Report
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Negative Externalities and Their Discontents

In the previous Report, we went through articles of association, documents, and discussions at the shareholders' meetings of a number of relevant companies in the energy sector in search of signs that were compatible with the journey toward energy transition and the decarbonization of economies.

Although they belong to the same sector, we examined a not entirely homogeneous sample comprising companies with varying asset bases, corporate strategies, and ownership profiles, incorporated in different jurisdictions and subject to various regulatory regimes. Even so, in the aggregate, amidst the countless disparities as regards positioning on issues involving decisions on the energy transition, we have identified converging patterns of behavior across the board, which we can summarize as follows:

1. The articles of association have been updated little or not at all with regard to the corporate purpose clauses, in order to affirm their purpose and commitment to decarbonization.
2. The boards have been resistant to the motions put to the meetings, either by the 'activist' shareholders or more recently by the 'conservative' ones, in the sense that the latter group opposes the changes suggested by the former. In both cases, the majority of shareholders´ base has chosen to support the establishment by voting against the proponents of the initiatives.
3. Companies have shown a 'pragmatic' sensitivity to the energy transition. They claim to respect climate science but resist reducing the production/use of hydrocarbons. They advocate an 'orderly transition,' based on more robust signs of demand reduction that are not yet evident. Without this, they argue, offering space to less established producers could make the problem even worse, not to mention the regressive side-effect of the commodity's price increase, which has a greater impact on the population with lower purchasing power.
4. Directors seek to take control of the corporate agenda by presenting decarbonization plans/strategies compatible with the 'orderly transition'.
5. How plans/strategies have been presented at general meetings makes directors less exposed to legal constraints and responsibilities.
6. When it comes to voting at shareholders' meetings, the shareholders of this collection of companies show significant support for the managers, attesting at the end of the day that they are not willing to give up immediate financial returns to contribute to decarbonization.
7. This is an obvious manifestation of the collective action problem, since in energy companies, oil companies, or utilities, where the production of fossil fuels or their use to generate electricity is an important foundation of their activities, the individual contribution to the common good of achieving a healthier atmosphere for the planet is perceived in a very diluted way. At the same time, the particular financial effort required to promote the reduction of greenhouse gas emissions is high.

In this environment, the roadmap we have described above, a brief summary of the research of the last Report, reflects pragmatic behaviors and rational decisions duly mapped by what is known as the logic of the impossibility of collective action[1].

However, the social and economic fabrics are much broader than just the sectors analyzed above. The forces of change aligned with a less carbon-intensive worldview are everywhere. Behaviors that express increasingly greener choices are spreading, particularly among the younger population, such as millennials, for example. There is also a

1 *This is the argument put forward by Mancur Olson in 1965, postulating that in the presence of diluted collective benefits and concentrated individual costs, the incentive to free ride on the efforts of others is such that a group of rational and interested individuals will not be able to promote the common good. Again, in this case, investors in energy companies will not have sufficient incentive to pass up a significant financial result in order to contribute to a healthier atmosphere for the planet, which is perceived as a public good for humanity.*

spectrum of institutional investors, including sovereign wealth funds, pension funds, and family offices and endowments, the latter ones are particularly close to the research centers of major universities, connected to good science, and increasingly concerned about the delay in climate resolutions. We also see governments taking important initiatives, such as the much-publicized Inflation Reduction Act (IRA) in the United States, and the Green Deal in the European Community, which has been devoting significant public resources to promote innovation and encourage sustainable initiatives. Less well known are the aggregate results of public initiatives. The *Climate Change Laws of the World* – a database organized by the London School of Economics and Columbia Law School that seeks to map legislative and governmental actions promoting a low-carbon transition across the planet – currently encompasses 1350 laws, 3089 policies, and 1702 submissions to the UNFCCC[2].

In parallel, G20 central banks – convinced that the climate issue poses risks to the financial stability of economies – are also adjusting their monetary policy instruments and capital requirements in order to create incentives to shift investments to less carbon-intensive industries. The most recent measure was the creation of the Green Central Banking Scorecard, which ranks member countries according to how well their policies adhere to their commitments. The Central Bank of Brazil (BCB) is currently in 6th place in the ranking. In the same vein, stock exchanges have been trying to encourage companies to adopt more sustainable business practices by playing their part in innovating financial services, setting benchmarks, formulating guidelines, and disseminating information – all with a view to increasing the climate resilience of their markets. The Sustainable Stock Exchanges Initiative is the most visible expression of this concerted effort and comprises 134 members around the world, including B3. The issue has also reached capital market regulators. IOSCO, the international organization that brings together the "sheriffs" of the markets, in recognizing the economic and financial materiality of climate change and ESG considerations, has already issued a long list of recommendations, 'calls to action,' and guidance reports, the most recent of which is called Supervisory Practices to Address Greenwashing, where concern is expressed about unreliable statements about the risks, opportunities and impacts of the ESG agenda.

As we commented in Dynamo Report 113, carbon pricing has emerged as the most recommended instrument for directly, efficiently, and transparently addressing the climate issue, by incorporating the externalities caused by greenhouse gas emissions. And in this domain, governments have made progress. The World Bank includes 110 pricing/compliance mechanisms implemented around the world, including carbon taxation (39), emissions trading systems (36), and domestic carbon credits (35), covering around 24% of global emissions.

The above paragraphs condense a brief collection of manifestations, illustrating that the forces of transition are moving in different regions. What about the shareholders? In our last Report, we noted that in the energy sector, where decarbonization initiatives often pose a threat to business continuity, directors and shareholders adopt a more pragmatic stance, preferring the rhetoric that the transition must be conducted in an 'orderly' manner. In other words, they try to maintain the status quo of operations by calibrating the narrative in order to avoid possible reputational risks. On the other hand, in other sectors, where conflicts are not so exposed (i.e., when addressing the negative impacts of companies' actions on the planet does not represent a major financial trade-off), we are beginning to see some signs of shifting preferences. We see signs of greater social and environmental sensitivity among investors, who are beginning to express growing frustration with the production of negative externalities and are demanding more responsible corporate behavior.

In this past 2024 harvest (i.e., up to June), considering only the climate issue, 130 proposals managed to overcome procedural hurdles and were put to vote at the general meetings of companies in the main countries. The resolutions come from individual investors or investors acting collectively, such as Climate Action 100+, a global initiative comprising some 700 investors with around USD 68 trillion under management, which seeks to ensure that the main greenhouse gas emitting companies adopt the necessary measures to deal with the climate issue.

Matters involving demands for the adoption and disclosure of greenhouse gas reduction targets received an average of 27.1% of the votes (ranging from 9.4% to 55.0%). Among large companies were Boeing (30.4%), IBM (30.8%), and Lockheed Martin (32.2%). In two cases (Wingstop (51.7% and Jack in the Box 55.0%), the proposers for the first time managed to form a majority and pass the motions, notwithstanding the contrary recommendation of the respective boards. Proposals for companies to consider the social impacts of their climate policies (just transition) garnered 23.4% of the votes at Amazon, 10.0% at Goldman Sachs, and 7.5% at Exxon Mobil. Proposals aimed at reducing the use of plastics and encouraging sustainable packaging achieved support of 28.6% at Amazon, 26.3% at Dow, 20.8% at Exxon, and 20.6% at Kraft Heinz, among others. Five financial institutions received proposals to disclose the emissions underlying underwriting, insurance, and investment transactions, or to adopt emission reduction targets in lending and

2 *The UNFCCC (United Nations Framework Convention for Climate Change) was created at the conference held in Rio de January in 1992, being responsible for establishing a global agenda of commitments and obligations between member countries with the aim of stabilizing greenhouse gas concentrations and promote the idea of sustainable development.*

investment activities. The average voter support was 22.5% (ranging from 10.1% to 37.9%). Among them was Berkshire Hathaway, where 17.7% of shareholders supported the resolution. Investors have also submitted proposals for companies such as Alphabet, Amazon, IBM, Boeing, American Express, Bank of America, and Wells Fargo, to disclose and explain how their lobbying practices align with climate goals. In this case, shareholder support was 23.9% on average, ranging from 8.3% to 32.5% (cf. *Freshfields*, 2024)[3].

Achieving 20 to 30% of the vote at the meetings of the main American corporations has never been a trivial matter, a sign that something is indeed afoot. Beyond the core problem of collective action, where the trade-offs are not so acute, experts point to other reasons, of a historical-institutional nature, which make it difficult for companies to move towards an agenda of greater sensitivity to socio-environmental issues at a speed compatible with climate imperatives. It is off course a literature based on the American experience. The obstacles are manifested through the action/presence of some important actors/elements, described below.

i. SEC – The SEC's conduct has always been based on the assumption that decisions on the ordinary conduct of business should be taken exclusively by company managers and not by their shareholders. Under this precept, the SEC empowered directors to bar access to meetings for proposals that attempted to discuss ethical issues of a more pro-environmental nature, when, for example, shareholders demanded that companies should act more effectively against the harmful effects of their activities on human health and the environment. Perhaps this is an unintended consequence, but for a long time, shareholders did not have the opportunity to debate matters at meetings that involved discussions about proposals, values, and corporate purposes.

ii. Corporate law – American corporate law gives managers wide latitude. It requires them to act in good faith, considering the fiduciary standards of loyalty, prudence, and diligence; in other words, to make informed decisions and put the company's interests first. The jurisprudence of the American courts endorses this legal permissiveness, preferring not to interfere with or judge the operational/strategic merits of decisions – the business judgment rule doctrine – which aims to offer a region of protection to managers against accusations of damages arising from their ordinary decisions on the conduct of business. At the same time, the obligations of the managers are the signals sent by the legal system to those responsible for the company regarding the objectives they must pursue. Because the corporate objective is identified with the interests of shareholders and the promotion of a financial return on their investments, the managers' fiduciary duties are geared towards achieving these purposes. In other words, the American corporate model, while giving managers a great deal of autonomy in running the business, compels them to pursue the interests of the shareholders.

iii. Supreme Courts – The jurisprudence of the American courts also does not provide the incentives for managers to commit themselves to objectives that go beyond the consolidated understanding of their fiduciary duties. This long tradition dates back to the seminal 1919 decision in the famous Dodge v. Ford Motor Co. case, when Henry Ford decided to cancel extraordinary dividends in order to *"employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this, we are putting the greatest share of our profits back into the business"*. Minorities opposed to the decision appealed to the Michigan Supreme Court, which declared in response that "*a business corporation is organized and carried on primarily for the profit of the stockholders;*" the discretionary powers of management must be used for this purpose. They must not retain them "*or devote them for other purposes*" (Supreme Court of Michigan, 1919).

iv. ERISA – This line of interpretation by the courts prevailed throughout the century. In 2014, when asked to rule on the law that regulates US citizens' voluntary retirement system (ERISA, 1974), which established that the pension fund administrator has the exclusive fiduciary duty of providing benefits to its participants and beneficiaries, the Supreme Court ruled that the term 'benefit' must be treated as a 'financial' rather than 'non-pecuniary' (US Supreme Court, 2014) benefit. And so the court discouraged managers from offering funds with broader purposes, at the risk of being sued by 401k plans.

v. Department of Labor – In the same direction, American regulatory bodies have historically had a stance of preserving this status quo, where companies must be managed exclusively to generate financial returns for their shareholders. In 2016, Larry Fink, CEO of BlackRock described the work of the Department of Labor thusly: *"We live in a world where the Department of Labor gave us this guidance about what is our fiduciary responsibility as investors. We only have one responsibility as investors: to maximize return. That's it. So basically, we can tell a company to fire five thousand employees tomorrow, and if that maximizes return for the company, we did something well. We can tell that company to do something that maybe is bad for the environment. There is nothing right now that guides, other than a maximization of return behavior"* (*Promarket*, 2016).

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3 *As usual, in order to make the text more concise, we chose for the shortest quotes. Complete bibliographical references can be found on our website:* https://www.dynamo.com.br/pt/library.

In this context, it's not surprising to see the results among energy companies that we described in our last Report, where we noted the extreme parsimony of the wording of corporate purpose clauses, their long immobility, the inertia to change them, and the resistance of management vis-à-vis the reform proposals that come before the shareholders' meetings. Because most institutional investors understand that their mandate is also based on the fiduciary obligation to maximize value for their clients/shareholders, the voting recommendations of management end up receiving broad support from this majority category of investors. In other words, in the American tradition, the institutional arrangement under the mantra of the principle of fiduciary duty at the exclusive service of the shareholder's **financial** interest perfectly accommodated a 'pragmatic' vision in the orientation of business, leaving little room for any consideration of other (socio-environmental) dimensions of shareholder preferences and corporate purposes.

Based on this diagnosis and given the reality of the forces of change described above, some reformist suggestions have emerged in academic circles, whose proposals have also started to reverberate among regulators, public policy makers, and market players.

One line of reform proposes updating the dominant model by replacing the 'primacy of shareholders' with stakeholderism, which appears in two versions. The first, softer approach calls for managers to consider the interests of other stakeholders (employees, customers, suppliers, creditors, government bodies, local communities, society, the environment) in their decisions, as an 'instrumental' means of achieving long-term value maximization for the company and its shareholders. This variant is also known as enlightened shareholder value. The reform of the 2006 English law seems to be in line with this vision. The UK Companies Act, Section 172, establishes that directors acting in good faith must pursue the success of the company for the "benefit of its members as a whole," considering among other things "the interests of employees," "*the need to foster the company's business relationships with suppliers, customers, and others*" and "*the impact of the company's operations on the community and the environment.*"

The interpretation of this rule of corporate law was tested in the Supreme Court of the United Kingdom in the case known as Sequana, when AWA's creditors claimed a breach of the above obligation, since the company, before becoming insolvent, distributed generous dividends to its parent company (Sequana SA). The English court's decision reinforced the jurisprudence that the company's interests should be aligned with those of the shareholders, and did not recognize that directors owed obligations to creditors. According to UKSC, the primary duty of directors is to promote the success of the company. The obligation to respect the interests of other stakeholders "remains a duty to consider and does not extend into a duty to act" (Lan & Wan, 2024). In other words, the English court's decision followed the Anglo-Saxon tradition of preserving the primacy of shareholders' interests.

The second strand proposes a conceptually more ambitious reform by advocating that management should treat the interests of each stakeholder group as an end in itself, and not just as a means. In other words, management must serve a plurality of bosses. It has already been said (Bebchuk & Tallarita, 2020) that the first (instrumental) version is no different from the dominant governance structure, since by definition the interests of shareholders and other stakeholders are mutually dependent. Generally speaking, there are no dividends without employees, nor salaries without shareholders. Treating employees well is in the company's long-term interest, even if it means lower profits.

The second version, on the other hand, seems more problematic as it may pose more danger than benefit to the stakeholders themselves. Given the well-established institutional reality that we have pointed out above, there are no incentives in practice for management to pursue objectives other than the interests of shareholders. Empirical evidence from M&As, even among companies incorporated in the US states that have adopted the constituency statutes regime, reveals that management tends to bargain only to maximize value for shareholders and benefits for themselves, practically ignoring the preferences of other stakeholders – including the employees. This is because the incentives of CEOs and board members are more aligned with those of shareholders, and almost never with those of other stakeholders (Bebchuk, Kastiel, & Tallarita, 2021).

The fear of these experts is that this pluralistic version, when implemented in practice, could result in executives becoming less responsible in their accountability and more insulated from shareholder oversight, something which will probably result in lower corporate performance and losses for all stakeholders. In fact, we know from the past that associations representing executives' interests, such as the Business Roundtable, have supported movements aligned with stakeholderist rhetoric as a veiled strategy to obtain greater autonomy and insulation. In addition, the multiplicity of 'principals' could cause confusion in the agenda of priorities and fiduciary obligations of the directors (agents), not to mention the potential for litigation that could arise when the parties feel that they have not been treated according to their expectations.

Another line of reform is also based on questioning the conventional paradigm. Proponents of this version – whose main advocate is Colin Mayer of Oxford University – believe that a model focused exclusively on promoting the interests of shareholders and the financial return on their investments ends up producing negative social impacts. From there, they suggest a complete reversal of this construct: Companies exist to serve, and their central purpose would be to generate social and environmental benefits. Profit would be a consequence

of this priority of solving other people's problems and creating social welfare, and not an end in itself. In this sense, the company is perceived as a 'nexus of relationships' rather than contracts (Mayer, 2019). Relationships are based on trust, which is established through commitment. The statutory purpose, by infusing this amplified commitment, guides the actions and the very reason for the company's existence. Therefore, according to the proponents of this variant, companies should include in their articles of association a statement of purpose expressing these extended commitments. And they go further: As a way of recruiting fiduciary obligations, corporate law should enforce this determination to "*ensure the alignment of the corporation's incentives with individual, societal, and planetary interests*" (Mayer, 2022). Yet the critics counter that if the suggestion to include the purpose in the statutes is only voluntary, it should have no practical effect. If it is mandatory, it would have to be "*accompanied by either substantial changes in corporate law which would downgrade the governance rights of shareholders, almost to the point of elimination, or a substantial change in the investment goals of shareholders, coupled with some less far-reaching legal reforms*" (Davies, 2023). In other words, it's an idea that only appears to be simple, but in practice it would be very difficult to implement.

In fact, the fear of imposing such transformational changes through legal constraint is reflected in the French PACTE law that we mentioned in the previous Report. The legislative initiative preferred to state only suggestively that companies update their bylaws. Being a non-mandatory guideline, in practice what we saw was a rather timid uptake: A minority of French companies decided to include the declaration of their raison d'être in their bylaws, and even then, those that did, presented a version far from expressing a "firm commitment to communal or social goals" (Davies, 2023).

In the same direction, an interesting empirical study (Rajan, Ramella, & Zingales, 2023) covering 519 American companies from 1955 to 2020 sought to analyze the evolution of mentions of corporate objectives and purposes in 'letters to shareholders.' The study found that over time the content of the objectives would change, becoming less focused on financial results and "maximizing shareholder value" to, more recently, comprehending additional purposes and interests of the other stakeholders. Over the period analyzed, the number of objectives also gradually grew. In 1955, only 33% of companies had at least one objective and in this 'positive' group the average was two. In 2020, all companies announced at least one objective and the average was seven. It turns out that the 'letter to shareholders' is not part of the SEC's package of disclosure obligations, and it is still controversial whether a company can be sued for a statement made in a document that is not part of the transparency requirements. Not coincidentally, the study concluded that in many cases the statements of objectives were merely opportunistic, aimed at securing a 'license to operate' and at 'diverting attention:' "*We do find a fair amount of evidence suggesting that managers state goals opportunistically to escape scrutiny or alleviate stakeholder pressures.*" This shows that declarations of purpose and good intentions without proper enforcement can end up being mere rhetorical statements and diversionary exercises.

Our impression is that these stakeholder reforms are not necessary and could be dangerous. We don't need to jeopardize the proven model of shareholder primacy, whose structure of incentives and controls has been able to produce undeniable results in terms of business competitiveness, economic development, and social welfare. In this sense, an alternative line seems more promising. It was brought into the debate by Oliver Hart and Luigi Zingales (2017) in an article proposing that companies should seek to maximize the welfare of their shareholders and not their market value. The idea deserves some preliminary consideration in order to situate it properly.

As is widely accepted, the intellectual support for the paradigm of shareholder primacy has its foundations laid by Milton Friedman in his book *Capitalism and Freedom* (1962) and especially from the famous article published in The New York Times in 1970, when (in more accessible language) his ideas achieved great public repercussion. In both texts, we find the well-known passage, which has become an oft-used quote: "*There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits...*" It turns out that the sentence doesn't end there, although its complement is much less remembered: "*... so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.*" Since Friedman identifies a corporation as "*an instrument of the stockholders who own it*" (1962), the executive's

Dynamo Cougar x Ibovespa Performance in R$ up to October 2024

Period	Dynamo Cougar	Ibovespa*
120 months	227.5%	137.4%
60 months	33.3%	21.0%
36 months	6.0%	25.3%
24 months	13.6%	11.8%
12 months	20.6%	14.6%
Year (2024)	2.4%	-3.3%
Month (October)	-0.5%	-1.6%

(*) Ibovespa closing. Indices are presented as economic reference only. and not as a benchmark.

responsibility would be to run the business according to the wishes of the owners, which generally consists of "*making as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom*" (1970).

Friedman was one of the most influential economists of all time: His ideas transcended academic boundaries, infusing public policy debates with repercussions on the daily lives of citizens. Some critics, especially those mainly with an ideological bias, imbued with the fight against the 'capitalist system,' have preferred a shallow reading of his extensive work and, in the case of this article specifically, have conferred upon his arguments a 'doctrinal' tinge. A more appropriate hermeneutic for this text would be to say that he set out a mental model delimiting the elements that he believed would lead a society to become more prosperous – while not forgetting that at this time the Americans were dealing with problems of economic efficiency and flirting with statist insinuations.

In this sense, in the article above, Friedman proposed a theorem addressing the following question: Under what conditions would it be socially efficient for executives to focus only on maximizing shareholder value? To this end, Friedman made a number of underlying assumptions:

i. The economy operates in perfect competition. The Friedmanian entrepreneur has no power to change the terms of trade: He is a price taker as well as a rule taker. As such, "*it is hard to argue that he has any "social responsibility" except that which is shared by all citizens to obey the law of the land and to live according to his rights*." The existence of a monopoly, on the other hand, raises the issue of social responsibility, because "*the monopolist is visible and has power. It is easy to argue that he should discharge his power not solely to further his own interests but to further socially desirable ends*" (Friedman, 1962).
ii. Contracts are perfect. In other words, all the other stakeholders – employees, customers, suppliers, creditors – are able to adequately contract their demands and contingencies, so it is legitimate for shareholders to become the 'residual claimants' of the company's results.
iii. There is no production of negative externalities. Governments act effectively to prevent companies from producing externalities for society. Also implicit is the premise that governments and regulators cannot be captured by businesspersons, not least because we are in a regime of perfect competition where agents do not have the necessary size for this type of action.

By emphasizing the premises necessary for his argument to hold, Friedman shows that companies should only deviate from the intentional goal of profit maximization where these propositions are violated. Within these limits, the value generated by the company is commensurate with the increase in the welfare of its shareholders. Since no one seems to be negatively affected, this value also corresponds to the social optimum. Once these conditions are met, it would be socially efficient for managers to focus solely on the task of maximizing shareholder value. And so Friedman proposes his Separation Theorem: Companies should pursue the making of money; individuals and governments should pursue social/ethical issues.

Fifty years on, however, these assumptions hardly hold up when confronted with reality. Oligopolies and monopolies are everywhere, contracts are far from complete given the huge volume of litigation and indemnities, companies often produce negative externalities, and some have acquired sufficient scale to capture governments and regulators.

"*Corporations are larger, more complex, and more powerful than they were in the 1970s and early 1980s when the traditional paradigm became established*" (Hart & Zingales, 2022). The activities that generate profits for companies are the same as those that cause damage; they cannot be separated as the well-known theorem supposes. In a more populous and interconnected world, the importance of externalities has increased, while the capacity of governments to deal with them seems to have diminished. When the problem of the capture of government and regulatory bodies by large companies worsens, public bodies are no longer able to adequately internalize externalities. On the subject of climate, this is even more striking, as it is a global phenomenon with intergenerational consequences. As we discussed in Dynamo Report 113, the issue would be well addressed if we had a tax that covered all agents and geographies. However, it is known that it is extremely difficult to implement a global carbon price market. In addition, we are faced with externalities that are often difficult to address. In the case of pollution, for example, shareholders would face coordination problems to clean up the damage and, even if they succeeded, the cost of repairing would be much higher than that of polluting. It is known that greenhouse gases have remained in the atmosphere for hundreds to thousands of years and that, when it comes to biodiversity, the losses imposed on ecosystems tend to be irreversible. It is clear that in these circumstances the well-being of shareholders (and society as a whole) is no longer equivalent to the wealth produced by the company and recognized in terms of its market value.

In this environment, the basic premises that underpinned the Friedmanian model no longer apply to their full extent. The presence of negative externalities arising from companies' actions breaks the identity that the social benefit produced by the companies and captured by their market value would be Pareto-optimal; that is, transformed into a gain for society in the same proportion. Some shareholders, perceiving these corporate 'excesses,' may decide to address the source of these externalities, even if this means some offset in financial results. Unlike the results of the previous Report (in which

hydrocarbons took centerstage of the energy companies' operating activities and accounted for a substantial part of their financial results in other sectors, where trade-offs are less acute), the voting hands in this latest crop of meetings on the move seem to indicate signs that some shareholders are willing to face up to this reality. When externalities are important and shareholders express pro-social concerns, Hart & Zingales propose that the objective to be pursued by the company would no longer be to maximize financial value, but rather the 'utility' or 'welfare' of shareholders, amplified by these social preferences. The suggestion in a way implies a paradigm shift, even if it preserves the central pillar of shareholder primacy.

It's interesting that Friedman himself never argued that shareholders couldn't pursue broader social preferences. What Friedman did not admit, within his understanding of the company as a nexus of perfect contracts, was that other participants could impose these different responsibilities or objectives on the shareholders. In other words, the understanding that shareholders have the prerogative to pursue a broad objective function, including ethical and social considerations, has never been questioned. In order to do this, they must be able to spontaneously express their wishes at meetings, and management must be able to execute the results of the majority's wishes without the legal constraint that they are going against their fiduciary obligations. This perception still seems to prevail in American jurisprudence.

In its original essence, the ESG movement is an expression of social preferences that change over time. It is a particular manifestation of these choices through which companies and investors seek to align their actions by incorporating amplified principles of greater environmental sustainability, social justice, and higher standards of governance into their business strategies and investment policies. When social preferences expand, the admissible space for the production of negative externalities shrinks proportionally. Every advance in ESG understanding presupposes a proportional increase in intolerance for the effects of externalities resulting from corporate activities. And so, the practices of expropriation and asymmetry of rights between shareholders that we experienced in the militancy of governance in the first decade of Dynamo's existence would be completely unacceptable today – (G-governance). Taking the 1970s as an example, until then, less than half of American workers were covered by pension plans and only then were occupational health and safety standards taken into consideration. In Brazil, this was when updates to vacation rights were instituted in the CLT (Decree-Law 1.535/77) – (S-*social*). Similarly, it wasn't until the 1970s that the US established stricter federal rules to control air and water pollution, waste, and toxic substances. Likewise in Brazil, it was during this period that companies responsible for polluting activities became obliged to prevent and correct the damage caused to the environment (Decree-Law 1.413/75) – (*E-environmental*). In other words, liberalities that were commonplace fifty years ago would today be considered not only inadmissible conduct from an ESG perspective but possibly violations subject to criminal prosecution.

We know that companies need to focus on the imperatives of their business, which are imposed by highly competitive environments. Sometimes, moreover, if the incentives are not well aligned, this can encourage decisions that are not completely consistent with long-term sustainability or with the high cost of keeping the reputational franchise unharmed. We cannot be naïve and imagine that we will always be in a win-win environment. These cases are obvious. The problem lies in trade-offs where there are conflicts between maximizing financial performance today and building something more resilient in the future. In line with what we have argued, the issue of externalities is a central divide in our understanding and way of acting.

In the last Report, which took a closer look at the energy sector, when we analyzed the dynamics of corporate discussions, we saw the predominance of a pragmatic vision, when companies, management, and shareholders showed resistance to sacrificing financial performance today in order to advance decarbonization and contribute to future collective well-being. We note that this is a typical expression of the problem of collective action. When we leave this environment where the trade-off is more explicit, we see that the initiatives to address climate challenges in various dimensions of the social fabric are also beginning to reverberate among shareholders, with substantial votes of support for environmentally sensitive issues being recorded in the last round of shareholders' meetings of large corporations.

In parallel with the growing manifestation of more pro-social behavior among some categories of shareholders, suggestions for reforms in the governance regime and eventually in corporate law, which first emerged in academic circles, began to circulate among regulators. All this is very recent. In this Report, we try to provide a brief summary of these discussions that take place on the border of geographies far from our own, but which are of great interest to us and are the subject of ongoing discussions here at Dynamo. As we have said before, in this *ESG* theme, without ever neglecting the *S* (or much less the *G*, which is always present in our work), we have tried to concentrate our efforts on the environmental dimension (*E*) due to the greater sensitivity of our portfolio to the impacts of the transformations that are already taking place. From the outset, we approached the appeal of the acronym's "wave" with caution and introspection, remembering that patient investors already incorporate sustainability as a fundamental element into their mental model and modus operandi. Naturally, from then on, we continued to broaden our horizons in this vast lexical universe

DYNAMO COUGAR x IBOVESPA (Performance in US$*)

Period	DYNAMO COUGAR Year	DYNAMO COUGAR Since Sep 1. 1993	IBOVESPA** Year	IBOVESPA** Since Sep 1. 1993
1993	38.8%	38.8%	7.7%	7.7%
1994	245.6%	379.5%	62.6%	75.1%
1995	-3.6%	362.2%	-14.0%	50.5%
1996	53.6%	609.8%	53.2%	130.6%
1997	-6.2%	565.5%	34.7%	210.6%
1998	-19.1%	438.1%	-38.5%	91.0%
1999	104.6%	1,001.2%	70.2%	224.9%
2000	3.0%	1,034.5%	-18.3%	165.4%
2001	-6.4%	962.4%	-25.0%	99.0%
2002	-7.9%	878.9%	-45.5%	8.5%
2003	93.9%	1,798.5%	141.3%	161.8%
2004	64.4%	3,020.2%	28.2%	235.7%
2005	41.2%	4,305.5%	44.8%	386.1%
2006	49.8%	6,498.3%	45.5%	607.5%
2007	59.7%	10,436.6%	73.4%	1,126.8%
2008	-47.1%	5,470.1%	-55.4%	446.5%
2009	143.7%	13,472.6%	145.2%	1,239.9%
2010	28.1%	17,282.0%	5.6%	1,331.8%
2011	-4.4%	16,514.5%	-27.3%	929.1%
2012	14.0%	18,844.6%	-1.4%	914.5%
2013	-7.3%	17,456.8%	-26.3%	647.9%
2014	-6.0%	16,401.5%	-14.4%	540.4%
2015	-23.3%	12,560.8%	-41.0%	277.6%
2016	42.4%	17,926.4%	66.5%	528.6%
2017	25.8%	22,574.0%	25.0%	685.6%
2018	-8.9%	20,567.8%	-1.8%	671.5%
2019	53.2%	31,570.4%	26.5%	875.9%
2020	-2.2%	30,886.1%	-20.2%	679.0%
2021	-23.0%	23,762.3%	-18.0%	538.9%
2022	-7.8%	21,899.9%	12.0%	615.4%
2023	32.1%	28,965.0%	31.8%	842.8%
2024***	-14.2%	24,840.8%	-19.0%	663.6%

(*) Considering that this is a Fund that has existed since 1993. the figures were converted into dollars (US$) as a way to eliminate the volatility of the Brazilian currency throughout the period and. in this way. minimize the risk of possible misinterpretations by the reader in the case of an investment decision/ divestment. Dynamo Cougar is a fund that invests in NAV of an equity investment fund and is currently closed for new investments. (**) Ibovespa closing price. The index is presented as a mere economic reference and does not constitute a target or benchmark for the Fund. (***) Return up to October 2024.

that we came to understand better and respect even more. This text is another chapter in that journey.

As a long-term investor, our role is to raise awareness and suggest alternatives for dealing with any externalities produced by the companies in our portfolio, bearing in mind that, as the climate-environment problem is urgent and worsening exponentially, the opportunity cost of procrastination is high.

Rio de Janeiro, 4th November 2024.

Additional information:

- **Inception:** 09/01/1993
- **Objective:** Deliver NAV appreciation above inflation in a medium/long term horizon by investing at least 95% (ninety-five percent) of the fund´s net worth in the NAV of Dynamo Cougar Master Equity Investment Fund ("Master Fund")
- **Target investor:** Qualified investors
- **Status:** Closed for new investments
- **Redemption grace period:** 12 months grace period or liquidity fee of 3% for redemption within this time period*
- **Redemption NAV:** D+12 (calendar days)*
- **Redemption payment:** D+2 (working days) after NAV conversion*
- **Applicable taxation:** Equity
- **Anbima´s classification:** "Equity – Free Portfolio"
- **Management fee:** 1.90% per year for the Fund + 0.10% for the Master Fund
- **Performance fee:** on the top of IPCA + IMAB*
- **Average monthly net worth last 12 months:** R$ 6.026,6 Million.

(*) Detailed description provided in the bylaws

To find more information about Dynamo and our funds. or if you wish to compare the performance of Dynamo Cougar to other indices in different time periods. please visit our website:

www.dynamo.com.br

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