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The UK Stewardship Code: Bridging the Gap Between Companies and Institutional Investors

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Le Code britannique de gouvernance : vers une réduction du fossé entre les entreprises et les investisseurs institutionnels

El Código de Administración del Reino Unido: reducir la brecha entre las Empresas y los inversionistas institucionales

O Código Stewardship do Reino Unido: construindo uma ponte entre Empresas e Investidores Institucionais

《英国监管守则》：消除公司与机构投资者之间的隔阂

Résumé

L'exercice des responsabilités de gouvernance par les investisseurs institutionnels est devenu un sujet émergent et largement débattu, en particulier du fait de sa capacité à réformer la culture de la gouvernance d'entreprise. Son ultime objectif semble être le changement de conception même et de fonctionnement des investissements, en vue d'optimiser le fonctionnement des marchés financiers et de soutenir l'existence des sociétés

Abstract

The exercise of stewardship responsibilities by institutional investors has become an important emerging and widely-debated topic, especially due to its potential to reform corporate governance culture. Its ultimate objective appears to be change in how investment is thought of and carried out, in order to optimise the functioning of financial markets and to sustain companies' existence and investors' portfolio value in the long

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ainsi que la valeur des investissements à long terme. Les investisseurs peuvent contribuer à cet objectif s'ils collaborent efficacement avec les entreprises et peuvent atteindre un niveau d'interaction convaincant pour exprimer leurs préoccupations par rapport à ce qu'ils attendent de leurs investissements et à la manière dont la société doit être gérée. L'obstacle à la réalisation de cet objectif est la distance croissante entre les investisseurs et les sociétés, ce qui a créé un vide en matière de communication, de compréhension et de coopération. L'intermédiation financière a rendu plus difficile la coopération entre ces deux parties et doit donc être repensée.

La régulation est en mesure d'intervenir indirectement pour influer sur cette relation continue en exigeant des investisseurs, notamment des investisseurs institutionnels et de leurs gestionnaires d'actifs, plus de transparence sur la façon dont ils conçoivent leur rôle et dont ils exercent leurs activités. À cet égard, le *UK Stewardship Code* a été introduit en 2010 et révisé en 2012. Ce Code aborde ces questions et vise à devenir un point de référence pour les investisseurs afin de les amener à réaliser un engagement plus large et plus profond avec les sociétés. Cet article vise à analyser les avantages du Code et à présenter les problématiques récurrentes qui, une fois traitées, permettront au cadre réglementaire britannique d'avoir un impact optimal sur le marché. L'article étudie également la voie à suivre en vue d'améliorer le cadre actuel et d'explorer de nouveaux champs de recherche dans ce domaine. La première partie fait une analyse de l'état actuel du *Stewardship* Code. La deuxième partie examine les lacunes du Code et propose des modifi-

term. Investors can contribute towards this objective if they engage effectively with companies and achieve a convincing level of interaction in order to express concerns about what they expect from their investments and how the investee company should be managed. The barrier that hampers this objective is the growing distance between investors and companies, which has created a gap in terms of communication, understanding and cooperation. Financial intermediation has made cooperation between these two parties more difficult, and therefore needs to be revisited.

Regulation is able to intervene indirectly to influence this ongoing relationship by requiring that investors, especially institutional ones and their asset managers, become more transparent in how they conceive their role and how they carry out their business. In this respect, the UK Stewardship Code was introduced in 2010 and revised in 2012. It addresses these issues and aims to become a point of reference for investors in order to assist them in achieving broader and more advanced engagement with companies. This paper aims to analyse the benefits of the Code, as well as to address remaining problematic issues, which, once dealt with, will help the UK regulatory framework achieve optimal impact on the market. It will further explore the way forward in order to improve the current framework and explore new fields of research in this area. Part I will analyse and explore the current status of the Stewardship Code. Part II will analyse the shortfalls of the Code and will strive to propose future amendments. Part III will concentrate on wider market-related issues associated with the Stewardship Code, which, once resolved,

cations pour l'avenir. La troisième partie se concentre sur des questions généralement liées aux marchés et au *Stewardship Code*, qui, une fois résolues, faciliteront son adoption et son acceptation par le marché. La quatrième partie clôt le débat et évalue la contribution du *Stewardship Code* à l'amélioration de la relation entre les sociétés et les investisseurs.

will increase its effective adoption and acceptance by the market. Part IV will conclude the debate and evaluate the contribution of the Stewardship Code in improving the relationship between companies and investors.

Resumen

El ejercicio de las responsabilidades de administración de los inversionistas institucionales se ha convertido en un tema emergente ampliamente debatido, sobre todo debido a su capacidad para reformar la cultura de gobierno corporativo. Su objetivo final parece ser la de cambiar el diseño y operación de las inversiones para optimizar el funcionamiento de los mercados financieros, apoyar la existencia de las empresas y el valor de la inversión a largo plazo. Los inversionistas pueden lograr este objetivo si colaboran eficazmente con las empresas y si alcanzan un nivel convincente de interacción para así expresar sus preocupaciones acerca de lo que esperan de sus inversiones y de cómo la sociedad debería ser manejada. El obstáculo para lograr este objetivo es la distancia cada vez mayor entre los inversionistas y las empresas, lo que ha creado una brecha en la comunicación, la comprensión y la cooperación. La intermediación financiera ha hecho más difícil la cooperación entre estas dos partes y por lo tanto debe ser reconsiderada.

La reglamentación puede intervenir indirectamente para influenciar esta relación continúa exigiendo a los inversionistas, incluso aquellos institucionales y a sus administradores de activos, mayor

Resumo

O exercício das responsabilidades de gestão (*stewardship*) por parte de investidores institucionais, tornou-se um tema emergente amplamente debatido, especialmente por causa de sua capacidade de reformar a cultura de governança corporativa. O objetivo final parece ser a mudança na forma como o investimento é pensado e realizado, a fim de otimizar o funcionamento dos mercados financeiros, manter a existência de investidores nas companhias e de valores de investimento a longo prazo. Os investidores podem contribuir para este objetivo, colaborarem efetivamente com as empresas e podem atingir um nível de interação eloquente para expressar suas preocupações sobre o que eles esperam de seus investimentos e como a empresa investida deve ser gerenciada. O obstáculo que dificulta a realização deste objetivo é a distância crescente entre investidores e as empresas, o que criou uma lacuna em termos de compreensão, comunicação e cooperação. Intermediação financeira tornou mais difícil a cooperação entre estas duas partes e deve ser reconsiderada.

A regulamentação é uma medida de intervenção indireta capaz de influenciar essa relação contínua exigindo que investidores, principalmente os institucionais transparencia en la forma en que operan. En este sentido, el Código de Administración del Reino Unido se introdujo en 2010 y fue revisado en 2012. Este Código se ocupa de estas cuestiones y pretende convertirse en un punto de referencia para los inversionistas con el fin de lograr que se comprometan a un más con las empresas. Este artículo tiene como objetivo analizar los beneficios del presente Código al igual que los problemas recurrentes que han surgido en el marco legal del Reino Unido y que tienen un impacto en el funcionamiento del mercado. El artículo también examina el camino a seguir para mejorar el marco actual y explorar nuevos campos de investigación en esta área. La primera parte es un análisis de la situación actual del Código de Administración. La segunda parte examina las deficiencias del Código y propone cambios para el futuro. La tercera parte se centra en temas relacionados con los mercados en general y el Código de Administración. La cuarta parte concluye el debate y determinará la contribución del Código de Administración en la mejora de las relaciones entre las empresas y los inversionistas.

e gestores de ativos, a se tornarem mais transparente na forma como eles concebem seu papel e como eles realizam seus negócios. A este respeito, o Código *Stewardship* do Reino Unido foi introduzido em 2010 e revisto em 2012. O Código aborda estas questões e pretende se tornar um ponto de referência para os investidores, a fim de auxiliá-los na obtenção de engajamento mais amplo e mais avançado com empresas. Este artigo tem como objetivo analisar os benefícios do Código, bem como apresentar as questões problemáticas recorrentes, que, uma vez tratados, permitirão ao quadro regulamentar do Reino Unido conseguir o impacto máximo no mercado. O presente artigo examina o caminho a se seguir para melhorar o quadro atual e explorar novos campos de pesquisa nesta área. A primeira parte é uma análise do estado atual do Código *Stewardship*. A segunda parte examina as lacunas do Código e propõe mudanças para o futuro. A terceira parte se concentra em questões relacionadas com os mercados em geral e ao Código *Stewardship*, que, uma vez resolvido, facilitará a sua aprovação e aceitação de mercado. A quarta parte conclui o debate e avalia a contribuição do Código *Stewardship* para melhorar a relação entre empresas e investidores.

摘要

机构投资者监管责任的履行已成为一个新兴话题并得到热烈探讨，尤其是因为它可以改革企业的管理文化。它的终极目标是改变怎样考虑和运作投资，旨在使金融市场的运作最优化并支持公司和投资价值的长期存在。投资者与企业进行有效合作可以促成这一目标的实现，可以达到一个令人信服的互动级别，以表达他们对其投资的期待、对公司管理方式的关切。实现这一目标的障碍在于投资者与公司之间渐行渐远的距离，并形成了一个沟通、理解与合作的真空。金融的中介作用进一步加剧了让双方之间的合作困难，因此需要重新审视。

监管机构可以通过间接介入的方式影响这一依旧持续的关系，要求投资者——尤其是机构投资者及其资产管理者——提供更透明的角色定位和执行活动的方式。为此，2010年引入了《英国监管守则》，并在2012年进一步修正。该《守则》涉及到这些问题，希望成为投资者的参考工具，好让他们向公司履行更广泛深刻的承诺。本文旨在分析《守则》的益处，并指出其存在的一些问题。一旦这些问题得到解决，英国的调控范围便能对市场产生良性影响。文章同时研究了旨在改善当前框架和开辟本领域新的研究视野的道路方向。第一章分析了《监管守则》的现状。第二章考察了《守则》的缺陷，并提出了未来的修改建议。第三章着重考察了与市场和《监管守则》相关的问题。这些问题若得以解决，将会有利于其被市场所采纳和接受。第四章对争议作出了结论，并评价了《监管守则》对于改善公司与投资者关系所做的贡献。

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Stewardship is an emerging phenomenon, indirectly associated with the current eroded image of financial markets and corporate governance. It appears to be one of the remedies for avoiding financial crises in the future, as it triggers more active engagement of market participants in various critical issues. Its core notion refers to the responsibility of taking care of assets that belong to other parties, and more specifically, as far as institutional investors are concerned, the stewardship responsibilities are bestowed upon the trustees of the investor group, as well as on the asset managers in charge of monitoring and developing their portfolios. In an ideal scenario, a good steward is someone who truly understands the needs of the ultimate beneficiaries of his/her actions and is able to engage effectively with the latter in order to establish a trustful relationship and to manage their financial interests in an optimal way.

According to another definition,

> "stewardship is responsible and thoughtful ownership. It is synonymous with an ownership mindset and adopts a long-term perspective, but with a focus on value creation […] It is also a mechanism to ensure the appropriate use of the power vested in institutions to properly and effectively manage the funds, such as savings and pension contributions, entrusted to them by the ultimate investors, the beneficiaries."[1]

Unfortunately, for a series of reasons that will be analysed later on in this paper, trust in the financial markets has been eroded and several regulatory reforms across the globe are currently aimed to restore confidence in the ever-lengthening investment chain that separates final investors from companies. One of those initiatives is the UK Stewardship Code[2], which has set a target of increasing awareness of the problematic issues involved in the vicious circle of investment and probably to change the current mentality of market participants in exercising different powers and rights involved in this chain.

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1 Foundation for Governance Research and Education, *An Investigation into Stewardship: Engagement between Investors and Public Companies: Impediments and their Resolution*, 2011, p. 12, at <http://www.foundationgre.com/Stewardship%20Report%20Final%20-%2022.6.11.pdf> (accessed 16 January 2013).

2 Financial Reporting Council, *The UK Stewardship Code*, 2012, at <http://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx> (accessed 16 January 2013) [hereinafter "*Stewardship Code*"].

Academic literature has developed the debate surrounding the usefulness of institutional investors, reaching controversial conclusions. Some views support the idea that investor groups are beneficial to the financial markets since they prefer long-term investment, loyalty to the investee company, and serious engagement with the latter in order to improve corporate governance strategies[3]. Others consider institutional investors to be potentially harmful to the stability of companies and markets in general, since they are deemed to act with an excessive focus on short-term returns[4] and the achievement of a specific set of goals that are not compatible with the true progression of the company and its overall perspectives and objectives[5].

Although the distinction cannot be clear-cut[6], it should be useful to emphasise the importance of shifting the debate towards the inspiration

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3 The debate continues on the existence of empirical proof of the benefits of shareholder engagement. The empirical studies conducted in the past are not conclusive as to whether shareholder activism is crucial to improving companies' performance or simply irrelevant. Regardless of the negative or positive effect of this kind of activism, it could be said that in theory it is always better to have a certain amount indirect pressure from asset managers or asset owners of the shares, which will possibly alert the company's management in order to avert certain deficiencies in conducting business: Stuart L. Gillan and Laura T. Starks, "The Evolution of Shareholder Activism in the United States", (2007) 19 *Journal of Applied Corp. Fin.* 55; Ilhan Demiralp, Ranjan D'Mello, Frederik Schlingemann and Venkat Subramaniam, "Are there monitoring benefits to institutional ownership? Evidence from seasoned equity offerings", (2011) 17 *Journal of Corporate Finance* 1340; Roberta Romano, "Less is More: Making Institutional Shareholder Activism a Valuable Mechanism of Corporate Governance", (2001) 18 *Yale Journal on Regulation* 174.

4 Up to a point where managers had declared that they were willing to sacrifice the company's prospective value in order to satisfy those pressures: John R. Graham, Campbell R. Harvey and Shivaram Rajgopal, "Value Destruction and Financial Reporting Decisions", 6 September 2006, at <http://cmsu2.ucmo.edu/public/classes/young/Guidance%20Research/Value%20Destruction%20and%20Financial%20Reporting%20Decisions.pdf> (accessed 16 January 2013).

5 Benjamin W. Heineman Jr., "A 'Stewardship Code' for institutional investors", *Harvard Business Review blog*, 18 January 2010, at < http://blogs.hbr.org/cs/2010/01/a_stewardship_code_for_institu.html > (accessed 16 January 2013).

6 Benjamin W. Heineman Jr. and Stephen Davis, "Are Institutional investors part of the problem or part of the solution? Key descriptive and prescriptive questions about shareholders' role in US public equity markets", Yale School of Management, Millstein Center for Corporate Governance and Performance, October 2011, at <http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/80235_CED_WEB.pdf> (accessed 16 January 2013).

of a common set of principles for better stewardship instead of continuing to focus on the possible differences between the same type of investors groups. Under this perspective, long-term oriented groups will continue to exercise their rights in the same way, while functioning as an inspirational point for short-term ones. The latter will have the chance to disclose information about their specific profiles and, eventually, to justify the reasons for which they cannot adhere completely to the principles set in the UK framework.

The UK Stewardship Code aims to address these issues by enhancing the activism of institutional investors. Serious corporate governance issues have arisen in the past few years, partially because companies do not feel that they have to respond to considerable pressure from investors or – even worse – they cannot perceive this pressure, especially in cases of widespread investor apathy[7]. Although different types of investment or certain groups may exist and be engaged in influencing companies towards better corporate governance practices, considerable effort has to be made to broaden shareholder activism[8] and address concerns and priorities to companies in a much more visible way.

The Stewardship Code aims to foster awareness of investors' potential effect on a company's long-term and sustainable performance. The outcome of such an effort carried out through a viable and continuous dialogue with the company's management derives from the interaction between these two decisions poles, which are supposed to align themselves to a common perception of the company's future strategy and development.

Stewardship responsibilities cannot be bestowed solely upon shareholders, since a company's directors have the duty to guide the company towards long-term growth and a sustainable presence in society in general. Nevertheless, the core subject of this paper will be exclusively related to the UK Stewardship Code, which aims to encourage the various groups of

7 On the absence of a strong shareholder engagement, see: Marc Goergen, Luc Renneboog and Chendi Zhang, "Do UK Institutional Shareholders Monitor their Investee Firms?", (2008) 8(1) *Journal of Corporate Law Studies* 39.

8 See more generally: Janet H. Marler and Christophe Faugère, "Shareholder Activism and Middle Management Equity Incentives", (2010) 18 *Corporate Governance: An International Review* 313.

institutional shareholders to engage more actively with their investee companies.

The notion of stewardship itself has proven to be crucial to the viability of the modern financial system. This fact became particularly apparent given the fact that, during the major financial crisis that occurred in 2007-2008, better stewardship could have alerted to erroneous management decisions in advance, acting indirectly as a pre-emptive intervention means against the crisis itself[9]. Indeed, a generation of active and informed investors exercising a beneficial amount of pressure on companies' managers could have helped avert numerous short-term and highly risk management decisions.

However, the main problem with the current generation of investors lies in the fact that "educational efforts" stemming from regulatory initiatives have not ramped up decisively enough for this generation to become increasingly or even adequately aware of its rights. Moreover, it is crucial for investors to understand the broader challenges they have to face and the responsibilities arising from the fact that they own shares of a company. Having a fair view of their rights and responsibilities, they thus need to move forward to a more active position with regard to the rest of the market, express their views and require different market practice plans that respect their investment decisions.

Therefore, the main contributions of the Code is firstly to play an educational role to the benefit of fund managers and various groups of investors, and, secondly, to make them engage in a more demanding disclosure framework on how they view their role and how they are prepared to exercise it in the global corporate landscape.

I. The current framework

UK Stewardship Code's current framework must be viewed in the broader historical context that served as the basis for its introduction. Moreover, the Code's provisions, especially after its revision in 2012, strive to broaden not only the circle of potential stewards that need to assume

9 Stephen M. Davis, Jon Lukomnik and David Pitt-Watson, "Active Shareowner Stewardship: A New Paradigm for Capitalism", (2009) 2(2) *Rotman International Journal of Pension Management* 10.

respective responsibilities, but the spectrum of relationships and activities that trigger the requirements of stewardship and need to be transparent for the benefit of the rest of the market.

A. Historical background

The UK Stewardship Code became a true necessity after the 2009 Walker Review[10], which reiterated the debate about the importance of adherence to such a Code, based on the ISC Code of Responsibilities of Institutional Investors[11]. Following this trend, the Financial Reporting Council (hereinafter FRC) issued a consultation paper in early 2010, which later resulted in the issuance of the Code. The necessity of ramping up shareholders' engagement in corporate affairs is not a recently-emerged topic in the UK. In 1992, the Cadbury Report referred to the necessity of much closer cooperation between companies and major shareholders[12]. This suggestion, amongst others, was later followed by the Hampel Report, which reiterated and furthered the initial recommendations by including specific requirements for dialogue between the two parties[13], as well as guidance for institutional investors[14]. Moreover, the Myners[15] and Higgs[16] Reports added to requirements for institutional investors. At the same time, the ISC issued guidance in 2002 stipulating that institutional investors should assume a monitoring role vis-à-vis investee companies, estab-

10 Sir David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations*, November 2009, at <http://www.hm-treasury.gov.uk/walker_review_information.htm> (accessed 16 January 2013).

11 Institutional Shareholders Committee (now renamed Institutional Investors Committee): <http://www.iicomm.org/>.

12 Sir Adrian Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, par. 6.9-6.16, 49-51, at <http://www.ecgi.org/codes/documents/cadbury.pdf> (accessed 16 January 2013), [hereinafter "*Cadbury Report*"].

13 Hampel Committee, *Hampel Committee on Corporate Governance, Final Report*, 1998, c. 1, p. 19 and 20, at <http://www.ecgi.org/codes/documents/hampel_index.htm> (accessed 16 January 2013).

14 *Id.*, p. 20.

15 Paul Myners, *Institutional Investment in the United Kingdom: A Review*, 2001, at <http://archive.treasury.gov.uk/pdf/2001/myners_report.pdf> (accessed 16 January 2013).

16 Derek Higgs, *Review of the role and effectiveness of non-executive directors*, January 2003, p. 69 and 70, at <http://www.bis.gov.uk/files/file23012.pdf> (accessed 16 January 2013).

lish an active dialogue with their management, and intervene in corporate affairs while disclosing the impact of their engagement and informing their clients accordingly.

The major resurgence of the debate became clear at the beginning of the global financial crisis that peaked in 2008. Institutional investors were considered to be a part of the problem, since they were supposed to monitor companies more closely and to alert their management of any risky practices, something which seems not to have occurred during that period[17]. As correctly mentioned by the House of Commons Treasury Committee, "investors have failed in one of their core tasks, namely the effective scrutiny and monitoring the decisions of boards and executive management in the banking sector […]"[18].

The ISC Code, which later served as the intellectual basis and main source of inspiration for the UK Stewardship Code, was issued in 2009 after a series of criticisms formulated against the reluctance of institutional investors[19]. As a text, it is based on the principles of responsibilities for institutional shareholders and their agents, which had been initiated in 2002 and was amended subsequently in 2005 by the ISC. In July 2010, the first UK Stewardship Code came into effect, representing an initial attempt to make the exercise of stewardship responsibilities more transparent and to encourage more effective shareholder engagement[20].

17 Natasha BURNS, Simi KEDIA and Marc LIPSON, "Institutional ownership and monitoring: Evidence from financial misreporting", (2010) 16 *Journal of Corporate Finance* 443.

18 HOUSE OF COMMONS TREASURY COMMITTEE, *Banking Crisis: Reforming Corporate Governance and Pay in the City*, Ninth Report of Session 2008-09, p. 64, at <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf> (accessed 16 January 2013).

19 INSTITUTIONAL SHAREHOLDERS' COMMITTEE, *The Responsibilities of Institutional Shareholders and Agents – Statement of Principles*, 2009, at <http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCCode161109.pdf> (accessed 16 January 2013).

20 Michael MCKERSIE, "The Stewardship Code and the pattern of engagement by institutional shareholders with listed companies", (2010) 5(4) *Capital Markets Law Journal* 439.

After a consultation period[21], the UK Stewardship Code was revised in September 2012 and took effect on 1 October 2012. The provisions of the Code aim to address most of the problematic issues surrounding the investment environment and to encourage stewardship and most market participants involved in this investment chain. The major contribution of the revised version is the enrichment of the guidance notes, as well as an introductory section aimed at clarifying the notion of stewardship and the use of the 'comply or explain' principle in this context.

As far as the notion of stewardship itself is concerned, a problematic area of the Code was – in its initial version – the fact that it was not clarified in a way that would allow full understanding of the range of responsibilities for all stakeholders. The Code now indicated that "[s]tewardship aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole"[22]. It goes further by adding that:

> "[f]or investors, stewardship is more than just voting. Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings."[23]

The Code seeks to increase awareness of the depth of stewardship as a notion and the responsibilities that it entails for all market participants who can be seen as stewards. Mentioning also that stewards are not merely a company's investors, since the main responsibility is bestowed upon the board of directors, it emphasises the need for a widely-accepted framework that enhances the perception of stewardship as a prerequisite for the viability for both companies and financial markets. Even though the new version does not provide a crystal clear definition of stewardship itself, it is important to mention that the long-term success of the investee compa-

21 Financial Reporting Council, *Consultation Document: Revisions to the UK Stewardship Code*, 2012, at <http://www.frc.org.uk/getattachment/fa05e79c-22c6-4f8f-b5b3-2ab55ec41113/Consultation-Document-Revisions-to-the-UK-Stewards.aspx> (accessed 16 January 2013).

22 *Stewardship Code*, *supra*, note 2, p. 4.

23 *Id.*

nies is mentioned as a criterion, along with the priority of taking care of investors' assets and allowing them to prosper in the same framework. The overall attempt to describe stewardship in such a way may be preferable, since the definition provided encompasses different sorts of activities and ways of potential intervention instead of providing a more stringent and stagnant description[24].

B. The provisions of the Code

1. Stewards

The initial version of the Code in 2010 stated that it was "addressed in the first instance to firms who manage assets on behalf of institutional shareholders such as pension funds, insurance companies, investment trusts and other collective investment vehicles"[25]. Additionally, the Code clarified the fact that monitoring responsibilities could not be solely bestowed upon fund managers since other potential factors such as fund trustees and other owners could also assume those responsibilities and disclose information on the impact of their actions with regard to the investee companies. Therefore, the Code aimed to influence and engage a wider variety of market actors related to the exercise of stewardship. Nevertheless, the initial text was not very detailed in terms of other market participants potentially involved in the investment procedure and thus subject to the same stewardship responsibilities. The phrasing of the initial version of the Code thus left room for improvement, and the current revision of the Code seeks to satisfy this necessity by mentioning that:

[24] This description of stewardship is undoubtedly inspired by the Report that emphasised the long-term culture in investment and the need to change culture in conceiving and applying management strategies for all market participants. The UK government, following a call for evidence 'A long-term focus for corporate Britain' published in October 2010, asked from Professor John Kay in 2011 to launch a report examining up to what extent equity markets are achieving their core purposes. After a respective call for evidence and an Interim Report, the Final Report: John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making*, July 2012, at <http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf> (accessed 16 January 2013) [hereinafter "*Kay Report*"].

[25] Financial Reporting Council, *The UK Stewardship Code*, 2010, p. 2, at <http://www.frc.org.uk/getattachment/3006d141-4704-4712-9f13-771cf93897b8/The-UK-Stewardship-Code.aspx> (accessed 16 January 2013).

> "[t]he Code is directed in the first instance to institutional investors, by which is meant asset owners and asset managers with equity holdings in UK listed companies. Institutional investors may choose to outsource to external service providers some of the activities associated with stewardship. However, they cannot delegate their responsibility for stewardship. They remain responsible for ensuring those activities are carried out in a manner consistent with their own approach to stewardship. Accordingly, the Code also applies, by extension, to service providers, such as proxy advisors and investment consultants."[26]

The first advantage of such a classification is the official enlargement of stewardship responsibilities and the specification of other potential market participants involved in the investment chain who become jointly responsible for achieving optimal stewardship levels. Secondly, reminding institutional investors that they have the possibility to outsource to external actors some of their activities but not the stewardship itself, the Code focuses on the main priority for every participant in this 'circle', which is to honour the role that is associated with its presence in the market. Even though substitution of some of the duties involved may be possible, investors need to ensure themselves that other interconnected service providers keep stewardship standards intact.

2. Principles

The first issue addressed by the UK Stewardship Code is the requirement for institutional investors to disclose information on their policies on how they discharge their responsibilities. The Code reiterates the notion of stewardship, namely the monitoring and engagement with companies on a series of important issues, such as corporate strategy, risk, corporate governance, culture and remuneration practices. Institutional investors need to provide information on the means of stewardship applied, in view of the objective of preserving and strengthening the value of the investment for the benefit of their clients. Moreover, they must show all possible interactions in the investment chain with other service providers and the responsibilities that arise from these relationships[27]. Stewardship is obviously a multi-faceted concept depending on who is exercising it and under which circumstances. The required statement must therefore address the links between different stewards, such as asset own-

[26] *Stewardship Code*, *supra*, note 2, p. 5.

[27] *Id.*

ers and asset managers, in order for the reader to understand which kind of activities have already been outsourced and how the overall outcome respects the general principles of effective stewardship.

With the first principle, the Code seeks to engage institutional investors in a much more transparent framework for the disclosure of information on their stewardship policies and the way in which they intend to exercise them while outsourcing certain activities to other market participants. According to the Kay Report, the distance between companies and institutional investors had already been lengthened considerably, thus making effective communication problematic between these two actors, as well as any possible interaction in dialogue and collective agreement on how to improve corporate governance strategies[28]. Therefore, the requirement for disclosure regarding the overall investment chain and its compatibility with the stewardship responsibilities is highly useful, as it allows the reader of the statement to understand whether the institutional investor has minimised any possible risk that could impede the effective presence of stewardship through the outsourcing of services to other financial intermediaries or, on the contrary, the fragmentation of relationships is persistent with a problematic conception and application of stewardship responsibilities.

According to the second principle, institutional investors should adopt a rigorous policy in order to manage conflicts of interest in relation to their stewardship role, then they should disclose this policy accordingly[29]. This kind of disclosure is extremely beneficial, as institutional investors' principal role is to represent the interests of their clients. This framework can create delicate situations where conflicts of interest are likely to arise on an institutional, individual or even group basis, creating enormous difficulties in the effective exercise of stewardship responsibilities[30]. The Code thus invites institutional investors to disclose their strategies for dealing with such issues. The interesting improvements made with the new revised

[28] J. KAY, *supra*, note 24, p. 30.

[29] *Stewardship Code*, *supra*, note 2, p. 6.

[30] For a series of possible conflicts of interest, see: Bernard BLACK and John COFFEE, "Hail Britannia? Institutional Investor Behavior Under Limited Regulation", (1994) 92 *Michigan Law Review* 1997, 2068. See also: Simon C. Y. WONG, "How Conflicts of Interest Thwart Institutional Investor Stewardship", (2011) *Butterworths Journal of International Banking and Financial Law* 481, at <http://ssrn.com/abstract=1925485> (accessed 10 August 2012).

version of the Stewardship Code are that the duty to act in the client's interests is not solely conceived with regard to engagement and voting – which were mentioned in the initial version of the Code – but it is generally required by institutional investors, enlarging the scope and application of this duty[31].

Institutional investors have an obligation to protect the interests of their clients first of all with regard to any possible situations where conflicts of interest may arise. Moreover, the new version of the Code requires not just putting in place and maintaining, but also publicly disclosing the institutional investor's policy for contending with and managing all possible conflicts of interests and, furthermore, insists once again on the necessity of focusing on the protection of the client's interests as the ultimate priority.

Nevertheless, it is interesting to note that the 2007 ISC Statement of Principles had a requirement for institutional investors to explain how they would minimise or deal with conflicts of interest[32]. The current UK Stewardship Code refers only to the requirement of explaining how such conflicts are managed, with no further pressure on minimisation or avoidance of such situations. It could be stated that the newer text has taken something of a compromise approach on this subject even though there was "strong support for improved disclosure around conflicts of interest" from respondents to the consultation document during the recent revision of the Code[33]. A potential way to resolve this issue would be to adopt this provision once again in order to engage institutional investors to dis-

31 *Stewardship Code*, *supra*, note 2, p. 6.

32 Requiring institutional investors to explain their policy on how "situations where institutional shareholders and/or agents have a conflict of interest will be minimised or dealt with": Institutional Shareholders' Committee, *The Responsibilities of Institutional Shareholders and Agents – Statement of Principles*, 2007, p. 2, at <http://institutionalshareholderscommittee.org.uk/sitebuildercontent/sitebuilderfiles/ISCStatementofPrinciplesJun07.pdf> (accessed 16 January 2013).

33 As is stated in the same document, "[t]he FRC will assess the quality of disclosure under the revised Code before considering whether further changes are needed in future editions". Financial Reporting Committee, *Feedback Statement Revisions to the UK Stewardship Code*, 2012, at <http://www.frc.org.uk/getattachment/bfa5e0f5-6250-4336-b9ab-9a384a1b83a5/Feedback-Statement-UK-Stewardship-Code-September-2012.aspx> (accessed 16 January 2013).

close information about their strategies with regard to minimising such situations[34].

The Code goes further in trying to provide investors with guidance on how they should monitor their companies. Their monitoring role in this field can be achieved via periodic and continuous dialogue with the company. In that sense, the Code encourages them to be constantly updated on a series of critical issues, such as the company's performance, internal and external developments that affect its value and risks, the effectiveness of its leadership, and the company's reporting quality. Moreover, they should have meetings with the chairman and other board members, and attend general shareholders' meetings in cases where this is considered necessary and feasible[35].

The Code repeats the importance of accepting the deviation from the Corporate Governance Codes provisions in order to ensure full effectiveness of the "comply or explain" approach. In that sense, it encourages investors to give the company a timely explanation on certain points that a controversial topic may involve, and to be prepared to engage in a dialogue with them to clarify diverging opinions. None of the abovementioned strategies will be fully efficient unless institutional investors are interested in them or prepared to locate them at a very early stage. The Code addresses this priority by encouraging them to inform the company as soon as possible in order to avoid potential loss of shareholder value, on the one hand, and to have a chance to engage in constructive dialogue that might resolve the problem, on the other.

The Code then turns to institutional investors' means of potential intervention and their transparency. Investors should be in a position to have a clear set of plans to influence a company's corporate governance strategy. In that respect, they must disclose certain circumstances that might trigger an active intervention, and assess the outcome of this strategy on a regular basis. Moreover, they are required to disclose reasons for not intervening in a company's strategy[36]. This set of obligations is aimed at enhancing the transparency of the approach adopted by various inves-

34 Simon C.Y. Wong, "The UK Stewardship Code: A Missed Opportunity for Higher Standards", in *Responsible Investor*, 13 July 2010, at <http://ssrn.com/abstract=1640897> (accessed 16 January 2013). See also: S. C. Y. Wong, *supra*, note 30.

35 *Stewardship Code*, *supra*, note 2, p. 7.

36 *Id.*, p. 8.

tor groups so that their clients can understand their underlying motivations in managing investments, as well as their perception of the crucial character of any event that may or may not justify their intervention. In this perspective, the regulator will have an opportunity to understand how institutional investors value their role in the corporate world and to guide them in the future regarding the expansion of their activities. This aim is apparent in the same text, as an indication is given regarding social and environmental matters that might trigger institutional investors' intervention with a company.

The Code goes further in suggesting a gradual level of intervention, beginning with a confidential discussion with the company, and gradually leading up to demanding a change in board membership at a general meeting[37]. This escalated intervention scheme seeks to educate institutional investors and ensure that matters are not only dealt with in a timely framework, but also in an appropriate one. Various situations with different degrees of seriousness require different methods of intervention and reactiveness by investors, and this gradual intervention scheme seeks to ensure that activism comes hand in hand with a sophisticated and well-prepared strategy.

Moreover, the Code encourages institutional investors to act collectively with other similar groups, without further specifying possible ways of developing such initiatives, as it should be up to various groups to create and activate such potential links[38]. This kind of collaboration seeks to achieve an appropriate effect while respecting the delicacy of certain moments of financial distress during financial crises affecting the company or the broader economy. A collective response by various groups of investors, who are able to engage in a similar way during a critical moment in a company's existence, is crucial. Such investors are expected to disclose

37 *Id.*

38 As it had been mentioned already by the FRC, "[i]nsofar as institutional investors do feel their individual influence is waning, this highlights the importance of collective engagement. Institutions therefore need to find a way of working together more strategically and proactively": Financial Reporting Council, *Developments in Corporate Governance 2011, The Impact and Implementation of the UK Corporate Governance and Stewardship Codes*, 2011, p. 27, at http://www.frc.org.uk/getattachment/5f4fada9-2a88-43a4-bbec-be15b6519e79/Developments-in-Corporate-Governance-2011-The-impact-and-implementation-of-the-UK-Corporate-Governance-and-Stewardship-Codes.aspx> (accessed 16 January 2013).

their policies in that respect. The scope of this principle is not just to extract information about how the strategy of an investor group can be shaped along with that of another group, but also to encourage interconnectivity between the same pools of investors in a wider context, since they will ultimately all be affected by the company's progression. With regard to information disclosure, institutional investors are required to give samples of circumstances that would trigger an eventual participation in a collective action with other similar groups. This kind of information is particularly helpful to their clients, since they will be able to understand the institutional investors' approach to this issue and to evaluate further the depth and quality of their collective activism[39].

The Code also addresses the delicate issue of voting policies and requires investors to vote all shares that are held without automatically supporting the board[40]. This requirement arises from past events where shareholder activism was confused with a rather simplified approval of companies' strategies and ultimately translated into shareholder apathy. As is well known, a lot of investor groups were partially responsible for the magnitude of the financial crisis, especially because they did not question risky strategies, as they were influenced by the potential profits that could be generated. Having been considered, fortunately or unfortunately, as part of the problem, the Code requires them to become much more present even if they do not approve the strategies adopted, and especially to engage in an active dialogue with the company instead of just avoiding exercising their rights. They can thus either register an abstention or vote against the resolution if the dialogue has not reached a convincing outcome. In either case, they should inform the company of their intentions in advance and explain their position. Under a more general framework, they are required to publicly disclose voting records that will be useful for their clients.

39 It would be useful to remind that if institutional investors had adopted a collective response to the unreasonable remuneration packages of CEOs during the period preceding the financial crisis, banks would not have been so keen on disregarding some critical approaches coming from few similar groups but they would have taken into a much stronger consideration a collective reaction from investors. This could have eventually helped to avoid maintaining those remuneration policies based on excessive risk business strategies.

40 *Stewardship Code*, *supra*, note 2, p. 9.

Two additional requirements, introduced by the new version of the Code in 2012, are related to voting services and stock lending. As is well known, these two issues were at the centre of the debate regarding the intermediation of other market participants and its effects on the exercise of voting rights which may impede the efficient exercise of stewardship. The Code seeks to extract information from institutional investors regarding their potential use of proxy voting or other voting-related services in order to increase the transparency of an additional circle of connections with providers. Moreover, institutional investors are required to describe the aim of those services, name the providers and disclose information regarding the level of use of recommendations related to those services. Finally, they must be transparent with regard to their conception of stock lending and when they decide to recall the stock lent in order to inform investors about their strategies in that respect[41]. Stock lending is widely considered to be an impediment to the exercise of effective shareholder activism since it blocks a potentially powerful exercise of voting rights.

The last principle of the Code seeks to make institutional investors – both asset managers and owners – much more accountable to their clients. In that sense, asset owners are required to report on a periodic basis – at least annually – their stewardship activities in order to explain the perception of the policies adopted and how they have executed them throughout the year. As far as asset managers are concerned, they must provide information about the exercise of their stewardship responsibilities on a regular basis. The context of information itself should be an object defined between them and their clients[42]. For that reason, the Code refrains from intervening in the type of information ideally provided, since this context requires maximum flexibility. Every investor group has different priorities, and its agents may have diverse perceptions of the right strategy to achieve a positive outcome on an investment. Hence the Code suggests transparency with a certain amount of limits, since confidentiality might prove to be a productive means to assuming stewardship responsibility instead of disclosing all strategies adopted[43].

41 *Id.*

42 *Id.*

43 A further requirement to increase the credibility of asset managers' statements regards the reception of an independent opinion in relation to their engagement and voting policies. Asset managers that have become signatories of the Code should obtain a statement following either international or national standards: for the UK, see the

II. The imperfections of the Code

As previously mentioned, the UK Stewardship Code has undergone some improvements with the 2012 revision. This allows for a certain optimism for its future influence on market participants. Nevertheless, there are certainly several issues that need to be addressed further for the Code not to be perceived any more as a "document that appears to reflect lowest common denominator compromises"[44]. It is therefore necessary to concentrate on a series of issues and propose an enlargement of the Code's scope.

A. The territorial effect of the Code

The basic concern about the revolutionary impact of the Code lies in the fact that since it is a Code addressed to UK-based institutional investors, it basically fails to achieve an international impact, especially with regard to overseas investors, and furthermore reiterates principles and practices that are already largely followed by national market actors.

Indeed, as it is applicable only to national market actors, one could expect its provisions to be very stringent, especially given the historical background in this area, as previously analysed, namely all the previous ISC Statements of Principles that substantially prepared market actors for this kind of regulatory evolution. Nevertheless, the Stewardship Code has taken a rather 'soft' approach in terms of the rigour of its context and the level of transparency sought from the signatories. According to research carried out in the past few years, a large majority of UK-based fund managers already adhered to the statements of Principles of the ISC Code in its 2005 version[45]. It comes as no surprise that the Code has been considered

Institute of Chartered Accountants in England and Wales at <http://www.icaew.com/en/technical/audit-and-assurance/assurance/technical-release-aaf-01-06>. This additional requirement seeks to improve the trustworthiness of their declarations and introduces a private monitoring mechanism in order to ensure better quality in the information disclosed.

44 S.C.Y. Wong, *supra*, note 34.

45 See, for example: Investment Management Association, *Survey of Fund Managers' Engagement with Companies for the Two Years Ended 30 June 2008,* 2009, at <http://www.investmentfunds.org.uk/assets/files/press/2009/20090520-2-01.pdf> (accessed 16 January 2013).

a "restatement of existing industry practices"[46] since it testifies to a certain compromise between already existing calls for more active shareholder engagement and barriers to greater transparency of institutional shareholders' and asset managers' practices[47].

Moreover, the Code's applicability to "all institutional investors" could also be construed as covering overseas investors. Thus, the Code in theory addresses its principles to this category of the market as well. Nevertheless, it fails to expand its territorial effect to the overseas market, aiming basically and mainly at the national market[48]. Under this reality, overseas investors are simply encouraged to declare voluntarily how they apply the principles of the Code, and moreover, according to the same text, they should not feel that compliance creates a further regulatory burden, as they can always use the explanatory part of the "comply or explain" approach if they follow other national or international standards[49]. This situation is certainly disappointing, especially given the fact that overseas investors have considerable shareholdings in the UK market and the Code should constrain them to follow its principles and not just expect them to become signatories. Therefore, it remains to be seen whether they will adhere to its principles given that it is only intended to engage them on a purely voluntary basis. Thus, the true challenge of the Code is to convince this part of the market, taking into consideration especially the fact that the shares in UK-listed companies are now largely held by investment schemes not based in the UK. The predominance of overseas investors in the UK market makes it quite unrealistic to expect shareholder activism to become much more feasible thanks to the Code.

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46 Roman TOMASIC and Folarin AKINBAMI, "Towards a new corporate governance after the global financial crisis", (2011) 22(8) *International Company and Commercial Law Review* 237. See also: Iain MACNEIL, "Activism and Collaboration among Shareholders in UK Listed Companies", (2010) 5(4) *Capital Markets Law Journal* 419.

47 Brooke MASTERS and Kate BURGESS, "Investors raise fears on 'Stewardship Code' ", (15 April 2010) *Financial Times*, at <http://www.ft.com/cms/s/0/9da94b7a-48c9-11df-8af4-00144feab49a.html#axzz29aKQ0Xle> (accessed 16 January 2013).

48 Brian R. CHEFFINS, "The Stewardship Code's Achilles' Heel", University of Cambridge Faculty of Law Research Paper 28/2011, 2010, p. 21, at <http://ssrn.com/abstract=1837344> (accessed 16 January 2013). See also: Arad REISBERG, "The notion of stewardship from a company law perspective", (2011) 18(2) *Journal of Financial Crime* 126, 135 and 136.

49 *Stewardship Code*, *supra*, note 2, p. 3.

In an additional perspective, overseas investors are undoubtedly less interested than national ones in increasing their stewardship responsibilities towards UK companies. Moreover, geographical distance does not help to build a solid and long-term relationship with the managers of the company[50] since according to their strategy it might be preferable and save time to continue to trust the board of directors, as long as profits are generated, or to change for another company instead of engaging in a long discussion about ways to improve the company's current management methods. The constant fragmentation of the share ownership scheme thus makes it more arduous to convince both national and overseas investors to engage in a more sophisticated perception and application of their stewardship responsibilities.

Moreover and most importantly, as it has been shown recently, there is a "hidden truth of practice", which is basically based on the premise that:

> "in practice, companies operate in an ever-changing business world, a more rapidly changing business practice with more pressures and complexity and, more important, with more diverse 'players' and conflicting interests at play. Although this is hardly a revelation, it may still underline or better explain or, in fact, provide a fuller account for some of the difficulties facing regulators, such as the FRC, as they try to take stock of companies, their operations and the way in which they are run."[51]

Indeed, any possible regulatory effort of this sort needs to take into account that the principles provided as a reference are subject to use by a very diversified spectrum of national, and much more important, overseas investors from different corporate cultures and having already converging or contradictory priorities in terms of engagement with companies.

The Stewardship Code is therefore inevitably affected by this reality, and the only thing that will contribute decisively towards its effective adoption by overseas investors is market convergence in terms of acknowledgement, understanding, application and compliance with a set of best practices. Nevertheless, this convergence needs to move along with the Code and not come immediately after its introduction, as it would be utopic to conceive compliance through stringent rules without a common perception of the above-mentioned priorities. This conclusion leads to the

50 B. R. Cheffins, *supra*, note 48, p. 31.
51 A. Reisberg, *supra*, note 48, 136.

assumption that the Code will still need time to "attract" compliance from abroad and act as an exemplary document. The 'hidden truth of practice' clearly shows that adapting to a flexible but precise set of rules will be subject to a series of further discussion and compromises between market participants and companies. Given the above-mentioned diversity of the corporate and investment landscape, the "softness" of the regulatory approach is the only possible way forward for the current period, even though it lacks enforceability and is therefore another imperfection of the Code itself.

B. The "softness" of the Code

A further problem with the Code is therefore its overall effectiveness. As a soft regulatory tool that encourages but does not require compliance with a set of principles[52] and is dependent on the "comply or explain" approach, it is highly unlikely that institutional investors will show immediate results in terms of compliance and a change in current practices. This is partially because the softness of the intervention itself presents a series of deficiencies.

As is well known, the 'comply or explain' approach was introduced by the Cadbury Report in 1992[53]. With already a 20-year tradition in the UK corporate landscape, it has certainly achieved a better result regarding compliance with a standard set of principles, maintaining necessary flexibility amongst a largely diversified corporate landscape[54], but has also triggered a series of criticisms regarding its effectiveness and usefulness. In the UK Stewardship Code framework, the 'comply or explain' approach will probably be accepted, but it will certainly continue to trigger mixed feel-

52 For a discussion on the debate "soft law v. hard law", see: Ruth V. Aguilera, Michel Goyer and Luiz Ricardo Kabbach-Castro, "Regulation and Comparative Corporate Governance", in Mike Wright, Donald S. Siegel, Kevin Keasey and Igor Filatotchev (eds.), *Handbook of Corporate Governance*, Oxford, Oxford University Press, p. 22-28, at <http://ssrn.com/abstract=2071191> (accessed 16 January 2013).

53 Every company is thus required to comply with the corporate governance code or to explain the reasons it has decided not to do so.

54 Oliver Hart, "Corporate governance: some theory and implications", (1995) 105(430) *The Economic Journal* 678. See more generally: Reinier Kraakman, John Armour, Paul Davies, Luca Enriques, Henry B. Hansmann, Gérard Hertig, Klaus J. Hopt, Hideki Kanda and Edward B. Rock (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Oxford, Oxford University Press, 2004.

ings about its wide acceptance and use by the majority of institutional investors.

Experience from Corporate Governance Codes and the 'comply or explain' approach has already shown that the issue is twofold: on the one hand, companies in some countries struggle to comply with the Code[55] but even in the case where they declare compliance, the true level of compliance seems questionable since a mere declaration cannot always correspond with a pragmatic one[56]. On the other hand, when companies use the explanatory part of the principle in order to explain the reasons for non-compliance, they tend to give perfunctory explanations that prove useless for investors since they lack the necessary degree of transparency and informativeness[57].

In order to emphasise the importance of the "comply or explain" approach to the success of the Stewardship Code, the FRC has dedicated a separate section in the updated version of 2012. Departing from a simple reminder of the basic function of this approach, as in the first version of

55 See, for example, the UK annual review, according to which 50% of companies reported full compliance with the UK Corporate Governance Code, and the remaining 50% that declared non-compliance had difficulty complying with one or two provisions of the Code. Overall, the level of compliance with the Code's provisions reached 96%, which is objectively a relatively satisfactory percentage: Grant THORNTON, "Corporate Governance Review 2011, A changing climate: Fresh challenges ahead", 2011, at <http://www.grant-thornton.co.uk/pdf/corporate_governance.pdf> (accessed 16 January 2013). Nevertheless, there is still room for improvement, especially in countries where levels of compliance are particularly low: for an overview, see: RISKMETRICS GROUP, *Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States*, 2009, at <http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923_en.pdf> (accessed 16 January 2013). See also Sridhar ARCOT and Valentina Giulia BRUNO, "One Size Does Not Fit All, After All: Evidence from Corporate Governance", 1st Annual Conference on Empirical Legal Studies, January 2007, at <http://ssrn.com/abstract=887947> (accessed 16 January 2013).

56 David F. LARCKER and Brian TAYAN, "Seven Myths of Corporate Governance", Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance CGRP-16, 2011, at <http://ssrn.com/abstract=1856869> (accessed 16 January 2013).

57 Joseph A. MCCAHERY and Erik M. VERMEULEN, "The Role of Corporate Governance Reform and Enforcement in the Netherlands", in Michel TISON, Hans DE WULF, Christoph VAN DER ELST and Reinhard STEENNOT (eds), *Perspectives in Company Law and Financial Regulation*, Cambridge, Cambridge University Press, 2009, p. 322.

the Stewardship Code, the new version goes further by requiring that the signatories deliver meaningful explanations whenever they decide not to comply with one of the principles or to adhere to the approach adopted by the guidelines in each one of the principles[58]. The concept of "meaningful explanation" was introduced in the "comply or explain" approach quite recently[59] and has provided for a more clear rationale in order to maintain the principle itself. Earlier this year, the FRC began a consultation process in that respect[60], after having met with senior investors and companies in December 2011 to discuss the notion of "meaningful explanation."

The results of those meetings were published in February 2012[61]. In non-compliance cases, it is indeed necessary to provide not just a mere explanation, but a meaningful one so that readers can evaluate the statement and understand the signatory's approach to the concept of stewardship.

Regarding the context of a "meaningful explanation" as such, the FRC consultation document issued three criteria: firstly, the explanation should provide the context and the historical background; secondly, it should provide a convincing argument for the solution adopted by the company and further analyse any potential moderating actions that have been taken by the company in order to resolve any eventual additional risks and to ensure a certain level of compliance with the Code's provisions; thirdly, the company should explain whether the respective deviation was limited in time and when it intends to start complying with the Code's provisions again[62]. These three criteria could easily be adopted in the framework of the Stewardship Code, and thus the signatories should be involved in such

58 *Stewardship Code*, *supra*, note 2, p. 4.

59 Financial Reporting Council, *What Constitutes an Explanation under "Comply or Explain?" Report of discussions between companies and investors*, 2012, at <http://www.frc.org.uk/getattachment/590dd61a-d3b1-4a2e-a214-90f17453fa24/What-constitutes-an-explanation-under-comply-or-explain.aspx> (accessed 16 January 2013).

60 Financial Reporting Council, *Revisions to the UK Corporate Governance Code and Guidance on Audit Committees – Consultation document*, 2012, at <https://www.frc.org.uk/getattachment/4794e206-50a7-45d1-815c-7393046fef33/Consultation-Document-revisions-to-the-UK-Corporat.aspx> (accessed 16 January 2013).

61 Financial Reporting Council, *supra*, note 59.

62 *Id.*, p. 6.

a disclosure in order for readers of their statements to be able to understand the reasons for non-compliance.

In order not to experience the same series of problems with the Stewardship Code, the only possible solution would be to bolster trust in the principle itself and convince institutional shareholders and fund managers to make full use of the explanatory part in order to analyse their own personal strategy that happens to be less suitable to the principles. Moreover, in the eventual case that levels of compliance remain low in the future, a more stringent monitoring framework could be developed by the national authority in order to control compliance with the Code and exchange views and practices with various groups of investors.

As far as the reaction of institutional investors to non-compliance statements is concerned, they are expected to include their perception when they consider and evaluate explanations made by companies to the Code. This latter aspect is deemed to be crucial since it is well known that companies are expected to use the "comply or explain" approach to justify any deviations from the Code under the assumption that investors will not immediately consider such a position to be a breach of the Code but instead a sign of its flexibility. The legal framework and the basic logical premise of this approach is based on the fact that a meaningful explanation is not considered to be a breach, but is encouraged, especially when a company is not in a position to comply with the Code[63]. Therefore, the UK Stewardship Code tries to establish an internal connection with the UK Corporate Governance Code, since both codes operate in the same sphere of activity and more specifically they strive to establish their legitimate framework upon which transparency is to be conveyed.

According to the latest version of the Code,

63 This approach is strongly backed by the FRC, which has already clarified in the most obvious way that "[w]hilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way, and departures from the Code should not be automatically treated as breaches": FRC, *UK Corporate Governance Code*, June 2010, p. 4. For a similar academic approach, see: David SEIDL, Paul SANDERSON and John ROBERTS, "Applying 'Comply-or-Explain': Conformance with Codes of Corporate Governance in the UK and Germany", Centre for Business Research, University of Cambridge Working Paper 389, 2009, at <http://www.cbr.cam.ac.uk/pdf/WP389.pdf> (accessed 16 January 2013).

"[i]n their responses to explanations, clients and beneficiaries should pay due regard to the signatory's individual circumstances and bear in mind in particular the size and complexity of the signatory, the nature of the risks and challenges it faces, and the investment objectives of the signatory or its clients."[64]

It is thus clear that the Code seeks to address the delicate issue of evaluation of a stewardship statement by trying to justify the needs of both parties, namely the complex structure and the challenges that the signatory might be facing on the one hand, and the need for more transparency on its general strategies needed by clients so that they can assess the rationale of their choice, on the other. On this point, the Code reiterates that the use of the explanatory part of the "comply or explain" principle should not be considered a breach of the Code. As in the case of the UK Corporate Governance Code, the FRC is trying to avoid heavy reputational sanctions by market participants[65], which might be unreasonable if exercised without a further in-depth analysis of the explanation provided and which can substantially harm a company's or an institutional investor's position[66].

The Code seeks to convince the signatory's clients to engage in an active dialogue and more generally both parties to be prepared to discuss the problematic issues. It is crucial to convince the ultimate beneficiaries not to choose the quickest and easiest option of selecting another manager for their assets due to the fact that non-compliance with the Code might be interpreted immediately as non-fulfilment of the role they were initially expecting. It is therefore necessary for the beneficiaries to understand their stewardship role in such a context, and as they are invited to engage in a more active way with the investee companies, they should do

64 *Stewardship Code*, *supra*, note 2, p. 4.

65 John Armour, Colin Mayer and Andrea Polo, "Regulatory Sanctions and Reputational Damage in Financial Markets", Oxford Legal Studies Research Paper 62, 2010, at <http://papers.ssrn.com/sol3/papers.cfm? abstract_id=1678028> (accessed 16 January 2013); Cindy Alexander, "On the Nature of the Reputational Penalty for Corporate Crime: Evidence Penalties: Public and Private", (1999) 42 *Journal of Law & Economics* 489.

66 Especially in the case where investors feel that non-compliance associated with poor explanations do not meet their criteria and they decide to penalise the company by altering the investment decision and thus by triggering a negative impact on its share price: Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law*, Cambridge, Harvard University Press, 1996.

the same with the market participants that are managing their assets in order to establish a relationship of trust and not to seek immediate replacement[67]. The Code emphasises this last point – and wisely so – since it has become a common practice to substitute managers according to evaluation criteria that should be reviewed in the future, as will be discussed later in this paper, and the same risk exists with explanations of Code non-compliance.

C. The exclusion of stakeholders from the dialogue spectrum

The Code's current form focuses on establishing a more active dialogue between companies and institutional investors. One equally important issue, namely the potential development of a constructive exchange of views with all stakeholders, is left outside the scope of the Code. It is rather frustrating that two years after the first version of the Code and the emerging importance of sustainable development issues in the investment chain, the chance was not seized to broaden the spectrum of dialogue with stakeholders. Therefore, a future form of the Code could concern institutional investors' potential engagement with all stakeholders, and more specifically the requirement to disclose how they intend to exercise such a role and the activities that they could develop with all interested parties. Acting in their clients' best interests entails taking care of a wide variety of issues, and to deal with these, they can greatly benefit from an interaction with stakeholders affected by the company's activities.

The benefits of such cooperation could be numerous. First of all, institutional investors would be able to receive valuable information on how stakeholders perceive the investee companies' plans and possibly present companies' boards with other priorities that are equally important to long-term development. Secondly and most importantly, they could become more aware of another series of issues that might have escaped their own agendas or that of their clients while investing in a certain company. The various types of stakeholders can thus help them improve their openness and prioritisation of several broader issues, such as environmental, social and ethical topics. They could thus act as surprisingly good stewards by showing clients that they go above and beyond their initial

67 *Stewardship Code*, *supra*, note 2, p. 4.

mandate and strive to satisfy additional requirements in order to exercise stewardship responsibilities in an exemplary fashion. The only disadvantage of such an additional potential requirement would be the cost involved in communication with stakeholders since additional time and staff would have to be dedicated. Stakeholders might be numerous, especially in the cases of companies with varied activities and several potential sectors affected by its operations. Nevertheless, as will be shown later on in this paper, fiduciary duties should include sustainable development concerns, and alternative incentives for asset owners or managers should therefore be implemented for such a broadening of their mandates to be feasible and interesting.

III. Broader challenges for a more efficient company/investor relationship

Apart from the above-mentioned obstacles, which are closely related to the structure and nature of the Stewardship Code, there are other broader and equally important factors that need to be taken into consideration in any kind of debate aimed at improving stewardship responsibilities[68]. As was recently stated in the Kay Report, the distance between a company and its investors continues to become lengthier and more complicated due to a series of factors that characterise modern investment and trading techniques[69]. Financial intermediaries continue to increase and this does not facilitate the establishment of a true dialogue between a company and shareholders. Moreover, the tendency to diversify investment portfolios does not encourage shareholders to commit themselves in a long-term relationship with the investee company. Current investment strategies and the very nature of institutional ownership have become extremely complicated and interrelated to a series of other investment priorities that need closer examination. More precisely, there is a range of issues that will continue to be a preoccupation despite regulatory reform aimed at changing the market's investment mentality.

68 A series of obstacles to greater shareholder activism has already been analysed by the Treasury Committee: Treasury Select Committee, *supra*, note 18, par. 179.

69 J. Kay, *supra*, note 24, p. 22.

A. Change in investment strategies

The Stewardship Code currently aspires to an effective monitoring role and disclosure framework that may be difficult to apply effectively due to the nature of institutional shareholders' current practices[70]. More precisely, fund managers and institutional investors might not be interested in being engaged in lengthy and time-consuming discussions with companies, and they might prefer just to alternate their portfolio investments[71]. The growing trend towards portfolio diversification in order to mitigate market risk is a counter-indicator of the proximity that should exist between investors and companies since it becomes a true conundrum either for the institutional investors or their fund managers to maintain a beneficial contact with every single investee company, especially when hundreds might be included in the same portfolio[72]. Monitoring the activities and strategies of those companies, as well as engaging in a dialogue in order to draw managers' attention to crucial issues, thus becomes quite

[70] For a more general analysis on the correlation between regulatory reforms that aim to increase shareholders' rights and the actual improvement in shareholder activism, which does not always seem so obvious, see: Jose Miguel MENDOZA, Christoph VAN DER ELST and Erik P. M. VERMEULEN, "Entrepreneurship and Innovation: The Hidden Costs of Corporate Governance in Europe", Lex Research Topics in Corporate Law & Economics Working Paper No. 2/2010, 2010, p. 29-34, at <http://ssrn.com/abstract=1698352> (accessed 16 January 2013).

[71] Subodh MISHRA, "Questions remain on UK Stewardship Code", Riskmetrics, 4 May 2010, at <http://blog.issgovernance.com/gov/2010/05/questions-remain-on-uk-stewardship-code.html> (accessed 16 January 2013).

[72] As has been correctly mentioned, diversification as such has numerous advantages since risk is minimised, but if we accept that the ultimate beneficiaries are not in a position to effectively supervise all the companies in which they are investing, the overall risk will increase in the financial markets due to the absence of effective stewardship. Under this scenario, risk as such might not be priced in correctly by the markets and if it reaches considerable dimensions, it might lead to a systemic destabilisation of the market: Stephen M. DAVIS, Jon LUKOMNIK and David PITT-WATSON, "Active Shareowner Stewardship: A New Paradigm for Capitalism", (2009) 2(2) *Rotman International Journal of Pension Management* 10, 12.

burdensome[73] or even unrealistic in current investment strategies[74]. Shareholders are not very interested in engaging in such activities since they know that the "exit" possibility is a quicker and – in their perception – safer method of managing their portfolios[75]. However, concentrating on a reduced number of holdings would be preferable since it would allow asset owners and managers to better engage investee companies. A large portfolio is unlikely to yield the desire or possibility for those market actors to monitor the entire group of investee companies effectively.

Keeping a core number of holdings would thus create a much more active awareness of the importance of being the asset owner and would eventually trigger a series of initiatives from investors[76]. Monitoring activities would become much more efficient and feasible for both investors and their asset managers. This would eventually create a much more active dialogue with companies and a closer examination of corporate strategies. Additionally, companies aware of this change in the monitoring approach would be much more careful and open to arguments put forth by investors, as they would understand that the investment approach is focused on individual aspects of their company's profile, rather than on just a company that forms a small part of their portfolio[77]. A certain optimism is

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73 Since extra resources might have to be dedicated in order to monitor all investee companies with the inevitable increase in costs: EUROPEAN COMMISSION, *Corporate governance in financial institutions: the lessons to be learnt from the current financial crisis and possible steps forward*, Commission Staff Working Document, SEC (2010) 669 (2 June 2010), p. 25, at <http://ec.europa.eu/internal_market/company/modern/corporate_governance_in_financial_institutions_en.htm> (accessed 16 January 2013).

74 FINANCIAL REPORTING COUNCIL, *Developments in Corporate Governance 2011, The Impact and Implementation of the UK Corporate Governance and Stewardship Codes*, 2011, p. 26, at http://www.frc.org.uk/getattachment/5f4fada9-2a88-43a4-bbec-be15b6519e79/Developments-in-Corporate-Governance-2011-The-impact-and-implementation-of-the-UK-Corporate-Governance-and-Stewardship-Codes.aspx> (accessed 16 January 2013). For a sceptical approach with regard to the opportunity of more active shareholder engagement in companies' corporate governance issues, see: Anthony GOODMAN, "Investors – Be Careful What You Wish For", (5 July 2010) *Financial Times*, at <http://www.ft.com/cms/s/0/5db3186c-8847-11df-a4e7-00144feabdc0.html#axzz29aKQ0Xle> (accessed 16 January 2013).

75 See also: J. KAY, *supra*, note 24, p. 20 and 21.

76 Simon C. Y. WONG and Peter BUTLER, "Essential Steps to Close the 'Stewardship Deficit' ", (3 June 2012) *Financial Times*, at <http://ssrn.com/abstract=2111602> (accessed 16 January 2013).

77 On the difficulty of monitoring companies when the investment is relatively small, see: Jaap W. WINTER, "Shareholder Engagement and Stewardship: The Realities and Illu-

allowed in that sense since the number of signatory parties of the Code continues to increase[78], and this trend shows that the climate might change in the future as many more institutional shareholder groups and fund managers are willing to adhere to a certain set of principles that is different from the extremely fluid and volatile strategy adopted by those groups in the past.

Moreover, the presence of the passive investment model, which supports in theory but not in practice a long-term presence in the stock ownership of a company and precludes exiting individual holdings, actually undermines the importance of active stewardship since its current function is restricted for asset managers to remain in the acceptable percentage of index return rather than to engage in a more active exercise of their stewardship responsibilities and show their clients that their contribution is beneficial in the long term. Indeed, as it has been stated by UK pension funds[79], the majority seeks to evaluate asset managers by understanding if they have remained in the acceptable amount of error performance without going further and scrutinising the eventual activities that they have developed as stewards of their assets. Moreover, asset managers prefer not to engage in those activities since their basic concern is not to lose their clients' mandate.

It is therefore crucial to change the philosophy of the passive model in order to encourage both investors and managers to engage in more active stewardship. For this proposal to be put into effect, it would be preferable if the above-mentioned fees for good stewardship were introduced and implemented effectively. Moreover, given the fact that passive management is very popular and covers a substantial percentage of the assets owned by institutional investors, there might be an incentive to start engaging asset managers to a minimum of activity in terms of stewardship. This would not alter the basic mentality of the passive investing model, but it would at least avoid completely passive strategies that risk

sions of Institutional Share Ownership", p. 3, at <http://papers.ssrn.com/sol3/papers.cfm? abstract_id=1867564> (accessed 16 January 2013).

78 The list is on the FRC's website: <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code/UK-Stewardship-Code-statements.aspx> (accessed 16 January 2013).

79 Simon C. Y. Wong, "Why Stewardship is Proving Elusive for Institutional Investors", (2010) *Butterworths Journal of International Banking and Financial Law* 406, 409.

maintaining erroneous approaches to investing and encouraging inadequate corporate strategies[80].

One other priority, if the ultimate purpose of regulation is to reintroduce an efficient dialogue between companies and institutional shareholders, should be fundamental change in the investing mentality, namely the reorientation of companies' targets towards a long-term perspective[81]. Companies are often subject to various forms of pressure from institutional groups in order to meet short-term targets[82]. This counter-trend to the passive investment model, previously analysed, is also gaining strength, and if it is reiterated on several occasions, the risk of constant overestimation of a company's prospects is imminent and can lead to a partial or total loss of the company's real value[83].

It can be said with certainty that short-termism goes along with investor apathy, since in the presence of immediate targets, investors tend to pay less attention to the exercise of their voting rights, the general corporate strategy for the future, and the company's management philosophy[84]. Being thus concentrated on short-term profits, they exercise a form of trading activeness, which is the exact opposite of "shareholder activism", namely a greater involvement in corporate affairs, since they ignore the priority of the change in the corporate strategy and exclusively favour the meeting of a specific set of targets[85]. Under this assumption, achieving

80 *Id.*, 411.

81 Simon C. Y. Wong, "How Institutional Investors Should Step Up as Owners", (2010) *The McKinsey Quarterly*, 3, at <http://ssrn.com/abstract=1675443> (accessed 16 January 2013).

82 Caitlin Helms, Mark Fox and Robert Kenagy, "Corporate short-termism: causes and remedies", (2012) *International Company and Commercial Law Review* 23(2), 45. See also: Dean Krehmeyer, Matthew Orsagh and Kurt N. Schacht, "Breaking the Short-Term Cycle", 2006, p. 17 and 18, at <http://www.corporate-ethics.org/pdf/Short-termism_Report.pdf> (accessed 16 January 2013).

83 Michael Jensen, "Agency Costs of Overvalued Equity", (2005) 34(1) *Financial Management* 5, 5.

84 Corporate Values Strategy Group, *Overcoming Short-termism*, 2009, at, <http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/overcome_short_state0909_0.pdf> (accessed 16 January 2013).

85 This situation could not be explained any better than it has been described by the Kay Report as "the rise of an ethos which emphasized transactions and trading over relationships": J. Kay, *supra*, note 24, p. 27.

trading activity at all costs and all forms has a strong potential of harming the company instead of functioning as an 'alert signal' for its management.

In order to achieve a change in investors' mentality and reduce these risks, the UK Stewardship Code endeavours to fulfil an educational role by encouraging disclosure of information with regard to the ultimate objectives in the agendas of groups or other asset managers, as well as the conception of their role. Improvement in the investing philosophy will not be accomplished immediately since educating investors and their asset managers will be a long and arduous process[86]. Nevertheless, it is the only possible solution given that if investors start changing their demands towards companies and their asset managers, the cycle currently driven by short-term objectives will start functioning around a whole new series of priorities that have thus far been dissociated from long-term targets[87].

This task will not be without difficulties since, as is well known, ownership structures play a major role in shaping corporate culture[88]. It is believed that in companies with dispersed shareholding, management will be much more focused on short-term objectives, especially in comparison with family-owned businesses where the management board is much more closely associated with the company's identity and tends to pay more attention to longer-term plans as they strive to secure the company's continuous existence and prosperous development. Hence it will be very difficult to convince institutional investors to work with the management board to shape a new culture based on longer-term profits and prospects. The contribution of some well-known investor groups, which have already proven to be highly beneficial in this respect, will thus be more than necessary.

In order for institutional investors to change their mentality, education should not be the only possible way of regulatory intervention. Providing financial incentives will help greatly towards this goal, as

86 See, for example, the creation of the Investor Academy in Australia, whose "mission is to foster a responsible investment profession through the provision of structured learning pathways, continuing professional development and opportunities for collaboration, research and innovation": <http://www.responsibleinvestment.org/ri-academy/>.

87 D. Krehmeyer, M. Orsagh and K. N. Schacht, *supra*, note 82, p. 17 and 18.

88 More generally on this topic, see: Brian R. Cheffins, *Corporate Ownership and Control: British Business Transformed*, Oxford, Oxford University Press, 2008.

institutional investor groups inevitably need additional motivation to adhere to a new investment technique. One way to encourage long-term trading would be to reduce capital gains tax rates for longer stockholding periods[89].

B. Reduction of financial intermediation

Another difficult situation arises from the fact that the distance between companies and investors continues to be extremely long, especially due to the predominant presence of financial intermediaries that manage assets, receive mandates or even act as consultants on some investments[90]. The circle of financial intermediaries has flourished considerably, notably due to the lack of trust and confidence in the role that managers were supposed to play when they were holding shares on behalf of a group of shareholders[91]. The numerous factors that can influence the entire investment chain created a need to increase the number specialised market actors whose main responsibility was to undertake a specific task, thus ensuring credibility for the task accomplished. More generally, this situation got easily out of control since the multitude of tasks to be performed generated an enormous number of controllers, consultants, managers and trustees who were ideally functioning in a collective and harmonious way between the company and the ultimate beneficiary of the investment, namely the shareholder. The distance between these two fundamental market actors thus became longer and shareholders lost the crucial contact with their investment and its impact on the overall performance of the company.

In this situation, both companies and investors struggle to understand their responsibilities in shaping a long-term relationship. The first step would thus be to start reducing the presence of unnecessary or even more complicated financial intermediaries in the chain leading up to the com-

89 Corporate Values Strategy Group, *supra*, note 84, p. 3.

90 Franklin Allen and Anthony Santomero, "What Do Financial Intermediaries Do?", (1998) 25 *Journal of Banking and Finance* 271; Eva Micheler, "Facilitating Investor Engagement and Stewardship", 2012, p. 11-13, at <http://ssrn.com/abstract=2046125> (accessed 16 January 2013); Usha Rodrigues, "Corporate Governance in an Age of Separation of Ownership from Ownership", (2010-11) 95 *Minnesota Law Review* 1822.

91 J. Kay, *supra*, note 24, p. 30.

pany's shares[92]. Furthermore, recent empirical research has shown that investors who become part of a rather distant and complicated chain of fund managers and consultants do not benefit from the same amount of return as those who decide to invest in a much more direct way[93]. One of the reasons for this difference is, amongst other things, the amount of management fees dedicated to a larger number of intermediaries present in the first scenario. It would thus be much more beneficial if reforms strengthened the evaluation and decision-making abilities of institutional investors instead of maintaining their dependence on a series of asset managers. The latter would obviously not disappear from the market, since they would still be employed to evaluate much more complicated issues for which institutional investors would remain unable to deal with.

C. Clarification of fiduciary duties

Further extending the argument of the increasing number of financial intermediaries, it would be important to repeat and reiterate that their perception of fiduciary duty is concentrated on satisfying their clients' best financial interests, which is erroneously conceived in a strict interpretation of the term "fiduciary duties"[94], namely translated in the maximisation of financial returns rather than allowing a broader interpretation such as the achievement of long-term objectives that will help companies grow further and will boost their investments[95].

With the current perception of fiduciary duties based on the assumption that the main priority is to secure immediate return for clients, it becomes challenging to change this mentality and convince asset managers that they can fulfil those duties while expanding their objectives and still working in their clients' best interests. It is therefore crucial to obtain a common understanding of the term fiduciary duties in this specific frame-

92 S.C.Y. Wong, *supra*, note 79.

93 Lily H. Fang, Victoria Ivashina and Josh Lerner, "The Disintermediation of Financial Markets: Direct Investing in Private Equity", INSEAD Working Paper No. 2012/109/FIN, 9 October 2012, at <http://ssrn.com/abstract=2159229> (accessed 16 January 2013).

94 *Id.*, p. 66-69.

95 Foundation for Governance Research and Education, *An Investigation into Stewardship: Engagement between Investors and Public Companies: Impediments and their Resolution*, 2011, p. 23, at <http://www.foundationgre.com/Stewardship%20Report%20Final%20-%2022.6.11.pdf> (accessed 16 January 2013).

work[96]. Asset managers cannot continue to conceive their fiduciary role exclusively as the guarantors of short-term returns for their clients. Long-term objectives, as well as the exercise of a different kind of evaluation, based on the quality of the decision-making and different priorities to be taken into consideration[97], should be included in the fiduciary obligations so that asset managers and owners not only reorient their mentality, but feel more comfortable participating as market actors in a more sophisticated and potentially less volatile framework.

To overcome this problematic interpretation of those duties, further regulatory or legislative action needs to be taken. As previously mentioned, the UK Stewardship Code refers to the importance of "enhancing and protecting the value for the ultimate beneficiary or client"[98]. This interpretation, although accurate and testimony to a certain improvement in the investment, is undoubtedly subject to various interpretations and does not clarify the necessity of enlarging the scope of fiduciary duties in the investment chain. In 2011, the FairPensions Report proposed more stringent obligations, namely the introduction of a new section in the 2006 Companies Act, parallel to section 172[99], which would introduce fiduciary obligations in the exercise of investment functions[100]. These duties could entail the consideration of a series of additional factors when seeking to ensure benefits for the ultimate beneficiary, such as the consequences of the investment decision in the long term, the impact on the

96 Corporate Values Strategy Group, *supra*, note 84, p. 4.

97 Such as corporate governance strategies, environmental, social and ethical issues involved in the activities of the investee company.

98 *Stewardship Code*, *supra*, note 2, p. 6.

99 "A director of a company must act in the way he/she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –
i) the likely consequences of any decision in the long term,
ii) the interests of the company's employees,
iii) the need to foster the company's business relationships with suppliers, customers and others,
iv) the impact of the company's operations on the community and the environment,
v) the desirability of the company maintaining a reputation for high standards of business conduct, and
vi) the need to act fairly as between members of the company."

100 FairPensions, *Protecting Our Best Interests: Rediscovering Fiduciary Duty*, 2011, p. 117, at <http://www.fairpensions.org.uk/sites/default/files/uploaded_files/fidduty/FPProtectingOurBestInterests.pdf> (accessed 16 January 2013).

stability of the entire financial and economic system, as well as various sustainable development issues[101], the equal treatment of present and future beneficiaries, and the maintenance of a good reputation in investment-making. Furthermore, the report proposes a new definition of "benefit" that would include not just the financial benefit, but "any non-financial benefit that the fiduciary considers can be conferred on beneficiaries without any material prejudice to their financial benefit"[102].

There is no doubt that the introduction of such a statutory obligation and the gradual abandonment of the Stewardship Code as a soft regulatory tool could ensure a higher level of compliance since enforcement of a hard law measure would be much more direct and feasible. Nevertheless, in the current investment era, the centre of attention seems to remain on soft law measures in order to increase awareness and compliance amongst an extremely diverse investment landscape. Market participants need to achieve gradual convergence in terms of the perception, exercise and effective application of the best practices included in the Stewardship Code. Once this compliance reaches a satisfactory level, the scenario for hard law requirements in order to ensure fiduciary duties would undoubtedly be beneficial and could be developed in the UK legal framework if deemed necessary.

D. Change in remuneration practices for asset managers

A further problem that needs careful consideration involves remuneration practices for asset managers and their ongoing relationship with institutional shareholders. The remuneration of asset managers is based on a purely short-term evaluation (a quarterly benchmark), which focuses on their capacity to generate short-term returns by exercising adequate pressure on investee companies towards that objective[103]. In this case, it is

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101 The UK Stewardship Code (2012) could be enlarged in this sense and require not just from asset managers but from asset owners as well to take into consideration the environmental or social impact of investee companies in order to manage the assets of the ultimate beneficiaries: J. Kay, *supra*, note 24, p. 79. For such an improvement to take place, companies have to engage in a more active transparency with regard to sustainable development issues: Jacquelyn E. Humphrey, Darren D. Lee and Yaokan Shen, "Does it cost to be sustainable?", (2012) 18(3) *Journal of Corporate Finance* 626.

102 FairPensions, *supra*, note 100, p. 117.

103 Foundation for Governance Research and Education, *supra*, note 95, p. 22.

highly unlikely that asset managers will be willing to engage with companies in order to build up a better understanding of the long-term priorities and objectives that will eventually lead to better financial performance for the benefit of all actors engaged in this procedure[104]. The quarterly benchmark triggers a collateral effect on the short-termism with which asset managers and companies interact in order for both of them to capture profits to satisfy their mandates according to the predominant trading rules and methods of evaluation.

It would therefore be essential to review the period of evaluation of asset managers and extend it considerably[105] in order to give them the possibility to engage actively with companies and investors without having the constant pressure of generating immediate returns for their clients, and for the latter in order to start evaluating them in another perspective based on a wider perception of their performance in the long term. With regard to the fees paid to asset managers, improvement could be made if a considerable percentage of fees were to be associated with performance criteria related to the exercise of stewardship responsibilities[106].

It seems that the Code carefully avoids intervening in this relationship since it becomes extremely difficult to impose criteria to shape their cooperation. The problem remains, however, in the sense that the exercise of institutional investors' rights might be bestowed upon fund managers and the Code needs to increase its requirements in order to inspire stewardship for the entire investment chain and not just institutional investors. Moreover, remuneration practices or evaluation criteria of a series of financial intermediaries are interrelated with the ultimate goal of stewardship since they work as the basis for exercising potential powers. Even if the Code were to introduce new stewardship requirements, leaving unchanged this structural framework, this situation would be slightly – but not decisively – improved.

104 J. Kay, *supra*, note 24, p. 78.

105 In various reports, an extension to 3-5 years has been a recurrent proposal during the past few years; see, for example, D. Krehmeyer, M. Orsagh and K. N. Schacht, *supra*, note 82, p. 13 and 14: "By creating more transparent links between asset manager pay and long-term performance, asset management firms will help ensure fund shareowners that asset managers are paid for performance, not asset gathering".

106 J. Kay, *supra*, note 24, p. 74.

E. Facilitation of institutional investor activism

Recent proposals have focused on the creation of various investor forums that could allow for interconnection between investors and increasing awareness of all problematic areas involving companies' ongoing activities. It is hoped that such a technological means could serve as a potential pool of valuable information for the entire investment community and as a starting point for collective action that would trigger more active shareholder activism, while working as a sort of collective "feedback" for companies. The Kay Report referred to the establishment of an investors' forum whose principal aim would be the facilitation of supportive and critical action on a series of issues that seem important to the investor community. Moreover, the body needs to acquire its own independence from both the corporate and regulatory sectors, but it would have the role of exercising an effective dialogue with both of them. The composition of the forum should not be restricted to investors since dialogue should be enriched by the contribution of asset managers[107].

A similar but slightly different proposal was recently formulated by academics regarding the creation of an Internet review and rating facility system open to all market actors and focused on corporate governance statements. Indeed, it has been proposed to create a site that all companies' websites would link to, operated under regulatory oversight and giving access to anyone that might wish to express a personal view on a company's corporate strategies[108]. Companies would be in a position to reply to the reviews posted on this site in order to participate constructively with all participants. Under this proposal, investor engagement would be facilitated considerably, thus opening the perspective of a wider dialogue with the companies concerned. This kind of initiative could significantly improve the understanding of the market's view of the information disclosed and serve as a basis for greater dialogue between companies and shareholders. These proposals, supporting or rejecting regulatory oversight of the proposed investor forum, should therefore be given serious consideration, as they could become the optimal facilitating process for shareholder engagement, which currently appears to be at least partially unsatisfactory.

107 *Id.*, p. 50 and 51.

108 E. Micheler, *supra*, note 90.

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The UK Stewardship Code has served so far as a basis upon which the investment chain needs to operate with the ultimate purpose of maintaining and increasing the value of the ultimate beneficiaries, whose continued confidence in financial markets is required. The distance between investee companies and investors has been lengthened considerably, thus making it impracticable for all market participants to exercise stewardship. Prosperous markets need effective communication, dialogue and interaction between all market actors. Stewardship has come and will remain at the centre of debate in order to introduce and strengthen a better coexistence in the same investment chain of different and various participants.

For future financial and economic crises to be avoided, this chain needs to be fully transparent and open to criticism when decision-making methods are subject to different interpretations and generate excessive risk levels. The ultimate beneficiaries in every company need to exercise the rights and acquire a higher level of activism in order to become more useful for both companies and society as a whole. Institutional investors have a unique responsibility in that sense since the magnitude of their investments and their potential influence require additional attention and importance. The interaction between institutional investors with all other market actors in the investment chain needs to be monitored, clarified and made transparent.

For such a regulatory system to be fully functional, Stewardship Codes would have to be introduced in the legislation of all countries and applied effectively, covering relationships on a European or even international scale. In the current phase, the scenario of a European Stewardship Code would thus be welcome, as it could accelerate adoption of a set of principles for institutional investors to perform their roles in a more responsible and useful way. It remains to be seen whether the optimal way to achieve all these goals is a soft law approach based not just on the well-known "comply or explain" principle, but also on the private sector's willingness to respect and adhere to widely-acceptable practices, as moulded during the past few decades and reflected today in the UK Stewardship Code. The updated version of the Code allows for a certain degree of optimism since improvements have been made to increase the level of transparency and encourage a higher level of stewardship. Nevertheless, there is no doubt that if this or similar approaches in other countries fail to achieve their initial goals in the future, the scenario of a hard law framework, imposing a certain set of standards to ensure that the coexistence of different market actors does not disrupt effective communication between companies and investors and defends the overall market structure, would be an equally acceptable evolution towards the improvement of stewardship standards.