Becoming virtuous?
Mutual Funds' Reactions to ESG Scandals

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Abstract

We study how mutual funds respond to ESG scandals of portfolio companies. We find that, after experiencing an ESG scandal in their portfolio, active mutual fund managers (but not passive ones) are more likely to vote in favor of ESG proposals compared to other funds voting on the same proposal, *and* are more likely to reduce their stakes (and hence their voting power) in high-ESG risk stocks compared to other funds holding the same stock at the same time. Both results are pronounced (a) when the stake in the scandal stock is large, (b) when the scandal is less expected, and (c) when the scandal is accompanied by more negative stock returns. Our results suggest that scandal-shocked funds manage ESG risks in their portfolios, but do not try to maximize impact. As a result, divestments may undermine engagement efforts precisely for those firms that presumably have the biggest need for reform.

JEL classification: G11, G12, G14, G15

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Preliminary; comments highly welcome!

1. Introduction

An increasing number of institutional investors claim to invest with environmental, social, and governance (ESG) criteria in mind. For example, in its latest report, the Global Sustainable Investment Alliance states that "sustainable" assets, which purportedly follow ESG standards, reached 35.3 trillion USD in 2020, up from 22.8 trillion USD in 2016. In a similar vein, signatories of the UN-backed Principles for Responsible Investment (PRI) now represent more than 50% of global public equity (Kim and Yoon (2022), Gibson et al. (2022)). Crucially, these commitments extend far beyond "ESG funds" in the narrow sense, i.e., funds that carry investment mandates with explicit ESG performance targets. How do these newly ESG-aware investors behave? Do they care about making companies more virtuous or do they simply want to avoid exposure to "sinful" companies? While we have some answers to these questions from the laboratory (Bonnefon et al., 2022) and from surveys (Krueger et al., 2020), we still lack well-identified evidence from the field.

In this paper, we provide such evidence by *jointly* studying mutual funds' proxy voting and trading behavior in response to ESG scandals of (other) portfolio stocks. We posit that such scandals represent idiosyncratic shocks to mutual funds' awareness of ESG risks. Moreover, since different funds are exposed to different scandals, we can saturate our regressions with high-dimensional fixed effects, allowing us to compare fund managers' voting and trading behavior for the same (non-scandal) stock. We argue that, by identifying the causal effects of ESG awareness on voting and trading, our analysis sheds light on what mutual fund managers care about: reducing ESG risks in their portfolio (e.g., to avoid poor performance and/or outflows in the future) or impact (i.e., improving companies' ESG performance).

The literature distinguishes between two channels for how an ESG-aware investor can try to influence a high-ESG risk firm in her portfolio:[1] she can engage with the stock's management with the aim of reducing ESG risks (*voice*), or she can divest from the stock (*exit*). To date, these two channels have usually been studied in isolation.[2] To the best of our knowledge, ours is the first empirical paper to *jointly* describe mutual funds' voice and exit behavior after a (plausibly exogenous) shock to their ESG awareness. We document that, after experiencing ESG scandals for some of their portfolio stocks, mutual funds use both voice and exit simultaneously.[3] This creates a tension. Indeed, by reducing their stakes in high-ESG risk stocks, mutual funds undermine their voting power for ESG-related shareholder proposals in precisely those firms that arguably have the biggest need of reform. Thus, our evidence suggests that mutual funds use voice and exit in order to manage ESG risks in their portfolios (i.e., to reduce exposure to future ESG scandals), but at the cost of potentially reducing their impact on firms with poor ESG track records.

To identify ESG scandals, we rely on the RepRisk database. RepRisk scans newspapers, news broadcasts, and social media sources worldwide for ESG incidents—i.e., news stories about environmental, social, or governance problems at public or private firms. RepRisk then uses a proprietary algorithm to construct the *RepRisk Index* (RRI) from this raw data. The RRI jumps up when an ESG incident occurs, and the size of the jump reflects the seriousness and novelty of the incident. After some time without incident, the RRI slowly decays toward zero. We rely on this RRI and define an ESG scandal as having occurred when the RRI for a given firm-month observation jumps by a certain threshold.[4] This approach ensures that we pick up important ESG scandals that come as a surprise.[5] We identify 3,213 ESG scandals in our sample,

[1] With ESG risks, we mean the (uncertain) negative consequences for companies with ESG incidents or poor ESG performance: more costly access to capital, loss in customers and/or key employees due to poor reputation, becoming the target of regulation or policy intervention etc..

[2] A notable exception is Broccardo et al. (2022), who study the relative effectiveness of voice and exit strategies in a model with corporate externalities. They show that in terms of impact voice is more effective than exit.

[3] With exit we mean a reduction in portfolio weights (i.e., partial sells of a stock position). Indeed, the mutual funds in our sample rarely completely liquidate a stock position from one quarter to the next.

[4] In robustness checks, we verify that our results go through when we identify ESG scandals based on stricter or laxer thresholds.

[5] Specifically, the RRI is capped at 100 and slowly decays in the absence of a scandal. Together, these two features imply that, for a company with a long history of ESG incidents, the RRI is already elevated and thus cannot jump as much when a new scandal hits.

confirming that such large and surprise increases are relatively rare.[6] On average, stocks with an ESG scandal exhibit negative abnormal returns and funds exposed to scandals experience outflows after controlling for the fund return. This shows that mutual funds are hurt and ought to pay attention to these scandals.

We begin our empirical investigation with voice. Specifically, we look at the proxy voting behavior of mutual funds for ESG-related shareholder proposals.[7] Such proposals allow investors to put pressure on management (Thomas and Cotter, 2007; Ertimur et al., 2010; Cunat et al., 2012). Our explanatory variable is *ESG scandal experience*, which we define as the average of the monthly fraction of a fund's portfolio holdings that experienced an ESG scandal over the prior year. A key advantage of our identification strategy is that different mutual fund managers hold different portfolios and are thus exposed to different ESG scandals. This allows us to employ high-dimensional fixed effects. Specifically, thanks to the inclusion of proposal fixed effects, we can test whether mutual funds whose portfolios were exposed to ESG scandals vote differently compared to other mutual funds taking part in the same vote, thereby controlling for all proposal-specific and stock-time-specific factors that could influence mutual funds' voting behavior. Thus, factors like the proposal type, ISS recommendation, media coverage, public opinion, management's reaction, past performance etc. cannot explain our results.

Using this setup, we find that mutual funds with higher *ESG scandal experience* are more likely to vote for ESG proposals in subsequent shareholders' meetings compared to other funds voting on the same proposals. In terms of magnitude, a 1 percentage point increase in ESG scandal experience (corresponding to 2-3 scandal months in the prior year for average-sized positions) increases the probability of voting in favor of an ESG proposal by 1.1 percentage points or 3% relative to the mean vote share in favor of ESG proposals. When we separate between active and passive funds, we find that only active funds change their voting

[6] In Appendix B, we give a few examples as well as an overview of the different types of ESG scandals that we have in our sample.

[7] Voting on shareholder proposals is only a part of mutual funds' overall engagement efforts. Indeed, using data from a large UK asset manager, Becht et al. (2019) document that votes are often preceded by meetings between the asset manager's stewardship team and firm management. As such meetings are unobservable to us, we use voting behavior as a proxy for engagement.

behavior in response to ESG scandals in their portfolios. This no-result for passive funds could be due to them not paying attention to individual portfolio stocks or because their own investors do not blame them for holding a scandal stock. Either way, it is consistent with recent critique that, with respect to ESG, passive funds often do not *walk the talk*.[8]

In subsequent analyses, we focus on active funds. We first verify that the effect on voting for ESG proposals is stronger when ESG scandals come from stocks with a larger portfolio weight. This is consistent with the idea that mutual funds pay more attention to—and are thus more impressed by—ESG scandals that matter more for fund performance. We also find that the effect on voting is pronounced when the ESG scandal comes as a surprise (i.e., when it occurs for a company whose prior RepRisk rating indicates low ESG risks) and for funds who previously displayed a less ideological stance on ESG (i.e., for funds that in the past neither consistently voted for nor against ESG proposals). Hence, ESG scandals resonate more with funds that "have not yet made up their mind" on ESG.

The environmental and social dimension of ESG concern externalities, and proposals that promote these dimensions could come at the detriment of shareholder value. In contrast, the governance dimension is presumably more aligned with shareholders' interests. We therefore attempt to separate between the ES and G dimensions—both for proposals and for scandals—to see which type of scandal mostly affects which type of proposal. We find that both ES and G scandals affect the voting for both ES and G proposals with comparable magnitudes. Thus, it appears that mutual fund managers lump these dimensions together, in line with the popularity of (broad) ESG labels. We acknowledge, however, that the RepRisk data only allows for an imperfect distinction between ES and G scandals, so our finding could also be due to this data limitation.

[8] In his annual letter to CEOs, BlackRock's CEO Larry Fink repeatedly extolls the importance of ESG and particularly climate change for BlackRock's clients and, in turn, its investment strategy (https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter). According to, for example, Tariq Fancy, BlackRock's former chief investment manager for sustainable investing, this is little more than "marketing hype, PR spin and disingenuous promises" (see Tariq Fancy's 2020 essay entitled "The Secret Diary of a 'Sustainable Investor'").

We next ask *why* (active) mutual funds appear to change their ESG preferences after scandals. One possibility is that mutual funds are purely opportunistic: they are aware that ESG scandals hurt performance and are disliked by their end investors, leading them to try to proactively manage ESG risks for their portfolios. Another possibility is that mutual fund managers become intrinsically averse to ESG scandals, perhaps because they personally feel guilt or shame of having invested in a "sinful" company (Hong and Kacperczyk (2009), Riedl and Smeets (2017)). To tease out which explanation is more likely to drive our results, we study whether ESG scandals have a stronger effect on voting when the associated stock had a more negative return around the scandal; i.e., when the connection between ESG scandals and performance is presumably more salient. We indeed find that, the more negative the return surrounding an ESG scandal, the larger is the effect on subsequent voting behavior. It thus appears as if mutual fund managers respond to ESG scandals out of concern for performance. That is, they vote in favor of ESG proposals in order to mitigate exposure to future ESG scandals. A feeling of personal responsibility for improving ESG policies at portfolio companies seems to play less of a role, although our results may also partly be explained by this.

We then look at exit. Our tests proceed analogously to those for voice. Specifically, we compare the exit behavior in high-ESG risk stocks, i.e. stocks more prone to exhibit future scandals, for funds with different prior ESG scandal experiences. Through high-dimensional fixed effects, we control for all stock-time-specific reasons as to why any investor may want to sell a given stock at a given point in time. We find that, compared to other funds holding the same stock, funds with a recent ESG scandal in their portfolio are more likely to (partially) sell their positions in high-ESG risk stocks. Consistent with our results for voice, this effect is pronounced for scandals in stocks with a larger portfolio weight, for more surprising scandals, and for scandals accompanied by negative stock returns. Taken together, funds' joint voice and exit behavior is likely detrimental to having much impact: by reducing their stakes in high-ESG risk stocks, funds undermine their voting power in exactly those stocks for which the benefits of a successful engagement are presumably the greatest.

Mutual funds are aware that a partial divestment implies a reduction in voting power for shareholder proposals. Indeed, we find that they divest less from high-ESG risk stocks when the ex-ante probability of a successful engagement is arguably higher, i.e. they are more likely to choose exit when voice is less likely to be successful. We use 4 measures of the ex-ante success probability of engagement: (1) whether the stock had an ESG-related shareholder proposal in the prior year, (2) whether an ESG-related shareholder proposal passed in the prior year, (3) whether the stock has high institutional ownership and (4) whether the stock has a higher estimated propensity for successful engagement. Overall, our results are consistent with shocked funds managing ESG risks in their portfolios—by trying to engage with a few high-ESG risk stocks and, for the many stocks for which engagement is unlikely to succeed, by directly limiting their exposure. Yet, overall impact may be minimal. Indeed, by selling off many high-ESG risk stocks to investors that presumably care less, these stocks may become harder to reform going forward.

Our paper contributes to the burgeoning literature on ESG investing.[9] On the theory side, Heinkel et al. (2001), Broccardo et al. (2022), Landier and Lovo (2020), Berk and van Binsbergen (2022), among others, explore how different strategies—voice, boycotts, or exit—can help mitigate the welfare loss arising from a negative production externality (e.g., CO2 emissions arising in the production process). A loose consensus from this work is that voice (or direct engagement) is more effective than exit. In addition, Oehmke and Opp (2022) stress the importance of broad mandates: only if sustainable investors care about negative externalities broadly (e.g., even for polluting firm not in the portfolio) will they invest and engage with dirty companies. In this regard our empirical evidence is sobering. While we find that shocked mutual funds are more likely to vote for ESG proposals, they also tilt their portfolios away from (and thus reduce their voting power in) stocks with a high risk of future ESG scandals. This suggests that funds do not try to maximize impact, but rather care about managing ESG risks in their portfolios.

[9] See Margolis et al. (2009) and Kitzmueller and Shimshack (2012) for literature reviews on ESG or Corporate Social Responsibility (CSR) more generally. See Dimson et al. (2015) and Dyck et al. (2019) for evidence of the impact of socially responsible investors on firms' CSR performance.

On the empirical side, our paper belongs to a recent strand of literature that studies ESG risks through ESG *incidents*, instead of relying on conventional ESG ratings.[10] Our data provider, RepRisk, provides the most comprehensive coverage of such incidents. Using the same data, Glossner (2021) finds that, in the cross-section of U.S. stocks, ESG incidents predict future ESG incidents and low stock returns, suggesting that U.S. investors are not paying sufficient attention to these events. Derrien et al. (2021) study how sell-side analysts adjust their earnings forecasts following ESG incidents. Gantchev et al. (2022) find that, after an ESG incident, firms exhibit mild divestitures and decrease their greenhouse gas emissions when they are held by more climate-conscious investors. In a related paper, He et al. (2022) show that firms are more likely to have ES incidents *after* failed ES proposals (which explains why ESG-aware funds want to vote for ESG-related shareholder proposals). Instead, we use (surprise) ESG scandals for portfolio stocks as shocks to mutual funds' ESG awareness, which allows us to jointly study how these investors employ voice and exit strategies.

Finally, we contribute to the literature on mutual fund proxy voting (Bolton et al. (2020); Iliev and Lowry (2015); Davis and Kim (2007)). Contemporaneous work finds that mutual funds are more likely to vote for environmental shareholder proposals after experiencing natural disasters (Fich and Xu, 2021) or extreme temperatures (Di Guili et al., 2022). In these settings, mutual fund investors are reacting to salient cues about global warming that are orthogonal to the actual worth of a given environmental shareholder proposal. Instead, we focus on investment experiences—ESG scandals for portfolio stocks—that potentially bear on performance and the fund's reputation vis-à-vis investors. Moreover, we do not only consider voice, but also study exit. Overall, our results are more consistent with fund managers responding to ESG scandals for opportunistic (performance- or reputation-related) reasons, and less consistent with them internalizing the negative impact of ESG externalities. Indeed, we find that funds respond more strongly to ESG scandals that are accompanied by negative stock returns, and they take (visible) actions to reduce the risk of future portfolio scandals in a way that is unlikely to have a lasting impact on high-ESG risk firms. We thus

[10] As shown by Berg et al. (2021), ESG ratings from different data providers are often inconsistent and notoriously noisy.

complement recent papers questioning the impact of divestment campaigns (Berk and van Binsbergen (2021), Edmans et al. (2022)).

Our paper is organized as follows. In Section 2, we describe data sources and present summary statistics. In Section 3, we show how mutual funds are hurt by being exposed to ESG scandals. In Section 4, we explain our empirical methodology and our main findings for voice (mutual fund voting). Section 5 presents our main findings for divestments of high-ESG risk stocks. Section 6 studies how funds choose between exit and voice. Section 7 presents robustness checks. Section 8 concludes.

2. Data and Variable Construction

a. RepRisk Data

To identify ESG scandals, we use data from RepRisk on ESG incidents that spans the years 2007 to 2018.[11] RepRisk screens newspapers, news broadcasts, and social media sources worldwide to identify negative stories related to ESG issues that implicate firms.[12] RepRisk then uses a proprietary algorithm to construct the *RepRisk Index* (RRI) from this raw data. The RRI runs from 0 to 100 with higher values indicating a higher "reputational risk exposure to ESG issues" (Rep Risk, 2020). When a new ESG incident occurs, the RRI is increased by an amount that relates to the reach, severity, novelty, and intensity of the incident. In months without an incident, the RRI slowly reverts back to zero. We define an ESG scandal event when the RRI for a given firm-month observation increases by more than 25 points.[13] Importantly, our approach ensures that we identify ESG incidents that are both *severe and unexpected*. Indeed, firms with a checkered

[11] This dataset has been used in previous research such as Glossner (2019, 2021) and Akey et al. (2021).

[12] Firms are added to the dataset when they are mentioned for the first time in one of RepRisk's sources in relation to an ESG incident. We therefore treat firms that are not in the RepRisk data as having no ESG incident. Our results remain robust if we exclude stocks not in RepRisk before constructing our *ESG scandal experience* measure (see Table 12).

[13] The value of 25 corresponds to the 90th percentile amongst increases. In the robustness section, we verify that our results hold when we identify ESG scandals based on stricter or laxer thresholds (see Table 11).

history already have an elevated RRI, thus leaving less scope for further increases when a new ESG incident emerges. Our ESG scandals therefore constitute large shocks that are likely to draw fund managers' attention. Overall, we have 3213 ESG scandals in our sample. In Appendix B, we give a few examples as well as an overview of the different types of ESG scandals that we cover.

RepRisk data is merged with CRSP using stock CUSIPs. In RepRisk, company identifiers map to several CUSIPs that do not change over time. We therefore use the historical 8-digit CUSIP ("NCUSIP") available in CRSP to merge between PERMNO and RepRisk ID. We match about 4000 PERMNOs in this way, which is in line with previous papers (see Akey et al., 2021).

b. CRSP Mutual Fund Data and creating the ESG scandal experience measure

We obtain quarterly mutual fund holdings data from the CRSP mutual funds data. Slightly below half of the funds in the sample have monthly holding data while the other half has quarterly data. To treat all funds equally, we reduce the monthly holdings data to quarterly frequency by keeping only the last monthly observation in the quarter.

To compute fund-level ESG scandal experience, we first compute the value-weighted fraction of the fund's stocks that experienced a scandal each month using the fund holdings at the beginning of the quarter. Depending on whether we look at (annual) votes or quarterly holding changes, we then compute *ESG scandal experience* as the average of these monthly values for the fund over the previous 12 or 3 months as follows:

$$ESG\ scandal\ experience_{f,T} = \sum_{t=T-1}^{T-h} \left(\sum_{i=1}^{N} weight_{f,i,t} * D(ESG\ scandal)_{i,t} \right) / h$$

where the subscript *f* denotes the fund, *i* denotes the stock, *t* denotes the month, and $D(ESG\ scandal)_{i,t}$ is a dummy variable equal to one if stock *i* has a scandal in month *t*. For our (annual) voting analysis, *T* is the date of the vote and the lookback horizon *h* is 12 months. For our (quarterly) exit analysis, *T* is the quarter

in question and *h* is 3 months. Our definition ensures that the fund was actually holding a given stock at the time of the scandal.

To separate between active and passive mutual funds, we obtain fund names and the "index_fund_flag" variable from the CRSP mutual fund data. Following Appel et al. (2016), we treat a mutual fund as passive if the index fund flag equals "D" ("Pure Index Fund") or if the fund name contains a string suggesting it is an index fund.[14] We also run our main analysis separately on ES funds. Following Michaely et al. (2022), we identify ES funds based on whether their names suggest that they have an environmental or social mission.[15]

c. Voting data

Since 2003, the U.S. Securities and Exchange Commission (SEC) requires all U.S. mutual funds to report their proxy votes in annual N-PX filings. We use the Institutional Shareholder Services (ISS) voting dataset that compiles information from N-PX filings as well as votes' results and ISS recommendations for both shareholder and management proposals of Russell 3000 companies. We follow Iliev and Lowry (2021) to match ISS to CRSP. Specifically, we determine the N-PX file id provided by ISS to download the actual file from EDGAR. We extract both the Central Index Key (CIK: EDGAR institution identifier) and the funds' tickers from the N-PX files' headers. Then for all funds with the same N-PX file id, we name-match the scrapped EDGAR data with ISS to obtain a corresponding ticker to each ISS fund id. When we are unable to retrieve a fund ticker from the N-PX files, we manually match funds in ISS to CRSP by CIK and fund name. We are thus able to match around 80% of all funds in ISS.

[14] Specifically, following Appel et al. (2016), we mark funds as index funds if their lower-case fund name contains one of the following strings: *Index, Idx, Indx, Ind_* (where_ indicates a space), *Russell, S & P, S and P, S&P, SandP, SP, DOW, Dow, DJ, MSCI, Bloomberg, KBW, NASDAQ, NYSE, STOXX, FTSE, Wilshire, Morningstar, 100, 400, 500, 600, 900, 1000, 1500, 2000* , and *5000*.

[15] Specifically, following Michaely et al. (2022), we look at lower-case fund names containing one of the following strings: *sustain* (excluding *sustainable dividend*), *social* (excluding *social media*), *esg*, *pax*, *responsib*, *clean*, *impact*, *water*, *sri*, *environm*, *green*, *catholic*, *parnassus*, *aquina*, *women*, *alternative energy*, *equality*, *wind energy*, *fossil*, *low carbon*, *amana*, *eco or ecolog*, *epiphany*, *solar*, *climate*, *better world*, *energy solutions*, *gender*, and *just*.

We identify ESG-related shareholder proposals by looking at the proposal's description provided by ISS. Our list of ES proposals starts with He et al. (2022) but we add a few items that we think also pertain to ES issues (e.g., ISS description "board diversity" or "report on pay disparity"). Our list of G proposals is manually constructed and includes issues such as: proxy access, poison pills, or require a majority vote for directors' election. Our sample spans 9,155 ESG shareholders' proposals that were voted between 2007 and 2018 and covers the votes of 8,406 funds, out of which 6,950 are actively managed.

d. Summary Statistics

Table 1 presents summary statistics. In Panel A, we display summary statistics at the firm-month level for the RepRisk data. The RepRisk index (RRI) is a monthly index that increases whenever a company is in the news due to an ESG incident. In months without an ESG incident, the RepRisk index slowly declines toward zero. The average RRI is 7.5, which is due to more than half the observations being equal to zero. In 6.6% of the months, there is an ESG incident and the RRI increases. Of these increases, the average increase size is 9.7, while the median is 6. As mentioned above, our definition of an ESG scandal is an increase in the RRI of more than 25 points, which corresponds to the 90^{th} percentile. These ESG scandals are rare events happening in 0.58% of firm-months observations. Using the alternative cutoffs of 30 and 20 points, ESG scandals occur in 0.39% and 0.95% of firm-months, respectively.

In Table 1 Panel B, we display fund-level summary statistics. We use quarterly holdings data to compute ESG scandal experience on the fund level. For the average fund, the average position size as a fraction of positions that have a PERMNO is 4.9%, the median position size is 3.7% and the maximum position size is 21.2%. This means that position sizes are large enough for the fund manager to pay close attention to their position. Monthly fund returns have a standard deviation of 3.8%, while monthly fund flows have a standard deviation of 13.5%.

In Panel C, we display summary statistics for the proposal-level data used in our vote analysis. On average, funds vote in favor of ESG shareholder proposals 36.9% of the time. The average position size the fund

holds in the company with a vote is 0.06% as a fraction of the firm's shares outstanding. The fund and the firm are headquartered in the same state in 5.7% of cases.

In Panel D, we display summary statistics for the fund-stock-quarter level data used in our exit analysis. On average, funds sell shares in 36.8% of their stock positions each quarter and about half of stocks have a low RepRisk rating, which we define as a rating of A or worse.

3. **Should (opportunistic) funds care about ESG Scandals?**

In this section, we present evidence that even performance-driven mutual fund managers should care about ESG scandals. This evidence serves as a precursor for our main analyses in that it validates our choice of events (ESG scandals) and thus helps understand why mutual fund managers may react to them.

We start with reporting stock returns around ESG scandals. To get a sharper timing of when ESG scandal news might be incorporated in stock prices, we rely on daily media coverage data of ESG incidents. This data is also provided by RepRisk (and forms the raw data on which the RepRisk index is based). Specifically, we identify as events all media articles related to ESG incidents that are recorded during stock-months with an ESG scandal (i.e., when the RepRisk index jumps by 25 points). In Table 2 Panel A, we report cumulative market-adjusted returns for three different windows surrounding these media articles. When looking at the day of and the day following an article, we find a statistically negative return of 23 basis points (column (1)). When looking at windows up to 20 days after the article (columns (2)) or including 5 days prior to the article (columns (3)), cumulative returns become more negative, suggesting that information pertaining to ESG scandals slowly trickles into prices (consistent with the findings in Glossner (2021)). In short, ESG scandals are accompanied by negative stock returns and thus directly hurt the performance of exposed fund managers.

Next, we investigate whether funds suffer outflows after experiencing ESG scandals in their portfolios. The idea is that, if mutual funds' end-investors were to care about ESG, they might withdraw their assets from

mutual funds with large portfolio holdings in scandal stocks. Following standard practice in the literature (e.g., Sirri and Tufano (1998)), we compute monthly fund flows as a fraction of net asset value from the CRSP mutual fund database:

$$Fund\ flows_t = \frac{Net\ asset\ value_t - (Net\ asset\ value_{t-1} * Fund\ return_t)}{Net\ asset\ value_{t-1}}$$

We then regress monthly fund flows on our measure of *ESG scandal experience*, which captures funds' (position-weighted) average exposure to ESG scandals over the past year. We include fund returns—a common driver of fund flows (e.g., Chevalier and Ellison (1997))—as well as month and fund fixed effects. Standard errors are two-way clustered by fund and month.

Table 2 Panel B presents the results. In the fund-month panel including all funds (columns (1) and (2)), the coefficient of *ESG scandal experience* is negative and statistically significant, implying that ESG scandals of portfolio firms trigger fund outflows. Importantly, these results are robust to controlling for fund returns over the current month and the previous year, suggesting that fund investors care about ESG scandals over and above their direct impact on fund performance. When splitting the sample into active and passive funds, we find that this result solely comes from the sample of active funds (columns (3) and (4)), while passive funds do not suffer outflows following ESG scandals in their portfolios (columns (5) and (6)).

In summary, exposure to ESG scandals especially hurts active funds: their performance suffers directly (albeit weakly) from the negative returns around scandals, and they experience additional outflows from their investors.

In what follows, we study how mutual funds respond to ESG scandals. Importantly, we do so by looking at the trading and voting behavior *for their other portfolio stocks*. Scandal firms themselves will be under pressure from various sides—customers, investors, the media, regulators etc.—making it difficult to pin down cause and effect. Studying how mutual funds respond to scandals for other portfolio stocks allows us to cleanly identify how, if at all, scandals shape fund managers' ESG awareness and, in turn, their

subsequent actions. Specifically, by comparing the actions of different mutual funds in the same stock, we can study how mutual funds exposed to an ESG scandal change their behavior after controlling for all stock-time-specific reasons that may influence such behavior.

4. Results for Voice

a. Empirical Methodology

In this section we study voice. We ask whether, following exposure to ESG scandals, fund managers are more likely to vote in favor of ESG shareholder proposals. Specifically, we run the following linear probability model:[16]

$$D(Vote\ for\ ESG\ proposal)_{f,p} = \alpha_p + \alpha_f + \beta_1 * ESG\ scandal\ experience_{f,m} + \beta_2 * Controls + \varepsilon_{f,p},$$

where $D(Vote\ for\ ESG\ proposal)_{f,p}$ is a dummy variable equal to one if the fund votes in favor of the specific ESG shareholder proposal and $ESG\ scandal\ experience_{f,m}$ measures the average fraction of the fund's portfolio holdings that had an ESG scandal over the prior 12 months. Because the data is at the fund-proposal level, we can include proposal fixed effects (α_p) as well as fund fixed effects (α_f). The proposal fixed effects are particularly important as they allow us to control for proposal-specific omitted variables (such as the merit of the specific proposal) and any other firm-level omitted variables, including time-varying ones. Due to these fixed effects, the regression is relatively saturated even without adding other control variables (as evidenced by relatively high Adjusted R-squares). When displaying results below, we thus show first the specification without controls.

There are two types of omitted variables that our fixed effects cannot control for: fund-firm level and time-varying fund level variables. In our second specification, we add control variables along these dimensions.

[16] We estimate a linear probability model (i.e., OLS) in order to avoid the incidental parameters problem that arises for nonlinear models with many fixed effects (Neyman and Scott (1948)).

As fund-firm variables, we include position size and a dummy variable for whether the fund and the company are located in the same state. As time-varying fund level variables, we include the fund return over the previous year and fund size (measured as total net assets). Including these control variables barely changes our results (see below), suggesting that omitted variable concerns are small.

We two-way cluster standard errors at the fund and shareholder meeting level. Clustering at the shareholder meeting level is more conservative than clustering at the proposal level because it accounts for correlation between votes on different proposals voted at the same shareholder meeting.

b. Are funds exposed to ESG scandals more likely to vote for ESG proposals?

We present the results for all funds in Table 3 Panel A. Column (1) shows the baseline without controls. We find that having a higher *ESG scandal experience* is statistically significantly related to voting more often in favor of a shareholder proposal. Next, we control for the position size, a dummy variable for whether the fund and the company are headquartered in the same state, fund size, and for the fund return over the past 12 months. As shown in column (2), the result is robust to the inclusion of these control variables. In terms of economic magnitude, a 1 percentage point increase in *ESG scandal experience* increases the probability of voting for a shareholder proposal by 1.1 percentage points, corresponding to 3% of the mean vote share in favor of ESG proposals.[17] While the effect may appear small, we note that it is obtained in a saturated model (with proposal fixed effects) and for the sample of all funds, some of which may not pay attention to ESG scandals of individual portfolio stocks.

Environmental and social proposals are about externalities and may have an ambiguous or even detrimental effect on firm value (Bénabou and Tirole (2010)). In contrast, governance proposals usually increase firm value (Cunat et al. (2012), Renneboog and Szilagyi (2011)). In columns (3)-(6), we therefore split our

[17] A 1 percentage point increase is roughly equivalent to having 2-3 scandal months for averaged-sized portfolio positions over the past year.

sample by environmental or social (ES) and governance (G) proposals, respectively. We find that our results remain of similar magnitude and are statistically significant for both types of proposals.

In Panels B and C, we run our tests separately for active and passive funds. We expect active funds to follow their stock positions more closely, suggesting that they should be more affected by scandals in their portfolio. As shown in Panel B, we indeed find that the magnitude of our result increases for active funds and becomes significant at the 1% significance level. A 1 percentage point increase in *ESG scandal experience* now translates into a 1.4 percentage points larger ESG proposal vote share, a meaningful increase of 4%. In contrast, the result disappears when we limit the sample to passive funds in Panel C. Since passive funds have no discretion to sell a particular position, one could have expected them to exert more voice (Appel et al. (2016)). Our results suggest that—at least in response to ESG scandals—this is not the case.

Lastly, in Panel D, we show that our results do not hold when we restrict the sample to ES funds. This result is arguably not surprising as we expect ES funds to be sensitive to ESG concerns regardless of whether they recently experienced an ESG scandal or not. Indeed, in our data ES funds on average vote almost twice as often in favor of shareholders' ESG proposals (61.1% vs 35.9% for non-ES funds). Therefore, ES funds may already be voting in favor of sensible ESG proposals, so that there is no room for ESG scandals to have an incremental effect.

To sum up, ESG scandals matter for the voting of active funds, but not for the voting of passive funds and ES funds. We therefore focus on active funds for the remainder of the paper.

c. When do ESG scandals matter the most?

We next examine which ESG scandals have the largest effect on fund voting behavior. We start with the idea that funds will pay more attention to their largest stock positions (Schmidt (2019)). Thus, we split fund holdings for each fund-quarter by size into above and below median and compute *ESG scandal experience* separately for each group. This gives us two scandal experience measures for each fund: *ESG scandal*

experience – large positions, which is based only on above median holdings and *ESG scandal experience – small positions,* which is only based on below median holdings. For comparison, we standardize both measures to have a mean of zero and a variance of one. Fixed effects and control variables are the same as above.

The results are presented in Table 4 columns (1) and (2). We see that the coefficient of *ESG scandal experience – large positions* is highly significant, and the size of its coefficient is larger than in the baseline. In contrast, *ESG scandal experience – small positions* is not significant. This is consistent with the idea that fund managers pay more attention to scandals occurring for large portfolio positions, implying that their subsequent voting behavior is more influenced by these scandals.[18]

Next, we examine whether an ESG scandal will be particularly shocking if it occurs for a stock with an unblemished ESG track record (e.g., a firm with few prior ESG incidents). To do so, we rely on (ex-ante) ESG risk ratings provided by RepRisk, which take 10 different values from D (worst) to AAA (best) with AA being the median rating. We split fund holdings by whether the ex-ante RepRisk ratings are AA or higher or below AA; i.e., by whether the ESG scandal comes as a large or small surprise. We then compute separate *ESG scandal experience measures* for these two groups, standardize them, and include both in the same regression.

We display the results in Table 4 columns (3) and (4). *ESG scandal experience* computed using (ex-ante) highly rated firms ("large surprise") strongly affects future ESG votes, while *ESG scandal experience* computed using (ex-ante) low rated firms ("small surprise") does not. Hence, mutual fund managers respond more strongly to surprise scandals, consistent with these scandals drawing more attention.

In the spirit of Bolton et al. (2020), we investigate next whether ESG scandals affect funds differently depending on whether they appear to have strong views on ESG as displayed by their prior voting behavior.

[18] In unreported tests, we find that this and the following results also hold for ES and G votes separately.

Specifically, we hypothesize that funds that consistently vote in favor or against ESG shareholder proposals will be less influenced by ESG scandals. We therefore distinguish between two groups of funds: those which are in the top or bottom quartile in terms of support for ESG proposals over the previous year and thus have "strong ESG priors," and those which are in the middle two quartiles and thus have "weak ESG priors." We then compute *ESG scandal experience – funds with weak ESG prior* (which is set equal to zero for funds with strong ESG priors) and *ESG scandal experience – funds with strong ESG prior* (which is set equal to zero for funds with weak ESG priors). We standardize both variables and include them in the same regression.

The results in Table 4 columns (5) and (6) confirm that ESG scandals particularly affect funds with weak (ex-ante) ESG priors, while funds with strong ESG priors are not significantly affected. This finding suggests that funds that have already "made up their mind" on ESG do not change their opinion after being exposed to ESG scandals, while funds without strong views on ESG are more likely to be swayed by scandals.

d. Separating between E, S, and G

In this subsection, we examine how different types of scandals affect different types of shareholder proposals. On the one hand, one can image that governance scandals drive the support for governance-related shareholder proposals while environmental and social scandals mainly affect votes on environmental and social issues. On the other hand, it is also possible that fund managers lump all ESG issues together, such that any ESG scandal will affect votes on all ESG-related shareholder proposals. To examine this question, we attempt to classify scandals along the ES and G dimensions. Specifically, we rely on the monthly RepRisk index percentages coming from E, S, and G as provided by RepRisk. When this information is missing, we classify scandals based on, in that order, the UN Global Compact (UNGC) principles[19] or the related issues list available in the daily ESG incidents data provided by RepRisk. For

[19] The list of UNGC principles can be at https://www.unglobalcompact.org/what-is-gc/mission/principles.

example, if an ESG incident pertains to UNGC Principles 7-9, it is classified as an E scandal. Many scandals/incidents simultaneously have a social and an environmental dimension. We therefore focus on classifying into ES and G, instead of also trying to subdivide between E and S. Based on our classification, we identify 2,199 ES and 1,854 G scandals.[20]

Table 5 presents the results. In Panel A, we show the results using *ES scandal experience*, which is computed like *ESG scandal experience* but only using environmental and social scandals. The effects of ES scandal experience on ES and G scandals are of similar magnitude. Next, in Panel B, we show results using *G scandal experience*, which is computed only on governance-related scandals. Once again, the effects are similar irrespective of the type of proposal. These findings suggest that mutual fund managers—perhaps owing to the popularity of the ESG label—lump E, S, and G dimensions together so that all types of scandals affect their voting on all types of ESG shareholder proposals. An alternative interpretation is that the distinction between E, S, and G is just too fluid in the context of media-reported scandals.[21]

e. Why do funds change their voting patterns after ESG scandals in their portfolio?

In this section, we shed light on why funds change their voting behavior after ESG scandals. One possibility is that funds are purely concerned with performance. After all, ESG scandals are accompanied by negative returns (confer Table 2 Panel A). A related possibility is that fund managers are worried that ESG scandals tarnish their reputation vis-à-vis their investors. Indeed, we have shown that funds experience outflows following scandals in their portfolios (confer Table 2 Panel B). Thus, performance-driven or reputation-concerned managers may vote in favor of ESG proposals in order to reduce the occurrence of future scandals. Finally, it is also conceivable that ESG scandals weigh on fund managers' conscience and that their support for ESG proposals reflects a growing conviction that this is the right thing to do.

[20] Our classification is not mutually exclusive.

[21] For example, G scandals in RepRisk are only scandals that pertain to UNGC Principle 10 (anti-corruption), which also have a social dimension. News stories about, e.g., egregious executive compensation, which would presumably be seen as a governance issue, do not appear as ESG incidents in RepRisk.

To tease these explanations apart, we look at different pieces of evidence. First, we examine whether funds react more to scandals that are accompanied by negative stock returns. The idea is that performance-driven fund managers are expected to react more strongly to scandals accompanied by negative returns, while fund managers that genuinely care about ESG may be less impressed by the scandal return. We rely on the daily ESG media coverage data to compute, for each stock-month with an ESG scandal, the average stock return reaction to ESG media articles over two trading days; i.e., the trading day of the article and the following trading day (we use two days because some incidents may be reported after markets have closed). Next, we compute *ESG scandal experience* using different subsamples based on this average scandal return.

The results are presented in Table 6. In columns (1) and (2), we split ESG scandals by whether the ESG scandal return is above or below the median and compute *ESG scandal experience* for each subgroup. The coefficient of *ESG scandal experience – below median return* is economically larger and more statistically significant than the coefficient for scandals with above-median returns. When we compare the effect of scandals with top vs. bottom quartile returns (columns (3) and (4)), the difference in coefficients widens. Indeed, scandals with above-quartile returns do not significantly affect future support for ESG proposals.

Second, we investigate the persistence of the effect of ESG scandals on future voting activity. We intuit that a genuine change in conviction should lead to a long-lasting change in voting behavior, whereas a behavior change motivated by reputation concerns could be more temporary (as the salience of past scandal experiences diminishes). To test this idea, we re-run our voting regression after lagging (or leading) our ESG scandal experience variable. The results in Table 7 show that only recent scandal experiences (i.e. over the last 12 months) matter for ESG voting behavior (column (4)). In contrast, scandals that occurred more than one year ago do not lead to a higher support for ESG proposals (columns (1) to (3)). It thus appears that funds are particularly keen to "signal their virtue" by supporting ESG proposals after *recent* portfolio scandals, while their support ebbs away as these scandal experiences grow older. We acknowledge, however, that by requiring a longer scandal history our test loses in statistical power, so the

null-result for older scandals could also be due to this lack in power. Note that, as a useful placebo test, Table 7 further shows that future ESG scandals do not affect past voting (columns (5) to (7)).

Third, we allude to our earlier finding that ESG scandals affect the voting for ES and G proposals by similar magnitudes (see Table 3). Indeed, the passage of governance proposals is known to increase shareholder value (Cunat et al. (2012)), whereas support for ES proposals—while more predictive of future ES incidents (He et al. (2023))—is arguably less directly linked to future performance. Thus, our finding that ES and G proposals are equally affected suggests that scandal-exposed funds do not only care about performance—virtue-signaling and/or a genuine desire to reduce future ES incidents may also play a role.

In conclusion, our evidence paints a mixed picture. While performance considerations certainly matter (explaining why scandals with more negative returns have a bigger effect on subsequent voting behavior), the equal support for ES and G proposals suggests they are not the whole story. The fact that the change in voting behavior appears to be short-lived is most consistent with fund managers' attempting to salvage their (damaged) reputation after "being caught" holding scandal stocks. To understand better what motivates fund managers, we next look at their portfolio reallocations following ESG scandals.

5. Results for Exit

a. Empirical methodology

In this section, we turn to exit and examine whether funds tend to sell stocks with a bad ESG track record after experiencing an ESG scandal in their portfolio.[22]

We start from the sample of quarterly portfolio holdings reported in the CRSP mutual fund holdings database for the 2006-2018 period. We create a dummy variable *D(Sell)*, which equals one if the fund reduces the number of shares held in a given stock over the quarter (and zero if the number of stocks

[22] See, for instance, Admati and Pfleiderer (2009) and Edmans (2009) on the corporate governance role of "voting with their feet."

increased or remained constant).[23] We then run the following regression with *D(Sell)* as the dependent variable:

$$D(Sell)_{f,i,t} = \alpha_{i,t} + \alpha_f + \beta_1 * ESG\ scandal\ experience_{f,t} + \beta_2 * ESG\ scandal\ experience_{f,t} * D(RepRisk\ rating\ low)_{i,t-1} + \beta_3 * Controls + \varepsilon_{f,i,t},$$

where f indexes the fund, i indexes the stock, and t indexes the quarter. ESG scandal experience is now computed over the current quarter given that funds can immediately adjust their portfolios after a scandal (in contrast to the voice tests, as funds can only vote at the next annual meeting). *D(RepRisk rating low)* is a dummy variable equal to one if the firm's RepRisk rating was A or worse (i.e., below median) at the end of the previous quarter. Stocks with a low RepRisk rating are prone to experience future ESG incidents, either because they have had ESG incidents in the past or because they belong to a sector with lots of ESG incidents.[24] Thus, stocks with a low RepRisk rating have a "high ESG risk." Our key variable of interest is β_2, which captures whether funds are more likely to sell high-ESG risk stocks after experiencing ESG scandals in their portfolios. We include stock-quarter fixed effects ($\alpha_{i,t}$), thereby controlling for all stock-time-specific reasons for why funds may want to sell a given stock in a given quarter.[25] Thus, analogous to our voting specification, we examine how different funds trade the same stock depending on ESG scandals in their portfolios. We also include fund fixed effects and the same controls as before (position size, same-state dummy, past fund return, and fund size). We two-way cluster standard errors by fund and quarter.

b. Do funds exit from high-ESG risk stocks following ESG scandals?

Table 8 Panel A presents our results. In columns (1) and (2), we focus on active funds. The coefficient of the interaction between *ESG scandal experience* and *D(RepRisk rating low)* is positive and significant at

[23] We make sure to also include complete selloffs, i.e., when a fund does not report holding any shares in a stock in which it had reported holdings at the end of the previous quarter. Such completely selloffs are relatively rare (18% of all sells).

[24] See https://www.reprisk.com/news-research/resources/methodology.

[25] The level effect of *D(RepRisk rating low)* is subsumed by the stock-quarter fixed effects.

the 1 percent confidence level, suggesting that active funds are more likely to divest stocks with high ESG risks after they experience ESG scandals in their portfolios. In terms of economic magnitude, a one-standard deviation increase in scandal experience increases the probability to sell by 0.3 percentage points, corresponding to a 1% increase relative to the unconditional sell probability (of around 1/3). The result remains significant after adding our usual set of control variables in column (2). In columns (3) and (4), we show that we do not find any effect for passive funds. This result is expected as passive funds have much less discretion to reallocate their portfolios for reasons unrelated to index membership.

In Panel B, we rerun our specification for active funds but using leads and lags of *ESG Scandal Experience* for up to 3 quarters. We find that only current but not past scandals increase the likelihood of selling high-ESG risk stocks. Thus, fund managers adjust their portfolios quickly following a scandal. Using leads of scandal experience again serves as a placebo test and shows that future scandals do not drive divestment decisions.

c. Which type of scandals affect exit the most?

In this subsection, we examine which ESG scandals most cause mutual funds to divest from high-ESG risk stocks. We examine the same characteristics that we examined for votes. First, we study if ESG scandals of larger positions have a larger effect. As before, we do this by computing two measures of *ESG scandal experience*: *ESG scandal experience – large positions* and *ESG scandal experience – small positions,* which are based, respectively, on fund positions that are either above or below median for a given fund-quarter. We then interact both of these variables with *D(RepRisk rating low)* and include them in the same regression.

The results are presented in columns (1) and (2) of Table 9. The coefficient for the interaction with ESG scandal experience based on large positions is large and statistically significant while that for small positions is not. Thus, as before, ESG scandals for above-median portfolio positions have a bigger effect.

Next, in columns (3) and (4), we create two *ESG scandal experience* variables based on whether the scandal firm had a high or a low ex-ante RepRisk rating; i.e., based on whether the scandal comes as a large or small surprise. We find that the interaction including *ESG scandal experience – large surprise* is positive and statistically significant while the one for *ESG scandal experience – small surprise* is not significant and even slightly negative. This finding suggests that, consistent with the results for voice, more surprising ESG scandals lead to larger divestment effects on firms with high ESG risk. Finally, we construct two ESG scandal experience variables based on whether the scandals were accompanied by above or below median returns. We find that the interaction including *ESG scandal experience – below median return* is positive and statistically significant, while the one for *ESG scandal experience – above median return* is not significant and close to zero. Hence, funds react more to scandals with below-median returns.

To conclude, our findings for exit dovetail with those for voice: funds are more likely to sell high-ESG risk stocks following ESG scandals for large portfolio stocks, following scandals that come as a surprise, and following scandals that are accompanied by low returns.

d. Do funds' average RepRisk ratings improve following ESG scandals?

In this subsection, we examine whether the divestitures that we observe following scandals actually result in an improved overall RepRisk rating of the fund's portfolio. To examine this idea, we run a fund-quarter panel regression using the change in the value-weighted average RepRisk rating of the fund as the dependent variable. When computing this change, we keep the RepRisk rating of the stocks constant at last quarters values. This ensures that the observed changes are driven by actions the fund takes rather than spurious changes in rating, which is especially important for the stocks that experience a scandal. To be able to compute an average, we assign numeric values to the RepRisk rating categories from 1 (D) to 10 (AAA). We then regress the change in the average ESG rating on our usual ESG scandal experience variable computed over the contemporaneous quarter.

Table 10 presents our results. We find that funds experiencing more ESG scandals during a quarter, improve the average rating of their portfolio holdings more. This finding suggests that the divestitures we measure indeed change the funds' ESG risk profile (and are not offset by other sales or purchases). While this test is less well-identified than the previous tests with high-dimensional fixed effects, it nonetheless confirms that funds react to ESG scandals not just by changing their voting behavior but also by tilting their portfolios away from high-ESG risk stocks.

6. How do funds decide between voice and exit?

So far, we have shown that funds use both voice and (partial) exit to manage ESG risks in their portfolios after experiencing an ESG scandal. There exists a clear tension between exit and voice. Indeed, by reducing their portfolio weights in high-ESG risk stocks, funds also reduce the number of votes they have in upcoming ESG-related shareholder proposals, thereby making it less likely that the proposal can pass. This raises the obvious question whether funds are conscious about this trade-off, and how they decide between exit and voice. In this section, we shed light on these questions by examining whether funds are more likely to choose exit for firms for which voice is expected to be less effective. To do so, we return to the divestment setup at the individual stock positions level with *D(Sell)* as the dependent variable (see Subsection 5.a) and run several interaction tests based on different proxies for the expected effectiveness of voice.

Our first proxy is based on whether the firm had an ESG-related shareholder proposal on the ballot at the last shareholder meeting. The idea is that having an ESG proposal on the ballot is a sign that other investors might also care about ESG issues, making it more likely for engagement to succeed. We thus create *ESG scandal experience – no ESG proposal*$_{t-1}$*, which is* set to zero if the firm that the fund might exit had an ESG proposal in the past year and *ESG scandal experience – had ESG proposal*$_{t-1}$, which is set to zero if the firm didn't have an ESG proposal. We then interact both of these dummy variables with *D(RepRisk ESG rating low)* and include them in the same regression. As shown in columns (1) and (2) of Table 11

Panel A, the coefficients of the interaction with *ESG scandal experience – no ESG proposal*$_{t-1}$) are large and significant while that with *ESG scandal experience – had ESG proposal*$_{t-1}$ is smaller and not significant. This finding shows that after ESG scandals funds are more likely to divest from positions in high-ESG risk firms that did not have an ESG proposal at their prior shareholder meeting.

Next, in columns (3) and (4), we run analogous regressions based on whether an ESG shareholder proposal *passed* at the prior shareholder meeting. The idea is that the successful passage of an ESG proposal is a strong sign that engagement can succeed (again). Indeed, we find that funds are much more likely to divest from high-ESG risk firms that did not pass an ESG proposal at their last shareholder meeting.

Existing work finds that institutional investors are more likely to push for ESG improvements than individual investors (Thomas and Cotter (2007), Crane et al. (2016), and more recently Chen et al. (2020)).[26] Motivated by this evidence, in Table 11 Panel B columns (1) and (2), we run analogous regressions to our setup above based on whether the firm has above or below institutional ownership. The interaction based on *ESG scandal experience – low institutional ownership* is large and statistically significant while the one for *ESG scandal experience – high institutional ownership* is smaller though also significant. Thus, funds seem to be somewhat more likely to exit high-ESG risk firms with low institutional ownership, presumably because they expect voice to be less successful in those firms.

Finally, we create a fourth proxy for the effectiveness of voice based on a predictive regression model. Specifically, we run a year-firm panel regression with the fraction of passed ESG proposals as the dependent variable. As explanatory variables we use fixed effects for year, 48-Fama French industries, 5 size quintiles, and 5 institutional ownership quintiles. We then use the coefficients from this regression to predict the likelihood of passing an ESG proposal for a specific firm. Our approach allows us to obtain the predicted likelihood of passing an ESG proposal even for firms that never passed an ESG proposal. We then run our

[26] In our data, roughly 36.9% of (active and passive) mutual funds vote for ESG proposals. From the ISS data, we know that the average support for ESG proposals is 33.8%. Hence, non-mutual fund investors (including individuals) are less likely to vote in favor of ESG proposals than our sample mutual funds.

usual regression setup splitting by whether the likelihood of passing an ESG proposal is above or below median. We find that the coefficient for the interaction based on *ESG scandal experience – low likelihood to pass ESG proposal* is large and significant while that for *ESG scandal experience – high likelihood to pass ESG proposal* is small and insignificant.

To summarize, we find that after ESG scandals funds are more likely to sell high-ESG risk firms for which engagement through voting ("voice") is expected to be less effective. We obtain consistent results using four different proxies for the expected effectiveness of engagement: (1) whether an ESG proposal was proposed, (2) whether an ESG proposal was passed, (3) whether institutional ownership is high, or (4) whether the firm has a high predicted likelihood of passing an ESG proposal. These findings suggest that funds strategically exit more when voice is less likely to be successful.

7. Robustness checks

In this section, we present several robustness checks. We start with robustness checks for the "voice" result, which we present in Panel A of Table 12. When constructing our *ESG scandal experience* variable, we treat firms that are not in RepRisk as never having had an ESG scandal, i.e. we fill in zeros for them. We do this because RepRisk adds firms to RepRisk (and fills back zeros) once a company is mentioned in regard to an ESG issue. Thus, if a company is not in RepRisk, this means that it never had a media-covered ESG scandal. In the first robustness check, we instead treat firms not in RepRisk as missing observations when creating the ESG scandal experience variable. As seen in columns (1) and (2), our results remain significant at the 1% level and of similar economic magnitude.

We next assess robustness with respect to the 25 points cutoff for the change in the RepRisk index that we use to define an ESG scandal. Our cutoff choice of 25 points was motivated by the fact that it corresponds to the 90th percentile of monthly ESG increases and the RepRisk index decays at different speeds above and below 25 points. Nonetheless, we show that our results are robust to defining ESG scandals using a 30 or

20 points cutoff, respectively. These seemingly small changes to the definition produce a meaningful change to the number of scandals: using a cutoff of 30 points reduces the number of scandals by about a third, while using a cutoff of 20 points increases the number of scandals by about two-thirds. As shown in columns (3) to (6), using these alternative cutoffs to define ESG scandals does not meaningfully change our results.

In our main specification, we compute *ESG scandal experience* based on ESG scandals occurring in the prior 12 months because this corresponds to the time between (annual) shareholder meetings. In regressions 7 and 8, we show that our results are robust to shortening this time period to 6 months.

Next, in Panel B, we conduct the same type of robustness checks for our main exit test, in which we regress *D(Sell)* on an interaction between *D(RepRisk rating low)* and *ESG scandal experience* (based on scandals in the same quarter). Our results remain statistically and economically significant in all four robustness checks.

In Panel C, we present additional robustness tests that are specific to the vote results. In our main specification, the key independent variable, *ESG scandal experience*, is constructed as the fund-level average of the ESG scandal dummy for portfolio firms. This measure has the potential downside that the firm for which the fund is voting is included in the construction of *ESG scandal experience*. One may thus be worried that our findings for fund voting behavior could be partly explained by exposure to past ESG scandals in the firm for which they are voting.[27] Note that any effect of past scandals for the voting firm is arguably small given the average fund holds more than 130 different stock positions. Nonetheless, we assess the possibility that funds only change their ESG voting behavior in firms that experienced an ESG scandal rather than in their portfolio holdings more broadly. To do so, we reconstruct the *ESG scandal experience* measure after excluding, for each proposal, the company with the proposal when averaging across portfolio

[27] Note that any constant level shift in the propensity to vote for ESG proposals for firms with a prior ESG scandal is absorbed by the proposal fixed effects in our main specification.

stocks. As shown in columns (1) and (2) of Panel C, this change does not alter the results. Hence, funds change their voting behavior not only in scandal firms but also for their other portfolio stocks.

In our baseline tests, we measure ESG scandal experience at the fund level. However, one may be concerned that it is more relevant to measure scandal exposure at the fund-family level when examining voting behavior. Indeed, several financial institutions—such as for example Blackrock (Dougherty et al. (2022))—have stewardship teams at the family level that are responsible for overseeing corporate governance of their portfolio firms. To examine whether our results are driven by effects on the fund or family level, we create a *ESG scandal experience measure – family* as the average of all the family's ESG scandals weighed by the family's stock positions for the past 12-months excluding the voting fund's positions. This measure thus accounts for family experience effects outside of the fund's own ESG scandal experience. In columns (3) and (4) of Panel C, we run a regression including both our main (fund level) experience variable and the family level experience variable. The latter is not significant while the former remains strongly significant, suggesting that the relevant experience measure is at the fund level.

Lastly, we run our main analysis separately for whether ISS is in favor and against the specific shareholder proposal. There is a debate about whether mutual funds over-rely on proxy advisors (Iliev and Lowry (2015)). We therefore try to see if our results only hold when ISS supports an ESG shareholder proposals. Results in columns (5) to (8) of Panel C show that the ESG scandal experience measure affects funds' votes for both ESG proposals for which ISS recommends voting in favor (columns (1) and (2)) and those for which it recommends voting against (columns (3) and (4)). If anything, the effect seems to be slightly stronger when ISS recommends voting against the proposal, presumably because many funds vote in favor of ESG proposals irrespective of their scandal experience when the ISS recommendation is favorable.

8. Conclusion

In this paper, we study how prior investment experiences shape mutual fund managers' perception of and actions toward ESG risks. Specifically, we show that, after being exposed to ESG scandals in their portfolios, managers of active (but not passive) funds are more likely (1) to vote in favor of ESG-related shareholder proposals and (2) to reduce their stakes in high-ESG risk stocks. Both findings are more pronounced when the scandal stock has a larger portfolio weight, and when the scandal was less expected. Moreover, we find that managers react more to the scandals that are accompanied by negative stock returns and that the change in voting behavior is not permanent. This suggests that exposed mutual fund managers are more concerned with performance and/or their reputation vis-à-vis investors, rather than changing their behavior out of a genuine shift in personal preferences.

Our findings highlight a tension between exit and voice: by reducing their portfolio positions in high-ESG risk stocks, funds undermine their voting power in precisely those stocks that arguably have the biggest need of reform. The funds in our sample appear to be acutely aware of this tension as we find that they divest less when they expect voice to be more effective. Nevertheless, the equilibrium effects of such behavior are likely to be detrimental to having an impact: to the extent that scandal-exposed mutual funds sell their shares to investors that care less about ESG, these divestment decisions collectively undermine their engagement efforts in precisely those firms that would benefit the most from a successful engagement.

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Table 1: Summary statistics

This table displays summary statistics. In Panel A, we display the summary statistics for the RepRisk data at the stock-month level. *RepRisk Index* (RRI) is an index computed by RepRisk that increases when the company has an ESG incident and slowly decreases otherwise. *D(RepRisk Index increased)* is a dummy variable equal to one if the *RepRisk Index* increased in that month and *Size of RepRisk Index increase* shows the size of that increase in index points (for the cases where there is an increase). *D(RepRisk index increase>25)* is a dummy variable equal to 1 if the RepRisk Index increased over 25 points. In Panel B, we display summary statistics at the fund-quarter and fund-month level. We show the average, median, and maximum of position sizes as a fraction of fund assets including only positions with a PERMNO. We also show the number of positions with a PERMNO, *Fund Size*, which is the fund's total net assets in $ million, monthly fund returns, and fund flows. In Panel C, we display proposal-level data. *ESG scandal experience* is the fraction of equity holdings of the funds over the past year that experienced an ESG scandal. *Position size* is the size of the equity position that the fund holds in the firm as a fraction of the firm's total shares outstanding. *D(same state)* is a dummy variable equal to one if the fund and the firm are headquartered in the same state. In Panel D, we show summary statistics for the fund-stock-quarter level data that we use for our divestment tests. Details on variable constructions can be found in Appendix A

Panel A: Rep Risk data (stock-month level)

Variable	Mean	10th Percentile	Median	90th Percentile	Standard Deviation
RepRisk Index (RRI)	7.53	0	0	24	11.8
D(RepRisk Index increased) (%)	6.57	0	0	0	24.8
Size of RepRisk Index increase (only increases)	9.70	2	6	25	9.44
D(Reprisk index increase>25) (%)	0.58	0	0	0	7.59
D(Reprisk index increase>30) (%)	0.39	0	0	0	6.22
D(Reprisk index increase>20) (%)	0.95	0	0	0	9.70
Observations	553960				

Panel B: Fund-time level data

Variable	Mean	10th Percentile	Median	90th Percentile	Standard Deviation
Average position size (%)	4.93	1.41	3.49	10.1	4.71
Median position size (%)	3.73	0.91	2.33	7.78	4.56
Largest position size (%)	21.2	4.11	17.6	36.8	15.1
Number of positions (with PERMNO)	130.8	4	50	308	291.2
Fund Size (m$)	412.5	0.40	35.9	882.4	1253.8
Monthly fund return (%)	0.46	-3.83	0.40	4.83	3.81
Monthly fund flow (%)	1.64	-4.78	-0.27	7.07	13.5
Observations	934193				

Panel C: Proposal-level data

Variable	Mean	10th Percentile	Median	90th Percentile	Standard Deviation
D(Vote for ESG proposal) (%)	36.90	0	0	100	48.20
ESG scandal experience (%) – 12 months	0.35	0.034	0.28	0.72	0.30
Position size	0.06	0.0002	0.005	0.11	0.28
D(same state) (%)	5.74	0	0	0	23.3
Observations	2042326				

Panel D: Fund-stock-quarter data

Variable	Mean	10th Percentile	Median	90th Percentile	Standard Deviation
D(Sell) (%)	36.8	0	0	100	48.2
D(RepRisk rating low) (%)	48.8	0	0	100	50.0
ESG scandal experience (%) – 3 months	0.38	0	0.28	0.85	0.40
Observations	38759529				

Table 2: Should mutual funds care about ESG scandals?

In this table, we show that even performance-driven mutual funds should care about ESG scandals. In Panel A, we show cumulative market-adjusted returns around ESG incidents recorded during ESG scandal-months (i.e., months where the RepRisk index increases by 25 points). Standard errors are two-way clustered by stock and month. In Panel B, we examine if funds experience outflows after having ESG scandals in their portfolio firms. For this purpose, we regress monthly fund flows on *ESG scandal experience*, which measures the fraction of equity holdings of the funds over the past year that experienced an ESG scandal. Columns 1 and 2 show results for all funds, columns 3 and 4 show results for actively-managed funds, and columns 5 and 6 show results for passively-managed funds. In all regressions, we control for fund size, defined as funds' assets under management at the end of the previous month, fund returns over the previous 12 months (t-12 to t-1), month fixed effects, and fund fixed effects. In columns 2, 4, and 6 we additionally control for the fund return in the current month. Standard errors are two-way clustered by fund and month. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Panel A: Stock returns around ESG scandals

Return window:	[0, 1]	[0, 20]	[-5, 20]
	(1)	(2)	(3)
Cumulative market-adjusted return (%)	-0.23***	-0.40***	-0.75***
	(-5.01)	(-2.66)	(-4.16)
N	4376	4376	4376

Panel B: Fund flows and ESG scandal experience

Dependent variable:	Fund flows					
Sample:	All funds		Active funds		Passive funds	
	(1)	(2)	(3)	(4)	(5)	(6)
ESG scandal experience (%)	-0.116***	-0.116***	-0.122***	-0.122***	-0.066	-0.065
	(-2.96)	(-2.98)	(-3.03)	(-3.03)	(-0.46)	(-0.48)
$Fund\ Return_t$		0.077***		0.051***		0.256***
		(4.77)		(3.23)		(7.47)
$Fund\ Return_{t-12,t-1}$	1.307***	1.319***	1.314***	1.322***	1.310***	1.347***
	(19.84)	(20.48)	(20.13)	(20.59)	(11.12)	(11.64)
$Fund\ Size_{t-1}$	-0.019***	-0.019***	-0.018***	-0.018***	-0.027***	-0.026***
	(-34.64)	(-34.76)	(-33.32)	(-33.37)	(-18.15)	(-18.16)
Observations	2040170	2040170	1827953	1827953	212217	212217
Adjusted R^2	0.112	0.113	0.113	0.114	0.114	0.116
Month fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

Table 3: Funds with ESG scandal experience support ESG proposals

This table displays regressions examining if funds are more likely to vote for ESG shareholder proposals if they experienced more ESG scandals in their portfolio holdings in the previous year. The dependent variable is a dummy variable equal to one if the fund votes in favor of the proposal and equal to zero if it votes against or abstains. The explanatory variable of interest is *ESG scandal experience*, which measures the fraction of equity holdings of the funds over the past year that experienced an ESG scandal (in percent). In columns 2, 4, and 6, we include the following control variables: *Position size* is the size of the equity position that the fund holds in the firm as a fraction of the firm's total equity. *D(same state)* is a dummy variable equal to one if the fund and the firm are headquartered in the same state. $Fund\ Return_{t,t-12}$ is the cumulated fund return over the past year. $Fund\ Size_{t-1}$ is the natural logarithm of total net assets of the fund at the beginning of the quarter. In Panel A, we include all funds. In Panel B, we focus on active funds. In Panel C, we focus on passive funds. In Panel D, we focus on funds with an environmental or social focus (dedicated ES funds). In all regressions, we include proposal fixed effects and fund fixed effects. Standard errors are two-way clustered by fund and shareholder meeting. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Panel A: All funds

Dependent variable:	D(Vote for ESG proposal) (%)					
Sample:	All ESG proposals		ES proposals		G proposals	
	(1)	(2)	(3)	(4)	(5)	(6)
ESG scandal experience (%)	1.161**	1.087**	1.080**	1.013**	1.397***	1.377**
	(2.57)	(2.34)	(2.19)	(1.98)	(2.66)	(2.55)
Position size		-137.536***		-262.557***		-80.643*
		(-4.12)		(-6.86)		(-1.79)
D(same state)		-0.464		0.074		-0.345
		(-1.18)		(0.15)		(-0.74)
$Fund\ Return_{t-12,t-1}$		-28.947*		-9.937		-47.248***
		(-1.96)		(-0.61)		(-2.60)
$Fund\ Size_{t-1}$		-0.082		0.317*		-0.257
		(-0.54)		(1.90)		(-1.45)
Observations	2042326	1900254	718706	674967	1249917	1157655
Adjusted R^2	0.510	0.510	0.495	0.494	0.515	0.515
Proposal fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

Panel B: Active funds

Dependent variable:	D(Vote for ESG proposal) (%)					
Sample:	All ESG proposals		ES proposals		G proposals	
	(1)	(2)	(3)	(4)	(5)	(6)
ESG scandal experience (%)	1.466***	1.389***	1.396***	1.384***	1.772***	1.709***
	(3.33)	(3.17)	(2.81)	(2.74)	(3.28)	(3.16)
Position size		-130.555***		-270.029***		-49.484
		(-3.73)		(-6.69)		(-1.05)
D(same state)		-0.840*		-0.274		-0.534
		(-1.83)		(-0.47)		(-0.99)
$Fund\ Return_{t-12,t-1}$		-14.282		-5.674		-27.498
		(-0.88)		(-0.31)		(-1.38)
$Fund\ Size_{t-1}$		-0.043		0.181		-0.132
		(-0.22)		(0.91)		(-0.61)
Observations	1342006	1235747	484423	451039	809749	741345
Adjusted R^2	0.510	0.510	0.497	0.498	0.512	0.513
Proposal fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

Panel C: Passive funds

Dependent variable:	D(Vote for ESG proposal) (%)					
Sample:	All ESG proposals		ES proposals		G proposals	
	(1)	(2)	(3)	(4)	(5)	(6)
ESG scandal experience (%)	-0.514	-0.637	-0.777	-1.504	-0.627	-0.435
	(-0.34)	(-0.37)	(-0.51)	(-0.87)	(-0.40)	(-0.24)
Position size		-1.957		-178.593		64.200
		(-0.02)		(-1.30)		(0.41)
D(same state)		-0.394		0.380		-0.758
		(-0.60)		(0.52)		(-0.93)
$Fund\ Return_{t-12,t-1}$		-70.757**		-33.943		-98.121**
		(-2.11)		(-0.97)		(-2.50)
$Fund\ Size_{t-1}$		-0.432		0.136		-0.648**
		(-1.60)		(0.49)		(-2.00)
Observations	700320	664507	234283	223928	440168	416310
Adjusted R^2	0.533	0.532	0.509	0.505	0.543	0.543
Proposal fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

Panel D: ES funds

Dependent variable:	D(Vote for ESG proposal) (%)					
Sample:	All ESG proposals		ES proposals		G proposals	
	(1)	(2)	(3)	(4)	(5)	(6)
ESG scandal experience (%)	-0.120	-1.162	3.297	1.589	-3.129	-4.144
	(-0.04)	(-0.39)	(1.06)	(0.46)	(-0.86)	(-1.11)
Position size		-772.502***		61.472		-1303.973***
		(-2.65)		(0.42)		(-4.67)
D(same state)		-1.541		-0.117		-0.360
		(-0.79)		(-0.04)		(-0.20)
$Fund\ Return_{t-12,t-1}$		-110.307		-16.504		-152.123
		(-0.74)		(-0.10)		(-0.82)
$Fund\ Size_{t-1}$		3.528		5.504		2.102
		(0.84)		(1.02)		(0.58)
Observations	44375	42518	15547	15045	27237	25968
Adjusted R^2	0.580	0.580	0.619	0.622	0.597	0.598
Proposal fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

Table 4: Which ESG scandals affect fund voting the most?

In this table, we examine which types of ESG scandals affect funds' voting decisions the most. We split scandals by position size, ex-ante ESG rating of the scandal firm, and the funds' past voting pattern on ESG proposals. For the first test (columns (1) and (2)), we create two variables of *ESG scandal experience*, one based on ESG scandals for positions that are above the median by size and the other based on ESG scandals for below-median positions. For the second test (columns (3) and (4)), we create two variables of *ESG scandal experience*, one based on ESG scandals that come as a large surprise (i.e., for positions in firms with an ex-ante RepRisk rating of AA or better), and the other based on ESG scandals that come as a small surprise (i.e., in firms with an ex-ante RepRisk rating of A or worse). For the third test (columns (5) and (6)), we split the sample into funds that have strong ESG priors (i.e., are in the top or bottom quartiles by average support for ESG shareholders' proposals in the previous year) versus funds that have weak ESG priors (i.e., are in the two middle quartiles). For ease of comparison, we standardize variables in all three cases to have mean zero and variance one. Other variables are defined as above (and as explained in Appendix A). We limit our sample to actively-managed funds. In all regressions, we include proposal fixed effects and fund fixed effects. Standard errors are two-way clustered by fund and shareholder meeting. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Dependent variable:	D(Vote for ESG proposal) (%)					
Test:	Position Size		Rep Risk Rating			Past ESG Vote
	(1)	(2)	(3)	(4)	(5)	(6)
ESG scandal experience – large positions	0.472***	0.450***				
	(3.78)	(3.62)				
ESG scandal experience – small positions	0.004	0.000				
	(0.04)	(0.00)				
ESG scandal experience – large surprise			0.475***	0.511***		
			(3.47)	(3.84)		
ESG scandal experience – small surprise			0.058	0.003		
			(0.56)	(0.03)		
ESG scandal experience – fund with weak ESG prior					0.700***	0.661***
					(3.94)	(3.74)
ESG scandal experience – fund with strong ESG prior					0.147	0.158
					(0.88)	(0.94)
Position size		-130.345***		-130.785***		-121.850***
		(-3.72)		(-3.74)		(-2.95)
D(same state)		-0.841*		-0.840*		-0.413
		(-1.83)		(-1.83)		(-0.75)
$Fund\ Return_{t-12,t-1}$		-14.366		-13.574		-31.804
		(-0.89)		(-0.84)		(-1.48)
$Fund\ Size_{t-1}$		-0.044		-0.043		-0.131
		(-0.22)		(-0.22)		(-0.54)
Observations	1342006	1235747	1342006	1235747	926216	861825
Adjusted R^2	0.510	0.510	0.510	0.510	0.517	0.517
Proposal fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

Table 5: Split by ES vs. G scandals

In this table, we examine if fund managers react differently to environmental and social (ES) or governance (G) scandals. For this purpose, we create *ES scandal experience* and *G scandal experience*, which are computed in the same way as *ESG scandal experience* but only include ES or G scandals, respectively. We present results for *ES scandal experience* in Panel A, and for *G scandal experience* in Panel B. Other variables are defined as above (and as explained in Appendix A). We limit our sample to actively-managed funds. In all regressions, we include proposal fixed effects and fund fixed effects. Standard errors are two-way clustered by fund and shareholder meeting. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Panel A: ES scandal experience

Dependent variable:	D(Vote for ESG proposal) (%)					
Sample:	All ESG proposals		ES proposals		G proposals	
	(1)	(2)	(3)	(4)	(5)	(6)
ES scandal experience (%)	1.511***	1.461***	1.270**	1.243**	2.089***	2.129***
	(2.93)	(2.86)	(2.19)	(2.09)	(3.29)	(3.36)
Position size		-130.338***		-269.988***		-49.160
		(-3.72)		(-6.68)		(-1.04)
D(same state)		-0.840*		-0.273		-0.537
		(-1.83)		(-0.46)		(-1.00)
$Fund\ Return_{t-12,t-1}$		-14.589		-5.980		-28.223
		(-0.90)		(-0.32)		(-1.42)
$Fund\ Size_{t-1}$		-0.042		0.182		-0.132
		(-0.22)		(0.92)		(-0.61)
Observations	1342006	1235747	484423	451039	809749	741345
Adjusted R^2	0.510	0.509	0.497	0.498	0.512	0.513
Proposal fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

Panel B: G scandal experience

Dependent variable:	D(Vote for ESG proposal) (%)					
Sample:	All ESG proposals		ES proposals		G proposals	
	(1)	(2)	(3)	(4)	(5)	(6)
G scandal experience (%)	1.570***	1.411**	1.560**	1.628**	1.679**	1.406**
	(2.70)	(2.41)	(2.26)	(2.30)	(2.33)	(1.97)
Position size		-130.624***		-270.280***		-49.522
		(-3.73)		(-6.69)		(-1.05)
D(same state)		-0.838*		-0.273		-0.533
		(-1.83)		(-0.47)		(-0.99)
$Fund\ Return_{t-12,t-1}$		-12.403		-3.967		-24.699
		(-0.76)		(-0.21)		(-1.23)
$Fund\ Size_{t-1}$		-0.042		0.183		-0.130
		(-0.21)		(0.92)		(-0.59)
Observations	1342006	1235747	484423	451039	809749	741345
Adjusted R^2	0.510	0.509	0.497	0.498	0.512	0.513
Proposal fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

Table 6: ESG scandals with negative returns affect fund's voting more

In this table, we examine if ESG scandals that have lower scandal reaction returns affect funds' voting behavior more. For this purpose, we create two pairs of ESG scandal experience variables based on ESG scandals with stock returns that are (1) above/below median or (2) in the top/bottom quartile, respectively. For ease of comparison, we standardize the variables to have mean zero and variance one. For more details on variable construction see Appendix A. We limit our sample to actively-managed funds. In all regressions, we include proposal fixed effects and fund fixed effects. Standard errors are two-way clustered by fund and shareholder meeting. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Dependent variable:	D(Vote for ESG proposal) (%)			
Sample:	All ESG proposals			
	(1)	(2)	(3)	(4)
ESG scandal experience – below median return	0.323***	0.292***		
	(3.03)	(2.72)		
ESG scandal experience – above median return	0.266**	0.282**		
	(2.31)	(2.41)		
ESG scandal experience – bottom quartile return			0.244***	0.242***
			(2.65)	(2.58)
ESG scandal experience – top quartile return			0.104	0.138
			(1.04)	(1.36)
Position size		-130.544***		-130.315***
		(-3.73)		(-3.72)
D(same state)		-0.840*		-0.837*
		(-1.83)		(-1.82)
$Fund\ Return_{t-12,t-1}$		-14.912		-12.637
		(-0.92)		(-0.78)
$Fund\ Size_{t-1}$		-0.044		-0.042
		(-0.22)		(-0.21)
Observations	1342006	1235747	1342006	1235747
Adjusted R^2	0.510	0.510	0.510	0.509
Proposal fixed effects	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes

Table 7: Funds only react to the most recent scandals

In this table, we examine whether funds' reaction to ESG scandals is persistent over time (or anticipated). We run the same analysis as in Table 3 (for active funds only), but where the independent variable ESG scandal experience is lagged or forwarded by up to 3 years. The dependent variable is a dummy variable equal to one if the fund votes in favor of the proposal and equal to zero if it votes against or abstains. The explanatory variable of interest is ESG scandal experience$_y$(%), which measures the fraction of equity holdings of the funds that experienced an ESG scandal (in percent) in year y relative to the vote. Column (4) shows again our baseline result from Table 3 Panel B. We include the following control variables: *Position size* is the size of the equity position that the fund holds in the firm as a fraction of the firm's total equity. *D(same state)* is a dummy variable equal to one if the fund and the firm are headquartered in the same state. $Fund\ Return_{t,t-12}$ is the cumulated fund return over the past year. $Fund\ Size_{t-1}$ is the natural logarithm of total net assets of the fund at the beginning of the quarter. In all regressions, we include proposal fixed effects and fund fixed effects. Standard errors are two-way clustered by fund and shareholder meeting. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Dependent variable:	D(Vote for ESG proposal) (%)						
Sample:	All ESG proposals						
Year (y)	-3	-2	-1	0	1	2	3
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
ESG scandal experience$_y$(%)	-0.305	-0.103	0.441	1.389***	0.305	-0.498	0.436
	(-0.73)	(-0.24)	(1.08)	(3.18)	(0.55)	(-0.81)	(0.7)
Position size	-165.28***	-154.49***	-138.48***	-130.56***	-137.66***	-129.05***	-119.22***
	(-3.98)	(-4.17)	(-3.81)	(-3.74)	(-3.75)	(-3.32)	(-2.84)
D(same state)	-0.601	-0.747	-0.857*	-0.840*	-0.617	-0.907*	-0.928
	(-1.10)	(-1.44)	(-1.73)	(-1.83)	(-1.24)	(-1.69)	(-1.52)
$Fund\ Return_{t-12,t-1}$	-13.818	-28.212	-19.601	-14.282	1.578	-6.419	-3.17
	(-0.53)	(-1.26)	(-0.99)	(-0.88)	(0.09)	(-0.33)	(-0.16)
$Fund\ Size_{t-1}$	0.055	0.021	-0.147	-0.043	-0.143	-0.092	-0.211
	(0.17)	(0.07)	(-0.61)	(-0.22)	(-0.76)	(-0.46)	(-1.11)
Observations	823720	944815	1061631	1235251	1040479	842242	669496
Adjusted R^2	0.509	0.509	0.51	0.51	0.51	0.516	0.515
Proposal fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Table 8: Funds divest firms with low ESG-ratings after ESG scandals

In this table, we examine if funds divest firms with low ESG ratings after experiencing an ESG scandal in their portfolios. The dependent variable is *D(Sell)*, which is a dummy variable equal to 1 if the fund decreases the number of shares of the firm it holds and equal to 0 if it keeps the number of shares constant or increases it. The explanatory variable of interest is the interaction between *ESG scandal experience* and *D(RepRisk rating low)*. *ESG scandal experience* measures the fraction of equity holdings of the fund that experience an ESG scandal in the current quarter. *D(RepRisk rating low)* is a dummy variable equal to one if the firm's RepRisk rating is A or worse. We include stock-quarter and fund fixed effects in all regressions. In Panel A, we limit our sample to actively-managed funds in regressions 1 and 2 and to passively-managed funds in regressions 3 and 4. In Panel B, we rerun the same specification but *ESG scandal experience* is lagged or forwarded by up to 3 quarters. For example, in column 1, the *ESG scandal experience* variable is computed over the quarter that is 3 quarters earlier. Standard errors are two-way clustered by fund and quarter. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Panel A: Main specification

Dependent variable:	D(Sell) (%)			
Sample:	Active Funds		Passive Funds	
	(1)	(2)	(3)	(4)
ESG scandal experience * D(RepRisk rating low) (%)	0.720***	0.739***	-0.170	-0.093
	(3.33)	(2.95)	(-0.23)	(-0.13)
ESG scandal experience (%)	-0.587**	-0.505*	-2.002	-1.806
	(-2.16)	(-1.69)	(-1.56)	(-1.28)
Position size$_{t-1}$		437.772***		420.168*
		(9.15)		(1.69)
D(same state)		-0.296**		-0.119
		(-2.28)		(-0.98)
$Fund\ Return_{t-12,t-1}$		-291.663***		
		(-6.20)		
$Fund\ Size_{t-1}$		3.236***		4.702***
		(7.74)		(5.24)
Observations	13337312	12338695	8085025	7645753
Adjusted R^2	0.156	0.161	0.220	0.221
Stock-quarter fixed effects	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes

Panel B: Explanatory variable lags and forwards (for active funds)

Dependent variable:	D(Sell) (%)						
Sample:	Active Funds						
Quarter (y)	-3	-2	-1	0	1	2	3
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
ESG scandal experience$_y$* D(RepRisk rating low) (%)	0.247	0.078	0.276	0.739***	0.369	-0.102	-0.010
	(0.67)	(0.29)	(1.03)	(2.95)	(1.48)	(-0.45)	(-0.04)
ESG scandal experience$_y$ (%)	0.359	-0.606*	-0.705*	-0.505*	-0.491	0.174	0.412
	(0.71)	(-1.74)	(-1.74)	(-1.69)	(-1.49)	(0.63)	(1.03)
Position size	1010.804***	1012.605***	1015.444***	437.772***	437.221***	394.998***	311.786***
	(19.45)	(18.65)	(18.16)	(9.15)	(9.12)	(8.33)	(6.53)
D(same state)	0.042	-0.054	-0.109	-0.296**	-0.297**	-0.328**	-0.333**
	(0.27)	(-0.39)	(-0.86)	(-2.28)	(-2.29)	(-2.53)	(-2.23)
$Fund\ Return_{t-12,t-1}$	-265.019***	-281.907***	-292.105***	-291.663***	-291.494***	-322.213***	-330.445***
	(-4.44)	(-5.01)	(-5.54)	(-6.20)	(-6.19)	(-5.78)	(-5.64)
$Fund\ Size_{t-1}$	3.222***	3.199***	3.130***	3.236***	3.238***	3.311***	3.717***
	(6.13)	(6.79)	(7.06)	(7.74)	(7.70)	(7.37)	(8.46)
Observations	7725038	8764487	10140643	12338695	12346768	11144405	9608917
Adjusted R^2	0.170	0.168	0.167	0.161	0.161	0.166	0.172
Stock-quarter fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Table 9: Which ESG scandals affect exit the most?

In this table, we examine which type of ESG scandals lead to bigger divestments from stocks with high ESG risks. The dependent variable is *D(Sell)*, which is a dummy variable equal to 1 if the fund decreases the number of shares of the firm it holds and equal to 0 if it keeps the number of shares constant or increases it. The explanatory variable of interest is the interaction between *D(Firm RepRisk rating low)* and *ESG scandal experience* based on three different splits: whether the position was above or below median in size for the fund (columns (1) and (2)), whether the scandal comes as a large surprise (scandal stock has an ex-ante RepRisk rating of AA or better) or small surprise (scandal stock has an ex-ante RepRisk rating of A or worse) (columns (3) and (4)), and whether the scandal return was above or below median (columns 5 and 6). For example, *ESG scandal experience – large position* is the fraction of a fund positions (weighted by size) that are above median and had an ESG scandal during that quarter. Control variables are omitted for brevity. In all cases, we include the constituents of the interaction as control variables. In columns (2), (4), and (6), we also include the following control variables: *Position size*, $Fund\ Return_{t-12,t-1}$, and $Fund\ Size_{t-1}$. We limit our sample to actively-managed funds. We include fund and stock-quarter fixed effects. Standard errors are two-way clustered by fund and quarter. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Dependent variable:	D(Sell) (%)					
	(1)	(2)	(3)	(4)	(5)	(6)
ESG scandal experience – large position *						
D(RepRisk rating low) (%)	0.317***	0.325***				
	(3.91)	(3.43)				
ESG scandal experience – small position *						
D(RepRisk rating low) (%)	0.038	0.044				
	(0.56)	(0.63)				
ESG scandal experience – large surprise *						
D(RepRisk rating low) (%)			0.330***	0.329***		
			(4.37)	(3.75)		
ESG scandal experience – small surprise *						
D(RepRisk rating low) (%)			-0.047	-0.027		
			(-0.51)	(-0.26)		
ESG scandal experience – below median return *						
D(RepRisk rating low) (%)					0.249***	0.294***
					(2.75)	(2.92)
ESG scandal experience – above median return *						
D(RepRisk rating low) (%)					0.092	0.037
					(0.96)	(0.36)
Observations	13337312	12338695	13337312	12338695	13337312	12338695
Adjusted R^2	0.156	0.161	0.156	0.161	0.156	0.161
Control variables	No	Yes	No	Yes	No	Yes
Stock-quarter fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

Table 10: Funds' average RepRisk rating improves after scandal

In this table, we examine if funds improve the RepRisk rating of their holdings after a scandal occurs in their portfolio. The dependent variable is the change in the value-weighted average RepRisk rating of the fund (using previous quarter's RepRisk rating). For this purpose, we assign numeric values to the rating categories from 1 (D) to 10 (AAA). The explanatory variable of interest is *ESG scandal experience*, which measures the fraction of equity holdings of the fund that experience an ESG scandal in the current quarter. We only include active funds. In all regressions, we include fund and quarter fixed effects. Standard errors are two-way clustered by fund and quarter. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Dependent variable:	Change in average ESG rating of fund holdings	
	(1)	(2)
ESG scandal experience	0.711***	0.582***
	(2.77)	(3.13)
$Fund\ Return_{t-1}$		-0.325
		(-1.57)
$Fund\ Size_{t-1}$		0.001
		(0.81)
Observations	178691	160647
Adjusted R^2	0.001	0.007
Fund fixed effects	Yes	Yes
Quarter fixed effects	Yes	Yes

Table 11: Are firms more likely to exit if voice is more difficult?

In this table, we examine if after ESG scandals funds are more likely to divest from high-ESG risk stocks in which a successful engagement with management ("using voice") is expected to be more difficult. The dependent variable is *D(Sell)*, which is a dummy variable equal to 1 if the fund decreases the number of shares of the firm it holds and equal to 0 if it keeps the number of shares constant or increases it. The explanatory variable of interest is the interaction between *D(RepRiks rating low)* and *ESG scandal experience*$_{3m}$ variables based on four different splits meant to measure the likelihood of engagement: whether the firm had an ESG shareholder proposal in the previous year (Panel A, regressions 1 and 2), whether the firm passed a shareholder proposal in the previous year (Panel A, regressions 3 and 4), whether the firm has above or below median institutional ownership (Panel B, regression 1 and 2), and whether the firms is above or below median by likelihood to pass an ESG proposal based on a predictive regression using dummy variables for year, Fama-French 48 industry, firm size quintile, and institutional ownership quintile. For example, *ESG scandal experience*$_{3m}$ *– no ESG proposal*$_{t-1}$ is *ESG scandal experience*$_{3m}$ set equal to zero if the firm did not have an ESG proposal in the previous year. Control variables are omitted for brevity. In all cases, we include the constituents of the interaction as control variables. In columns (2), (4), and (6), we also include the following control variables: *Position size,* $Fund\ Return_{t-12,t-1}$, and $Fund\ Size_{t-1}$. We limit our sample to actively-managed funds. We include fund and stock-quarter fixed effects. Standard errors are two-way clustered by fund and quarter. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Panel A: Proposal and passed proposal in prior year

Dependent variable:	D(Sell) (%)			
	(1)	(2)	(3)	(4)
ESG scandal experience – no ESG proposal$_{t-1}$ *				
D(RepRiks rating low) (%)	0.220***	0.226***		
	(3.04)	(2.75)		
ESG scandal experience – had ESG proposal$_{t-1}$ *				
D(RepRiks rating low) (%)	0.096	0.081		
	(1.26)	(0.92)		
ESG scandal exp. – no ESG proposal passed $_{t-1}$ *				
D(RepRiks rating low) (%)			0.271***	0.274***
			(3.09)	(2.77)
ESG scandal exp. – passed ESG proposal $_{t-1}$ *				
D(RepRiks rating low) (%)			0.114	0.113
			(1.43)	(1.15)
Observations	11707410	10858704	11707410	10858704
Adjusted R^2	0.155	0.160	0.155	0.160
Control variables	No	Yes	No	Yes
Stock-quarter fixed effects	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes

Panel B: Institutional ownership and likelihood to pass ESG proposal

Dependent variable:	D(Sell) (%)			
	(1)	(2)	(3)	(4)
ESG scandal experience – low institutional ownership *				
D(RepRiks rating low) (%)	0.292***	0.324***		
	(2.80)	(2.78)		
ESG scandal experience – high institutional ownership *				
D(RepRiks rating low) (%)	0.188**	0.180**		
	(2.69)	(2.23)		
ESG scandal exp. – low likelihood to pass ESG proposal *				
D(RepRiks rating low) (%)			0.283***	0.276***
			(3.55)	(3.09)
ESG scandal exp. – high likelihood to pass ESG proposal *				
D(RepRiks rating low) (%)			0.117	0.115
			(1.63)	(1.39)
Observations	12425519	11451035	11845916	10983761
Adjusted R^2	0.154	0.159	0.154	0.159
Control variables	No	Yes	No	Yes
Stock-quarter fixed effects	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes

Table 12: Robustness checks

This table displays robustness checks for our main specifications. In Panel A, we show robustness checks to our main result on voice (Table 2). *ESG scandal experience – exclude stocks not in RepRisk* is the same as *ESG scandal experience* but we do not fill in zeros for stocks not covered in RepRisk. We also compute *ESG scandal experience* using cutoffs of 30 and 20 respectively (instead of 25) and computing it over the previous 6 months instead of 12 months. In regressions 2, 4, 6, and 8 we include the following control variables that are omitted for brevity: *Position size, D(same state),* $Fund\ Return_{t-12,t-1}$, and $Fund\ Size_{t-1}$. In Panel B, we show robustness checks to our main result on exit (Table 8). We use the same alternative explanatory variables as in Panel A but interact them with *D(RepRiks rating low) (%).* In all regressions we include the constituents of the interactions. In regressions 2, 4, 6, and 8 we include the following control variables that are omitted for brevity: *Position size, D(same state),* $Fund\ Return_{t-12,t-1}$, and $Fund\ Size_{t-1}$. In Panel C, we display additional results for the vote test. *ESG scandal experience – excluding firm with proposal* is the same as *ESG scandal experience* but we exclude the firm having the proposal when computing the variable. In regressions 3 and 4, we add a variable capturing the ESG scandal experience of the funds' family other funds. Regressions 5 to 8 show the results for proposals with different ISS recommendations separately. In all regressions and panels, we limit our attention to actively managed funds. In Panels A and C, we include proposal fixed effects and fund fixed effects and standard errors are two-way clustered by fund and shareholder meeting. Panel B, we include stock-quarter fixed effects and fund fixed effects and standard errors are two-way clustered by fund and quarter. We report t-statistics below the coefficients in parenthesis. ***, **, * indicate significance at the 1%, 5% and 10% level.

Panel A: Robustness checks for vote result

Dependent variable:	D(Vote for ESG proposal) (%)							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
ESG scandal experience – exclude stocks not in RepRisk	1.178***	1.128***						
	(3.16)	(3.02)						
ESG scandal experience – 30 cutoff			1.377***	1.229**				
			(2.88)	(2.51)				
ESG scandal experience – 20 cutoff					0.549**	0.461**		
					(2.33)	(1.97)		
ESG scandal experience – 6 months							0.900***	0.824***
							(2.97)	(2.73)
Observations	1341464	1235732	1341464	1235732	1341464	1235732	1342006	1235747
Adjusted R^2	0.510	0.509	0.510	0.509	0.510	0.509	0.510	0.509
Controls	No	Yes	No	Yes	No	Yes	No	Yes
Proposal fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Panel B: Robustness checks for exit result

Dependent variable:	D(Sell) (%)							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
ESG scandal experience – exclude stocks not in RepRisk * D(RepRiks rating low) (%)	0.547***	0.569***						
	(3.29)	(3.02)						
ESG scandal experience – 30 cutoff * D(RepRiks rating low) (%)			0.922***	0.894***				
			(3.54)	(2.96)				
ESG scandal experience – 20 cutoff * D(RepRiks rating low) (%)					0.257*	0.336**		
					(1.75)	(2.04)		
ESG scandal experience – 6 months * D(RepRiks rating low) (%)							0.847***	0.924***
							(3.07)	(2.84)
Observations	13292763	12295144	13337312	12338695	13337312	12338695	13346859	12347114
Adjusted R^2	0.156	0.161	0.156	0.161	0.156	0.161	0.157	0.161
Controls	No	Yes	No	Yes	No	Yes	No	Yes
Stock-quarter fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Panel C: Additional tests for vote results

Dependent variable:	D(Vote for ESG proposal) (%)							
Sample:	All ESG proposals				ISS For		ISS Against	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
ESG scandal experience – excluding firm with proposal	1.419***	1.336***						
	(3.29)	(3.12)						
ESG scandal experience			1.259**	0.996**	0.823**	0.877**	1.714***	1.538***
			(2.55)	(2.01)	(2.45)	(2.54)	(2.93)	(2.63)
ESG scandal experience – family			-0.990	-0.540				
			(-1.19)	(-0.61)				
Observations	1342006	1235747	994815	913102	394075	366441	907345	832168
Adjusted R^2	0.510	0.509	0.513	0.513	0.314	0.314	0.522	0.524
Controls	No	Yes	No	Yes	No	Yes	No	Yes
Proposal fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Fund fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Appendix A: Variable definitions

This table displays the variable definitions for all variables used in the regressions. All continuous variables are winsorized at the 1% level on both sides.

Variable Name	Definition
D(Vote for ESG proposal)	Dummy variable equal to one if the fund votes in favor of the ESG proposal and equal to zero if the fund votes against or abstains from voting.
D(ESG scandal)	Dummy variable equal to one if the RepRisk index of the firm increases by more than 25 points within a months and zero otherwise.
ESG scandal experience	To compute fund-level ESG scandal experience, we start by computing each month the value-weighted average of D(ESG scandal), where the weights are based on the market value of the fund's holdings at the beginning of the quarter. We then compute ESC scandal experience at the fund level as the average of these monthly values over the previous 12 months in our (annual) voting analysis, or over the previous 3 months in our (quarterly) divestment analysis. We treat stocks that have a PERMNO but are not in the RepRisk data as not having had a scandal because RepRisk states that stocks are added to their data as soon as they are mentioned in their sources in relation to an ESG incident. This implies that stocks not in RepRisk have not had a reported ESG incident.
Position size	The size of the equity position that the fund holds in a given stock at the beginning of the quarter as a fraction of shares outstanding of the firm as reported in CRSP.
D(same state)	A dummy variable equal to one if the fund and the firm are headquartered in the same state according to CRSP and zero if they are located in different states or we do not have information about their location.
ESG scandal experience – large positions	This variable is constructed like ESG scandal experience with the exception that only ESG scandals for above-median positions by size are included when computing the average. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – small positions	This variable is constructed like ESG scandal experience with the exception that only ESG scandals for below-median positions by size are included when computing the average. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – large surprise	This variable is constructed like ESG scandal experience with the exception that only ESG scandals for firms with an ex-ante RepRisk rating of AA or better are included when computing the average. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – small surprise	This variable is constructed like ESG scandal experience with the exception that only ESG scandals for firms with an ex-ante RepRisk rating of AA or better worse are included when computing the average. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – fund with weak ESG prior	Same as *ESG scandal experience* but set to zero if the fund is in the top or bottom quartile by average support for ESG shareholders' proposals in the previous year. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – fund with strong ESG prior	Same as *ESG scandal experience* but set to zero if the fund is **not** in the top or bottom quartiles by average support for ESG shareholders' proposals in the previous year. For comparison, the variable is standardized to have mean 0 and variance of 1.
ES scandal experience	Same as ESG scandal experience but only using environmental or social scandals. Scandals are classified based on the percentages of the current RepRisk index that pertain to the E, S, or G dimension as provided by RepRisk. When this information is missing, we classify scandals based on, in that order, the UN Global Compact (UNGC) principles or the related issues list available in the daily incidents data provided by RepRisk.
G scandal experience	Same as ESG scandal experience but only using governance scandals. Scandals are classified based on the percentages of the current RepRisk index that pertain to the E, S, or G dimension as provided by RepRisk. When this information is missing, we classify scandals based on, in that order, the UN Global Compact (UNGC) principles or the related issues list available in the daily incidents data provided by RepRisk.
ESG scandal experience – below median return	This variable is constructed like *ESG scandal experience* with the exception that only ESG scandals for firms with below median return are included when computing the average. Scandal returns are computed as the average two-trading day (t,t+1) return over all days with ESG incidents for the firm in that month reported in the daily incidents data provided by RepRisk. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – above median return	Same as *ESG scandal experience – below median return* but using ESG scandals with above-median returns. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – bottom quartile return	Same as *ESG scandal experience – below median return* but using ESG scandals with bottom-quartile returns. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – top quartile return	Same as *ESG scandal experience – below median return* but using ESG scandals with top-quartile returns. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – bottom decile return	Same as *ESG scandal experience – below median return* but using ESG scandals with bottom-decile returns. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – top decile return	Same as *ESG scandal experience – below median return* but using ESG scandals with top-decile returns. For comparison, the variable is standardized to have mean 0 and variance of 1.

D(RepRisk rating low)	Dummy variable equal to one if the firm's RepRisk rating is A or worse.
D(ESG scandal in portfolio)	Dummy variable equal to one if the fund had an ESG scandal in its portfolio in that quarter.
$Fund\ return_t$	Monthly fund return from CRSP mutual fund data in the current month.
$Fund\ Return_{t-12,t-1}$	Monthly fund return from CRSP mutual fund data in the previous year.
$Fund\ Size_{t-1}$	Sum of market value of all fund positionsLogarithm of the net asset value of the fund at the end of the previous quarter.
D(Sell)	Dummy variable equal to 1 if the fund decreases the number of shares of the stock and equal to 0 if it keeps the number of shares constant or increases it.
ESG scandal experience – no ESG proposal$_{t-1}$	Same as ESG scandal experience but set to zero if the firm had an ESG shareholder proposal on the ballot in the previous year. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – had ESG proposal$_{t-1}$	Same as ESG scandal experience but set to zero if the firm had no ESG shareholder proposal on the ballot in the previous year. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – no ESG proposal passed$_{t-1}$	Same as ESG scandal experience but set to zero if the firm passed an ESG shareholder proposal in the previous year. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – passed ESG proposal$_{t-1}$	Same as ESG scandal experience but set to zero if the firm passed no ESG shareholder proposal in the previous year. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – low institutional ownership	Same as ESG scandal experience but set to zero if the firm had above median institutional ownership (from Thompson Reuters 13f database). For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – high institutional ownership	Same as ESG scandal experience but set to zero if the firm had below median institutional ownership (from Thompson Reuters 13f database). For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – low likelihood to pass ESG proposal	Same as ESG scandal experience but set to zero if the firm had above median likelihood to pass an ESG proposal as predicted using a regression of yearly pass fraction of ESG proposals on fixed effects for year, Fama-French 48 industry, 5 quintiles for firm maket capitalization and 5 quintiles for fraction of institutional ownership. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – high likelihood to pass ESG proposal	Same as ESG scandal experience but set to zero if the firm had below median likelihood to pass an ESG proposal as predicted using a regression of yearly pass fraction of ESG proposals on fixed effects for year, Fama-French 48 industry, 5 quintiles for firm maket capitalization and 5 quintiles for fraction of institutional ownership. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – excluding firm with proposal	This variable is constructed like ESG scandal experience with the exception that it excludes the firm with the shareholder proposal from the computation. For comparison, the variable is standardized to have mean 0 and variance of 1.
ESG scandal experience – 30 cut-off	Same as ESG scandal experience but using a cut-off of 30 instead of 25 for the increase in the RepRisk rating to define an ESG scandal.
ESG scandal experience – 20 cut-off	Same as ESG scandal experience but using a cut-off of 20 instead of 25 for the increase in the RepRisk rating to define an ESG scandal.
ESG scandal experience – 6 months	This variable is computed in the same way as ESG scandal experience but only uses the average over the previous 6 months.
ESG scandal experience – family	Computed analogous to ESG scandal experience but at the fund family level and excluding the positions of the fund itself.

Appendix B: Description of ESG scandals in our data

In this table, we give a few examples as well as on overview of different ESG scandals contained in our data. As described in Section 2, we define an ESG scandal as an event where the RepRisk Index for a given firm-month observation increases by more than 25 points. Importantly, our approach ensures that we identify ESG incidents that are both *severe and unexpected*. Indeed, firms with a checkered history already have an elevated RRI, thus leaving less scope for further increases when a new ESG incident emerges. With 3213 occurrences in our sample, such large increases are relatively rare, thus ensuring that we pick up important ESG scandals. In Panel A, we list three examples of ESG scandals together with a short description. In Panel B, we tabulate "related issues" identified in RepRisk for the news days within an ESG scandal-month (i.e., a stock-month in which the RepRisk index jumps by 25 points or more). We obtain this information from RepRisk's daily incidents data. Note that "related issues" are not mutually exclusive. Thus, a given scandal can relate to multiple issues.

Panel A: Three examples of ESG scandals in our data

Company	Month	Short description
NiSource Inc.	10/2018	On September 13, 2018, excessive pressure in natural gas lines owned by Columbia Gas of Massachusetts [owned by NiSource Inc.] caused a series of explosions and fires to occur in as many as 40 homes. One person was killed and 30,000 were forced to evacuate their homes immediately. Source: https://en.wikipedia.org/wiki/Merrimack_Valley_gas_explosions
KFC Inc., McDonald	07/2014	McDonald's and KFC parent Yum apologized to customers on Monday after Chinese regulators shut a local meat supplier following a TV report that showed workers picking up meat from a factory floor, as well as mixing meat beyond its expiration date with fresh meat.
J&J Snack Foods Corp.	10/2015	J&J Snack Foods Corp. has agreed to pay more than $2.1 million in back wages and liquidated damages after federal investigators found temporary production line workers were denied wages by the company. The U.S. Department of Labor found J&J denied minimum wage and overtime pay to workers as required under the Fair Labor Standards Act.

Panel B: Overview of "related issues" identified with ESG scandals

Related issues	Frequency	Percent
Violation of national legislation	2,027	20.98
Fraud	883	9.14
Human rights abuses and corporate complicity	694	7.18
Impacts on communities	674	6.98
Impacts on landscapes, ecosystems and biodiversity	618	6.4
Products (health and environmental issues)	553	5.72
Local pollution	546	5.65
Corruption, bribery, extortion and money laundering	488	5.05
Poor employment conditions	424	4.39
Supply chain issues	401	4.15
Occupational health and safety issues	374	3.87
Anti-competitive practices	330	3.42
Controversial products and services	291	3.01
Climate change, GHG emissions, and global pollution	188	1.95
Waste issues	179	1.85
Executive compensation issues	138	1.43
Discrimination in employment	133	1.38
Misleading communication	118	1.22
Forced labor	108	1.12
Violation of international standards	88	0.91
Freedom of association and collective bargaining	87	0.9
Local participation issues	78	0.81
Child labor	64	0.66
Social discrimination	48	0.5
Overuse and wasting of resources	36	0.37
Tax evasion	35	0.36
Animal mistreatment	33	0.34
Tax optimization	20	0.21
Other environmental issues	2	0.02
Other issues	1	0.01
Other social issues	1	0.01
Total	9,660	100