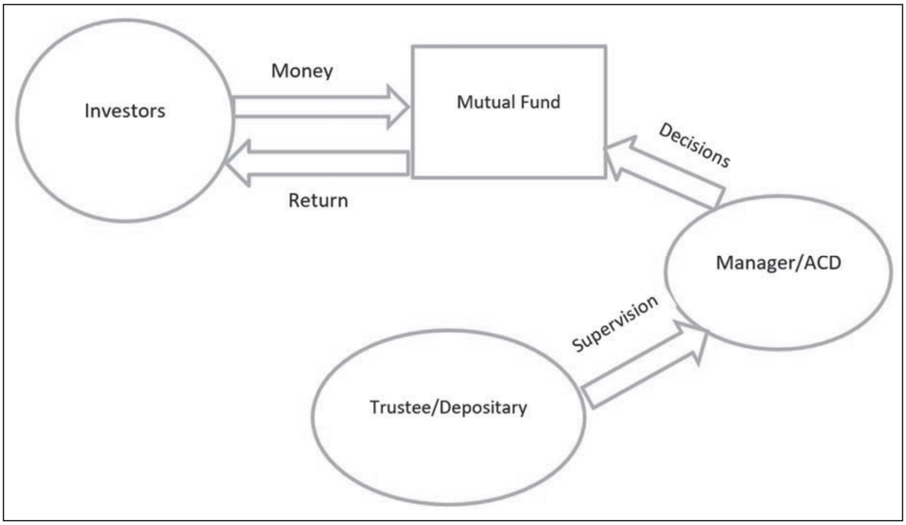

Figure 2. Mutual Funds' Structure and Operation

policies that ESG factors may impact portfolio performance since mutual funds, alongside pension funds,[60] insurance companies, hedge funds and other large business organizations, are institutional investors constituted of primary investors. In contrast to retail investors and other investors, institutional investors' domination of the equity market suggests a crucial role in influencing investee companies' decisions and demonstrating CSR commitments through ESG.[61]

The ESG integration process includes pre-investment (due diligence) and investment decision phases.[62] In the pre-investment phase, fund managers undertake ESG analyses of target investee companies alongside conventional financial due diligence by, for instance, issuing questionnaires to identify or confirm material ESG-related issues. Although fund managers can freely select target companies irrespective of ESG due diligence results, the information gathered facilitates investment decisions in the second phase.

A continuing commitment to ESG by mutual funds and other institutional investors through activism and investments screening is facilitated by three distinctive features. First, since institutional investors typically manage large pools of assets, they can influence changes in investee companies in which they tend to hold substantial equity

60 CFA Institute, *Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals* (2015) https://www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx.

61 Scott Hirst, *Social Responsibility Resolutions* 43 Journal of Corporation Law 1 (2017).

62 OECD, *ESG Investing: Practices, Progress and Challenges* (OECD Paris, 2020) https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf.

stakes.[63] Second, they can command regulators' attention or undertake political lobbying for market reforms. Third, institutional investors invest on others' behalf and discharging their legal or fiduciary duty to invest in those investors' best interests may require them to be active.[64] Following concerns about the financial impact of fund managers' unwillingness to actively engage with investee companies on issues such as strategy and corporate and personnel performance, Myners Report (2001) notably encouraged attempts at promoting institutional investors' shareholder activism.[65] A surge in such activism is partly due to the Institutional Shareholders' Committee Code, a voluntary statement of principles Myners Report recommended.[66]

Given their growing stock ownership, mutual funds can exert influence on investee companies' consideration of ESG factors. As discussed below, there are – nevertheless – questions surrounding fund managers' engagement with investee companies, their fiduciary duties and existence of multiple principals when ESG factors are being considered.

2.1.2. ESG Engagement with Investee Companies

Engagement involves mutual funds exercising their power as shareholders to influence investee companies' performance of some ESG criteria and includes voting, one-on-one interactions and filing shareholder proposals.[67] Mutual funds may have a vested interest in seeing investee companies proactively address material ESG issues affecting short and long-term value since ESG performance can be linked to risk mitigation and returns maximisation.[68] For example, since mutual funds' concern with liquidity is due to the investors' right to redeem shares at net asset value upon demand, investee companies' poor performances can depress share prices and funds may then encounter liquidity problems in selling their shareholdings.

Although engagement with investee companies is crucial for protecting the primary investors' interest, mutual funds' willingness to act as active owners may depend on their objectives. Growth funds and other funds with long-term investment objectives may engage more with investee companies than money market funds and others with short-term investment goals. While voting rights are a powerful tool for influencing investee companies, mutual funds are not well-known active voters as revealed by a voting behaviour study of 212,620 decisions of 1,794 funds in 1,047 shareholder

---

[63] Devon Reynolds & David Ciplet, *Transforming Socially Responsible Investment: Lessons from Environmental Justice* 183 Journal of Business Ethics 53, 55 (2023).

[64] Andrew Johnston & Paige Morrow, *Fiduciary Duties of European Institutional Investors Legal Analysis and Policy Recommendations*, University of Oslo Faculty of Law Research Paper No. 2016-04 (2016) https://ssrn.com/abstract=2783346.

[65] Myners Report, *Institutional Investment in the United Kingdom: A Review* (2001), https://webarchive.nationalarchives.gov.uk/ukgwa/+/http:/www.hm-treasury.gov.uk/media/1/6/31.pdf.

[66] Brian Cheffins, *The Stewardship Code's Achilles' Heel* 73 Modern Law Review 1004, 1006 (2010).

[67] Hirst, supra. n. 61.

[68] Gunnar Friede et al, *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies* 5 Journal of Sustainable Finance & Investment 210, 213 (2015).

proposals. The study found that mutual funds are less likely than other shareholders to vote for shareholder proposals and would prefer supporting wealth-increasing shareholder proposals to other proposals.[69] Mutual funds' unwillingness to vote or engage with investee companies can be contrasted with the more active approach of hedge funds that commonly take up concentrated shareholdings in struggling companies and use their voting powers to influence changes in investee companies.[70]

Arguably, an activist shareholder approach to investee companies by mutual funds is confronted by three barriers. First, their investments in individual companies are inevitably relatively small due to regulations favouring diversification and discouraging concentrated ownership. The diversified nature of their investments provides little room for mutual funds to be large shareholders and utilize monitoring as a tool for addressing PAP.[71] Second, unlike mutual fund managers, hedge fund managers typically receive specific percentages, usually 20 to 25 percent, of portfolio growth they generate and therefore are incentivised to increase their shareholdings' value.[72] As mutual fund managers' management fees are usually significantly lower, they benefit from good performance only by increasing fund assets and are less likely to engage with investee companies.[73]

Voting process costs in time, resources and expertise is the third impediment to mutual funds' engagement with investee companies. The costs of researching each voting agenda item may be substantial, especially for small and mid-sized mutual funds, and explain why some use proxy firms' services, such as Institutional Shareholder Services, to vote at investee companies' shareholder meetings.[74] In addition to the gatekeeping concerns this raises, the manner voting rights are exercised can have a bearing on fiduciary duties.

2.1.3. Fiduciary Duties

Arguably, the extent mutual fund managers are permitted or required to consider ESG factors while discharging their duties is equally demonstrative of the agency problem in the relationship between the managers and primary investors. As suggested by studies on CSR activities as manifestations of the agency problem, the relevance of ESG in investment decisions presents an agency problem due to wealth deterioration as a potential outcome.[75] The studies, including Friedman who asserted that managers

---

[69] Morgan et al, *supra*. n. 2.

[70] Dorothy S. Lund, *The Case Against Passive Shareholder Voting* 43 Journal of Corporation Law 101, 105 (2017).

[71] Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences* 93 Journal of Political Economy 1155, 1159 (1985).

[72] Michal Barzuza, Quinn Curtis & David H Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance* 93 S Cal L Rev 1243, 1247 (2020).

[73] Henri Servaes & Kari Sigurdsson, *The Costs and Benefits of Performance Fees in Mutual Funds* 50 Journal of Financial Intermediation, 1, 9 (2022).

[74] Serdar Çelik & Mats Isaksson, *Institutional Investors and Ownership Engagement* 2 OECD Journal: Financial Market Trends, 93, 95 (2014).

[75] Philipp Krueger, *Corporate Goodness and Shareholder Wealth* 115 Journal of Financial Economics, 304, 310 (2015).

should run businesses in accordance with shareholders' desire for wealth maximisation, have been heavily influenced by traditional interpretations of managers' fiduciary duties.[76]

Traditionally, managers owe fiduciary, contractual and regulatory duties to their mutual funds and investors. An important interplay is that the underlying principles of fiduciary duties largely influenced the regulatory framework for mutual funds that have also helped to define the scope of common law duties.[77] In USA, the 1940 Investment Company Act creates both general and specific fiduciary duties for mutual fund investment managers and directors.[78] For example, section 36(b) imposes fiduciary duties on the managers in relation to management fees. In England, unit trust managers and trustees have fiduciary duties and the stipulation in the Collective Investment Schemes Sourcebook that unit trust managers' duties and powers:

> Are in addition to the powers and duties under the general law'implicitly references fiduciary duties. Similarly, Regulation 35(2) of Open-Ended Investment Companies Regulations 2001 confirm that OIECs scheme directors' duty owed "to the company (and the company alone)" as a separate legal person and not to shareholders or investors 'is enforceable in the same way as any other fiduciary duty owed to a company by its directors.[79]

Mutual fund managers' fiduciary obligations to act in the investors' best interests originated from an ethical or legal relationship of trust and confidence in which the fiduciary acts in good faith for the principal's benefit.[80] An English court[81] confirmed this backdrop in the specific case of investment management as being that fiduciaries must always act solely in the beneficiaries' best interests. In *Pilmer*, the court therefore held:

> The fiduciary is under an obligation, without informed consent, not to promote the personal interests of the fiduciary by making or pursuing a gain in circumstances in which there is 'a conflict or a real or substantial possibility of a conflict' between personal interests of the fiduciary and those to whom the duty is owed.[82]

---

[76] Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits* (New York Time Magazine, 1970), 32, 35.

[77] Alshaleel, *supra* n.28, 160.

[78] Norman Knickle, *The Mutual Fund's Section 15(C) Process: Jones V. Harris, the SEC and Fiduciary Duties of Directors* 31 Review of Banking & Financial Law 265, 267 (2011).

[79] Collective Investment Schemes Sourcebook (2021), COLL 6.6.5 (1).

[80] David Glusman & Gabriel Ciociola, *Fiduciary Duties and Liabilities: Tax and Trust Accountant's Guide,* 3 (CCH, 2006).

[81] *Bristol & West Building Society v Mothew* [1998] Ch 1.

[82] *Pilmer v The Duke Group Limited* [2001] HCA 31.

Since mutual fund managers are required to act in the primary investors' (beneficiaries) best interests, this raises questions relating to the definition criteria for those interests. Traditionally, investors' "best interests" normally equate to their "best financial interests".[83] Although an English court[84] held that ethical factors could be a tiebreaker in trustees' duty to maximize financial returns, it may be difficult for fund managers to determine whether ESG considerations are consistent with investors' best financial interests.

The main implication of a "narrow" interpretation of investors' best financial interests is that fund managers, as fiduciaries, should not consider ESG factors in investment decision-making because such non-commercial factors can put financial returns at risk. Nonetheless, the incorporation of ESG in investment decisions as part of fiduciary duties may be justified on two grounds. First, a growing body of empirical research shows that ESG factors can have material impacts on the financial performance of financial institutions and companies.[85] These studies underline substantial changes in the investment landscape in recent years and, to this extent, leading to the widely accepted view that ESG factors are significant drivers of investment value. Bank of America Merrill Lynch concluded that ESG qualities provide better signals of future earnings volatility than other measures. Managers' failure to consider ESG factors can also undermine confidence in mutual funds.[86]

Second, as exemplified by the EU's Shareholder Rights Directive II, Taxonomy Regulation and SFDR and the UK Roadmap to Sustainable Investing, policy and regulatory frameworks in some jurisdictions are adapting to integration of ESG. Bearing in mind that the duty to exercise care and skill expected of reasonably competent advisers ordinarily includes compliance with regulations,[87] the omission of ESG factors in investment decisions may suggest that fund managers have not discharged their fiduciary duties.

A narrow interpretation of fiduciary duty, which constitutes a barrier to integration of ESG factors, appears to have given way to an emerging view of ESG considerations as not being inconsistent with fund managers' fiduciary duties. While its original formulation may have ethically targeted stakeholder effects rather than investment returns, ESG investing can provide benefits in addressing risks and enhancing financial returns. Fund managers may, however, be unclear as to what is expected since fiduciary duty is an evolving notion. This suggests that, while fiduciary duty itself may not present an obstacle to integrating ESG factors in investment decisions by fund managers, a lack of clarity can.

The consideration of ESG in investment decisions as part of fund managers' fiduciary duties is also applicable to the exercise of their voting rights as shareholders of investee companies. Fiduciary duties require fund managers to vote in the primary

---

83 *Cowan v Scargill* [1985] Ch 270.

84 *Harries v The Church Commissioners for England* [1992] 1 WLR 1241.

85 Mozaffar Khan, George Serafeim, & Aaron Yoon, *Corporate Sustainability: First Evidence on Materiality* 91 the Accounting Review 1697, 1699 (2016).

86 Van Ho & Alshaleel, *supra*. n. 35.

87 *Shore v Sedgwick Financial Services Ltd* [2008] EWCA Civ 863.

investors' best interests even if the managers have no incentives to encourage voting, and influence investee companies' decisions, on ESG matters. Whether fund managers should follow investors' preferences when voting on ESG issues is, however, open to debate. If fund managers are in a better position than investors to determine what is in the latter's best financial interests, investors' preferences may be irrelevant. If investors believe that certain actions can maximize the value of the fund's portfolio assets or reduce investment risks, arguably, fund managers should consider those actions.[88] Even then, there is the question of identifying investors' preferences. Would it be, for instance, the views of the majority or of a more vocal minority very much interested in gatekeeping via ESG? This arguably raises another level of the agency problem where an agent is confronted by potentially disparate views of multiple principals with varying degrees of ESG-related activism (Figure 3), an issue which is addressed next.

2.2. PPAP

In emphasising the need for contextual analysis, the organisational "open system" approach shows that other forms of the agency problem exist in addition to the traditional PAP.[89] Unlike PAP, the principal-principal agent problem (PPAP) or "Agency Problem II" occurs in corporate structures with concentrated ownership.[90] PPAP arises from self-serving and opportunistic behaviour of dominant or controlling principals against the corporate entity's interests or to the detriment of less powerful or minority principals.[91] The possibility of "adversarial relationships" of this nature has been examined mostly in jurisdictions with weak shareholder protection where family businesses and other concentrated ownership structures operate with dominant shareholders.[92]

2.2.1. Activism and Multiple Investors

Notwithstanding a reasonable level of clarity of justifications for integrating ESG in investment decisions, the primary investors' role in urging or influencing fund managers in that regard is less clearcut. Due to impreciseness of the wishes of investors as principals resulting from inadequate activism or lack of coordination of voice, the PPAP exists within mutual funds. Arguably, mutual fund investors may have similar

---

[88] Hirst, supra. n. 61.

[89] Ruth Aguilera Et Al*, An Organizational Approach to Comparative Corporate Governance: Costs, Contingencies and Complementarities* 19 Organization Science 475, 477 (2008).

[90] Ravi Dharwadkar, Gerard George & Pamela Brandes, *Privatization in Emerging Economies: An Agency Theory Perspective* 25 Academy of Management Review 650, 655 (2000); Nicola Moscariello et al, *Independent Minority Directors and Firm Value In A Principal–Principal Agency Setting: Evidence From Italy* 23 Journal of Management and Governance 165, 167 (2019).

[91] Jay Dahya, Orlin Dimitrov & John McConnell, *Dominant Shareholders, Corporate Boards, and Corporate Value: A Cross-Country Analysis* 87 Journal of Financial Economics 73, 75 (2008).

[92] Belen Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?* 80 Journal of Financial Economics 385, 388 (2006).

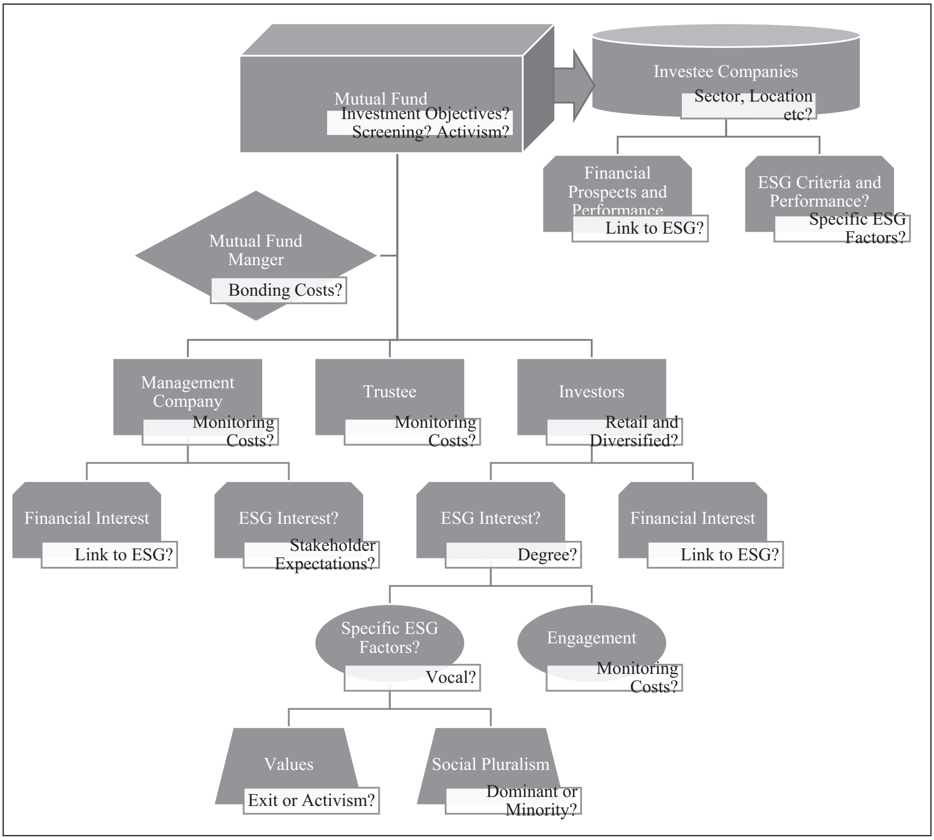

Figure 3. ESG and Mutual Funds' Agency Conflicts

tools for activism like retail investors. US shareholders,[93] for example, appeared to have had an impact on some funds' management while the UK does not have reported instances of successful investor opposition to management decisions that require investors' approval.

As a conglomeration of actions by shareholders using equity stake to apply pressure on boards of directors with the explicit intention of influencing corporate decisions and practices,[94] shareholder activism requires '*proactive efforts to change firm behaviour or governance rules*'.[95] To achieve goals ranging from short–term financial returns to changes in corporate behaviour, activist shareholders utilize tools such as

[93] E.g., *Navellier v. Sletten*, 262 F.3d 923 (9th Cir. 2001.

[94] Maria Goranova & Lori Ryan, *Shareholder Activism: A Multidisciplinary Review* 40 Journal of Management 1230, 1233 (2014).

[95] Bernard Black, *Shareholder Activism and Corporate Governance in the United States* in Peter Newman (eds), *The New Palgrave Dictionary of Economics and the Law* (Springer, 1998).

voting at annual general meetings, engaging in quiet diplomacy with investee companies' management by writing letters, lobbying other shareholders, undertaking press campaigns, adopting focus lists and submitting shareholder proposals.[96]

The exercise of voting rights is an important tool for shareholders' voices to be heard by directors and to protect their economic interests as investors.[97] It is a useful mechanism to stimulate corporate changes by providing opportunities for shareholders to weigh in on issues of wider concern. While companies may not always respond to shareholder votes, research suggests that directors usually pay attention to voting results and may even reflect those results in future decisions.[98]

Shareholders can draw attention to ESG issues through shareholder proposals, which is crucial for placing such issues on the schedule of companies. Filing shareholder ESG proposals enables shareholders to formally submit recommendations for action. For example, shareholder proposals, which gained prominence during the largely successful anti-apartheid divestment movement of 1970s and 1980s, provided a viable mechanism for initiating corporate actions, as opposed to only reacting to management actions.[99] Undoubtedly, shareholder activism can pressurise the management to integrate ESG in investment decisions, leading to a substantial increase in shareholder proposals as an engagement instrument. Shareholder proposals filed between 1999 and 2013 doubled to a total of 2,665.[100] Since shareholder proposals can be withdrawn if companies undertake to act on issues raised, they can create a sense of urgency in timelines for companies to respond and educate the shareholder community on emerging ESG issues. Interestingly, the Sustainable Investments Institute reported that a large proportion of ESG-related shareholder proposals filed between 2010 and 2018 were withdrawn, including 45 percent of proposed resolutions in 2018.[101]

Nonetheless, a likely impediment to ESG-related shareholder proposals is legal pluralism arising from jurisdiction variable filing rules. For example, the provision of some essential tools for shareholder intervention makes the UK a relatively more institutionally supportive setting for shareholder activism than USA.[102] One of the

---

[96] Hoffman Institute, *Shareholder Activism: Standing up for Sustainability?*(2018), https://luchoffmanninstitute.org/wp-content/uploads/2018/04/Shareholder-activism-report-.pdf.

[97] Efrat Dressler & Yevgeny Mugerman, *Doing the Right Thing? The Voting Power Effect and Institutional Shareholder Voting* 183 Journal of Business Ethics,1089,1100 (2023).

[98] Aaron A. Dhir, *Realigning the Corporate Building Blocks: Shareholder Proposals as a Vehicle for Achieving Corporate Social and Human Rights Accountability* 43 ABLJ 365 (2006).

[99] Henri-Claude Bettignies & François Lépineux, *Finance for a Better World: The Shift Toward Sustainability,* 80 (Springer, 2009).

[100] Jody Grewal, George Sarafeim & Aaron Yoon, *Shareholder Activism on Sustainability Issues,* Harvard Business School Working Paper (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2805512.

[101] Ceres, *The Role of Investors In Supporting Better Corporate ESG Performance: Influence Strategies For Sustainable and Long-Term Value Creation* (2019) https://www.ceres.org/sites/default/files/reports/2019-04/Investor_Influence_report.pdf.

[102] Bonnie Buchanan et al, *Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom* 49 American Business Law Journal 1, 5 (2012).

factors for the considerable increase in shareholder activism in the UK in the last decade is the Companies Act 2006, which aims at promoting effective shareholder engagement and improving long-term performance and its Part 13 provisions for proxy rules define the procedures for proposing resolutions for shareholder vote at annual general meetings. The binding nature of votes on UK shareholder proposals also makes them a more powerful tool for shareholders than the USA version. The USA's more restrictive Securities and Exchange Commission's Rule 14A-8 suggests a standardized approach to filing shareholder proposals by requiring that companies must include shareholder proposals of no more than 500 words in proxy materials for voting at shareholder meetings if shareholders own at least one percent (or $2,000 in market value) of the voting shares for at least a year and the proposals are within one of the 13 substantive bases for exclusion.[103] While shareholders can submit single proposals for inclusion in proxy materials at the company's expense, the result of the shareholder vote is usually non-binding.

Other factors suggest that, unlike in conventional businesses, investor engagement with mutual fund managers may not be effective. While investors often choose funds to lessen the burden of managing investments, their "right to exit", which is unavailable to ordinary company shareholders, raises questions about the effectiveness of investors' voting rights and activism in making fund managers to integrate ESG in investment decisions. As a key characteristic of mutual funds, the right to exit allows investors to redeem their shares/units for cash on a net asset value basis without facing significant financial consequences.[104]

An illustrative case is *Yacktman,* a claim by an investment adviser of two eponymous funds – Yacktman Fund (YF) and Yacktman Focused Fund – against YF's board of directors.[105] Following disputed changes in investment preferences between Yacktman and the board, the independent directors declined the investment adviser's demand for their voluntary resignation. The board dismissed the investment adviser and cancelled a special shareholders' meeting the adviser called to remove and replace the independent directors. While the claimant investment adviser and the independent directors accused each other of impropriety in separate letters to shareholders, most of the shareholders opted to redeem their shares. YF's assets valued at US$1.2 billion in 1997 before the dispute had by 1999 declined to US$280 million.[106] In effect, around 64 percent of the shareholders chose to redeem their investments rather than engage with the disputed issues.

In addition to demonstrating that mutual fund investors may not exert influence and prefer exit over activism, *Yacktman* suggests that retail investors may avoid interaction with the fund management and, as such, are more likely not to attend meetings

---

[103] Securities and Exchange Commission, *Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8: A Small Entity Compliance Guid*e (2020) https://www.sec.gov/corpfin/procedural-requirements-resubmission-thresholds-guide.

[104] Michael Brandl, Money, *Banking, Financial Markets and Institutions,* 470 (Cengage Learning, 2016).

[105] *Yacktman v. Carlson*, No. 98-278177 (Cir. Ct. Baltimore, Md. filed Oct. 5, 1998).

[106] Alshaleel, *supra* n.28, 177.

and exercise their voting rights. Although institutional investors can invest in mutual funds, retail investors are often in the majority. In Europe, for example, around 75 percent of investments in UCITS are by retail investors.[107] By contrast, ordinary company shareholders may hold large blocks of shares enabling them to exercise voting rights in a manner that affects corporate decisions, including on ESG. Since mutual funds pool their assets from many investors, their shares/units are normally dispersed widely, and individual investors may not hold large or sufficient shares/units to be capable of influencing the fund's investment and management decisions. In other words, when many investors are entitled to vote, a single investor may not have enough votes to influence voting results.

Despite the limited likelihood of investor activism, the business case for integrating ESG in mutual funds' financial analyses and management decisions may suggest possible investor interest in ESG factors and their impact on the funds' financial performance. A factor for investors' effectiveness as drivers of ESG in mutual funds – however – is what can be regarded as their social pluralism. Investors are confronted by different social realities, including varying religious and cultural values which can underpin ESG understandings and orientations. How can one define "social" in the ESG for numerous dispersed retail investors? Can it reflect, for instance, each individual investor's perspective or the fund management's viewpoint?

The debate around foie gras discussed above is illustrative. Another example is the role of religious groups such as the Quakers and Methodists in establishing specific ethical investment standards.[108] In the 18th Century, John Wesley – the Methodist Church founder – called on his followers to avoid harming one's neighbours, self or workers by profiting from businesses, such as alcohol, tobacco, dangerous chemicals and gambling, which were considered immoral products and services.[109] Originally labelled "ethical investment", the religious groups' approach to investment, later evolved to include a broader range of social, environmental and human rights issues termed, as discussed above, "socially responsible investment". Are religious values not possible causes of agency conflicts?

3. Resolving Agency Problems for ESG

As originally conceptualized, the agency problem is associated with two kinds of costs to ensure the agents' actions are aligned with the principals' interests. These costs embedded in corporate governance mechanisms are the principals' monitoring costs of the agents' behaviour and bonding costs agents incur to be assured of

---

[107] European Commission, *Greater Protection for Retail Investors: Commission Welcomes European Parliament Adoption of Strengthened European Rules On UCITS,* 2 (2014), http://europa.eu/rapid/press-release_STATEMENT-14-121_en.htm.

[108] Shuangge Wen, *Institutional Investor Activism on Socially Responsible Investment: Effects and Expectations* 18 Business Ethics: A European Review 308, 310 (2009).

[109] Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure* 3 Financial Econ 305, 307(1976).

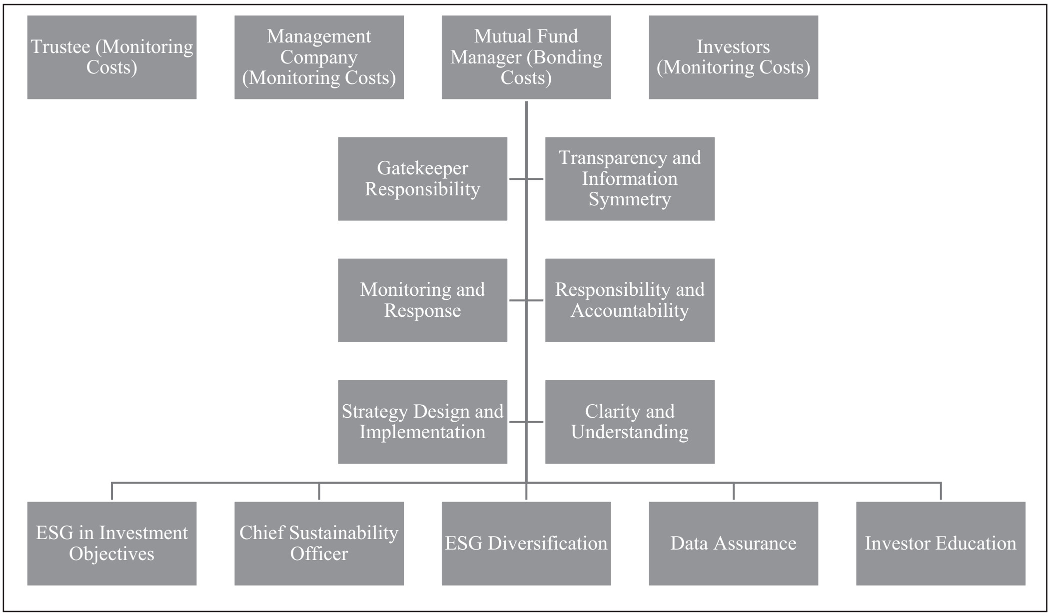

Figure 4. Resolving Mutual Funds' ESG Agency Conflicts

promoting the principals' interests. As long acknowledged, agency problems require corporate governance mechanisms suitable for the business size and sector and, given information asymmetries, limited investor engagement with fund managers and other agency problems in integrating ESG, we offer suggestions (see Figure 4) for enhancing the visibility and integration of ESG in mutual funds.[110] Our fivefold proposals are reframing mutual funds' investment objectives with explicit references to ESG criteria and principles, CSO role, linking investment diversification to ESG integration, data assurance, and investor education to facilitate understanding and activism.

(a) Investment Objectives

Commitments to ESG investing should be defined in mutual funds' investment objectives alongside the underlying factors. Since investment objectives prescribe what fund managers can do and matters that must be considered,[111] there is limited flexibility to act outside the objectives or to consider extraneous factors.[112] A case-by-case approach through investment objectives seems more helpful than relying on regulatory

---

[110] Eugene Fama & Michael Jensen, *Separation of Ownership and Contro*l 26 Journal of Law and Economics 301, 305 (1983).

[111] Collective Investment Schemes Sourcebook (2021), COLL 6.2.16 (6).

[112] Ibid, COLL 4.2.5.

instruments which are unlikely to contain provisions that are precisely worded to guarantee clarity of ESG commitments and applicable to all funds. This is useful for addressing information asymmetry in principal-agent relationships, including between mutual fund investors and managers, by frontloading precise meanings of ESG criteria for them.

An example of a generally worded instrument that raises information asymmetry concerns is the EU Sustainability-Related Disclosure Regulation 2019 (SFDR) Article 11 which provides rules on how financial market participants, such as UCITS management companies and financial advisors, should integrate ESG risks and opportunities as part of the duty to act in their clients' best interests and, with varying disclosure requirements, categorizes products as mainstream, 'promoting environmental or social characteristics' and promoting "sustainable investments".[113] Article 6 requires products without specific ESG or sustainability-related objectives to make sustainability risks disclosures. In investment advice or decision-making, Article 4 requires market participants and advisers to identify and publish information on how they account for "sustainability risks" defined by Article 2(2) as ESG events or conditions that have, or could have, impacted negatively on the investment value. The integration of ESG in the mutual funds' governance and processes is therefore not well defined in SFDR.

Of similar effects are the UK Guiding Principles on Design, Delivery and Disclosure of ESG and Sustainable Investment Funds which contain an overarching principle and three supporting principles focusing on ESG design, delivery and disclosure.[114] Unlike SFDR which requires both entity and product-level disclosures, the Guiding Principles operate at the product level targeting only mutual funds that make specific ESG-related claims or integrate ESG considerations in mainstream investment processes. Like SFDR, the Guiding Principles do not have definitive ESG provisions with a sufficient degree of preciseness to tackle information asymmetries between funds and investors.

Clarity of investment objectives is therefore necessary to ensure that fund managers are guided by ESG commitments defined for the fund as a corporate entity. To provide transparency for both investors and managers, investment objectives should outline how managers can apply ESG considerations and the data and sources for evaluating ESG materiality. Otherwise, managers may be constrained in their consideration of ESG factors and even deem it acceptable to buy and hold securities regardless of their ESG impact and identifying the wishes of investors or a majority of them will not be necessary. Even activist investors cannot complain of the direction of mutual funds if investment objectives spell out the rules of ESG engagement in advance of investments.

---

[113] 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] OJL L 317/1 (Regulation 2019).

[114] FCA, *Authorised ESG & Sustainable Investment Funds: Improving Quality and Clarity* (2021), https://www.fca.org.uk/publication/correspondence/dear-chair-letter-authorised-esg-sustainable-investment-funds.pdf.

(b) CSOs

Our second suggestion for resolving the agency problem and information asymmetry issues associated with integrating ESG is the creation of chief sustainability officer (CSO) roles in mutual funds' governance and management structures for reconfiguring strategies for delivering on ESG commitments. Due to divergence in nature and methodology, the integration of ESG factors in normal financial risk management processes may be challenging and require different sets of expertise. Since '*[h]ow a governance structure will function depends in part on who populates its roles*,' CSO roles will create room for specialized assistance to fund managers in integrating ESG principles and enhancing overall financial profile.[115] Fund managers, who usually undertake financial risk management, utilising information from a range of sources in assessing potential risks and establishing risk avoidance and mitigation policies, as indicated by the Collective Investment Schemes Sourcebook and section 64(b) of the 1940 Investment Company Act, for example, may need CSOs' assistance.[116] CSOs can contribute to identifying, quantifying, managing and responding to latent and emerging ESG risks and integrating them in investment and business risk frameworks.[117]

In addition to facilitating effective integration of ESG in mutual funds, CSOs can assist in addressing the PPAP. While representation of minority shareholders on boards of directors is regarded as one of the solutions to PPAP and may seem analogous to having representatives of minority investors in the mutual funds' management, this solution is inapplicable to such funds which are managed by professional managers without the oversight of shareholder appointed boards of directors.[118] Moreover, as minority principals may, just like dominant principals, be driven by their own self-centred interests, conflicts of interests in the composition of the board of directors (or equivalent body) can weaken its effectiveness.[119] Arguably, CSOs can represent the interests of ESG conscious investors without being nominated by those investors. Just like the expectations on independent directors on corporate boards in addressing PPAP, the need for CSOs to protect their reputation is an incentive.[120]

Furthermore, specialist CSO roles may be useful for keeping up with the speed of changes in regulatory, stakeholder and business expectations. The ESG activities of international standard-setting bodies, national legislators and industry-specific

[115] Lewis A Kornhauser, *Law as An Achievement of Governance* 47 Journal of Legal Philosophy, 1, 5 (2022).

[116] Collective Investment Schemes Sourcebook (2021), COLL 5.6.16; Investment Company Act of 1940, s 64 (b).

[117] Kathleen Miller Perkins & George Serafeim, *Chief Sustainability Officers: Who Are They and What Do They Do*? in Michael Tushman, Ranjay Gulati & Rebecca Henderson (eds), *Leading Sustainable Change: An Organizational Perspective* (Oxford University Press, 2016).

[118] Anzhela Knyazeva, Diana Knyazeva & Ronald Masulis, *The Supply of Corporate Directors and Board Independence* 26 Review of Financial Studies 1561, 1565 (2013).

[119] Filippo Belloc*, Law, Finance and Innovation: The Dark Side of Shareholder Protection* 37 Cambridge Journal of Economics 863, 866 (2013).

[120] Sally Wheeler, *Independent Directors and Corporate Governance* 27 Australian Journal of Corporate Law 168, 171 (2012).

regulators reflect a dynamic external reality for mutual funds that CSOs can assist in being abreast of changes. Since the need to adapt increases with the degree, pace, volume and complexity of change, the explicit designation of qualified persons as CSOs to champion the integration of ESG factors and assessment of related risks in investment decisions is vital. Like '*the 'Chief Translation Officer', [in] simplifying complex ideas and communicating the correlation between risk, trust, growth and cos*t', CSOs can help to ensure compliance with the evolving and complex ESG regulatory and stakeholder landscape and validate data for consistent application in investment decision-making processes.[121]

Since compulsory legal requirements may be disproportionate, particularly for small mutual funds, we suggest that funds should determine the creation of CSO roles a self-regulatory basis taking into account their individual circumstances, including organizational demography. A level of flexibility in regulatory expectation may mean that mutual funds can decide to establish single person roles as CSOs or appoint an ESG committee from their staff. Staff can be trained to acquire the necessary knowledge, skills and expertise for assessing and managing ESG risks and establishing, implementing and maintaining adequate internal control mechanisms acting independently or as teams.

(c) Diversification, Data Assurance and Categorisation

Diversification can also help in resolving agency problems associated with integrating ESG in mutual funds. Although fund managers may be required to spread investments across assets and sectors, ESG investing is largely concentrated in equities. While the number and innovativeness of ESG-related products and services, such as green bonds and sustainability-linked loans, have expanded in recent years, mutual funds may not be inclined to widen their investment portfolios across asset classes.[122] For example, about 68 percent of European ESG funds were directed to equities in the last quarter of 2020 and US equities attracted about 90 percent of sustainable funds flows.[123]

Other constraints include lack of standardized approaches and reliable investment data for measuring ESG risks, including in terms of comparability.[124] This may be traced to the relatively undeveloped market for ESG data with a growing, but largely unregulated, number of firms offering access to what was described as "largely

[121] Andrew Lowe et al, Th*e Rise of The Chief Sustainability Officer* 8 Korn Ferry (2022), https://www.kornferry.com/insights/featured-topics/people-planet-profit/the-rise-of-the-chief-sustainability-officer.

[122] Mascia Bedendo, Giacomo Nocera & Linus Siming, *Greening the Financial Sector: Evidence from Bank Green Bonds* 188 Journal of Business Ethics, 259, 270 (2023).

[123] Index Industry Association, *Measurable Impact: Asset Managers on the Challenges and Opportunities of ESG Investment* (2021). http://www.indexindustry.org/wp-content/uploads/2021/07/IIA_ESG-Main-Report-July-2021-vFINAL.pdf.

[124] Nofsinger & Varma, *supra.* n. 9.

worthless" data.[125] Moreover, are ratings systems clear in showing, for example, the relative values of corporate responsibility and financial risks in ESG rankings of products and businesses? The objectives of the ESG assurance system should be clear to investors with an understanding that *'[c]orporate responsibility and financial risk, however, are not the same thing [and] [i]ndeed, they can be diametrically opposed.'*.[126]

Arguably, the classifications and data sources introduced by the EU Taxonomy Regulation 2020, [127] which supplements the SFDR requirements in requiring pre-contractual and periodical transparency obligations, can assist fund managers in understanding the ESG impact of investments and ameliorate associated agency problems. In Article 7, the Regulation's definition of "financial product", which embeds the SFDR provisions, distinguishes between financial products with environmentally "sustainable investment" objective and those that promote environmental characteristics. [128] For the third category of "other financial products", information in pre-contractual disclosures and periodic reports is accompanied by a statement that *'[T]he investments underlying this financial product do not take into account the EU criteria for environmentally sustainable investments'*. [129] The disclosure requirements for the environmentally sustainable economic activities criteria may enable investors to understand the proportion of investments in underlying financial products and the degree of environmental sustainability.

Nonetheless, the Taxonomy Regulation has limited potential in resolving agency problems in integrating ESG in mutual funds. In addition to its obvious geographical limitation, the Regulation focuses on the environmental aspects of ESG and establishes a harmonized classification system for defining environmentally sustainable economic activities with six objectives, including climate change mitigation and climate change adaptation. To be designated as environmentally sustainable under Article 9, economic activities must positively make a "substantial contribution" to at least one of those objectives and not cause any significant harm to any of the others.[130] The Regulation is, however, unlikely to cover a broad range of potential issues, such as foie gras, within the social and governance criteria of ESG.

Moreover, how does one identify "substantial contribution" or harm, who makes the determination, from whose perspective should determinations be made, and what are the consequences for inaccurate or improper classifications? While these are pertinent questions in the disclosure of ESG-related standards and activities, the EU

[125] Patrick Greenfield, *Revealed: More Than 90% Of Rainforest Carbon Offsets By Biggest Certifier Are Worthless, Analysis Shows* (Guardian, 18 Jan 2023), https://www.theguardian.com/environment/2023/jan/18/revealed-forest-carbon-offsets-biggest-provider-worthless-verra-aoe.

[126] Hans Taparia, *One of the Hottest Trends in the World of Investing Is a Sham*, (New York Times, 29 Sep 2022), https://www.nytimes.com/2022/09/29/opinion/esg-investing-responsibility.html.

[127] Regulation (EU) 2020/852 of the European Parliament and of The Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 [2020] ojL L 198/13 (Regulation 2020).

[128] Ibid, Arts. 5, 6, and 7.

[129] Ibid, Art. 7.

[130] Ibid, Art. 9.

Commission noted that the Regulation is only to 'guide market participants in their investment decisions' and *'[t]here is no obligation for companies to be Taxonomy-aligned and investors are free to choose what to invest in'*.[131] Considering that James Hardie[132] and other cases of false and misleading ESG-related statements underline the need for a framework for ensuring credibility and reliability, the Regulation does not go far in addressing agency problems in integrating ESG in mutual funds' investment processes. Clearer benchmarks for determining what, how and who to disclose and consequences for disclosure are useful for investment processes and providing a good picture for investors and other market actors. As we discuss next, effective disclosure can also be linked to investors' financial education.

(d) Investor Education

Financial education arguably plays a role in addressing some of agency problems in integrating ESG in mutual funds' investment processes. Although not mutual funds or ESG specific, an apposite definition of financial education is:

> The process by which financial consumers/investors improve their understanding of financial products, concepts and risks and, through information, instruction and/or objective advice, develop the skills and confidence to become more aware of financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being. [133]

In the first instance, as discussed above, retail investors, who are predominant in mutual funds, may not have relevant financial and legal knowledge. Financial education will assist retail investors to understand the nature and scope of the ESG criteria and the potential operational and financial risks and impact. It can lead to greater investor awareness of their latent role in influencing ESG considerations in investment decisions and facilitating a change from a simple "do good" mentality to utilising ESG for longer-term risk-adjusted returns. While cognitive biases and behavioural inconsistency can create discrepancies between what investors say and do,[134] financial education helps by providing a picture of ESG criteria and what they entail for investors and society. Mutual fund investors largely "rely on simple signals" and, if "educated", may understand diverse investment strategies, wide range of sustainable

---

[131] *Questions and Answers: Taxonomy Climate Delegated Act and Amendments to Delegated Acts on Fiduciary Duties, Investment and Insurance Advice* (2021), https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_1805.

[132] *Australian Securities & Investments Commission v Hellicar & Ors* [2012] HCA17; *Shafron v Australian Securities & Investments Commission* [2012] HCA 18.

[133] Organisation for Economic Co-operation and Development, *Recommendation on Principles and Good Practices for Financial Education and Awareness* (2005), https://www.oecd.org/finance/financial-education/35108560.pdf.

[134] Richard Thaler, *From Homo Economicus to Homo Sapiens* 14 J. Econ. Perspect 133, 136 (2000).

finance products and how they work, the need for ESG risk integration in investment decisions, and financial decisions' relevance and impact. Investors will be in a better position to make informed choices.[135]

Then, the questions are who should provide ESG-related financial education for mutual fund investors, what does it involve, and how should it be undertaken? Regarding "who" and "what", mutual funds and their managers may be required to disclose "certain matters" to investors to facilitate financial education by, among others, explaining the meanings of ESG criteria and impact, providing information on investment standards and enabling comparative analysis of different funds, products and sectors. The linkages between financial education and disclosure can be strengthened by requiring filing obligations with regulatory and supervisory bodies to accompany certain disclosures and attaching consequences for inaccurate or misleading ones.[136]

The role of ESG rating agencies in financial education also needs to be considered. Given the characteristics of mutual fund investors, streamlining rating systems can assist investors in understanding the applicability of ESG criteria to certain funds and enable them to engage effectively in comparative suitability analysis, for example, in undertaking investment or adopting activist approaches. It can also protect investors by tackling "greenwashing" by aligning reliable disclosure with credible rating standards, an important point with the growing demand for sustainability-related financial products.[137]

In relation to "how", financial education can be promoted by requiring ESG disclosure, for example, in prospectuses, on websites and at regular intervals, and by using technology to improve investor engagement. Mutual funds can be encouraged to use online tools to enhance and tailor information to investors to enrich their experience in understanding ESG investing. Since investors are, for instance, increasingly reliant on smartphone applications for obtaining financial data and managing investments, such applications can be used in providing ESG information. Electronic tools such as infographics, pop-up information and interactive apps can enhance investors' understanding of ESG materials and facilitate awareness of proxy voting and other procedures and processes.

4. Conclusions

Despite the growing popularity of ESG investing, mutual funds seem to offer little in terms of engagement and promotion within and outside the funds. While investors and other market participants may be interested, ESG is not inextricably linked to the primary goal of value maximisation in mutual fund investments. This paper applies

---

[135] Itzhak Ben-David et al, *What do Mutual Fund Investors Really Care About*? 35 The Review of Financial Studies, 1723, 1760 (2022).

[136] See the facts of *Australian Securities & Investments Commission v Hellicar & Ors* [2012] HCA 17 and *Shafron v Australian Securities & Investments Commission* [2012] HCA 18.

[137] Alshaleel, *supra* n.28, 229.

the agency theory to conceptualize the existence of a resonance dilemma in the transposition of ESG to the ownership, governance and operational structures of profit-orientated mutual funds. On the one hand, fund managers may at best perceive ESG strategically due to the inherent profit elements in establishing and contributing to a pool of funds for investment. On the other hand, some investors and even managers may desire to promote ESG even if it requires the consideration of non-commercial factors. The possibility of conflicts in the circumstances is not farfetched and, perhaps, explains the relatively slow uptake of ESG by mutual funds.

This paper demonstrates that both the classic principal-agent-problem and principal-principal-agent conflicts can manifest in attempts to align mutual funds' investment policies and processes to ESG. Notwithstanding challenges including the funds' investment objectives, their undertaking of gatekeeping engagement with investee companies, insufficient clarity regarding the scope of their managers' fiduciary duties and lack of steer for responding to ESG-related investor activism, existing regulations display gaps in resolving potential agency conflicts. UK and EU instruments as illustrations show that uncoordinated regulatory interventions have not given sufficient attention to agency problems in integrating ESG and may even cause agency conflicts.

This paper's original suggestions for addressing agency conflicts in integrating ESG in mutual funds include definitional clarity in investment objectives, diversifying and categorising investments, provisions for CSOs in corporate governance structures, improved standards and credibility of assurance services, and investor education. Given that the diversity of standards globally is both a source of complexity and a constraint for mutual funds, a more coordinated international approach is useful in providing greater clarity to the ESG criteria's meaning and scope and robustness of rating standards. The goal is to accelerate an enabling framework for mutual funds to undertake social responsibilities through the instrumentality of ESG.