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Investment Management, Stewardship and Corporate Governance Roles

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25.1 INTRODUCTION

When the Stewardship Code was introduced in the UK in 2010 (UK Code),[1] it was ambiguous as to what 'stewardship' meant, in the context of institutional investors' legal duties to their clients and beneficiaries, while engaging in the corporate governance roles specified in the UK Code.[2] Are there two types of 'stewardship', that is, investors' 'soft' responsibilities as corporate governance actors in the companies they invest in, and investors' 'hard' responsibilities to their clients and beneficiaries? Or, does the UK Code's focus on corporate governance roles, which it assumes to be 'good stewardship', mean that playing an active role in investee companies is equivalent to discharging investors' 'hard' responsibilities to clients and beneficiaries?

The first interpretation may cause problems for the fabric of company law in the UK. Investors do not owe duties, especially fiduciary duties, to the companies they invest in. The second may also cause problems as it is uncertain on what basis one can assume that institutional investors' engagement with corporate governance roles necessarily results in either good investment management performance or the fulfilment of legal responsibilities. Indeed, empirical research presents mixed evidence as to the impact of investor engagement with corporate performance,[3] and it is not necessarily the case that being an engaged shareholder is part and parcel of fulfilling institutional investors' fiduciary or contractual duties to their clients and beneficiaries.[4] However, it is arguable that the revised European Shareholders' Rights Directive 2017 (SRD II) now makes the assumption

[1] Financial Reporting Council, *The UK Stewardship Code* (July 2010) <www.frc.org.uk/getattachment/e223e152-5515-4cdc-a951-da33e093eb28/UK-Stewardship-Code-July-2010.pdf> accessed 28 May 2020 [hereinafter UK Code 2010].

[2] Iris H-Y Chiu, 'Turning Institutional Investors into "Stewards": Exploring the Meaning and Objectives of "Stewardship"' (2013) 66 *Current Legal Problems* 443.

[3] Mariassunta Gianetti and Xiaoyun Yu, 'The Corporate Finance Benefits of Short Horizon Investors' (ECGI Working Paper 2016) on positive short- and long-term performance post shareholder engagement, while, on the contrary, see Bonnie G Buchanan, Jeffrey M Netter, Annette B Poulsen and Tina Yang, 'Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom' (2012) 49 *American Business Law Journal* 739.

[4] Pension trustees, for example, are subject to a duty of care in the exercise of trustee powers, subject to the experience and knowledge of the trustee concerned. Specific aspects of such a duty of care include a duty to consider the suitability of any investment, a duty to review suitability, a duty to ensure diversification of assets and a duty to obtain and consider proper advice. The duty of care operates at the standard of an 'ordinary prudent man', and there is no special provision for a higher standard of care in view of professional knowledge or expertise. The Pensions Act 1995 requires pension trustees to obtain written advice on their investments before establishing a Statement of Principles, and trustees may rely on the obtainment of advice as a proxy for discharge of duty. Trustees Act 2000, ss 1–6; Pensions Act 1995, s 35.

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explicit that institutional investors' roles as engaged shareholders are best practice for their investment management.[5]

The UK Code 2020 now clarifies that 'stewardship' refers to the quality of investment management for clients and beneficiaries.[6] Consistent with SRD II, engagement with investee companies is now part of good stewardship. This applies to both 'asset owners' (i.e. fund vehicles that collect or pool investors' capital together) and 'asset managers' (i.e. the delegates to whom funds entrust the management of portfolios of capital).

We have argued elsewhere[7] that the regulatory and legal frameworks for investment management do not necessarily cohere with engaged corporate governance roles, and that this policy preference for funds and asset managers to engage in such roles is owing to policymakers' need to build 'self-regulatory' credibility in the corporate sector. UK policymakers have, since the 1990s, looked to the private sector to develop self-healing techniques to address one corporate scandal or collapse after another.[8] This is to minimize the need for regulatory intrusion and also to galvanize proximate and resourceful actors such as shareholders. The reliance on shareholders to 'do the right thing' in monitoring the corporate economy for the common good is, however, a lofty ambition, and one that institutional investors have not quite lived up to, and may not be well placed to fulfil.[9]

Section 25.2 discusses the development of soft and hard law in compelling institutional investors to monitor their investee companies. This discussion is focused on the UK and the EU, as the UK has developed the pioneer version of soft law – in the UK Code – to govern institutions' shareholder conduct, and the UK and the EU are the markets where institutional investors have extensively participated for the purposes of managing their investment mandates. Some reference may be made to US markets, where relevant, as institutions participate as minority shareholders in the US markets much like in the UK and the EU. Section 25.3 discusses the main challenges to institutions' shareholder engagement role, drawing from the limitations of investment management roles and their legal and regulatory frameworks in the UK and the EU. We argue that, within the investment chain, value concerns in investment management and the governance of funds continue to pose challenges for engaged corporate governance roles for institutional investors. These concerns also persist, and are to an extent augmented, in relation to new expectations regarding 'environmental, social and governance' (ESG) engagement, discussed in Section 25.4. Section 25.5 provides a brief conclusion.

25.2 THE DEVELOPMENT OF EXPECTATIONS FOR INSTITUTIONAL INVESTORS' ENGAGEMENT IN CORPORATE GOVERNANCE ROLES

In the wake of corporate scandals in the early 1990s, UK policymakers urged the industry to find a robust solution for addressing corporate sector weaknesses, such as poor and misleading financial reporting. Sir Adrian Cadbury led a committee that contextualized corporate sector

5 Iris H–Y Chiu and Dionysia Katelouzou, 'Making a Case for Regulating Institutional Shareholders' Corporate Governance Roles' (2018) *Journal of Business Law* 67; Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement [2017] OJ L132/1 (SRD II).

6 Financial Reporting Council, *UK Stewardship Code 2020* (2019) 4 <www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf> accessed 28 May 2020 [hereinafter UK Code 2020].

7 Roger M Barker and Iris H-Y Chiu, *Corporate Governance and Investment Management: The Promises and Limitations of the New Financial Economy* (Edward Elgar 2017).

8 See Section 25.2.

9 Barker and Chiu (n 7).

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malaises such as poor financial reporting and transparency within the governance health of companies, and recommended that listed companies reform their governance, such as their board composition. The first and iconic Corporate Governance Code was, however, expressed to be an effective self-regulatory measure as institutional investors would be the main constituents that would hold publicly listed companies to account for their governance practices.[10]

In 2001, although the Myners Review[11] found that institutional investors were largely disengaged and voting levels were not healthy, continued reliance was placed on the role of institutional investors, and efforts were made to galvanize them and not to replace their roles with regulatory intrusion. Voting records, according to the annual surveys by the Investment Association, have improved significantly over the years.[12] Although institutions' voting levels have been reported to increase, this could be owing to the perception that they would be forced to engage in voting by regulation were no improvement to be perceived by policymakers. Further, the rise of the proxy advisory industry has helped with discharging voting responsibilities, although it remains questionable to what extent institutions are indeed 'engaged'.[13]

Mainstream institutional investors continued to show chequered patterns of corporate engagement through the 1990s, although the wind of 'defensive shareholder activism' inspired by the American pensions giant CalPERS started to influence fund and asset managers' behaviour. Defensive shareholder activism is defined as 'a defensive safeguarding of invested capital, which is exposed at hazardous moments in the company's existence because of increasing costs of exit'.[14] This type of shareholder behaviour may be activated in the face of performance failures in an investee company and/or management failures observed to threaten the viability of the investment, in particular governance failures.[15] In the UK, for example, the furore over executive pay arose in the mid-1990s after media reports of it skyrocketing at privatized utilities companies generated extremely negative opinion. The Greenbury Committee, which was tasked to look into the issue, took a 'corporate governance' approach by recommending more disclosure to shareholders of the relation between executive remuneration and corporate performance, the more robust involvement of the remuneration committee of the board in designing appropriate

[10] e.g. Adrian Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (Financial Reporting Council, Gee Publishing 1992) para 6.6 <https://ecgi.global/code/cadbury-report-financial-aspects-corporate-governance> accessed 28 May 2020. UK policymakers' convictions about institutions' corporate governance roles is extensively discussed in ch 2 of Iris H-Y Chiu, *The Foundations and Anatomy of Shareholder Activism* (Hart 2010).

[11] Paul Myners, 'Institutional Investment in the United Kingdom: A Review' (HM Treasury 2001) <https://uksif.org/wp-content/uploads/2012/12/MYNERS-P.-2001.-Institutional-Investment-in-the-United-Kingdom-A-Review.pdf> accessed 28 May 2020.

[12] See The Investment Association (IA), 'Adherence to the FRC's Stewardship Code Survey at 31 September 2014' (June 2015) 7 <www.theia.org/sites/default/files/press-releases/document/20150526-fullstewardshipcode.pdf> accessed 28 May 2020 (recording that voting levels were at about 84%, increasing from 78% the year before). According to the IA, levels of voting have been hovering about the 80% mark for several years.

[13] David Larcker and Allan McCall, 'Researchers: The Power of Proxy Advisory Firms' (*Stanford Business*, 13 January 2014); Michael C Schouten, 'Do Institutional Investors Follow Proxy Advice Blindly?' (2012) <http://ssrn.com/abstract=1978343> accessed 28 May 2020; Stephen J Choi, Jill E Fisch and Marcel Kahan, 'The Power of Proxy Advisors: Myth or Reality?' (2010) 59 *Emory Law Journal* 869; Paul Rose, 'The Corporate Governance Industry' (2007) 32 *Journal of Corporation Law* 887.

[14] Andreas Jansson, 'No Exit! The Logic of Defensive Shareholder Activism' (2014) 10 *Corporate Board: Roles, Duties & Composition* 16.

[15] This seems to be characteristic of UK pension and mutual funds; see Peter Cziraki, Luc Renneboog and Peter Szilagyi, 'Shareholder Activism through Proxy Proposals: The European Perspective' (2010) 16 *European Financial Management* 738; Najah Attig, Sadok El Ghoul and Omrane Guedhami, 'Institutional Investment Horizon and Firm Credit Ratings' in Narjess Boubakri and Jean-Claude Cosset (eds), *Institutional Investors in Global Capital Market* (International Finance Review Vol 12, Emerald 2015); also see Chiu, *The Foundations and Anatomy of Shareholder Activism* (n 10) general discussion in chs 1–2.

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executive remuneration, and the presentation of the committee report before shareholders in the annual report.[16]

After the Greenbury recommendations were introduced, the quality and comparability of corporate disclosure on executive remuneration made to shareholders was unsatisfactory and generally low.[17] The government took further action to improve disclosure and to introduce an advisory shareholder vote on pay ('say on pay') in order to compel shareholders to engage with the issue, via the Directors' Remuneration Report Regulations 2002 (DRRR). There is mixed evidence in the UK itself regarding the success of the DRRR prior to the 2008 global financial crisis (GFC).[18]

Through the 1990s, we also saw the beginnings of the development of hedge fund activism. This is referred to as 'offensive activism', which Armour and Cheffins define as taking an equity stake in order to facilitate corporate governance interventions.[19] Offensive activism has become an important investment management strategy for some funds.[20] Private equity funds take large concentrated stakes in order to assume management or governance powers over private companies,[21] while hedge funds take minority stakes in public companies.

Hedge fund activists are seen as being able to exert pressure by forging alliances with other investors and their proxy advisers, and by running high-profile campaigns in the media. Some view their activism as a much-needed form of monitoring for investee companies,[22] so as to ensure that the management of these companies focuses on value creation. There seems to be a significant body of consistent[23] empirical evidence on positive operating performance for companies subject to activist campaigns five to ten years after the campaign has concluded and the hedge fund has exited.[24] Moreover, hedge fund activism could produce a wider effect on

[16] Richard Greenbury, *Directors' Remuneration* (17 July 1995).

[17] Lee Roach, 'The Directors' Remuneration Report Regulations 2002 and the Disclosure of Executive Remuneration' (2004) 25 *The Company Lawyer* 141.

[18] Fabrizio Ferri and David A Maber, 'Say on Pay Votes and CEO Compensation: Evidence from the UK' (2013) 17 *Review of Finance* 527 on relative success but see Martin Conyon and Graham Sadler, 'Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK' (2010) 18 *Corporate Governance: An International Review* 296.

[19] John Armour and Brian Cheffins, 'The Rise and Fall (?) of Shareholder Activism by Hedge Funds' (2012) 14 *Journal of Alternative Investments* 17.

[20] Such as Third Point, Pershing Square.

[21] This model is discussed generally in Mike Wright and Ken Robbie (eds), *Management Buy-Outs and Venture Capital: Into the Next Millennium* (Edward Elgar 1999).

[22] Nicole M Boyson and Robert M Mooradian, 'Corporate Governance and Hedge Fund Activism' (2011) 14 *Review of Derivatives Research* 169; Thomas W Briggs, 'Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis' (2007) 32 *Journal of Corporation Law* 681; Shane Goodwin, 'Corporate Governance and Hedge Fund Activism' (DPhil Thesis, Oklahoma State University 2015); Paul Rose and Bernard Sharfman, 'Shareholder Activism as a Corrective Mechanism in Corporate Governance' (2015) 2014 *Brigham Young University Law Review* 1015. Further, there is empirical research that shows actual governance improvements such as better financial reporting; see CS Agnes Cheng, Henry He Huang and Yinghua Li, 'Hedge Fund Intervention and Accounting Conservatism' (2015) 32 *Contemporary Accounting Research* 392; and, on reduction in managerial rent-seeking, Heqing Zhu, 'The Preventive Effect of Hedge Fund Activism' (2013) <https://ssrn.com/abstract=2369533> accessed 28 May 2020.

[23] But see evidence to the contrary, John C Coffee and Darius Palia, 'The Impact of Hedge Fund Activism: Evidence and Implications' (2014) ECGI Law Working Paper No 266/2014 <http://ssrn.com/abstract=2496518> accessed 28 May 2020; Frank Partnoy, 'U.S. Hedge Fund Activism' in Jennifer G Hill and Randall S Thomas (eds), *Research Handbook on Shareholder Power* (Edward Elgar 2015).

[24] Lucian Bebchuk, Alon Brav and Wei Jiang, 'The Long-Term Effects of Hedge Fund Activism' (2015) 115 *Columbia Law Review* 1085; Marco Becht, Julian Franks, Jeremy Grant and Hannes Wagner, 'Returns to Hedge Fund Activism: An International Study' (2017) 30 *The Review of Financial Studies* 2933; Alon Brav, Wei Jiang and Hyunseob Kim, 'The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes' (2015) 28 *The Review of Financial Studies* 2723. On medium-term value creation, see Nick WA Stokman, 'Influences of Hedge Fund Activism on the Medium Term Target Value' (2007) <https://ssrn.com/abstract=1019968> accessed 28 May 2020.

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corporate culture.[25] Some commentators find qualitative changes in terms of better corporate governance and management accountability after an episode of hedge fund activism.[26]

However, other commentators[27] are of the view that hedge fund activism brings only disruption to the management role and makes it more likely that boards will be captured by short-termist shareholder demands, to the detriment of other stakeholders such as employees. Empirical research[28] shows that only the most disruptive forms of shareholder activism, such as agitating for the merger, sale or part-sale of a company, achieve significant share price reactions. Such disruptive behaviour could be deleterious to wider stakeholder interests and the longer-term prospects for the enterprise.[29] Partnoy and Thomas[30] refer to hedge fund activism as a form of 'financial innovation' in investment strategy that is mediated through its corporate governance role. Hedge funds have shown special interest in merger arbitrage, capital issues such as buy-backs and dividends, and the exploitation of short-term information asymmetries, all for the purposes of exploiting for financial gain. Such exploitation could be seen as an application of their quasi-proprietary rights, such as in asking for share buy-backs in order to extract value from return of capital,[31] or in engagement, voting or litigation pursuant to their profit-extraction agenda.[32] Hence, a number of commentators have argued that the substance of hedge fund activism is short-termist[33] and disruptive in nature.

It was against this context of uneven levels of incentive-based shareholder activism that the GFC imploded. Although the crisis was owing to risk mismanagement on the part of many mainstream banks in relation to financial innovation,[34] the UK government took

[25] Dionysia Katelouzou, 'Myths and Realities of Hedge Fund Activism: Some Empirical Evidence' (2013) 7 *Virginia Law & Business Review* 459.

[26] Shane Goodwin, Akshay Singh, Walter Slipetz and Ramesh Rao, 'Myopic Investor Myth Debunked: The Long-Term Efficacy of Shareholder Advocacy in the Boardroom' (2014) <https://ssrn.com/abstract=2555701> accessed 28 May 2020.

[27] David J Berger and Kenneth M Murray, 'As the Market Turns: Corporate Governance Litigation in an Age of Stockholder Activism' (2009) 5 *New York University Journal of Law & Business* 207; Dan Bernhardt and Ed Nosal, 'Gambling for Dollars: Strategic Hedge Fund Manager Investment' (2013) Federal Reserve Bank of Chicago Working Paper No 2013-23 <http://ssrn.com/abstract=2367475> accessed 28 May 2020; William W Bratton, 'Hedge Funds and Governance Targets' (2007) 95 *Georgetown Law Journal* 1375. But see Katelouzou (n 25).

[28] Sarah Gordon, 'Activist Hedge Funds Not So Good for Shareholders' *Financial Times* (20 May 2015) <www.ft.com/content/ddbabe64-fee1-11e4-84b2-00144feabdc0> accessed 28 May 2020; Becht and others (n 24).

[29] Robby Houben and Gert Straetmans, 'Shareholder Rights and Responsibilities in the Context of Corporate Social Responsibility' (2016) 27 *European Business Law Review* 615 argue that some forms of offensive activism raise the risk profile of the company, having implications for their cost of raising capital and their longer-term prospects.

[30] Frank Partnoy and Randall S Thomas, 'Gap Filling, Hedge Funds, and Financial Innovation' (2006) Vanderbilt Law and Economics Research Paper No 06-21 <http://ssrn.com/abstract=931254> accessed 28 May 2020.

[31] The self-interests of the activist would be predominant as share repurchases bring about increase in share price and a windfall from the capital return; see Balasingham Balachandran, Keryn Chalmers and Janto Haman, 'On-Market Share Buybacks, Exercisable Share Options and Earnings Management' (2008) 48 *Accounting & Finance* 25; Harrison Liu and Edward P Swanson, 'Is Price Support for Overvalued Equity a Motive for Increasing Share Repurchases?' (2016) 38 *Journal of Corporate Finance* 77; José-Miguel Gaspar and others, 'Can Buybacks Be a Product of Shorter Shareholder Horizons?' (2005) AFA 2005 Philadelphia Meetings Paper <https://ssrn.com/abstract=649482> accessed 28 May 2020. Also aligns with managerial incentives; see Jesse M Fried, 'Open Market Repurchases: Signaling or Managerial Opportunism?' (2001) 2 *Theoretical Inquiries in Law* 865 also again in Jesse M Fried, 'Informed Trading and False Signaling with Open Market Repurchases' (2005) 93 *California Law Review* 1323.

[32] Partnoy and Thomas (n 30).

[33] Véronique Bessière, Michael Kaestner and Anne-Laurence Lafont, 'Hedge Fund Activism: Insights from a French Clinical Study' (2011) 21 *Applied Financial Economics* 1225 on governance being used as an excuse to engage for instrumental returns.

[34] Markus Brunnermeier and others, *The Fundamental Principles of Financial Regulation* (Geneva Reports on the World Economy, Centre for Economic Policy Research 2009).

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a 'root-and-branch' approach to uncovering deficits in bank management and commissioned a corporate governance review of banks. Although institutional shareholder apathy is not regarded as the key cause of the UK banking crisis, the Walker Review on corporate governance in banks and financial institutions took the view that shortcomings in institutional shareholder oversight provided a tolerant or indeed encouraging context for misjudgements of risk made at the board level of the failed UK banks.[35] In response, the Institutional Shareholders' Committee, the trade association representing institutions, developed a broadly framed code to encourage institutions to be more active and engaged.[36] As this code has received bottom-up acceptance among institutions, the Financial Reporting Council (FRC) in the UK adopted this formally as a 'Stewardship Code' in 2010,[37] to reflect the expectations for institutions that to engage with their investee companies is a matter of 'stewardship' – a term which had previously been more associated with the benevolent role that corporate directors should adopt in the fulfilment of their legal duties to their companies, but which was now appropriated by the investment industry to describe the governance role of institutional shareholders.

The UK Stewardship Code originally was subject to a comply-or-explain regime, and applied only to voluntary signatories.[38] The first UK Code focused on institutions' relationships with their investee companies. This development cemented expectations of institutions' corporate governance behaviour,[39] and a slew of legal reforms in relation to corporate disclosure followed, as means to moderate and change corporate behaviour in various areas, but crucially reliant on shareholders to monitor and call companies to account.

For example, faith continues to be placed in institutions' role in say on pay and to provide the essential monitoring governance expected of 'good corporate equity owners'. Hence, law reform supports this policy direction by first providing institutions with information and then empowering them with 'say' in the general meeting.[40] The UK introduced a binding shareholder vote on forward-looking pay policy, to take place at least every three years.[41] Further, an annual shareholder advisory vote will be taken in a backward-looking manner to signal shareholder approval, or otherwise, on the previous year's implementation of pay packages.[42] The EU has now introduced this in SRD II, which provides for a binding say on pay every four years.[43]

[35] David Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities. Final Recommendations' (26 November 2009) <https://ecgi.global/sites/default/files/codes/documents/walker_review_261109.pdf> accessed 28 May 2020.

[36] Institutional Shareholders' Committee, 'Code on the Responsibilities of Institutional Shareholders' (November 2009) <www.plsa.co.uk/portals/0/documents/0039_isc_statement_of_principles_2007_0607.pdf> accessed 11 February 2022; Howard Davies, *The Financial Crisis: Who Is to Blame?* (Polity Press 2010).

[37] UK Code 2010 (n 1).

[38] On the relative ineffectiveness of comply-and-explain, see John Parkinson and Gavin Kelly, 'The Combined Code on Corporate Governance' (1999) 70 *The Political Quarterly* 101. Disclosure is often sub-optimal and the FRC has, in the recent UK Code 2020, enforced a system of disclosure vetting before listing an institution as a 'signatory'.

[39] More detail on the development of the UK Stewardship Code is discussed elsewhere in this book: see Davies, The UK Stewardship Code 2010–2020, Chapter 2 and Katelouzou and Micheler, The Market for Stewardship and the Role of the Government, Chapter 3.

[40] The US led in this reform; see Securities Exchange Act of 1934 rr 14a–21(a). On say on pay reforms, see global survey in Randall S Thomas and Christoph Van der Elst, 'Say on Pay Around the World' (2015) 92 *Washington University Law Review* 653.

[41] s 439A of the Companies Act, inserted via the Enterprise and Regulatory Reform Act 2013.

[42] Companies Act 2006, s 439.

[43] SRD II (n 5) Art 9a.

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Other disclosure requirements imposed on companies include narrative statements regarding prospects and risks, under the reformed Strategic Report;[44] the directors' narrative management report to the markets; the EU's non-financial disclosure statement regarding the company's performance in non-financial matters such as environmental impact, human rights impact and anti-corruption matters;[45] the directors' duty statement (also known as the section 172 report) that explicates how directors have taken into account stakeholders' interests including employees', creditors', suppliers', customers' and their community's interests in managing the company;[46] and non–corporate law mandatory disclosures in relation to supply chain diligence,[47] pay ratio,[48] gender pay gap reporting,[49] corporate tax transparency[50] and conflict mineral sourcing assurance.[51] Many of these disclosure statements are 'enforceable' only via market discipline, in relation to shareholders' response to their disclosure, whether in voice or exit. Hence it can be argued that although mainstream institutional investors have shown a chequered track record in terms of their involvement in investee companies, there is no let-up in relation to the public and policy expectation that they fulfil a monitoring role in the corporate sector.

Indeed, the near-legalization of funds' and asset managers' roles in engaging with their investee companies was undertaken in SRD II. Under the Directive, member states shall require institutional investors and asset managers to develop an engagement policy on (or otherwise explain) how institutional investors and asset managers intend to integrate shareholder engagement in their investment strategy, monitor their investee companies' performance,[52] exercise their voting rights, use proxy advisers' services, and co-operate with other shareholders. This has now been implemented for the investment management sector in the UK by the Financial Conduct Authority (FCA).[53]

The relentless reliance placed by policymakers upon the roles of institutional shareholders persists, in spite of findings that many institutions that signed up to the UK Code do not engage in purposeful and meaningful dialogue with investee companies.[54] The FRC even implemented a tiering system to classify institutional shareholders according to their quality of stewardship in

[44] Companies Act 2006, s 414A; discussed in Iris H-Y Chiu, 'Institutional Shareholders as Stewards: Towards a New Conception of Corporate Governance?' (2012) 6 *Brooklyn Journal of Financial, Corporate and Commercial Law* 387.

[45] Companies Act 2006, s 414CA; see Iris H-Y Chiu, 'Unpacking the Reforms in Europe and UK Relating to Mandatory Disclosure in Corporate Social Responsibility: Instituting a Hybrid Governance Model to Change Corporate Behaviour?' (2017) 14 *European Company Law* 193.

[46] Companies Act 2006, s 414CZA, implementing disclosure requirements into the director's duty under s 172 of the Act.

[47] Modern Slavery Act 2015, s 54, discussed in Iris H-Y Chiu, 'Disclosure Regulation and Sustainability: Legalisation and New Governance Implications' in Beate Sjåfjell and Christopher M Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (CUP 2019).

[48] Companies Act 2006, paras 19B and C of Sch 8, to report pay ratios among highest, median and lowest paid employees.

[49] Equality Act 2010, s 78.

[50] Finance Act 2015, ss 122(1), (4), (5) and (6), requiring country-by-country reporting of tax paid by multinational enterprises in order to discern tax arbitrage.

[51] EU Conflict Minerals Regulation 2017, art 7, to be in force from 2021, discussed in Chiu, 'Disclosure Regulation and Sustainability' (n 47).

[52] SRD II (n 5) art 3g.

[53] Applying to all institutions involved in portfolio management, whether UCITs, alternative investment funds, insurers; see Financial Conduct Authority (FCA) Handbook, SYSC 3.4.4-10.

[54] Julia Mundy, Lisa Jack and Sandra Einig, 'Is the Stewardship Code Fit for Purpose?' (CIMA Global Academic Research Programme, March 2019) <www.cimaglobal.com/Documents/Thought_leadership_docs/Academic-research/4841-stewardship-code-research-report.pdf> accessed 28 May 2020. The report finds that engagement can be highly instrumental for a fund's private information advantages and is seldom collective or escalated. Funds and asset managers seldom integrate stewardship into core strategy and remain deferential to management.

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order to incentivize optimal behaviour.[55] With the legalization of duties for the investment management sector, the FRC has now introduced soft law to govern asset owners' (funds), asset managers' and their service providers' investment management behaviour more generally, incorporating engagement with investee companies.[56] This soft law complements the legalization of SRD II's duties and edges us closer to a more comprehensive regime for regulating investment management behaviour. Although this regime still firmly entrenches the notion that engaged corporate governance roles is expected behaviour, it has become part of the wider strategic governance of the investment management industry in the UK and the EU.

25.3 Aspects of Challenge for Corporate Governance 'Stewardship' in the Investment Management Sector

Although the legal framework and soft law in the UK and the EU increasingly compel the investment management industry to engage in corporate governance roles as part of good stewardship, their effectiveness would be challenged by the business models of investment management, the structures of investment management and the governance of funds.

25.3.1 *Investment Management Business Models*

Leaving aside dedicated activist hedge funds whose engagement strategy is instrumental to their value generation strategy, we consider how mainstream investment management could be strategically integrated with expected corporate governance roles. In the UK and the EU, institutional investment management has grown owing to the need to serve the long-term savings goals of working populations, and certain established business models have developed. These factors also apply to markets such as the US. The two main investment management mandates that funds may be offered by their asset managers would be active or passive mandates, and strategies that mix features along the spectrum from passive to active. Active management refers to strategies employed in order to generate 'alpha' by informed and researched stock-picking and turnover of portfolio, so as to beat the average market returns embodied in particular stock market indices. Passive management refers to investment management strategies that adhere closely to a particular stock market index. These are generally low cost as there is less need for research and judgement-based effort on the part of asset managers.

Active management mandates are riddled with agency problems that permeate investment management practice, crucially affecting asset managers' corporate governance roles. Asset managers are optimally positioned in the investment chain to generate rents for themselves and other participants in the chain. For example, asset managers are reported to practise 'churning' (i.e. excessive trading of securities in order to generate transactions fees and charges).[57] In this sense they are more likely motivated by exit than by exercising voice in engaging with investee companies.[58] Other examples of rent-seeking for the investment chain as

[55] Financial Reporting Council, 'Tiering of signatories to the Stewardship Code' <www.frc.org.uk/news/november-2016/tiering-of-signatories-to-the-stewardship-code> accessed 22 February 2022.

[56] UK Code 2020 (n 6) Principles 9–11.

[57] See e.g. Norma Cohen, 'How Fund Managers Spend Your Money' *Financial Times* (7 June 2014) <www.ft.com/content/5dfc402a-ebdd-11e3-8cef-00144feabdc0> accessed 28 May 2020. The FCA has also found that asset managers do not optimally keep transaction costs under control; see Financial Conduct Authority, 'Asset Management Market Study Final Report' (Market Study 15/2.3, June 2017) para 7.2 <www.fca.org.uk/publication/market-studies/ms15-2-3.pdf> accessed 28 May 2020.

[58] Mundy, Jack and Einig (n 54).

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a whole include arrangements made with brokers or trading venues for routing orders and receiving commissions or kickbacks and third-party payments such as research payments bundled in dealing commissions to brokers and analysts.[59] These can consume much of the returns generated in active management, flatlining returns to investors. Indeed, in the current low-yield and competitive environment, Fama and French[60] have found that active fund management fees and charges inevitably reduce or nullify the returns for investors. In this context, active asset managers are increasingly struggling to deliver comfortably excess returns in their investment management, and regulators have also intruded into fee charging practices, to reduce conflicts of interest deleterious to investors. Legislation has been introduced to make fees and charges more controlled,[61] transparent and justifiable.[62] Active managers hardly have any more incentive to engage intensively with investee companies as such efforts are costly in terms of research and time.[63]

Funds have also become disillusioned with the high cost and lacklustre returns in active management and many now prefer passively managed investment products that track an index or replicate an index composition, and charge lower fees.[64] In particular, after the mandatory charge cap of 0.75 per cent of fund assets was introduced by the UK government[65] for defined contribution pension schemes, many asset managers of these schemes would invariably prefer to offer passively managed products such as those that track an established benchmark such as a stock market index or can be in the form of exchange-traded products (ETFs) that track an index or synthetic ETFs that aim to correlate with an index.

Passive investing creates another type of agency problem (i.e. that of 'neglect' and ultimate disengagement from the real economy). Funds are tied into a mechanistic approach to stock selection, and it is such a constrained approach that it makes investment management cost-effective. Further, as passive investing is engaged with a benchmark and not with the underlying corporate assets as such, the sense of disengagement could be augmented between asset managers and investee companies. On the other hand, passive funds may feel tied to certain companies in the index – in which they are, more or less, permanently invested – and are thus incentivized to revisit their 'ownership' role in investee companies. There seems to be some evidence that passive and large investors such as BlackRock do take shareholder engagement seriously as part of their investment management practice.[66] However, as passive funds are low cost in nature, the demands of shareholder engagement seem contrary to their cost-conscious

[59] Some of these practices are discussed in Graham Busby, 'Conflicts of Interest and Inducements under MiFID' (2008) *Journal of International Banking Law and Regulation* 1.

[60] Eugene F Fama and Kenneth R French, 'Luck Versus Skill in the Cross-Section of Mutual Fund Returns' (2010) 65 *The Journal of Finance* 1915.

[61] For example, MiFID 2014, art 24(8) and Commission delegated legislation specifying that bundled dealing commissions cannot continue to be passed on to investors. Research charges need to be specifically costed up front and passed on to investors with their consent.

[62] e.g. Financial Conduct Authority, 'Asset Management Market Study: Interim Report' (Market Study 15/2.2, November 2016) <www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf> accessed 28 May 2020; and Financial Conduct Authority (n 57).

[63] Mundy, Jack and Einig (n 54).

[64] Lodewjik van Setten, *The Law of Institutional Investment Management* (OUP 2009) paras 4.48ff, 4.86ff; see also Fisch, The Uncertain Stewardship Potential of Index Funds, Chapter 21.

[65] See discussion in Andrew Wood, Louise Amantani, Duncan McDougall and Niall Baker, *Landscape and Charges Survey 2013: Charges and Quality in Defined Contribution Pension Schemes* (Department for Work and Pensions, February 2014) 51ff, ch 4 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/281128/rr859-defined-contribution-pension-schemes.pdf> accessed 28 May 2020.

[66] John Authors, 'Passive Investors Are Good Corporate Stewards' *Financial Times* (19 January 2016) <www.ft.com/content/c4e7a4f6-be8a-11e5-846f-79b0e3d20eaf> accessed 28 May 2020; Ian R Appel, Todd R Gormley and Donald B Keim, 'Passive Investors, Not Passive Owners' (2016) 121 *Journal of Financial Economics* 111 <www.stern.nyu.edu/sites/default/

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approach.[67] Further empirical evidence finds that passive indexed asset managers often vote with management[68] and thus provide little in the way of a monitoring role.

In sum, the development of professional asset management has produced two rather extreme and perverse effects. One is substantial agency cost in the exercise of significant amounts of discretion in investment management, while the other is completely market-led and marked by a lack of discretionary intervention. In either case it is highly questionable whether meaningful investment intermediation through good corporate ownership is achieved to connect the long-term expectations of savers with the long-term wealth creation by the corporate economy.

It may be argued that long-term investors such as pension funds should be incentivized to exercise voice in investee companies and to persuade their asset managers to do so, too. There are two barriers. One is that funds may be invested in pooled mandates (that may be active or passive) and not tailor-made mandates, hence making it difficult to instruct asset managers to take certain corporate governance positions. This is the issue of the investment chain canvassed shortly. The second is that pension funds that are defined benefit in nature have maturing liabilities, just like insurers managing annuities, and liability-driven strategies may be cost-conscious and not necessarily long-termist.[69]

Where defined contribution schemes are concerned, scheme trustees or the internal governance committee of the employer that monitors contract-based providers need to regularly assess investment performance and review objectives.[70] Empirical research shows that such reviews take place regularly, frequently on a quarterly basis,[71] and these performance reviews can drive short-termism in defined contribution scheme management, which can encourage exit over voice and the avoidance of costly efforts in engaged corporate governance roles.

For retail, collective investment schemes such as Undertakings for Collective Investment in Transferable Securities (UCITS; see Directive 2009/65/EC), as well as non-UCITS open-ended (NURS) and closed-ended schemes, are subject to regular periodic accountability.[72] Alternative investment fund managers, under EU legislation, are subject to harmonized reporting obligations to investors on a yearly basis.[73] However, in addition to the mandatory annual report, funds and investors could enter into agreements to have additional reporting frequency such as on a quarterly basis.[74] The regulatory regime for regular reporting has played no small part in encouraging funds and their asset managers to pursue short-termist investment performance.[75]

files/assets/documents/1%20Gormley%20Passive%20Investors%20Not%20Passive%20Owners.pdf> accessed 28 May 2020.

[67] John Plender, 'Pay-Offs and Perils of Passive Investing' *Financial Times* (27 October 2013) <www.ft.com/content/cf04a1e2-3b1e-11e3-87fa-00144feab7de> accessed 28 May 2020.

[68] Tom Eckett, 'Index Funds Rarely Challenge Management in Shareholder Votes' (*ETF Stream*, 10 October 2019) <www.etfstream.com/news/9398_index-funds-rarely-challenge-management-in-shareholder-votes/> accessed 28 May 2020. See also: Lucian Bebchuk and Scott Hirst, 'Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy' (December 2019) 119 *Columbia Law Review* 2029; Fisch, The Uncertain Stewardship Potential of Index Funds, Chapter 21.

[69] Discussed in Barker and Chiu (n 7) ch 4.

[70] Pensions Act 2004, s 244.

[71] Wood and others (n 65) 107–8, para 10.2.3.

[72] Undertakings in Collective Investments in Transferable Securities Directive 2009, art 68.

[73] Alternative Investment Fund Managers Directive 2011, art 22.

[74] Where investors use online platforms, hedge funds may even in due course aim to provide weekly or daily accounting transparency. See BNY Mellon, 'Risk Roadmap: Hedge Funds and Investors' Evolving Approach to Risk' (August 2012) <http://web.archive.org/web/20180312002312/www.thehedgefundjournal.com/sites/default/files/riskroadmap.pdf> archived 12 March 2018, accessed 28 May 2020.

[75] Some empirical research disagrees, although most empirical research shows that investment management is short-termist in nature. See Brian J Bushee, 'Do Institutional Investors Prefer Near-Term Earnings Over Long-Run Value?'

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Guyatt argues that investor myopia is entrenched as it is seen as a defensible practice in light of regulatory requirements.[76]

Furthermore, as Vayanos and Woolley have argued, asset owners and trustees tend to be uncertain as to the competence and diligence of the asset managers to whom they outsource fund management responsibilities.[77] It is increasingly recognized that most active asset managers find it extremely difficult to sustain portfolio outperformance relative to benchmarks over an extended period of time.[78] Consequently, if a fund develops negative deviation from the performance of a benchmark – even over a relatively short period – it becomes increasingly difficult for asset owners or trustees to simply ignore this development or seek to justify a continuation of the investment management mandate.[79]

Funds and asset owners, therefore, are reluctant to move away from the norm and adopt 'outlier' modes of investment thinking that do not strictly conform to the dominant practice of short-termist evaluation.[80]

Further, for retail collective investment schemes or alternative funds, investors' redemptions are generally unquestioned rights, albeit governed by terms of the fund and by regulation.[81] Regulation has played a key part in securing investors' rights in redemption as a means of investor protection, hence funds' requirement to meet liquidity needs may be contrary to integrating engaged corporate governance roles in their investment management. The provision of liquidity for investors means that a price for exit has to be regularly, if not constantly, available.[82] This reinforces the marketized model of investment management which commoditizes corporations as narrowly represented in securities assets that are regularly bought and sold, and reinforces the model of investment gains as derived from trading gains instead of real productivity and operational performance. A number of empirical researchers are of the view that a liquid market for securities may be essential for capital formation but adverse to corporate governance (i.e.

(2001) 18 *Contemporary Accounting Research* 207; Alberto Manconi, Massimo Massa and Ayako Yasuda, 'The Role of Institutional Investors in Propagating the Crisis of 2007–2008' (2012) 104 *Journal of Financial Economics* 491; Michael Porter, *Capital Choices: Changing the Way America Invests in Industry* (Harvard Business School Press 1994); Xuemin Yan and Zhe Zhang, 'Institutional Investors and Equity Returns: Are Short-Term Institutions Better Informed?' (2009) 22 *The Review of Financial Studies* 893. On the contrary, see Jeffrey L Callen and Xiaohua Fang, 'Institutional Investor Stability and Crash Risk: Monitoring versus Short-Termism?' (2013) 37 *Journal of Banking & Finance* 3047 (arguing that companies with institutional investors that are long-termist in nature do not 'hoard' bad news until the very last minute causing share price crashes and volatility, and that empirical research reveals that most companies are not subject to such share price crashes and short-termist pressures from investors); Mark J Roe, 'Corporate Short-Termism: In the Boardroom and in the Courtroom' (2013) 68 *The Business Lawyer* 977 (arguing that short-termist traders are only part of the landscape, the most short-termist being high-frequency traders, and there are plenty of long-termist institutions whose holding periods have not changed much over the years, e.g. Vanguard and Fidelity).

76 Danyelle Guyatt, 'Meeting Objectives and Resisting Conventions: A Focus on Institutional Investors and Long-Term Responsible Investing' (2005) 5 *Corporate Governance: The International Journal of Effective Board Performance* 139

77 Dimitri Vayanos and Paul Woolley, 'Curse of the Benchmarks' (March 2016) Financial Markets Group Discussion Paper No 747 <www.lse.ac.uk/fmg/assets/documents/paul-woolley-centre/articles-of-general-interest/DP747CurseoftheBenchmarks.pdf> accessed 28 May 2020.

78 Hendrik Bessembinder, 'Do Stocks Outperform Treasury Bills?' (2018) 129 *Journal of Financial Economics* 440.

79 Vayanos and Woolley (n 77).

80 Guyatt (n 76). On herding and group conformance, David Marginson and Laurie McAulay, 'Exploring the Debate on Short-Termism: A Theoretical and Empirical Analysis' (2008) 29 *Strategic Management Journal* 273.

81 The right to request redemption for UCITs investors must be met, UCITs Directive, art 84; AIFMD, arts 16, 18.

82 For example, the *Financial Times* describes the 2019 implosion of Neil Woodford's investment business (owing to its inability to fulfil redemption requests relating to its Equity Income Fund) and M&G's decision to bar withdrawals from its UK property fund for the second time in three years as 'ignominious failures that have cast a shadow across the entire sector' (Chris Flood, 'UK Fund Industry Has Had a Year to Forget – Especially the Regulator' *Financial Times* (16 December 2019) <www.ft.com/content/daa6d154-c81f-4969-bc8c-85981b44b728> accessed 28 May 2020).

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investors are not encouraged to be actively engaged with their investments over the long-term). Under relative conditions of less liquidity, shareholders are more likely to be engaged.[83]

25.3.2 *Investment Chain*

As Morley points out, investment management is structured as a 'separation of funds from managers',[84] in a complex chain structure crucially involving funds delegating to asset managers who further use a web of service providers in investment management.[85] This phenomenon means that investors' capital is being placed under the ownership of an entity, the fund, which is a separate legal entity from the fund manager, an investment management company (which is often the one that has constituted the fund). The investor's relationship is with the fund, which may be structured as a trust, a company or under contract. The fund entity appoints the management company to invest and manage the fund assets, usually by contract. In this way, investors in a fund do not have a direct legal relationship with the fund manager, who is crucial to making strategic and operational decisions in relation to the investment management of the fund's assets. Such a structure of 'separation of funds from management' can be observed in pension funds, which outsource investment management to various portfolio managers,[86] retail collective investment funds such as the popular UCITS,[87] as well as hedge and private equity funds.[88]

As the responsibility for investment management is disaggregated and reposed in a separate entity from the fund, the scope of legal responsibility owed by the fund manager (and other investment entities contracting with the fund) to the ultimate investor is limited. The fund may take action against fund managers for sub-optimal investment management, but investors do not have direct recourse to such an action, having to rely on instructing the fund as such.[89] In the same vein, the investment management strategy and practice adopted by the management company are usually not susceptible to the fund investor's input or influence.[90]

The separation of funds from management is a structure that is arguably accepted if not endorsed in much of financial regulation. In the EU, UCITS, the fund entity, is referred to as the 'investment company' and is distinct from the 'management company'.[91] The 'investment company' and the 'management company' are subject to different authorization and regulatory

[83] Kerry Back, Tao Li and Alexander Ljungqvist, 'Liquidity and Governance' (2013) ECGI – Finance Working Paper No 388 <http://ssrn.com/abstract=2350362> accessed 28 May 2020.

[84] John Morley, 'The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation' (2014) 123 *Yale Law Journal* 1228.

[85] John Kay, 'The Kay Review of UK Equity Markets and Long-Term Decision Making' (Department for Business, Innovation and Skills July 2012) paras 3.9, 3.10, 4.10, 4.12 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf> accessed 28 May 2020 [hereinafter Kay Review].

[86] Whether in relation to defined benefit or contribution schemes, employers' fund entities often appoint outside investment managers for portfolios.

[87] Discussed in Barker and Chiu (n 7) ch 5.

[88] Discussed in Barker and Chiu (n 7) chs 6, 7.

[89] But enforcement by fund against fund manager may not be a realistic prospect if the fund manager and the fund are related; see discussion shortly.

[90] Although Ewan McGaughey ('Does Corporate Governance Exclude the Ultimate Investor?' (2016) 16 *Journal of Corporate Law Studies* 221) refers to old case law to support his argument that ultimate investors are owed fiduciary duties and can instruct funds, and are therefore not excluded from corporate governance, the lack of a direct relationship with the fund manager makes investors less incentivized or concerned to do so. Moreover, in a collective investment vehicle, it is hard to see how particular investors' preferences can percolate to the fund management level as the fund mediates investors' preferences as a whole.

[91] UCITs Directive 2009, arts 5, 6.

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regimes. The separation structure allows funds to be incorporated in low tax jurisdictions within the EU, such as Luxembourg and Ireland, and still enjoy rights of passporting to other EU member states for marketing and distribution.[92] Management companies can be located in other EU member states and are separately authorized. The Alternative Investment Fund Managers Directive (AIFMD) also recognizes that fund entities ('alternative investment funds' or AIFs) are separate from the fund manager, which is the subject of the Directive.[93] AIFs are expressly not regulated under the Directive, and this allows AIFs to incorporate in low tax jurisdictions chosen by the relevant funds and their investors.

One important implication of the separation structure is that investors are able to have relatively stronger exit rights from each distinct fund, and investors may see much less need for control or voice.[94] Hence, the important right of redemption already discussed may pose a compliance necessity that undercuts funds' incentives to encourage asset managers to undertake engaged and costly corporate governance roles. The implications of the investment chain for corporate governance as observed are voting apathy and general lack of engagement by asset managers and funds in their investee companies.[95] Further, if funds are invested in asset managers' pooled products, so that the fund does not enjoy a tailor-made investment management mandate, the funds would not be able to identify particular interests in investee companies in their portfolio in order to influence asset managers' strategies towards them.[96]

That said, it may be argued that ultimate fund beneficiaries have interests in the long-term well-being of investee companies, and it is perverse that the interposition of structures within the investment chain could result in the muteness or non-conveyance of such preferences. It is argued that there is potential for distributed ledger technology (DLT) to change the state of institutional shareholder stranglehold on corporate governance, if the use of DLT is able to penetrate the layers of the investment chain to identify share ownership and allocate shareholder rights to beneficiaries. Where the individual beneficial owner is obscured by the financial institution custodian that holds the legal rights to shares, DLT can be used to record levels of intermediated securities ownership, ultimately identifying and empowering beneficial share owners to exercise corporate governance rights.[97] It is less clear that the DLT can be used to identify and allocate shareholder rights to beneficiaries in funds that invest in corporate equities, as these beneficiaries' rights, usually contractual in nature, can be based only on units in funds. They do not have proprietary rights in particular shares.[98] Nevertheless, commentators take the

[92] Barker and Chiu (n 7) ch 5.

[93] Indeed, funds can be incorporated offshore, such as in Bermuda, while the fund manager is regulated under the Directive.

[94] Morley (n 84).

[95] Myners (n 11); Walker (n 35). The apathy of shareholders was especially critiqued in the wake of the 2007–09 Global Financial Crisis; see Jennifer Hughes, 'FSA Chief Lambasts Uncritical Investors' *Financial Times* (12 March 2009) <www.ft.com/content/9edc7548-0e8d-11de-b099-0000779fd2ac> accessed 28 May 2020; and Kate Burgess, 'Myners Lashes Out at Landlord Shareholders' *Financial Times* (London, 22 April 2009) <www.ft.com/content/c0217c20-2eaf-11de-b7d3-00144feabdc0> accessed 28 May 2020.

[96] Nick Fitzpatrick, 'FUNDS vs MANDATES: Would You Invest in a Pooled Fund?' *Funds Europe* (March 2009) <www.funds-europe.com/funds-vs-mandates-would-you-invest-in-a-pooled-fund> accessed 28 May 2020, on funds' increasingly likely use of pooled investment structures rather than tailor-made mandates.

[97] Christoph Van der Elst and Anne LaFarre, 'Blockchain and Smart Contracting for the Shareholder Community' (2019) 20 *European Business Organization Law Review* 111; David Yermack, 'Corporate Governance and Blockchains' (2017) 21 *Review of Finance* 7; Vedat Akgiray, 'The Potential for Blockchain Technology in Corporate Governance' (OECD 2019) OECD Corporate Governance Working Papers No 21 <www.oecd-ilibrary.org/docserver/ef4eba4c-en.pdf?expires=1590824852&id=id&accname=guest&checksum=1E5028A5C21F72F02DCCE09A18AE2627> accessed 28 May 2020.

[98] This is the investment practice of pooled mandates; see Fitzpatrick (n 96).

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view that a new cadre of beneficial owners can be brought into the corporate governance landscape, and corporate governance can become relevant to those outside the institutional sector.[99] This may in part be assisted by hard law as in the UCITS Directive and soft law as in the UK Code 2020.

In 2010, the European Commission introduced an initiative to improve investor protection by imposing conduct of business obligations on the management companies of UCITS funds.[100] The Directive imposes certain duties on management companies in order to secure the best interests of unit-holders in funds, such as due diligence in monitoring their portfolios and ensuring that the portfolios are managed within the investment limits and risk appetite.[101] Further, as part of regulating the investment management practices of fund managers, the Directive also imposes a duty on management companies to develop policies on how their voting rights in investee companies should be exercised for the benefit of the funds.[102] The beauty of such regulatory duties is that they 'cut across' the investment chain structures to construct a compliance requirement for asset managers that is ultimate investor–facing. Although it is questionable if ultimate investors can enforce against such duties under a breach of statutory action,[103] regulators can take enforcement action.

It can also be argued that SRD II introduces reform that cuts across the structures of the investment chain as it requires asset owners and managers to publicly disclose their engagement policies (or a sufficient alternative), the former's equity investment strategy, and the latter's adherence to asset owners' objectives and needs.[104] Disclosure may, however, rightly be criticized, as the Kingman Review in the UK has done, in relation to the obscurity of achieved outcomes.[105] The UK Code 2020, in setting out best practices for asset owners and asset managers in stewardship, further 'cuts across' the investment chain structures to encourage consistent and robust investment management practices from funds to their asset managers and service providers. Asset owners and managers should mirror best practices in terms of communicating their investment beliefs, strategy, governance processes and culture for achieving good stewardship,[106] and this allows beneficiaries to discern consistency between funds' mandates and asset management strategies.

Further, Principle 6 of the UK Code 2020 requires asset owners and managers to seek beneficiaries' needs and preferences in order to shape their investment management strategies, including stewardship activities.[107] The Principle also envisages that asset owners and managers will report on, and make adequate disclosure of, their stewardship activities and outcomes. This Principle is perhaps the most revolutionary innovation in the revised UK Code, as it overcomes investment chain structures, and compels asset owners and managers to be accountable directly to beneficiaries.[108] The possibility of using DLT technology to facilitate ease of engaging with

[99] van der Elst and LaFarre (n 97).
[100] Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company.
[101] Commission Directive 2010, art 23.
[102] Commission Directive 2010, art 24.
[103] Financial Services Markets Act 2000, s 138D.
[104] SRD II (n 5) arts 3g, 3h.
[105] John Kingman, 'Independent Review of the Financial Reporting Council' (Department for Business, Energy and Industrial Strategy December 2018) Para 2.86 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf> accessed 28 May 2020.
[106] UK Code 2020 (n 6) Principles 1, 2, 5–8.
[107] UK Code 2020 (n 6) 13–14.
[108] See other discussions in this book, notably Katelouzou and Micheler, The Market for Stewardship and the Role of the Government, Chapter 3.

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ultimate beneficiaries may also make adherence to this Principle difficult to avoid. It remains to be seen if Principle 6 will fundamentally change the disincentives and barriers to becoming engaged shareholders in investee companies. This is because taking into account beneficiary preferences and needs for accountability does not mean that beneficiaries will be galvanized into promoting corporate governance engagement as stewardship. Beneficiaries may not be experts who are able to constructively comment on what investment preferences work for the investment performance of the fund, and there may be disparate preferences which may not, on aggregate, become influential for the fund as a whole.[109] The implementation of this practice is likely to yield interesting observations in due course.

The difficulties inherent in achieving effective stewardship by institutional investors were highlighted by the UK government–sponsored review of UK equity markets following the banking crisis (the Kay Review).[110] This Review noted how the fragmentation of functions throughout the equity investment chain reduced the incentives for collective investor engagement with listed companies. It recommended that a new industry-led body – The Investor Forum – be established as a means of facilitating a greater magnitude of stewardship activities of asset managers and asset owners. Given the growing pressure on institutional investors to deliver more of a stewardship orientation, the investment industry acquiesced in this initiative – although there is no obligation for any individual fund manager to work with the Forum. Between 2014 and 2018, the Forum claims to have co-ordinated investor engagement with twenty-three UK companies at board level. However, given its modest resources and the fact that engagement activities occur behind closed doors, its likely impact on the overall UK investor stewardship landscape is uncertain.[111]

25.3.3 *Fund Governance*

It may be viewed as somewhat ironic that asset owners and managers should be seen as the champions of good corporate governance in the wider corporate sector when their own corporate governance has not been regarded as being particularly optimal.

First, there is the issue of expertise on the part of funds in being able to monitor their asset managers. Specifically, does the governance structure of funds permit them to overcome their core agency problem? – namely, that their investments are not being directly managed by their beneficiaries, or even by the fund entity itself, but by externally located fund managers, who therefore require careful monitoring.

Commentators[112] have pointed out that many employment defined contribution schemes are administered in companies as part of general human resources. The dedication of resources to

[109] A strong line on this issue has been taken by Robert Shillman, Chairman of the US industrial sensor company Cognex. He argues that asset managers are wrong to use their proxy voting power to ‘pressure “their” companies to include ESG factors when making business decisions’. Writing in his company’s 2018 annual report, he reflects:

> If they asked [the fund investors], ‘Do you want the board of directors and the managers of your companies to spend time and energy on environmental, social and governance issues or do you want them to spend all of their time and energy on increasing the value of your shares?’, I’m rather sure that an overwhelming number of them would choose the latter.

Quoted in Robert Armstrong, ‘Warren Buffett on Why Companies Cannot Be Moral Arbiters’ *Financial Times* (29 December 2019) <www.ft.com/content/ebbc9b46-1754-11ea-9ee4-11f260415385> accessed 28 May 2020.

[110] See Kay Review (n 85).

[111] The Investor Forum, ‘Review 2018’ (January 2019) 3 <www.investorforum.org.uk/wp-content/uploads/2019/01/Annual_Review_2018.pdf> accessed 28 May 2020.

[112] Gordon L Clark and Roger Urwin, ‘DC Pension Fund Best-Practice Design and Governance’ (2010) <http://ssrn.com/abstract=1652680> accessed 28 May 2020; Dietrich Hauptmeier and Graham Mannion, ‘Effective Investment

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help employees choose a suitable fund, or monitor the funds they have participated in, is extremely thin and limited. In the UK, the Department for Work and Pensions[113] has introduced reforms to mandate the establishment of 'Independent Governance Committees' in employers to oversee the DC schemes and provide governance over mandates. For trust-based schemes, a committee of trustees subject to similar duties has to be appointed.[114] There is some critique regarding how effective these committees are and, in particular, whether they are sufficiently accountable.[115] However, the FCA believes that they are working, although it has imposed more explicit duties upon them, to consider the value for money of their investment mandates and to consider ESG matters in relation to investment stewardship.[116]

Next, funds have been subject to less advanced prescriptions and practices for their own governance compared to the listed companies they invest in, and it may be queried whether funds have therefore the moral authority to challenge investee companies' governance.[117] Funds are usually set up by asset managers themselves, and many funds, though separate from their asset managers as legal persons, are managed by representatives of asset managers, and invariably delegate fund management back to the asset managers. In this sense, fund trustees or directors of funds that are structured as companies could be excessively deferential to their relevant asset managers. The connections with asset managers present conflicts of interest in being able to steward the interests of the beneficiaries in the fund.[118] There has been fund litigation in the hedge funds realm by investors against asset managers directly where funds have underperformed and the fund entity, managed by directors related to asset managers, has refused to sue.[119] The FCA has only very recently introduced reforms to intervene in board composition at funds so that independent directors are appointed to apply critical challenge and monitoring on fund boards.[120] Now, 25 per cent of fund boards are required to be independent formally, as well as in character and judgement. It is envisaged that these directors will also have sufficient expertise to discharge their monitoring roles.

We may query whether such reforms will improve governance at funds in the interests of the ultimate investor. Directors are subject to duties to the corporate entity that is the fund as

Governance in Defined Contribution Schemes' in Paul Thornton and Donald Fleming (eds), *Good Governance for Pension Schemes* (CUP 2011) 267.

[113] Department for Work and Pensions, *Better Workplace Pensions: Further Measures for Savers* (Cm 8840, March 2014) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf> accessed 28 May 2020.

[114] The Pensions Regulator, *Governance and Administration of Occupational Trust-Based Schemes Providing Money Purchase Benefits* (Code of Practice No 13, July 2016) <www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/code-13.ashx> accessed 28 May 2020.

[115] Josie Cox, 'Governance Bodies Set Up to Protect 12 Million Pensioners Are Not Doing Their Job, Charity Claims' *The Independent* (17 February 2018) <www.independent.co.uk/news/business/news/pension-savings-governance-bodies-fail-protect-money-igc-aviva-blackrock-fca-a8214296.html> accessed 28 May 2020.

[116] FCA Handbook COBS 19.5.1B; 19.5.5.

[117] Amy Whyte, 'Asset Managers Among the Worst-Governed Public Firms, Study Finds' (*Institutional Investor*, 22 June 2018) <www.institutionalinvestor.com/article/b18r4btg8ydfdc/asset-managers-among-the-worst-governed-public-firms,-study-finds> accessed 28 May 2020.

[118] A rare example of where a fund's board of directors appears to have meaningfully challenged management occurred in the case of Invesco Perpetual Enhanced Income Ltd, a Jersey-registered investment trust. In April 2018, a dispute between the trust board and its management company over management fees led to the temporary resignation of Invesco Perpetual as fund manager. Kate Beioley, 'Investors Pull Money from IPE Amid Invesco Row' *Financial Times* (5 July 2018) <www.ft.com/content/33003312-7e9c-11e8-8e67-1e1a0846c475> accessed 28 May 2020.

[119] *Certain Limited Partners in Henderson PFI Secondary Fund II LLP v Henderson PFI Secondary Fund II LP & Ors* [2012] EWHC 3259, [2013] 3 All ER 887.

[120] FCA Handbook COLL 6.6.25.

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a whole, and, depending on the fund structure, investors may not even be shareholders in the fund entity. However, with the imposition by the FCA of regulatory duties on authorized fund entities in relation to investor protection, such as pre- and post-sale communications,[121] proper valuation,[122] monitoring duties for outsourcing,[123] and the duty to ensure that outsourcing and delegation achieve 'value for money',[124] it is arguable that independent directors should at least be alert to compliance concerns, therefore contributing towards investor protection.

25.4 STEPS AHEAD AND ENGAGEMENT WITH ESG

Although we raise questions as to whether fund structures, practices and, indeed, their regulatory framework are always compatible with the expectations that they should act as engaged investors, raising the standards of corporate governance in the companies they invest in, the policy trajectory is towards increasing the investment management sector's roles in shaping corporate behaviour and governance. We suggest that what is important is that we recognize the limitations of the investment management sector in bearing upon the corporate sector, although we accept that institutions as investors are proximate and well placed to do so. For instance, policy trajectory is now relentless on institutions playing their part in influencing investee companies in their ESG performance, in particular in environmental sustainability.[125] Although companies should respond to the increasing hazards of climate change and their social footprint, such behavioural change is not merely a relational matter between companies and shareholders, and should also not be seen as a panacea for wider social issues.[126]

Owing to policy and social pressure, pension funds in particular have become more conscious of integrating ESG factors into investment management,[127] although shorter-term fund vehicles such as retail collective investment schemes are less engaged.[128] However, pension funds are not entirely convinced that ESG factors can be integrated into investment management, as they are concerned that integrating ESG factors into investment management is inconsistent with the fulfilment of their own fiduciary duties.

First, the fiduciary duty of loyalty does not permit pension fund trustees to integrate their own values, morals or preferences into investment management, and hence the objective pursuit of financial returns has historically been seen as key, although not necessarily paramount.[129] Second, the regulatory duty imposed on trustees to act as 'prudent investors' usually means the practice of portfolio diversification. However, it is uncertain whether pursuing ESG integration into conventional investment management would unduly preclude investing in many companies, making the portfolio less diversified and more risky.[130]

[121] FCA Handbook COLL 4.1, 4.2.
[122] ibid 6.3.
[123] ibid 6.6.
[124] ibid 4.5.7, 6.6.20–22, 8.3.5A, 8.5.16–19.
[125] See Katelouzou and Klettner, Sustainable Finance and Stewardship, Chapter 26.
[126] Jonathan Ford, 'Don't Expect the Earth from Fund Managers on Climate Change' *Financial Times* (19 January 2020) <www.ft.com/content/a865ff18-394b-11ea-a6d3-9a26f8c3cba4> accessed 28 May 2020.
[127] Riikka Sievänen, Hannu Rita and Bert Scholtens, 'The Drivers of Responsible Investment: The Case of European Pension Funds' (2012) 117 *Journal of Business Ethics* 137. Also see the influence of social culture in Scandinavia, Elias Bengtsson, 'A History of Scandinavian Socially Responsible Investing' (2008) 82 *Journal of Business Ethics* 969.
[128] Paul Cox, Stephen Brammer and Andrew Millington, 'An Empirical Examination of Institutional Investor Preferences for Corporate Social Performance' (2004) 52 *Journal of Business Ethics* 27.
[129] *Cowan v Scargill* [1985] 1 Ch 270.
[130] Rosy Thornton, 'Ethical Investments: A Case of Disjointed Thinking' (2008) 67 *The Cambridge Law Journal* 396. Question also asked in Benjamin Richardson, 'Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?' (2007) 22 *Banking and Finance Law Review* 145.

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Woods[131] also suggests that the 'prudent investor' rule for investment trustees has been interpreted narrowly by courts to mean the adoption of prevailing conventional investment management practices, and hence investment trustees are slow to take leadership in embracing 'new-fangled' investment criteria that may be more controversial.

The UNEPFI report, otherwise known as the Freshfields Report,[132] has produced a definitive analysis on the compatibility of fiduciary duties with ESG considerations.[133] It recommends that pension funds could take into account ESG considerations where investments already satisfy the 'business case'; where similarly competing investments are presented, the choice of the one with better ESG performance is not incompatible with fiduciary duties. Further, ESG factors may be imperative where the objective of the fund is for such purpose or where the consent of beneficiaries may be found. Richardson[134] argues that the report supports not only the proposition that ESG factors are not incompatible with the legal and regulatory duties imposed on funds but also that they may indeed be important for the fulfilment of those duties. Empirical research also provides support, finding that investment management integrating ESG concerns is better managed in terms of downside volatility.[135]

The uncertainty about fiduciary duties has become less of a barrier with the ramping up of policy rhetoric on the importance of non-financial considerations for investment management performance.[136] However, in order to dispel ambiguities, the UK has taken the step of introducing regulatory duties for funds and asset managers in relation to the taking into account of ESG factors in mainstream investment management, and not just in the niche sectors of sustainable finance. The FCA has now introduced duties for all investment firms to consider ESG factors material to financial performance of funds that they oversee and manage, as well as to consider non-financial considerations that present financial risk or are important to beneficiaries.[137] These should be part of the firm's investment strategy for their relevant investment horizons. Although the FCA acknowledged that the meaning of 'ESG' is not entirely settled in the industry and the FCA is not providing a definition, the area of practice will evolve organically while firms are not allowed to ignore it.[138] In this manner, although the duties to consider and also to account to beneficiaries how such consideration has been made will place ESG matters within the legitimate remit of investment management, there is considerable discretion in how funds relate to ESG and what developments of ESG in industry practice they take account of. Funds are able to determine what aspects of ESG are financially material and to what extent, and there is much ambiguity as to how to ascertain the importance of non-financial considerations. It may be argued that Principle 6 of the UK Code 2020 takes this up by requiring engagement with beneficiaries to ascertain

[131] Claire Woods, 'Funding Climate Change: How Pension Fund Fiduciary Duty Masks Trustee Inertia and Short-Termism' in James Hawley, Shyam Kamath and Andrew Williams (eds), *Corporate Governance Failures: The Role of Institutional Investors in the Global Financial Crisis* (University of Pennsylvania Press 2011) 242, ch 11.

[132] UNEP Finance Initiative, 'Fiduciary Responsibility: Legal and Practical Aspects of Integrating Environmental, Social and Governance Issues into Institutional Investment' (July 2009) <www.unepfi.org/fileadmin/documents/fiduciaryII.pdf> accessed 28 May 2020.

[133] See Katelouzou and Klettner, Sustainable Finance and Stewardship, Chapter 26.

[134] Richardson (n 130).

[135] Andreas GF Hoepner, Michael Rezec and Sebastian Siegl, 'Does Pension Funds' Fiduciary Duty Prohibit the Integration of Environmental Responsibility Criteria in Investment Processes?' (2011) <http://ssrn.com/abstract=1930189> accessed 28 May 2020.

[136] UNEP FI (n 132) has since clarified that ESG issues can be material to investment performance and it is not beyond the scope of fiduciary duties to take them into account.

[137] FCA Handbook SYSC 3.2.23 for investment firms, 4.1.15 for pension schemes.

[138] Financial Conduct Authority, 'Independent Governance Committees: Extension of Remit' (Policy Statement, 17 December 2019) <www.fca.org.uk/publication/policy/ps19-30.pdf> accessed 28 May 2020.

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their preferences.[139] However, where beneficiary preferences are mixed, it will be queried as to how that helps funds to determine the importance of non-financial ESG as such.

As to what ESG means, although the FCA has decided not to impose any definitions in case of incompatibility with industry developments and obsolescence, it can be argued that there is plenty of industry and multi-stakeholder development in this space that can provide guidance to funds: from stock exchange indices, to recognized and voluntary frameworks for evaluating performance in business and human rights,[140] environmental sustainability,[141] anti-corruption footprint,[142] supply chain labour standards[143] and many other ESG matters.[144]

It may be argued that the EU is developing greater clarity in the area of environmental sustainability as a taxonomy of sustainable investments has been introduced based on certain outcomes, such as the achievement of a circular economy, the reduction of emissions, the protection of biodiversity and so on.[145] Companies or funds targeting these outcomes could qualify as sustainable investments, thus providing greater clarity as to what sustainable finance means for the investment management sector's grappling with its new ESG duties. That said, the European initiative extends only to the 'E' aspect of ESG, and there remains work to be done in defining outcomes that are socially oriented in nature, such as in line with the UN's Sustainable Development Goals[146] that include no poverty, reducing inequalities, zero hunger, and peace and justice.

Although we are of the view that the investment management sector will likely tread slowly into this area of ESG oversight, it is aware of the policy pressures upon it, and it is likely that we are looking forward to the co-evolution of practice and law/regulation in the area of ESG performance in the mainstream investment as well as niche sectors. Unfortunately, however, there is still a way to go before the law and the practice of investment management place the achievement of ESG outcomes on a similar level to that of the generation of financial returns.

25.5 CONCLUSION

In this chapter we discuss the UK's and the EU's policy approaches to 'stewardship' on the part of the institutional investment sector, which is one of persistent nudging towards compulsion, to engage with their investee companies in order to monitor and change corporate behaviour, often for the purposes of wider social good. Institutions are seen as proximate to their investee companies and well placed to exercise shareholder powers, especially in jurisdictions such as the UK where dispersed ownership and significant shareholder powers in the legal framework are favourable conditions for stewardship. However, owing to limitations in the business models,

[139] UK Code 2020 (n 6) 13–14.

[140] The Shift-Mazars framework for reporting on corporate impact on human rights is found at Shift/Mazars, 'UN Guiding Principles Reporting Framework' (2015) <www.ungpreporting.org/wp-content/uploads/UNGPReportingFramework_withguidance2017.pdf> accessed 28 May 2020.

[141] Such as the ISO40001 standard for assurance.

[142] Such as Transparency International's work on measuring corruption at Transparency International, 'Measuring Corruption' <www.transparency.org.uk/corruption/measuring-corruption/> accessed 28 May 2020.

[143] Such as the SA8000 provided by Social Accountability International, at Social Accountability International, 'SA8000 ® Standard' <https://sa-intl.org/programs/sa8000/> accessed 28 May 2020.

[144] Such as the comprehensive reporting standards developed by the Global Reporting Institute for all corporate social responsibility matters; see Global Reporting Initiative, 'GRI Standards' <www.globalreporting.org/standards> accessed 28 May 2020.

[145] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

[146] See UN Sustainable Development Goals, 'Sustainable Development Goals' <https://sustainabledevelopment.un.org/?menu=1300> accessed 28 May 2020.

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structures and governance of the investment management industry, and such phenomena prevailing in the UK, as well as the EU and the US, we are sceptical that institutions will become key drivers of corporate behavioural change for wider good. There is also the misplaced perception that corporate behavioural change is a private matter for the corporate governance relationship, especially since greater causes such as sustainability are increasingly at stake.

At a less ambitious level, perhaps 'stewardship' can be a starting point for cultural adjustment on the part of the investment management industry as it considers how its structures, incentives, business models and governance affect the ultimate saver. There are numerous issues with the investment management industry that UK and EU regulators are only beginning to grapple with,[147] and the UK Code 2020 has rightly turned back to focusing on how funds and the investment chain serve their ultimate beneficiaries. How funds and asset managers use their corporate governance rights is not unimportant, but this should be crucially contextualized in their relationship with ultimate savers, and not be treated either as a panacea for corporate governance problems or as the ultimate market-based solution for social good.

[147] As discussed in Section 25.3.2.

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