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Learning from the UK in the Proposed Shareholders' Rights Directive 2014? European Corporate Governance Regulation from a UK Perspective

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I. Introduction

The term 'European corporate governance regulation' (ECGR) was explained by *Zumbansen*[1] as a form of norm-creation in corporate governance that reflects multi-level interests and voices in governance as well as pluralistic forms of expression as law.[2] At the European level, corporate governance as a policy area is important in relation to questions such as: (a) whether certain economic, political or legal institutions that underlie company law and corporate governance affect economic competitiveness and development; (b) whether corporate governance institutions affect the market integration project which is the economic constitution of the EU; (c) whether the EU is the appropriate level to address market failures in relation to corporate governance that has cross-border or pan-European implications; and (d) whether there may be other public interest reasons for ECGR which cannot be addressed at more micro-levels of corporate governance discussions i. e. firm or national levels.

In relation to (a), ECGR is intimately connected with comparative corporate governance studies from both economic and legal perspectives. The economic perspectives in comparative corporate governance seek to discern the features of corporate governance at country level that contribute to economic outcomes, such as the growth of capital markets[3] and the competitiveness of

* *Zumbensen*, 'New Governance' in European Corporate Law Regulation as Transnational Legal Pluralism (2008) 14 European Law Journal 246.

1 *Zumbansen*, 'New Governance' in European Corporate Law Regulation as Transnational Legal Pluralism (2008) 14 European Law Journal 246.

2 Which *Zumbansen* terms as transnational legal pluralism. See *Zumbansen*, Neither 'Public' nor 'Private', 'National' nor 'International': Transnational Corporate Governance from the Legal Pluralist Perspective (2011) 38 Journal of Law and Society 50; *Zumbansen*, Spaces and Places: A Systems Theory Approach to Regulatory Competition in European Company Law (2006) 12 European Law Journal 246.

3 Increasingly important for corporate finance in even countries that have traditionally seen bank-based financing as the dominant source of corporate finance, *O'Sulli-*

product and factor markets.[4] For example, the iconic studies by *La Porta et al*[5] in establishing the connection between legal traditions and minority shareholder protection regimes and the growth of capital markets, producing the 'law matters' thesis, are despite various criticisms of their methodology,[6] enduring in their scholarly contribution in leading a line of inquiry into the importance of the legal frameworks for corporate governance.[7] Another example would be the studies in national cultures[8] that match characteristics in national cultures (such as according to *Hofstede's* classification) with economic outcomes such as growth in capital markets and levels of entrepreneurial activity. Legal perspectives focus on the convergence/divergence debate,[9] looking into whether certain winning corporate governance characteristics or formulae would become drivers for legal convergence in corporate governance either through transplantation[10] or the harmonisation of norms at international levels.[11] Criticisms of the comparative corporate governance literature however

van, The Political Economy of Comparative Corporate Governance (2003) 10 Review of International Political Economy 23.

4 *Barker*, Corporate Governance, Competition, and Political Parties: Explaining Corporate Governance Change in Europe (Oxford 2010).

5 *La Porta*, *Lopez-de-Silanes*, *Shleifer* and *Vishny*, Law and Finance (1998) 106 Journal of Political Economy 1113; *La Porta, Lopez-de-Silanes* and *Shleifer*, What Works in Securities Laws (2006) 71 Journal of Finance 1.

6 Such as *Cheffins*, Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies (2003) 23 Oxford Journal of Legal Studies 1; *Aguilera* and *Williams*, 'Law and Finance': Inaccurate, Incomplete, and Important (2009) at http://ssrn.com/abstract=1523895.

7 *Aguilera* and *Williams*, Law and Finance (2009), above.

8 *Breuer* and *Salzmann*, National Culture and Corporate Governance (2009) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1260746; *Licht*, Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform (2003) at http://ssrn.com/abstract=386320.

9 *Hansmann* and *Kraakman*, The End of History for Corporate Law (2000) 89 Georgetown Law Journal 439; which views were defended in a nuanced manner in Hansmann, How Close is the End of History (2005) at http://lesliecaton.com/wordpress/wp-content/uploads/2012/01/7-Hansmann-FINAL.pdf; and in Hansmann and Kraakman, Reflections on the End of History for Corporate Law (2011) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2095419. See also *Yoshikawa* and *Rasheed* (eds), Convergence in Corporate Governance: Promise and Prospects (Abingdon 2012); *Gordon* and *Roe* (eds), Convergence and Persistence in Corporate Governance (Cambridge 2004).

10 Transplantation is driven by a variety of factors, see *Mosquera Valderrama*, Legal Transplants and Comparative Law (2004) International Law Journal 261, and success often depends on the compatibility of firm structures, macro-economic and institutional conditions and national culture, see *Kanda* and *Milhaupt*, Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law (2003) at http://ssrn.com/abstract=391821; *Licht*, Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform (2003) at http://ssrn.com/abstract=386320. Transplantation can also be superficial and cosmetic, as pointed

rightly point out that comparative studies are often based on simplistic presumptions of the functional equivalence of like institutions in different countries,[12] or presumptions of the uniformity of corporate governance practices at country level even if they may vary at firm level.[13] Commentators[14] acknowledge a range of different motivating factors that may affect convergence or divergence apart from the relationship between corporate governance institutions and economic success. Further, certain critics doubt that comparative corporate governance should aspire towards convergence given that corporate governance reflects bargains secured among a variety of economic actors in different political-economic contexts.[15]

In relation to (b), market integration is a fundamental raison d'être of the European Union and maintaining the four freedoms of movement of products, services, labour and capital may be regarded as an economic constitution.[16] It is acknowledged that company law and corporate governance regimes are often forged in local contexts as efficient transactional bargains[17] or socio-political bargains,[18] but differences in corporate law regimes among Member States may result in increased costs for cross-border business in navi-

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out by *Hill*, The Persistent Debate about Convergence in Comparative Corporate Governance (2004) at http://ssrn.com/abstract=881896.

11 *Cunningham*, Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance (1999) 84 Cornell Law Review 1133; *Coffee, Jnr [Î■]*, The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications (1999) 93 Northwestern University Law Review 641.

12 *Clarke*, 'Nothing But Wind'? The Past and Future of Comparative Corporate Governance (2011) 59 American Journal of Comparative Law 75.

13 *Aguilera, Filatotchev, Gospel, Jackson*, An Organizational Approach to Comparative Corporate Governance: Costs, Contingencies, and Complementarities (2008) 19 Organisational Science 475.

14 *Yoshikawa* and *Rasheed*, Convergence of Corporate Governance: Critical Review and Future Directions (2009) 17 Corporate Governance: An International Review 388–404.

15 *Roe*, Political Preconditions to Separating Ownership from Corporate Control (2000) 53 Stanford Law Review 539; *Bebchuk* and *Roe*, A Theory of Path Dependence in Corporate Ownership in *Gordon* and *Roe* (eds.), Convergence and Persistence in Corporate Governance (Cambridge 2004) at 69 ff.

16 *Pelkmans*, European Integration (Harlow 2001) at chapter 1; *Streit* and *Mussler*, The Economic Constitution of the European Community- From Rome to Maastricht, in Micklitz and Weatherill (eds), European Economic Law (Dartmouth 1997) at 30.

17 *Van der Elst*, Economic View on Corporate Law and Corporate Governance in Europe (2014) at http://ssrn.com/abstract=935013.

18 *Siebert*, Corporatist versus Market Approaches to Governance in Hopt et al. (eds), Corporate Governance in Context (Oxford 2005) at p. 281-294; *Hopt*, Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe (1994) 14 International Review of Law and Economics 203.

gating different legal regimes.[19] There is a role for ECGR in transaction-cost reduction and supporting the four freedoms. The rise in cross-border business activity in the EU may also give rise to issues that are best resolved at the pan-European level.[20] However, as *Enriques* and *Matti* argue, harmonising corporate governance at the European level in the interests of market integration produces some drawbacks that adversely affect business activities,[21] and a number of commentators have convincingly pointed out that the lack of harmonisation of corporate governance in the EU, which could give rise to regulatory competition as evidenced in a number of corporate migration cases,[22] does not produce a race to the bottom.[23]

Where (c) is concerned, ECGR needs to be a proportionate measure for addressing corporate governance concerns within the subsidiarity principle.[24] Even then, the protracted and negotiative [■negotiate■] processes in EU law-making may forge corporate governance solutions that are compromised, watered-down and inferior to bottom-up solutions that markets and Member States could produce. As the debates on (a) and (b) are far from settled, a revolutionary approach to ECGR seems unwarranted. ECGR may thus consist of modest steps to bringing corporate governance items onto EU discussion agendas,[25] or engagement in the Europeanisation of corporate governance soft law, such as in the form of a Model Act or Code,[26] that is non-binding in nat-

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19 *Armour* and *Ringe*, European Company Law 1999- 2010: Renaissance and Crisis (2011) at http://ssrn.com/abstract=1691688.

20 European Company Law Experts, Response to the European Commission's Consultation on the Future of European Company Law (May 2012) at http://ssrn.com/abstract=2075034.

21 *Enriques* and *Gatti*, The Uneasy Case for Top-Down Corporate Law Harmonization in the European Union (2006) 27 University of Pennsylvania Journal of International Economic Law 939.

22 Case C-212/97, Centros Ltd v Ehrvervs-og Selskabssyrelsen, ECLI:EU:C:1999:126; Case C-208/00 [■ C-280/00 = Altmark■], Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC), ECLI:EU:C:2002:632; Case C-378/10, VALE építési Kft, ECLI:EU:C:2012:440.

23 *Enriques* and *Gatti*, The Uneasy Case for Top-Down Corporate Law Harmonization in the European Union (2006) 27 University of Pennsylvania Journal of International Economic Law 939; *Armour*, Who Should Make Corporate Law? EC Legislation versus Regulatory Competition (2005) 48 Current Legal Problems 58; *Siems*, Convergence, Competition, *Centros* and Conflicts Of Law: European Company Law In The 21st Century (2002) 27 European Law Review 47.

24 European Company Law Experts, Response to the European Commission's Consultation on the Future of European Company Law (May 2012) at http://ssrn.com/abstract=2075034.

25 European Company Law Expert, Response to the European Commission's Green Paper 'The EU Corporate Governance Framework' (2011) at http://ssrn.com/abstract=1912548.

26 *Baums* and *Krueger Andersen*, The European Model Company Law Act Project (2008) at http://ssrn.com/abstract=1115737.

ure. The former is found in the European Corporate Governance Forum, a forum for dialogue and learning among Member States. Further, ECGR that is developed from soft law initiatives may have longer and more credible periods of gestation and may indeed evolve into more convincing EU-level norms in due course. [27]

However, a surge towards EU regulation in corporate governance is observed as riding on the back of phenomenal amounts of re-regulation in financial regulation in the wake of the global financial crisis 2008-9.[28] Corporate governance failings have been identified to be a contributing cause to a number of bank failures in the UK[29] and EU,[30] even if not the main cause. As corporate governance relates to risk management in the financial sector,[31] and the regulation of risk management may be necessary to avert bank failure,[32] the public interest rationale has, without much resistance, become the basis for extensive corporate governance regulation for the financial sector at the EU level.[33] In other words, corporate governance regulation in the financial sector has become part of prudential regulation.[34] The key initiatives are the regulation of Board responsibilities in banks and investment firms,[35] the eligibility

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27 *Zumbansen*, Neither 'Public' nor 'Private', 'National' nor 'International': Transnational Corporate Governance from the Legal Pluralist Perspective (2011) 38 Journal of Law and Society 50.

28 See chapter 1 and 2, *Andenas* and *Chiu*, Foundations and Future (2014); *Enriques*, Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View (2009) 30 University of Pennsylvania Journal of International Law 1147.

29 *Walker*, Review of Corporate Governance in Banks and Financial Institutions (Nov 2009).

30 *De Larosière* et al., Report by the High Level Group on Financial Supervision in the EU (Brussels, 25 February 2009) http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf, at 29ff.

31 See *Murphy*, Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension (2011) 36 Delaware Journal of Corporate Law 121.

32 *Sabato*, Financial Crisis: Where Did Risk Management Fall? (2009) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1460762; *Blommestein*, *Hoogduin* and *Peeters*, Uncertainty and Risk Management after the Great Moderation: The Role of Risk (Mis)Management by Financial Institutions (2009) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1489826; *Crouhy*, Risk Management Failures During the Financial Crisis in *Kolb* (ed), Lessons from the Financial Crisis (New Jersey 2010) at 283.

33 See Art. 88 ff, Capital Requirements IV Directive 2013.

34 *Avgouleas* and *Cullen*, Market Discipline and EU Corporate Governance Reform in the Banking Sector: Merits, Fallacies, and Cognitive Boundaries (2014) 41 Journal of Law and Society 28 at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2163118 however argue that corporate governance regulation is misguided and prudential regulation should focus on bank structure-related measures.

35 Art 88 Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (Capital Requirements Directive – CRD IV 2013 [■ CRD *or*: CR-Directive]).

of Board appointments,[36] constraints on other contemporaneous Board appointments in order to ensure time and dedication of Board members,[37] and design of financial sector pay in terms of composition, performance yardsticks, time of payout and constraints upon security of entitlement (such as malus and clawbacks).[38] Although the hard regulation of financial sector institutions' corporate governance such as in Board composition and responsibilities, and financial sector pay are not supported in the general listed corporate sector,[39] the new rhetoric of public interest and distrust of the private sector could go some way towards supporting the Commission's appropriation of power to harmonise and regulate aspects of corporate governance. The Commission makes the case for recent proposals in the Shareholders Rights Directive (proposed) by referring to increased remuneration regulation in the financial sector, viz.

> '[t]his proposal is also consistent with the existing regulatory framework. In particular, the new Capital Requirements Directive and Regulation (CRD IV package) have, in order to tackle excessive risk taking, further strengthened the framework with regard to the requirements for the relationship between the variable (or bonus) component of remuneration and the fixed component (or salary). These rules apply to credit institutions and investment firms, both listed and non-listed. The rules in this proposal would however only be applicable to listed companies…'.[40]

Hence, the re-regulation impetus has provided new drive to engage in ECGR, and the package of measures in the proposed Shareholders' Rights Directive show that the Commission's approach to ECGR is arguably based on (d). The implication of this approach is that ECGR may take on an increasingly top-down character as public interest rhetoric builds up around it, and the formerly modest and cautious approach in (c), which is based on the inconclusiveness of (a) and (b), nevertheless retreats. Will the Commission's proposed Shareholder Rights Directive bring about a new phase in ECGR? What will this mean for the role of the UK in ECGR?

This article discusses the development of ECGR and the role of the UK in ECGR. It argues that ECGR has moved from an organic and bottom-up approach and has gradually entered into a phase of more ambitious harmonisa-

36 Above.
37 Article 91 CRD IV 2013.
38 Article 92 ff. CRD IV 2013.
39 *Belcredi* and *Ferranini*, The European Corporate Governance Framework: Issues and Perspectives (2013) at http://ssrn.com/abstract_id=2264990.
40 European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (April 2014) (Commission Proposal 2014) at pp2-3.

tion, blending in with capital markets regulation. Some aspects of corporate governance are being treated for maximum regulatory harmonisation instead of being couched in adaptive and flexible learning. This article argues that where ECGR is pursued in a modest and dialogic way, the UK has enjoyed some norm-providing leadership in the bottom-up and learning framework in corporate governance in the EU. It is queried to what extent the new phase of ECGR would truncate the bottom-up and learning approach and would Member States such as the UK become more like norm-takers[41] of imposed prescriptive regulation?

In Section B [ÎII.■] , the article will first examine the norm-creation processes in UK corporate governance and argue that the UK has always engaged in domestic norm production in corporate governance rather than legal transplantation or borrowing, unless imposed with mandatory requirements from the EU, such as in financial sector regulation.[42] The drivers and context for the norm production tradition in the UK in corporate governance are examined and this article suggests that this context is highly important to the UK's role in ECGR.

Section III. [■] discusses the Commission's proposal to introduce a mandatory say on pay in the Shareholders' Rights Directive 2014[43] and critically discusses whether the role of the UK is that of a norm provider or leader in this particular reform. The UK was the first jurisdiction in the world to introduce a mandatory advisory vote on pay in 2002,[44] and the proliferation of say on pay regimes elsewhere in the world may suggest the UK's leadership in this area.[45] However, the 12 year lapse between the UK's introduction of the advisory say on pay and the initiative in the proposed Shareholders' Rights Directive 2014 may mitigate against arguments seeking to support impressions of the UK's leadership in this area. In fact, the UK has moved ahead again in introducing the binding say on pay in the Enterprise and Regulatory Reform Act 2013. In terms of the UK's role in ECGR, this section will suggest that the UK is not a deliberate but an opportunistic norm-influencer, and its influence on say on pay is critically consolidated by a congruence of private sector and

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41 Quaglia, 'Insurance' and *Howarth* and *Quaglia*, 'Hedge Funds' in Mügge (ed), Europe and the Governance of Global Finance (Oxford 2014) at 67 ff.and 113 ff.respectively, using the terms to mean a leader in setting norms or a follower in adopting norms set by others.

42 Even then the UK is challenging the provisions in the CRD IV in capping variable remuneration, see UK Treasury in legal challenge to EU bonus cap, BBC News (25 Sep 2013).

43 Commission Proposal 2014.

44 UK Directors' Remuneration Report Regulations 2002.

45 Such as the adoption of a binding say on pay in Australia and the advisory say on pay enacted in s951 of the Dodd-Frank Act 2012 in the US, see survey in Thomas and van der Elst, The International Scope of Say on Pay (2013) at http://ssrn.com/abstract_id= 2307510.

political interests. This section will reach into regulation theory to explain why the congruence of interests supporting ECGR in say on pay has been achieved. The article predicts that say on pay will largely be accepted and harmonised as a mature form of ECGR.

Section IV. [■] discusses the Commission's proposal to introduce mandatory disclosure rules for institutional shareholders and their asset managers on engagement with investee companies in the Shareholders' Rights Directive 2014. The UK introduced soft law in the form of the Stewardship Code in 2010 to encourage and govern engagement activity,[46] and this initiative has been keenly studied as to its appropriateness for transplantation elsewhere.[47] Although the proposed Directive does not endorse the Code as such, it endorses the framework of the Code[48] and introduces other requirements, albeit disclosure-based,[49] to shape the nature of shareholder engagement in the EU.[50] The proposal will change the position in the UK if it comes into force, perhaps in a way that would be seen as less comfortable. This section will critically discuss the nature of this reform proposal as a form of ECGR, the UK's influence in this reform proposal and the implications for the UK as a norm-taker.

Section V. [??] draws together the observations made regarding the UK's influence in the two aspects of the proposed Shareholders' Rights Directive 2014 discussed above and offers some general opinions and conclusions regarding the nature of ECGR and the UK's role and influence in ECGR.

The article has selected for discussion the two aspects of the Shareholders' Rights Directive 2014 as these two aspects are arguably pioneering and well-debated introductions when made in the UK, and make apt subjects of study in discussing the influence of the UK in ECGR. The proposed Directive contains a number of other very interesting proposals such as diversity disclosure on Boards, disclosure regulation of proxy advisory agencies, areas which the UK has not provided visible leadership in, as well as minority shareholder protection in related party transactions and obligations imposed on financial intermediaries to facilitate cross-border proxy voting. The very mixture of proposals in the proposed Directive goes to show that ECGR is a complex process and varying voices and influences are enmeshed in the product of the proposed Directive. The study above is therefore limited in certain respects but it hopes to show the extent of and limitations to the UK's role and influence in ECGR,

46 UK Stewardship Code 2010, 2012.
47 Such as the Japan Stewardship Code and the Malaysian Stewardship Code. See Almost 130 institutional investors adopt Japan shareholder code , Reuters (10 June 2014); MSWG and SCM, Joint Public Consultation Paper on the Malaysian Code for Institutional Investors 2014 at http://www.sc.com.my/wp-content/uploads/eng/html/consultation/140115_PublicConsultation_1.pdf.
48 Commission Proposal 2014, Art 3f.
49 Commission Proposal 2014, Arts 3f-3h.
50 This will be explained in Section IV. [??]

and articulates research questions on the UK's role in the new phase of rather prescriptive ECGR couched in public interest rhetoric.

II. The Development of Corporate Governance Norms in the UK

This section posits that the development of corporate governance norms in the UK has largely been domestically generated,[51] but the UK's developments have often become the subject for comparative learning. *Hopt*[52] is of the view that [?In Hopt's View?] the European corporate governance movement has been largely triggered by the first UK Cadbury Code of Corporate Governance.

The fall of BCCI and Polly Peck due to management fraud in 1991 triggered a thorough examination of honest financial reporting by companies and Sir Adrian Cadbury was asked to lead a committee to look into that issue. The Cadbury committee however rightly identified that the governance of the company was integral to a sound financial reporting process, and that internal governance and controls had to be in place before integrity in the output of financial reporting could be secured. Hence, much of the Cadbury Report[53] dealt with a model of good governance for companies, including Board effectiveness, Board composition including non-executive directors, the formation of independent committees of the Board, the appointment of auditors and how audit services should be provided, and the role of shareholders. The product of the Cadbury Committee's deliberations was the Cadbury Code of Corporate Governance, the pioneering piece of soft law on corporate governance in the UK. The Code represents for the UK the first explicit acceptance of the importance of 'corporate governance' in companies. The Code is subject to a comply-or-explain regime, and they are adopted into the Listing Rules which require explanation for deviation if the standards in the Code are not complied with by Premium-listed companies on [■ companies listed in the Premium Capital Port of?] the London Stock Exchange.

Jones and *Pollitt*[54] have carried out empirical research on the matrix of influences in the generation of corporate governance standards in the UK and find that the Cadbury Code was influenced strongly by the UK business sector, financial regulators and the professional services industry such as accountants

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51 See for discussion of the factors driving domestic norm generation or legal transplantation, *Grajzl* and *Dimitrova-Grajzl*, The Choice in the Lawmaking Process: Legal Transplants vs. Indigenous Law (2008) at http://ssrn.com/abstract=1130124.

52 *Hopt*, Comparative Corporate Governance: The State of the Art and International Regulation (2011) 59 American Journal of Comparative Law 1.

53 *Cadbury*, Report of the Committee on the Financial Aspects of Corporate Governance (Dec 1992).

54 *Jones* and *Pollitt*, Who Influences Debates in Business Ethics? An Investigation into the Development of Corporate Governance in the UK Since 1990 (ESRC CBR Research Paper 2001).

and lawyers, and to a lesser extent by the government and institutional fund industry, and even less by the media and the general public. The government was initially influential due to the negative media and social perception of the BCCI and Polly Peck scandals, but retreated in influence as public and media interest waned. The political context was however key to kick-starting the process culminating in corporate governance reforms. The corporate governance movement in the UK was focused on domestic business interests as post-scandal implications would affect UK businesses most acutely. Further, as corporate governance is a somewhat specialised and even technical area, the immediate stakeholders who were most interested and persistent in shaping its development were regulators, businesses who have to adjust to the new standards, and professional stakeholders.[55]The regulatory stakeholders, i.e. the Bank of England and London Stock Exchange, were also supportive of a soft law approach, as such aligned with the culture of 'negotiated' regulation in the UK – this means that businesses in the UK are not imposed with regulatory intervention unless necessary, and such regulatory intervention is shaped largely by bottom-up influences from the industry itself.[56] In sum, the Cadbury Code of Corporate Governance was a pragmatic and proportionate approach to addressing business scandals in the UK, shaped by a matrix of influences largely based in the UK and was in keeping with the British tradition of 'negotiated' regulation.

This trend of domestic generation of corporate governance reforms continued, most developments being in soft law rather than in legislation, except for the introduction of the Directors' Remuneration Report Regulations 2002 (which will be discussed in Section C [■ III.?]). In 1995 the governance issue in the spotlight was executive remuneration, as public outcry mounted against excessive executive remuneration in privatised utilities companies, while staff reductions and pay restraint for staff took place in such companies.[57] The Committee led by Sir Richard Greenbury to look into this issue produced a Report which recommended more robust guidelines for the structure and operation of independent remuneration committees on the Board, and also advocated greater shareholder engagement with remuneration issues. The Code

55 Further, although the CBI representing UK business interests was not wholly contented with the introduction of a Code, the adoption of soft law was seen as a necessary step to avoid regulation and preserve the credibility of bottom-up self-regulation that would be less costly and more acceptable to businesses.

56 *Wilks*, The Amoral Corporation and British Utility Regulation (1997) 2 New Political Economy 280, quoted in *Dignam*, Exporting Corporate Governance: UK Regulatory Systems in a Global Economy (2000) Company Lawyer 70, and this concept is also again extensively discussed in *Dignam*, Capturing Corporate Governance: The End of the UK Self-regulating System (2007) 4 International Journal of Disclosure and Governance 24.

57 Paras 1.6-1.7, *Greenbury*, Report: Directors' Remuneration (17 Jul 1995) (hereinafter known as the Greenbury Report).

was modestly amended in that light.[58] As the Committee was dominated by business interests, the recommendations did not go very far and addressed largely the financial stakeholders' interests. A similar matrix of influence was detected in the Hampel Committee instituted in 1999 to review the *Cadbury Code*,[59] which recommended much of the Code to be retained subject to minor tweaking.

The resultant Combined Code of Corporate Governance was then reviewed in 2003, 2005, 2009 and 2012. It could be argued that non-domestic influences started to affect the perspectives of corporate governance in the Code. In 2003,[60] the *Higgs Report*[61] recommended greater clarification to the institution of non-executive directors and made the 'independence' criteria more robust, learning from other jurisdictions such as Scandinavian jurisdictions. In 2005,[62] the *Turnbull Report*[63] recommended beefing up of internal control in companies in the wake of the US Enron scandal and Sarbanes-Oxley Act 2002; and in 2009[64] and then 2012,[65] the global financial crisis triggered important reviews such as the *Walker Review of Corporate Governance in Banks and Financial Institutions*[66] which fed into Code amendments. Although the wider context of international influences was important, these revisions focused ultimately on the needs of UK businesses and investors and sought to achieve a domestically generated solution that is proportionate and not over-reaching. In 2014, the Code was amended again. There were two major driving factors for the amendments, one being domestically generated and the other a manifestation of European influence. First, institutional share-

58 *Jones* and *Pollitt*, Who Influences Debates in Business Ethics? An Investigation into the Development of Corporate Governance in the UK Since 1990 (ESRC CBR Research Paper 2001).

59 Above.

60 See p4, [■] FRC, The UK Approach to Corporate Governance (2006) at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/The-UK-Approach-to-Corporate-Governance-(1).pdf.

61 *Higgs*, Review on the Role and Effectiveness of Non-executive Directors (Jan 2003).

62 FRC, Review of the Turnbull Guidance on Internal Control (2005) at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Turnbull-review-evidence-paper.pdf.

63 FRC, Internal Control: Guidance for Directors on the Combined Code (1999, rev. 2005).

64 FRC, 2009 Review of the Combined Code: Final Report (2009) at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/2009-Review-of-the-Combined-Code-Final-Report.pdf.

65 FRC, Revisions to the Corporate Governance Code and Guidance to Audit Committees (2012) at https://www.frc.org.uk/getattachment/cb2a31b9-f673-4c52-b02a-75996ab8f202/Feedback-statement-on-UK-Corporate-Governance-Code-and-Guidance-on-Audit-Committees-September-2012.aspx.

66 *Walker*, Review of Corporate Governance in Banks and Financial Institutions (Nov 2009).

holders were concerned about the quality of 'going-concern' certifications of listed companies, as it appeared that such certifications could not have supported the UK banks that were on the brink of failure in the UK banking crisis. The *Sharman Inquiry*[67] was constituted to look into the credibility and nature of the 'going-concern' certification and recommended that more clarification of the status of the certification was necessary. The 2014 Code amendments therefore support directors' obligations to provide better qualitative disclosure to shareholders regarding the longer-term viability of their companies, beyond the immediate 'going-concern' statement. Secondly, the Code was amended to encourage companies to design executive remuneration so that executives are incentivised to promote the long term success of the company. This may have been influenced by EU legislation in the financial sector that intervenes into pay design in order to discourage excessive and short-termist risk-taking.[68] The generation of corporate governance norms in the UK seems to be taking on a new character.

From a cursory look at the list of respondents to the 2005, 2009 and 2012 reviews of the Corporate Governance Code, representation by constituents in the UK is dominant. Businesses, the fund and asset management industry, regulators, think-tanks such as the Institute for Business Ethics and the Institute of Directors, professional bodies such as the ICAEW are all staple respondents and largely UK-based. The 2012 review saw responses from interested parties outside of the UK or are international outfits such as the Irish Stock Exchange, proxy advisory agency PIRC and fund managers with an international profile such as UBS Asset Management, and this trend carried on in the 2014 review.[69] Arguably, the global financial crisis 2008-9 has provided a context for UK to move away from a dominantly domestic approach to corporate governance norm creation. It is however noted that domestic influences remain very dominant, such as the Walker Review's (which was the main background for the 2012 Code review) focus on actual business practice in UK banks and the Sharman Inquiry's focus on UK capital markets. Specific reviews into the failures at the Halifax Bank of Scotland[70] and the Royal Bank of Scotland[71] also

67 The Sharman Inquiry, Going Concern and Liquidity Risks: Lessons for Companies and Auditors, Final Report and Recommendations of the Panel of Inquiry (June 2012), at http://www.frc.org.uk/getattachment/591a5e2a-35d7-4470-a46c-30c0d8ca2a14/Sharman-Inquiry-Final-Report.aspx.

68 Art 90 CRD IV 2014.

69 FRC, Proposed Revisions to the UK Corporate Governance Code: Consultation Paper (Apr 2014) at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Proposed-Revisions-to-the-UK-Corporate-Governance-File.pdf.

70 House of Commons and House of Lords, Parliamentary Commission on Banking Standards, An Accident Waiting to Happen: The Failure of HBOS (4 April 2013); PRA and FCA, Review into the Failure of HBOS: Terms of Reference (July 2014).

71 Financial Services Authority: The Failure of Royal Bank of Scotland (2011) at 220 ff, at http://www.fsa.gov.uk/pubs/other/rbs.pdf.

provided specific lessons to be learnt in the UK context and provided much material from which reforms in the UK were drawn.

Since the Cadbury Code, the development of corporate governance standards in the UK has largely been based on input from the matrix of dominantly UK-based influences, and reflects solutions that are forged in a bottom-up manner, addressing the problems that have arisen in the UK context.[72] The domestic nature of corporate governance norm generation in the UK has held fast, for example, in the face of regulatory changes in 2002 in the US when the Sarbanes-Oxley Act 2002 was introduced. Although the *Turnbull Guidance* encouraged the strengthening of internal control at companies and the Financial Reporting Council is cognisant of the US COSO guidance issued since 1992,[73] the UK refrained from adopting provisions mirroring the Sarbanes-Oxley Act 2002 such as certification of financial reporting by the Chief Financial Officer. Further, the UK's corporate governance norms dealt mainly with the principal-agent problem between managers and shareholders, reflecting very much the interests of a corporate sector that features dispersed ownership in much of the UK listed sector.[74] Therefore, corporate governance norms are not developed ideologically but pragmatically, and the UK was very slow in dealing with the principal-principal problems that feature in corporate sectors with concentrated ownership[75] until such companies were listed on the London Stock Exchange from the late 2000s and became embroiled in scandals in recent years.[76]

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72 *Rayton* and *Cheng* report steady adherence by UK listed companies to the Code up to 2002, see *Rayton* and *Cheng*, Corporate Governance in the UK: Changes to the Regulatory Template and Company Practice 1998-2002 (2004) at http://www.bath.ac.uk/management/research/papers.htm

73 The latest version is COSO, Internal Control: Integrated Framework (2013) at http://www.coso.org/documents/990025P_Executive_Summary_final_-may20_e.pdf.

74 *Hopt*, Comparative Corporate Governance: The State of the Art and International Regulation (2011) 59 American Journal of Comparative Law 1.

75 Much of the rest of the world, see *Morck* (ed), Concentrated Corporate Ownership (Chicago 2000); A History of Corporate Governance around the World (Chicago 2005).

76 Such as Bumi (now renamed Asia Mineral Resources -■), ENRC (Eurasian Natural Resources Corporation -■) and Essar Energy, discussed in *Barker* and *Chiu*, Protecting Minority Shareholders in Blockholder-Controlled Companies – Evaluating the UK's Enhanced Listing Regime in Comparison with Investor Protection Regimes in New York and Hong Kong (2015) Capital Markets Law Journal forthcoming. The reforms to combat block-holder principal-principal problems are found in a regime separate from the Corporate Governance Code – i. e. The Enhanced Listing Regime for companies featuring controlling owners, see Financial Services Authority, Enhancing the Effectiveness of the Listing Regime and Feedback on CP12/2 (Oct 2012); Financial Conduct Authority, Enhancing the Effectiveness of the Listing Regime and Further Consultation (November 2013); Response to CP13/15 – Enhancing the Effectiveness of the Listing Regime (16 May 2014).

Despite the rather context-specific nature of UK corporate governance norms, *Hopt*[77] observes that the UK Corporate Governance Code is the 'current prototype and international model' for many countries' corporate governance codes, and 'the corporate governance code movement has swept from the United Kingdom all over the world'.[78] In particular, the institution of the independent director, which was first endorsed as the 'non-executive director' in the Cadbury Code, then redefined and clarified in the Higgs Review in 2003, has become an international institution in corporate governance as academics who survey convergence in corporate governance observe its common adoption and importance in many jurisdictions.[79]

The influence of UK corporate governance internationally and in Europe is arguably not intentioned but certainly benefits from first mover advantage. The popularity and maturity of London's equity markets are also important for making the corporate governance standards of the listed sector appealing for emulation by others.[80] Jurisdictions looking to develop their capital markets may find the transplantation of corporate governance standards and minority shareholder protection regimes from the leading jurisdictions of the UK and US helpful to kick-start their own processes.[81] However, diversity in corporate structures remains an important factor for corporate governance divergences between jurisdictions.[82] That said, the growth of the international fund and asset management industry, dominated by US and UK institutions, has re-

77 *Hopt*, Comparative Corporate Governance: The State of the Art and International Regulation (2011) 59 American Journal of Comparative Law 1 at 12.

78 Above at 69.

79 *Davies* and *Hopt*, Boards in Europe: Accountability and Convergence (2013) 61 American Journal of Comparative Law 301. Empirical studies on Hong Kong listed issuers shows that independent directors are valued by the capital markets and investors reward these issuers with higher valuations, see for example *Lei* and *Song*, Board Structure, Corporate Governance and Firm Value: Evidence from Hong Kong (2012) 22 Applied Financial Economics 1289. This is also the case in India, see *Chakrabarti and Sarkar*, Corporate Governance in an Emerging Market – What Does the Market Trust? (2010) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615960 finds in empirical research that the market perceives listed companies with more and better qualified independent directors favourably.

80 *O'Sullivan*, The Political Economy of Comparative Corporate Governance (2003) 10 Review of International Political Economy 23.

81 *Cheffins*, Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies (2003) 23 Oxford Journal of Legal Studies 1.

82 *Armour*, Who Should Make Corporate Law? EC Legislation versus Regulatory Competition (2005) 48 Current Legal Problems 58; *Gerner-Beuerle*, Determinants of Corporate Governance Codes (2014) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2346673; *Cicon, Ferris, Kammel* and *Noronha*, European Corporate Governance: A Thematic Analysis of National Codes of Governance (2012) 18 European Financial Management 620; *Belcredi* and *Ferranini*, The European Corporate Governance Framework: Issues and Perspectives (2013) at http://ssrn.com/abstract_id=2264990.

sulted in a trend of bringing institutional preferences to bear on the capital markets of countries where these funds invest.[83] Such institutional preferences converge on minority protection rights, and certain corporate governance standards such as Board [? board] independence and the independent audit committee as safeguard for the integrity of corporate reporting.[84] The preferences of the international fund and asset management industry would become an important converging factor that helps in boosting the appeal of UK corporate governance norms which are familiar to UK institutions making investments abroad.[85]

In this light, we now turn to the issue of say on pay and whether and how the UK approach to say on pay[86] has played a leading role in ECGR. This model possibly represents the UK's preferred stance on ECGR where bottom-up corporate governance solutions are considered and learnt at the European level, perhaps happily culminating in an endorsement of the UK leadership in norm-provision.

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83 *Hawley* and *Williams*, Shifting Ground: Emerging Global Corporate-Governance Standards and the Rise of Fiduciary Capitalism (2005) 37 Environment and Planning 1995; *Barker* and *Chiu*, Protecting Minority Shareholders in Blockholder-Controlled Companies – Evaluating the UK's Enhanced Listing Regime in Comparison with Investor Protection Regimes in New York and Hong Kong (2015) Capital Markets Law Journal forthcoming.

84 There is much empirical evidence on the increased valuation of companies on securities markets driven by investor preferences where good corporate governance is instituted. See *Bertoni*, *Meoli*, and *Vismara*, Board Independence, Ownership Structure and the Valuation of IPOs in Continental Europe (2014) 22 Corporate Governance 116; *Brown* and *Caylor*, Corporate Governance and Firm Valuation (2009) 25 Journal of Accounting and Public Policy 409 (arguing that there are only a few cherished corporate governance notions that make a difference eg independent directors); *Chung* and *Zhang*, Corporate Governance and Institutional Ownership (2011) 46 Journal of Financial and Quantitative Analysis 247; *Picou* and *Rubach*, Does Good Governance Matter to Institutional Investors? Evidence from the Enactment of Corporate Governance Guidelines (2006) 65 Journal of Business Ethics 55.

85 For example, *Bauer* et al. [?*Moers* and *Viehs,* The Emerging Market for European Corporate Governance,?] document that corporate [? activities/earnings or …?] respond to the preferences of their institutional investors, and increased US and UK institutional ownership in European corporate sectors dominated by other ownership structures have led to changes in corporate practice such as increasing share buy-backs or dividends to cater to the demands of these institutional investors, see *Bauer, Braun,* and *Clark*, The Emerging Market for European Corporate Governance: The Relationship between Governance and Capital Expenditures, 1997-2005 (2007) at http://ssrn.com/abstract=1030771.

86 Which has been introduced since the Directors' Remuneration Report Regulations 2002 and now reformed under Chapter 4A of the Companies Act 2006 inserted by the Enterprise and Regulatory Reform Act 2013.

III. Shareholders' Say on Pay

Executive pay is an area where the agency problems between management and shareholders play out significantly – enormous pay packages for executives could imply wealth transfer to executives. However, *Jensen* suggests that '[i]f you took all the CEO's of our 1,000 largest companies and got them to work for nothing forever, the effect on aggregate shareholder wealth would be almost imperceptible.'[87] The effect of large pay packages for executives on shareholder wealth may not be pronounced where corporate performance is robust. But such packages would appear unjustified where performance is lacklustre, and 'rewards for failure' would be a manifestation of the agency malaise. Moreover, as *Dignam*[88] rightly points out, enormous executive pay packages is [?are?] not merely an issue of potential misalignment of managers' and shareholders' interests such as in rewards for failure, but an issue of social perception of inequality.

1. The Evolution of Executive Pay Reforms in the UK

Executive pay reforms in the UK have evolved in response to the domestic political and socio-economic contexts, and reflect a process of norm-generation for domestic concerns. However, this Section will show how such reforms have become internationally influential, and have assumed a leadership profile in ECGR.

2. Greenbury Reforms 1995

Executive pay is fundamentally a contractual issue. The company and executive negotiate with each other, settling upon terms that are to a large extent conditioned by the global market for executive talent. In the UK, the furore over executive pay arose in the mid 1990s after media reports of skyrocketing executive pay at privatised utilities companies generated extremely negative opinion. Excessive executive pay became a political issue as the Conservative government's programme of privatisations was controversial to begin with. The nature of the executive pay problem was therefore a social and not a corporate governance one. However, the Greenbury Committee which was tasked to look into this 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 on the Board in designing appropriate executive remuneration and the laying of the committee report before shareholders.[89]

87 Shadow SEC Roundtable on the New Disclosures of Executive Pay (1993) 5 J. of App. Corp. Fin. 62 at 73.

88 *Dignam*, Remuneration and Riots: Rethinking Corporate Governance Reform in the Age of Entitlement (2013) Current Legal Problems 66.

The policy approach of co-opting shareholders to govern the area of excessive executive remuneration is arguably in line with the British tradition of negotiated regulation, which seeks out a proportionate bottom-up approach to address problems without first resorting to regulation. It is also in line with modern regulatory theories which increasingly highlight the limits of top-down command-and-control regulation and argue for more flexible, inclusive and de-centred[90] means of governance. A de-centred landscape for governance means that there are many actors capable of exercising influence over policy-making and assuming governance capacity in the landscape, including the business sector, institutional shareholders, the stock market, professional services industries and other stakeholder groups such as consumers. Public authorities such as regulators are not in an exclusive position to exercise power and undertake governance. *Meyer*, *Drori* et al[91] argue that contemporary areas of governance are dominated by knowledge-based individuals and communities whose collective 'actorhood' provides a form of governance that is perceived as legitimate and credible because of the knowledge, expertise, professionalism and rationality in operation and action. In the area of executive pay, shareholders, especially institutional shareholders would have both the proximity and competence to provide governance in the form of monitoring the appropriateness of pay packages for senior executives. Hence, the co-option of shareholders to scrutinise executive pay was accepted by politicians as a good way forward and in this way, the issue becomes de-politicised while impression is created that it is being scrutinised.

3. The Directors' Remuneration Report Regulations 2002

However, *Roach*[92] documents that after the Greenbury recommendations were introduced, the quality and comparability of corporate disclosure on executive remuneration made to shareholders were unsatisfactory and generally low. The government thus took further action to improve disclosure and to introduce an advisory shareholder vote on pay in order to compel shareholders to engage with the issue, via the Directors' Remuneration Report Regulations 2002. The continued framing of the executive pay issue as a corporate governance issue was perhaps important to the government so that the issue would remain de-politicised and there would be no need for the government to assume further top-down governance in an area that is essentially private in nat-

89 *Greenbury*, Report: Directors' Remuneration (17 Jul 1995).

90 *Black*, Decentring Regulation (2001) Current Legal Problems 103; *Black*, Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation (2003) Public Law 63.

91 *Drori* and *Meyer*, Global Scientization: An Expanded Environment for Organization in Drori, *Meyer* and *Hwang* (eds), Globalization and Organization (Oxford 2009).

92 *Roach*, The Directors' Remuneration Report Regulations 2002 and the Disclosure of Executive Remuneration (2005) 25 Company Lawyer 141.

ure. Hence the objective of the Regulations was paradoxically, to limit the government's need to further intervene in executive pay!

This Section will therefore discuss the importance of the institutional shareholder community as a governance actor in the UK corporate sector. The City (shorthand for the financial sector in the UK), of which many well-established funds and asset managers are part, is a powerful institution on level with the business sector. American commentators in the 1990s[93] have noted with interest the peer respect business has for the City and how institutional shareholders may engage with business on governance issues behind closed doors. Although shareholder engagement has not been an overt and active phenomenon in those days, the relationship between business and the City is one of mutual respect and readiness for dialogue. This point will be elaborated further in Section D [■ IV.?]. This article therefore argues that the executive pay reforms in the DRRR 2002 introduced in the UK is [are?] very much bound up with the UK's context, viz., the power and position of institutional shareholders and the tradition of negotiated regulation, and is therefore an example of domestic corporate governance norm generation.

However, the pioneering advisory vote on pay for shareholders has become a leading standard globally. *Thomas* and *van der Elst*[94] in their international survey show that Australia, Belgium, the Netherlands and Sweden followed suit in terms of providing shareholders with a say on pay. The authors opine that the converging factors in the jurisdictions that have adopted say on pay reforms are: changes in the ownership and corporate governance structures in those jurisdictions such as increased dispersal of ownership from block-held companies; and the increased presence of foreign institutional shareholders from the US and UK as a source of equity finance in those markets. These changes, which seem to suggest greater resemblance with markets such as the UK's, are important in shaping policy perceptions in favour of the governance role of shareholders in monitoring executive pay. The authors suggest that the jurisdictions that have reformed say on pay taking their cue from the UK's leadership have also been facing social discontent over rising levels of executive pay and widening income inequalities. The 'corporate governance' framing of executive pay and the co-option of shareholders as monitors in this area would relieve of the need for top-down regulation, which is challenging in this intricate area, and achieve the de-politicisation of the issue. It seems that the exportability of UK corporate governance norms may come from a first mover advantage, but is also due to the relative similarity of market and social conditions in the adopting jurisdictions. In particular, it may be noteworthy that

93 *Black* and *Coffee*, Hail Britannia?: Institutional Investor Behavior under Limited Regulation (1993-4) 92 Michigan Law Rev 1997.

94 *Thomas* and *van der Elst*, The International Scope of Say on Pay (2013) at http://ssrn.com/abstract_id= 2307510.

changes in market conditions in adopting jurisdictions are in part due to the expansion of US and UK institutional investing activities in those markets.

In terms of the UK's role in ECGR in the area of say on pay, the Commission's communication in 2004[95] to encourage all listed companies to make disclosure of their remuneration policies and remuneration items for individual directors may be seen as an endorsement of the UK leadership on say on pay, albeit in the form of soft law. There is however mixed evidence in the UK itself regarding the success of the DRRR. *Ferris* and *Maber*[96] find that firms with the weakest governance improved remuneration design to be more aligned with performance, and shareholder engagement on pay such as significant numbers of negative votes would result in companies revising remuneration packages and in some cases removing the CEO altogether. The advisory vote on pay therefore had a marked governance effect. On the contrary, *Conyon* and *Sadler* find little shareholder dissent on pay and little change in companies that have previously experienced negative votes.[97]

The leadership of the UK in say on pay reforms could be summed up as being important for incremental learning by others. Interest in remuneration reforms however revived in the light of the global financial crisis 2008-2009. The crisis was a turning point for say on pay as bankers' remuneration became highlighted as a contributing risk factor for bank failure.

4. Impact of the Global Finance Crisis 2008-9

The structure of financial sector remuneration has arguably given rise to a number of perverse incentives[98] on the part of financial sector employees and management, including short-termism and excessive risk-taking. Much of financial sector remuneration is variable remuneration, but in this way, financial institutions can 'insure' themselves against poor performance, paying out only where there is performance to be rewarded.[99] However, the definition of 'performance' may be managed by financial sector employees and management such that the thresholds for eligibility for variable remuneration are aligned

95 European Commission, Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies.

96 *Ferri* and *Maber*, Say on Pay Votes and CEO Compensation: Evidence from the UK (2012) at http://ssrn.com/abstract=1420394.

97 *Conyon* and *Sadler*, Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK (2010) 18 Corporate Governance 296.

98 *Sharfman*, How the Strong Negotiating Position of Wall Street Employees Impacts the Corporate Governance of Financial Firms (2011) 5 Virginia Business and Law Review 350.

99 *Thannasoulis*, The Case for Intervening in Bankers' Pay (2012) 67 The Journal of Finance 849; *Ferranini* and *Ungureanu*, Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks (2011) 64 Vanderbilt Law Review 432.

with their interests, and are short-termist in nature, not taking into account of the longer term performance of financial products that have been distributed or sold. [100] Financial sector remuneration structures have played a major part in incentivising excessive risk-taking by financial intermediaries,[101] in the context of the dislocation of reward from purpose. Further, *Thannasoulis*[102] has found that bank remuneration may constitute 50 to 80 per cent of the institution's balance sheet, implying a very real problem of transfer of wealth to financial intermediaries while investors and stakeholders bear the risks. In the wake of the global financial crisis, regulatory interest in reforming financial sector remuneration has revived, and this has also entailed a knock-on effect in reforming corporate governance standards on executive remuneration generally in the corporate sector.

Regulation of financial sector pay has proceeded upon the basis that financial sector pay has become a stumbling block to the prudential governance of financial sector institutions. The EU has recognised that the 'inappropriate remuneration structures of some financial institutions have been a contributory factor' to the failure of various financial institutions in the global financial crisis[103] Hence, legislation was introduced to provide principles and guidelines on how remuneration policies in financial institutions should be aligned with sound and effective risk management.[104] A second round of tougher legislative reforms on financial sector pay took place in 2013, including introducing a cap on variable pay to a 1:1 ratio with fixed pay or a 2:1 ratio upon shareholder approval,[105] and provisions for malus (the forfeiture of unvested deferred remuneration) and clawback of remuneration in specified circumstances.[106]

5. The Development of European Initiatives on Say on Pay

Although the direct regulation of financial sector pay is based on unique prudential considerations that do not apply to the corporate sector generally, interest in reforming say on pay revived. The European Commission saw the opportunity to assert that the previous communication on remuneration disclosure for listed companies is generally inadequate to address the post-crisis

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100 *Davies*, The Financial Crisis: Who is to Blame? (Cambridge 2010) generally.

101 *Bhattacharyya* and *Purnanandam*, Risk-Taking By Banks: What Did We Know and When Did We Know It? (November 2011) http://ssrn.com/abstract=1619472, accessed 9 March 2013.

102 *Thannasoulis*, The Case for Intervening in Bankers' Pay (2012) 67 The Journal of Finance 849.

103 Recital 1, Capital Requirements Amendment Directive 2010.

104 Capital Requirements Amendment Directive 2010; CEBS Guidelines 2010; CRD IV Art 90, UK Remuneration Code, now PRA and FCA Handbooks SYSC 19A containing various rules on performance metrics, deferral, form of remuneration etc.

105 Art 90, CRD IV.

106 Above.

landscape and proceeded to introduce a communication[107] to compel listed companies in the EU to: (a) adopt a principle of proportionality of remuneration within the company, by benchmarking directors' remuneration to the other executive directors in the board and the (senior) employees in the company, (b) control severance pay (golden parachutes) and ensure that they are not be payable in case of failure, (c) design pay policies that reinforce the link between pay and performance, (d) provide for a balance between long and short term performance criteria in pay design in order to promote the long term sustainability of the company, such as deferment of variable directors' remuneration, (e) put in place clawback mechanisms for variable remuneration paid which is afterwards discovered to be based on misstated profits and (f) allow shareholders to vote on directors' remuneration packages.

The Commission's communication in 2009 includes quasi-prescriptive elements of regulating pay although shareholders are the primary actors in governance in this area. Direct regulation of listed company executive pay would amount to a form of micro-management that could untenable, as non-banking sectors do not pose the same extent of systemic risk. The Commission has adopted shareholder say on pay as the most acceptable blueprint for harmonising corporate governance norms in this area, reaching into this much contested area of corporate governance without appearing overly-prescriptive. It is arguable that the UK's leadership on say on pay is perhaps the inspiration for such legal integration in the EU when the appropriate opportunity for regulation (such as in the wake of a crisis[108]) arises.

The European Commission's interest in legal integration in the area of say on pay builds on its creeping success in harmonising shareholders' roles and rights. The Shareholders Rights Directive 2007[109] which harmonises shareholders' voting rights, purportedly in order to facilitate easier exercise of shareholders' voting rights in a cross-border context,[110] has been generally re-

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107 European Commission, Communication from the Commission accompanying Commission recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector (30 April 2009).

108 *Clarke*, Cycles of Crisis and Regulation (2004) 12 Corporate Governance 153.

109 Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.

110 A number of commentators felt that the Directive did not really address the issues of ease of access to voting by shareholders whose legal interests are held by custodians in dematerialised shares, see *Hainsworth*, The Shareholder Rights Directive and the Challenge of Re-Enfranchising Beneficial Shareholders (2007) 1 Law and Financial Markets Review 11; *Masouros*, Is the EU Taking Shareholder Rights Seriously?: An Essay on the Impotence of Shareholdership in Corporate Europe (2010) 5 European Company Law 195. As such the Directive could be seen more as furthering a corporate governance harmonisation agenda in shareholders' rights rather than achieving a pan-European objective of facilitating shareholders' exerci-

garded to be a step in the right direction[111] as the pan-EU level is an appropriate forum for cross-border shareholder voting to be addressed. Such legal harmonisation is also supported by the institutional shareholder quarter.[112] Building on that success and the 2009 communication, the Commission has now proceeded to propose a mandatory advisory vote for shareholders on pay in 2014.[113] The Commission's proposal is to provide shareholders with a right to vote on remuneration policies and where any remuneration package for individual directors may deviate from the policy. The Commission has also taken the opportunity to harden into legislation many of the disclosure items in the Communications of 2004 and 2009, in order to provide a meaningful information context for the shareholder vote.[114]

It is likely that the Commission proposals on say on pay would not be defeated in the political process, although the final legislation would be modified as the consultations and political processes bring about changes to the original proposal. The path towards less and less controversy over say on pay was first charted by the UK but for a while, the UK's pioneering norms provided only a platform for incremental learning. This article is of the view [■ says or …?] that the culmination of say on pay reforms in the Commission's 2014 proposal reflects in part the norm setting leadership of the UK. However, the UK's pioneering norms would arguably not have catalysed at the level of ECGR without the global financial crisis and the perception of acceptability in regulating financial sector pay. Further, the crucial adoption of say on pay reforms by the US in the Dodd-Frank Act of 2010[115] also levels the playing field for competition in corporate governance norms, and further reinforces ECGR in say on pay.

The Dodd-Frank Act 2010 provides for the right of the Securities Exchange Commission to prescribe rules on shareholder advisory votes on executive remuneration and golden parachutes. The SEC has prescribed rules requiring issuers to put to an advisory vote at least once every three years the executive pay package for the Chief Executive officer and at least 4 other named execu-

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se of rights as defined by Member States, see *Zetzsche*, Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive (2008) at http://ssrn.com/abstract=1120915.

111 *Rose*, The New European Shareholder Rights Directive: Removing Barriers and Creating Opportunities for More Shareholder Activism and Democracy (2012) 16 Journal of Management Governance 269.

112 Above, European Commission, Summary of the Informal Discussions Concerning the Initiative on Shareholders Engagement (March 2013).

113 European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (April 2014) (Commission Proposal 2014).

114 Articles 9a and 9b, Commission Proposal 2014.

115 Section 951.

tives.[116] Golden parachutes for any executive in connection with a merger, acquisition or sale or disposition of business would also have to be subject to an advisory shareholder vote. A number of empirical studies on the impact of say on pay have been conducted. *Cai* and *Walkling*[117] find that firms with the weakest governance subject to shareholder scrutiny on pay have improved their practices and performance. The authors are however sceptical that say on pay has a positive impact on firms that already have good governance as shareholders could use say on pay as a mechanism for other forms of activism that may adversely affect the firm. However, other commentators[118] regard the say on pay reforms positively as the relative weaknesses in US state law in shareholder rights and protection[119] are in part overcome by greater opportunities offered in securities regulation for engagement and activism. Thus, say on pay is looked at as a mechanism that has a broader purpose of addressing the agency problem and holding managers to account.

The breakthrough on say on pay achieved by US legislation and the SEC's rule could not have taken place if the global financial crisis had not created a favourable political opportunity. The adoption by the US of shareholder say on pay, a key capital markets jurisdiction, is likely to be important for international convergence in due course on shareholders' say on pay.

The evolution of say on pay reforms internationally and in ECGR shows that the domestic norm generation in the UK would likely have major international impact if (a) common perceptions of the agency problem exist; (b) appropriate political conditions exist, such as found in the US and the EU in the wake of the global financial crisis, where appetite for more intrusive corporate governance regulation has arisen; and (c) support is forthcoming from institutional shareholders, the sector being highly characterised as dominated by US and UK institutional investors who bring similar preferences to bear on international capital markets. Building on *Kanda* and *Milphaupt's* thesis that legal transplantation will only be successful in cases of both 'micro' and 'macro' fits between donor and donee jurisdictions, the observations in the evolution of say on pay reforms internationally suggest that ownership structures, in particular the presence of Anglo-American institutions as minority shareholders,

116 Exchange Act Rule 14a-21(a).

117 *Cai* and *Walkling*, Shareholders' Say on Pay: Does It Create Value? (2011) 46 Journal of Financial and Quantitative Analysis 299.

118 *Cotter*, *Palmiter* and *Thomas*, The First Year of 'Say on Pay' under Dodd-Frank: An Empirical Analysis and Look Forward (2013) 81 George Washington Law Review 967; *Kimbro* and *Xu*, Shareholders Have a Say On Executive Compensation: Evidence from Say-On-Pay in the United States (2013) at http://ssrn.com/abstract=2209936; *Liu*, The Impact of the Dodd-Frank Act on Executive Compensation (2012) at http://ssrn.com/abstract=1996257.

119 Discussed in *Bebchuk*, The Case for Increasing Shareholder Power (2005) 118 Harvard Law Review 833; *Bruner*, Corporate Governance in the Common Law World (Cambridge 2013).

are an important feature in 'micro-fit'. Common political-economic problems and conditions, such as the aftermath of the global financial crisis, are an important feature in 'macro-fit'.

In sum, the development of say on pay in ECGR was gradual and considered and the Commission proposal may be seen as a maturation of the ECGR process. The UK's first mover advantage in setting say on pay norms provided a learning template which became internationally welcomed in the reform efforts post- global financial crisis. The norm-providing leadership of the UK was therefore nuanced but this also allows ECGR to be an organic and thoughtful process, rather than an outcome of mere harmonisation.

6. The Introduction of Binding Say on Pay in the UK in 2013

However, the UK has moved ahead again in say on pay. In the Enterprise and Regulatory Reform Act 2013, the UK introduced a binding shareholder vote on pay, to take place at least every three years.[120] 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.[121] The UK's pioneering efforts in giving shareholder control over the forward and backward-looking aspects of executive remuneration caters to domestically generated concerns but is also influenced by international practices. The Business Department's consultation papers[122] referred to learning from the binding shareholder vote in the Netherlands and the Australian 'two-strike' rule as an example of regulatory enhancement of shareholders' rights (i. e. the receipt of two consecutive 'no' votes for executive pay packages in 25 % or above at the general meeting would trigger a spill resolution where shareholders could decide by simple majority if all directors should stand for re-election).

The passage of the binding shareholder vote in the UK arguably reflects domestic concerns. The initial BIS discussion paper[123] highlights social concern about excessive pay in the corporate sector in the wake of the global financial crisis, the dissatisfaction from the institutional investor quarter regarding the opacity of pay information and the need for single total figures to be represented to make disclosure more comparable. However, the Discussion paper was not initially in favour of a binding shareholder vote as a pressing need for that reform had not emerged. Nevertheless, from the issue of the Consultation Paper in 2012[124] onwards, BIS has adopted a preference for a binding share-

120 Section 439A of the Companies Act, inserted via the Enterprise and Regulatory Reform Act 2013.
121 Bank for International Settlements [??] (BIS), Frequently Asked Questions (March 2013).
122 BIS, Executive Pay: Shareholder Voting Rights Consultation (March 2012).
123 BIS, Executive Remuneration: Discussion Paper (Sep 2011).
124 BIS, Executive Pay: Shareholder Voting Rights Consultation (March 2012).

holder vote, apparently due to overwhelming support from the powerful institutional community, and therefore proceeded to focus on the design of the voting mechanism (such as by simple or super majority) and the frequency of voting (initially proposed as on a yearly basis). Responses from the institutional community[125] have arguably influenced the ultimate shape of the reform, settling at a three-yearly (at least) vote on executive remuneration by simple majority, to be complemented by simpler disclosure of single total figures for each director. The UK reforms seem to reflect the unique demands of the institutional community in UK listed equity. Consonant with empirical research,[126] say on pay has been viewed by the institutional community as a key plank in wider engagement dialogue, therefore becoming a cherished institution of UK shareholders' rights. However, the three-yearly advisory vote may dovetail with the US reforms in the SEC rule, this aspect perhaps suggesting an extent of convergence from learning. Further, support for the binding vote on pay was also recorded on the part of proxy advisory agencies such as PIRC and Manifest[127] which have international operations, and as such, the binding say on pay in the UK may be the early seeds for a start in an international movement on enhanced shareholder rights on executive pay. One curiously watches if the UK's binding say on pay would become another norm-setting trend in ECGR and in international corporate governance.

IV. Shareholder Engagement and Stewardship

This Section will discuss the development of shareholder engagement norms in the UK, and whether the UK has provided leadership in norm-setting in this area for ECGR and internationally. It is noted that the approach of the European Commission in the proposed Shareholder Rights Directive 2014 seems rather more top-down in ECGR compared to the development of say on pay norms. This approach is likely to pose certain problems for the UK which has already developed its own norms in this area.

1. The Evoution of UK Institutions' Role

UK institutions were in the 1980s and early 1990s dominant investors in UK listed equity but they are not consistently powerful corporate governance actors. At its peak, institutional shareholders have been reported to hold about 60-80 % of publicly listed equity in the UK.[128] Research on institutional shareholder activity and behaviour more or less agrees that institutions are

125 BIS, Summary of Responses (June 2012) and Frequently Asked Questions (March 2013).

126 *Conyon* and *Sadler*, Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK (2010) 18 Corporate Governance 296.

127 David Cameron's plans for executive pay may not end spiralling bonuses, The Guardian (8 Jan 2012).

generally passive,[129] preferring exit to the use of voice in investee companies. The systematic unwillingness on the part of institutional shareholders to engage in activism may be due to the free-riding concerns that such activism would cost the activist while benefits are being reaped by other shareholders.[130] Further, engagement is costly and any payoffs may be speculative, or realisable only over the long term.[131] However, some history of informal engagement between institutional shareholders and their investee companies in the UK has been observed by American commentators since the early 1990s.[132]

Policy-makers have always been keen to develop institutions' monitoring role in corporate governance as institutions are well-placed to exercise oversight of their investee companies. [133] They are normatively justified to take on the role based on their quasi-proprietary interests as shareholders, and their economic role as 'residual claimants' in the firm.[134] Further, UK policy-makers could leverage upon institutions' corporate governance role to depoliticise issues arising in the corporate sector. Hence, there has been a systematic and persistent policy call issued to institutional shareholders since the time of the Cadbury Code to engage with their investee companies whether by voting[135] at general meetings or engaging in informal dialogue.

For example, The Cadbury committee views shareholders as the key watchdogs for ensuring compliance with the Cadbury Code, and generally calling the company to account for its internal governance and structures.

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128 The peak of 80 % holdings in publicly listed UK equity was reached in about 1997-8, see *Morck*, A History of Corporate Governance and of the Oddity of the British at http://www.svs.cl/sitio/publicaciones/doc/Present_Randall%20Morck.pdf.

129 *Goergen* and *Renneboog*, Strong Managers and Passive Institutional Investors in the UK (1998) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=137068; *Short* and *Keasey*, Institutional Shareholders and Corporate Governance in the UK in Keasey et al. (eds), Corporate Governance: Enterprise and International Comparisons (New Jersey [■] 2005) at 61; *Goergen*, *Renneboog* and *Zhang*, Do UK Institutional Shareholders Monitor Their Investee Firms? (2008) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1120204.

130 *Clearfield*, 'With Friends Like These, Who Needs Enemies?' The Structure of the Investment Industry and Its Reluctance to Exercise Governance Oversight"(2005) 13 Corporate Governance 114.

131 [??]; *Goergen*, *Renneboog* and *Zhang*, Do UK Institutional Shareholders Monitor Their Investee Firms? (2008) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1120204.

132 *Black* and *Coffee*, Hail Britannia?: institutional Investor Behavior under Limited Regulation (1993-4) 92 Michigan Law Rev 1997.

133 Chapter 2, *Chiu*, The Foundations and Anatomy of Shareholder Activism (Oxford 2010).

134 See discussion in *Chiu*, The Foundations and Anatomy of Shareholder Activism (Oxford 2010) at chapter 4 including citations therein.

135 *Mallin*, Institutional Investors and Voting Practices: an international comparison (2001) 9 Corporate Governance 118.

Shareholders have delegated many of their responsibilities as owners to the directors who act as their stewards. It is for the shareholders to call the directors to book if they appear to be failing in their stewardship and they should use this power. While they cannot be involved in the direction and management of their company, they can insist on a high standard of corporate governance and good governance. (at para 6.6, Cadbury Report)

In particular, the *Myners Report*[136] on how institutional investment is managed in the UK indicates policy support for shareholder activism and views shareholder activism as an investment strategy to generate corporate out-performance. *Myners* strongly encourages investors to meet privately with executive officers and to register their concerns in a persistent manner with 'thick skin' until the concerns are addressed.[137] The Department of Work and Pensions consulted on whether shareholder activism as described by Myners should be included as part of investment funds' fiduciary duties,[138] although it is ultimately in favour of not enacting an explicit legal duty as such. Policy makers have been consistent in their strong support for institutional shareholders taking steps to intervene in their investee companies whether through voting or informally, as may be necessary.[139] Although institutional voting has improved over the years,[140] the exercise of more informal voice is a patchy and inconsistent landscape.

In the wake of the UK banking crisis 2008/2009, institutional shareholders have been accused to have been 'asleep'.[141] The critique is that institutional shareholders have been uncritical of risky business practices in their investee banks and should have monitored Board risk management. Although institutional shareholder apathy is not regarded as the key cause of the UK banking crisis, the *Walker Review*[142] on corporate governance in banks and financial institutions is of the view that such institutional shareholder apathy has provided a tolerant context for misjudgements of risk made at the Board level of several failed UK banks. The global financial crisis and the spectre of the near-failure of two large high street UK banks provided a catalytic opportunity for

136 *Myners*, Institutional Investment in the UK: A Review (2001) (hereinafter known as the Myners Report).
137 Para 5.79, Myners Report.
138 Department of Work and Pensions, Encouraging Shareholder Activism (Consultation Paper, 2002) at http://www.dwp.gov.uk/consultations/consult/2002/myners/shareact.pdf. (hereinafter referred to as DWP Paper).
139 Paras 8, 10, 14-16, DWP Paper, ibid.
140 *Hewitt*, The Exercise of Shareholder Rights (2011) at http://dx.doi.org/10.1787/5kg54d0l1lvf-en.
141 "FSA Chief Lambasts Uncritical Investors", Financial Times (11 March 2009) and "Myners Lashes out at Landlord Institutional shareholders", Financial Times (21 Apr 2009). Also "Institutional Institutional shareholders Admit Oversight Failure on Banks", The Daily Telegraph (27 Jan 2009).
142 *Walker*, A Review of Corporate Governance in Banks and Financial Institutions (Nov 2009).

policy-makers to crystallise their expectations of institutional shareholders' governance role in the form of soft law- the UK Stewardship Code 2010.[143]

2. The UK Stewardship Code 2010, 2012

The Code[144] contains seven principles to make explicit how shareholder engagement should be carried out. It requires that as a matter of stewardship, institutional shareholders should 'monitor' their investee companies.[145] Such 'monitoring' includes seeking to be satisfied that corporate governance arrangements are robust, carrying out meetings with company directors and/or the Chairman of the Board, maintaining records of such meetings, considering the use of voting power and attendance at general meetings. 'Monitoring' also includes the 'escalation' of shareholder engagement, including intensifying meetings with Board members, making public statements and even requisitioning general meetings, where appropriate to do so to protect and enhance shareholder value.[146]

Principles 2, 6 and 7 focus on institutions' accountability to and relationship with beneficiaries. Principles 2 and 6 require institutions to disclose their conflicts of interest policy and voting policy, and Principle 7 requires details of the discharge of stewardship to be made accountable to beneficiaries,[147] as well as for institutions to engage assurance providers to report on its stewardship activities and make such reports available to beneficiaries.

Principle 5 envisages that institutions may step up engagement collectively as a group especially 'at times of significant corporate or wider economic stress, or when the risks posed threaten the ability of the company to continue.' Collective institutional shareholder engagement may take on a representative type of market governance for wider social concerns, beyond the atomistic concerns of investment purposes. The reference to 'wider economic stress' could refer to concern for public interest.[148] Principle 5 arguably frames institutional shareholders' role as a form of governance even possibly in furtherance of public interest.[149]

143 https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx.

144 *Chiu*, Turning Institutional Investors into 'Stewards' – Exploring the Meaning and Objectives of 'Stewardship' (2013) Current Legal Problems 1 for an analysis of the Code; and *Chiu*, Shareholders as Stewards: Towards a New Conceptualisation of Corporate Governance (2012) Brooklyn Journal of Corporate Commercial and Financial Law 387.

145 Principle 3.

146 Principle 4.

147 It will shortly be queried whether the public disclosure requirements attached to some Principles may import wider 'governance' ambitions.

148 Part I, *Walker*, A Review of Corporate Governance in Banks and Financial Institutions (Nov 2010) which discusses stewardship as a part of the social legitimacy of shareholding.

The norm creation processes [■ process?] relating to shareholders' engagement and stewardship role in the UK is arguably one that reflects City and political interests. The early dominance of institutions in the 1990s and the largely dispersed ownership structures in most UK listed companies allowed minority shareholders such as institutions to become rather powerful corporate governance actors. Although institutions did not appropriate such power on a consistent basis, they were regarded as being in a position to exercise that power and having resources to do so. Hence, policy-makers have persistently reinforced institutions' governance role in the tradition of negotiated regulation and the de-politicisation of corporate matters. In fact, the Stewardship Code has evolved out of and mirrors the voluntary Institutional Shareholders' Committee Code 2008 put in place by the trade body that represents UK institutions. Although a number of commentators[150] have criticised the Financial Reporting Council's lack of initiative in setting norms for the expectations of stewardship, this development may be particularly indicative of policy-makers' stance that the Code should not be seen as imposed by regulators but as a bottom-up and consensual set of standards that the institutional investment industry is committed to undertake.

In the light of the global financial crisis, policy-makers have become more overt about the underlying public interest in shareholders' governance role. The most recent UK review on institutions' role, the *Kay Review*,[151] supports 'stewardship' as a concept of responsibility in 'securing the public purposes of high performing companies and strong returns to savers through an effective asset management industry'.[152] Policy-makers are interested in shareholders' governance role as a form of 'stewardship' as there is a public interest in robust stewardship- the investment sector supports a well-functioning and performing corporate sector so as to ensure returns to support staple investment needs such as pensions provision. The performance of the corporate sector and the provision of private pension needs are matters that straddle the private and social spheres. The state is retreating from public welfare but at the same time needs to keep an eye on the social dimension of issues in the private sphere.

149 *Chiu*, Turning Institutional Investors into Stewards' – Exploring the Meaning and Objectives of 'Stewardship' (2013) Current Legal Problems 1.

150 *Wong*, The UK Stewardship Code: A Missed Opportunity For Higher Standards? (June 2010) and *Roach*, The UK Stewardship Code (2011) 11 Journal of Corporate Law Studies 463 which reiterates some of Wong's points.

151 BIS, The Kay Review of UK Equity Markets and Long-Term Decision Making (Final Report, 23 July 2012).

152 BIS, The Kay Review of UK Equity Markets and Long-Term Decision Making (Interim Report, Feb 2012) at para 2.1, and Final Report, 23 July 2012 at Foreword. The private sector seems also to adopt this concept, see the formation of the Stewardship Working Party in early 2012 consisting of Aviva Investors, BlackRock, Governance for Owners, Railpen Investments, Ram Trust and USS, at http://www.tomorrowscompany.com/news.aspx.

The state is therefore finding such a balance in leveraging upon the 'actorhood' of private sector constituents like institutional shareholders that can supply a governance role.[153] However, Cheffins[154] rightly notes that the effectiveness of the Stewardship Code can be affected by the reduction in UK holdings by UK institutions in recent years.[155]

The context-specific nature of institutional shareholder 'stewardship' in the UK is also reflected in the non-adoption of language such as 'activism' which is more commonly used in the US. The author has earlier documented an episode of unsuccessful American hedge fund activism led by Polygon Global Opportunities Master Fund against British Energy in 2004, showing that unfamiliar forms of shareholder activism such as American-style hedge fund activism may be resisted by the UK corporate sector and successfully defended. UK institutions may not necessarily align themselves with such forms of activism,[156] and the UK has arguably charted its own path of shareholder stewardship that reflects domestic policy and market interests.

That said, the UK Stewardship Code has become a template for international study. The Section below discusses the examples of Japanese and Malaysian adoptions of the Code and seeks to understand the forces that support international convergence of a Code that is nevertheless deeply rooted in its domestic origins.

3. Adoption of UK Stewardship Code

If shareholder 'stewardship' is developed as an domestic solution for the UK context, then what are its prospects as an exportable norm in corporate governance? The Financial Reporting Council notes that international interest in the Code is increasing as foreign shareholders in UK listed companies have signed up to the Code.[157] This could be a channel for international influence. Further a number of authoritative bodies such as the Italian stock exchange and the Swiss Institutional Investor Association have adopted and adapted the Code, as well as the Japanese National Pension Fund and Malaysian stock exchange. The Japanese Code[158] is remarkably similar to the UK's except that it emphasises the constructive dialogue between investors and companies, in the

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153 *Zumbansen*, 'New Governance' in European Corporate Law Regulation as Transnational Legal Pluralism (2008) 14 European Law Journal.

154 *Cheffins*, The Stewardship Code's Achilles Heel (University of Cambridge Faculty of Law Legal Studies Research Paper 2011) at http://www.law.cam.ac.uk/ssrn/;

155 As UK institutions have increasingly diversified their portfolios and invested abroad, while UK equity is falling into the hands of foreign investors and institutions.

156 Chapter 3, *Chiu*, The Foundations and Anatomy of Shareholder Activism (Oxford 2010).

157 FRC, FRC statement on the publication of the IMA report on adherence to the FRC's Stewardship Code (27 June 2013) at https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2013/June/FRC-statement-on-the-recent-publication-of-the-IMA.aspx.

tradition of communitarian harmony important to Japanese tradition, and it compels investors to engage in an in-depth knowledge of investee companies in order to support engagement. There is perhaps something that the UK may learn from the Japanese Code. The Japanese Code is purportedly introduced as part of a package of measures to revitalise Japanese economy and to improve the investment appeal of its listed sector. However, as Japan is increasingly experiencing a form of unfamiliar American-style hedge fund activism, the Code may also be a move to provide some 'ground rules' foreign shareholder activism.[159]

The Malaysian Institutional Investor Code to drive Stewardship[160] introduced by the Malaysian Securities Commission is also remarkably similar to the UK Code except that institutional investors are to explicitly consider corporate governance and sustainability (environmental, social and governance) issues in their engagement. The motivation for the Code seems to be the perception that institutional shareholder engagement can drive companies towards good corporate governance in the corporate sector, thereby enhancing the reputation of the Malaysian corporate sector which has been dogged by an unfavourable image of cronyism and opacity.[161]

The adoption by Japan and Malaysia of large parts of the UK Stewardship Code are instrumental measures designed to promote domestic economic and competitive interests. However, they may also be driven by the increased presence of US and UK institutions in their domestic capital markets and the Code could be seen as providing an *ex ante* form of defence against more unpredictable forms of shareholder activism such as American shareholder activism taken by hedge funds. Nevertheless this article suggests that there is an outstanding 'micro-fit' issue in Japan and Malaysia respectively. The Japanese model of inclusive corporate governance that looks after stakeholders such as creditors and employees may pose issues in reconciling with the 'shareholder primacy' assumptions[162] that underlie the Code. The Malaysian corporate sec-

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158 As of 7 April 2014, at http://www.fsa.go.jp/en/refer/councils/stewardship/20140407/01.pdf.

159 *Buchanan*, *Heesang Chai* and *Deakin*, Hedge Fund Activism in Japan: The Limits of Shareholder Primacy (Cambridge 2014).

160 http://www.sc.com.my/wp-content/uploads/eng/html/consultation/140115_PublicConsultation_1.pdf, published 27 June 2014.

161 *Chang*, Corporate governance in Malaysia: Cosiness, Cronyism and Corruption in Mueller and Wells (eds), Governance in Action Globally – Strategy, Process and Reality (Oxford 2014) at 413-424; *Johnson* and *Mitton*, Cronyism and Capital Controls: Evidence from Malaysia (2003) 67 Journal of Financial Economics 651.

162 Well accepted in Anglo-American corporate governance, see *Bratton* and *Wachter*, Shareholder Primacy's Corporatist Origins: Adolf Berle and 'The Modern Corporation' (2008) 34 Journal of Corporation Law 99; *Sharfman*, Shareholder Wealth Maximization and Its Implementation Under Corporate Law (2013) 65 Florida Law Review (forthcoming 2013), available at http://ssrn.com/abstract=2198459; *Gelter*, The Pension System and the Rise of Shareholder Primacy (2013) 43 Seton

tor features largely concentrated ownership,[163] and it remains to be seen if minority institutional investors would be able to engage successfully with such companies on the basis of the Stewardship Code.

4. European Commission Proposal on Shareholders' Rights Directive 2014

The European Commission's proposed amendments to the Shareholders' Rights Directive include the introduction of an engagement policy for all institutions and a form of disclosure-based regulation of institutions' investment policies and strategies, their arrangements with asset managers, and the accountability of asset managers to institutions.[164] This section now analyses to what extent the UK has been a norm-providing leader to the Commission proposals, or is the UK indeed a norm-taker in light of the differences between the Commission proposals and the UK stewardship norms.

Article 3f of the Commission Proposal provides that Member States shall require institutional investors and asset managers to develop an engagement policy, and the engagement policy would state how institutional investors and asset managers intend to:

(a) integrate shareholder engagement in their investment strategy;
(b) monitor investee companies, including on their non-financial performance;
(c) conduct dialogues with investee companies;
(d) exercise voting rights;
(e) use services provided by proxy advisors;
(f) cooperate with other shareholders.

Other than (e) above, the list of matters in mandatory engagement policies are consonant with the Principles in the UK Stewardship Code. The key difference is of course that Article 3f makes engagement policies mandatory while the Stewardship Code is binding only upon voluntary signatories. One can argue that given UK policy-makers' emphasis on the importance of stewardship, there may be little difference between hard law and a tough soft law where institutional investors and asset managers are concerned. It could be argued that Article 3f reflects a maturation of bottom-up developments in ECGR and is not revolutionary in nature. Further, the standardisation of the matters to be included in engagement policies may be regarded as a form of tacit adoption of the UK's Code (even if the Commission has not adopted the

Hall Law Review 909; s172 of the UK Companies Act, *Ireland*, Shareholder Primacy and the Distribution of Wealth (2005) 68 Modern Law Review 49; but see *Armour*, *Deakin* and *Konzelmann*, Shareholder Primacy and the Trajectory of UK Corporate Governance (2003) 41 British Journal of Industrial Relations 531.

163 See *Claessens*, *Djankov* , *Fan*, and *Lang*, Expropriation of Minority Shareholders: Evidence from East Asia (1999) at http://elibrary.worldbank.org/doi/book/10.1596/1813-9450-2088.

164 Article 3f to 3h, Commission Proposal 2014.

same term 'stewardship'). For Member States that have not actively developed norm-setting in this area, adopting the UK's Code would also be a convenient means of adhering to the Directive if it eventually comes into force. However, one could also argue that the Commission is encouraging a form of regulatory competition in the development of shareholder codes as there is only minimalist prescription. As local institutions in Member States serving local pensions and savings needs may have unique interests, and the corporate governance structures in the EU are diverse, Member States could take the opportunity to develop their own shareholder codes and need not look to the UK as a norm-setter in this regard.

The step taken by the Commission to institute a norm for shareholder behaviour beyond passivity could be credited to the UK, and the Commission's endorsement of the importance of shareholders' corporate governance role may reflect implicit support for the Anglo-American perspective of corporate governance in spite of diversity in corporate governance structures in Europe.[165] However, Member States with a corporate sector that is largely block-held may find reasons to resist the introduction of Article 3f as Article 3f would then legitimate engagement activity that minority institutional investors can carry out. This could in particular benefit foreign hedge fund and asset managers holding small stakes in large block-held European companies. It is uncertain at this stage whether the diversity of corporate ownership structures in the EU would pose a fatal 'micro-fit' issue for the adoption of Article 3f.

Moreover, Article 3f needs to be read with the following two provisions, Articles 3g and 3h.

Article 3g provides that institutional investors should annually disclose to the public their investment strategies and explain how such strategies are aligned with the duration of their liabilities and with the medium to long term performance of their assets. In particular, if institutions appoint asset managers, institutions must disclose as to how such arrangements would meet their objectives, their policies and strategies in evaluating asset managers and portfolio turnover, the duration of the appointment and how the agreed performance yardsticks and asset management charges and fees accord with their objectives. Article 3h provides that asset managers must disclose on a half-yearly basis to their institutional clients how their investment strategies and policies intend to meet their clients' investment objectives and duration of liabilities. A list of prescribed matters such as portfolio composition, turnover, costs and policies on securities lending must be disclosed.

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165 This may explain why *Hansmann* and *Kraakman* continue to support their convergence thesis on the ultimate triumph of the Anglo-American paradigm of corporate governance, see *Hansmann* and *Kraakman*, Reflections on the End of History for Corporate Law' (2011) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2095419.

Articles 3g and 3h provide a form of disclosure-based regulation of how institutions manage savers' capital entrusted to them, and the accountability of asset managers. Article 3g requires disclosure to the public, and goes beyond merely disclosure to beneficiaries. Hence, this requirement would be in addition to private law obligations in contract and trust imposed on institutions towards their beneficiaries (depending on how the investment relationship is structured). How is such public disclosure monitored and enforced? Further, what is the objective of such public disclosure if not to allow some form of regulatory scrutiny and oversight of institutions' investment activities and behaviour? As beneficiaries are dispersed and suffer from the collective action problem, it is unlikely that public disclosure is meant to boost their enforcement capacity. It is suggested here that Article 3g must envisage some form of public regulatory oversight of such disclosure. If so, Article 3g may in fact be a form of securities regulation and the introduction of a disclosure-based regime may pave the way for greater harmonisation of the regulation of the institutional investment sector. Article 3h does not envisage public disclosure but mandatory disclosure of prescribed items by asset managers to their institutional clients. However this measure forces asset managers out of their hitherto opacity and such disclosures could conceivably be compelled to be released to regulators under regulators' generally extensive powers of investigation. In this way, the harmonisation of institutional shareholders' *obligations* as a form of ECGR may in fact be pursuant to the Commission's agenda in legal harmonisation in securities and capital markets regulation in general.

It is uncertain as to whether Articles 3g and 3h may eventually be adopted as EU legislation. Member States could argue that these Articles do not deal with enhancement of shareholders' rights as such but with regulatory oversight of institutional investment activity. There may be several factors at work in favour of adoption. If Member States are concerned about the behaviour of foreign institutions and asset managers, they would support the provisions so that more transparency regarding their objectives and activities could be generated for the purposes of oversight and scrutiny. If Member States with concentrated ownership structures are not entirely persuaded by Article 3f, Articles 3g and 3h may act as sweeteners for adopting Article 3f as institutional investors and their asset managers are made subject to a form of regulatory accountability for their engagement activities. Further, many powerful asset managers operate globally such as Fidelity, BlackRock and Vanguard, and it would be difficult to subject them to regulation without a pan-European initiative such as the Commission Proposal.

It is also uncertain whether the UK would support these provisions. If the UK could be regarded as having exported its stewardship norm to the EU, then the Commission Proposal has developed a new character of stewardship in the form of institutional shareholders' *obligations* that arguably forms part of securities regulation harmonisation, unravelling the UK conception altogether. The UK stewardship culture is based on policy respect for the City's

governance role and a tradition of negotiated regulation in corporate and commercial matters. The UK has refrained from incorporating corporate governance matters into mandatory securities regulation for a long time, as evidenced by the continued soft law nature of the Corporate Governance and Stewardship Codes.

On the one hand, we could argue that Commission proposal addresses unfinished work and weaknesses in the UK Code. The stewardship principles in the UK Code empower institutional shareholders and legitimise informal engagement gestures without correspondingly asking of shareholders for responsible behaviour themselves. It could be argued that the Commission proposal addresses this imbalance which has not been adequately addressed in the UK partly due to excessive deference to institutions. Further, the Kay Review[166] in the UK identified the need to address the complexity of the investment chain and pointed out that improvements can be made in terms of the responsibility and accountability of all constituents in the investment chain. The relationship between institutions, asset managers and other intermediaries are largely governed by contract and fiduciary duties in the UK. There are limits[167] to which private law can address corporate governance behaviour and accountability issues. Hence, there is a role for considering if regulatory governance may be more appropriate as regulatory governance could 'cut through' the layers of bilateral intermediation relationships and hold investment entities to standardised obligations and accountability.[168] The dominance and power of the asset management industry cannot be underestimated as shown in their successful resistance against being labelled as systemically important,[169] and their resistance against reforms introduced to combat their potential conflicts of interests such as in unbundling their charges and fees.[170] Hence, EU-level action may be the only appropriate means to introduce reforms to subject their investment behaviour to scrutiny. The Commission's proposal, although couched in the vein of ECGR, may be a form of securities and investment regulatory harmonisation. The UK may resist this particular

166 BIS, The Kay Review of UK Equity Markets and Long-Term Decision Making (Final Report, 23 July 2012).

167 The Law Commission in the UK reviewed the private law of fiduciary duties in the and opined that private law is still fit for purpose in terms of accountability within the chain of parties and reforms are not recommended. The Commission's conclusions show the limits of private law and its bilateral accountability and enforcement mechanisms in dealing with complexities of modern investment intermediation Law [Î , see or …?] Commission, Fiduciary Duties of Investment Intermediaries (July 2014) at http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm.

168 *Chiu*, Turning Institutional Investors into 'Stewards' – Exploring the Meaning and Objectives of 'Stewardship"' (2013) Current Legal Problems 1.

169 Big fund managers go into battle over tougher US capital rules, Financial Times (10 October 2013); Fund Managers: Assets or Liabilities, The Economist (2 Aug 2014) presenting a balanced view of the debate.

170 Europe fights to keep dealing commissions, Financial Times (27 July 2014).

trajectory of the evolution of the stewardship norm, but the boundaries between corporate law and securities regulation are not always clear. The premise of ECGR can indeed be used to support securities regulation which has taken place in great measure since the Financial Services Action Plan 1999, and the post-crisis reforms recommended in the de Larosière report 2009.[171]

The fate of Articles 3f to 3h is not yet predictable. There is a micro-fit issue of whether shareholder stewardship could be incorporated as a norm in the diverse corporate law traditions in EU Member States. There is also a 'macro-fit' issue of whether EU Member States see the need for extending securities regulation to the regulatory scrutiny of investment entities' behaviour in corporate governance. As argued in Section C [? III?], the global financial crisis was crucial to political and social acceptance for regulating bankers' pay and the convergence of such a common 'macro' moment is important for the UK's pioneering say on pay norms to be adopted in ECGR and internationally. One wonders if the Commission proposals on shareholder engagement may be premature in the absence of those macro conditions. Would perhaps the Banco Espírito Santo saga[172] in Portugal provide a coalescing moment for enhanced minority institutional shareholder involvement in EU capital markets, making a case for ECGR as a form of minority investor protection?

V. Conclusion

This article examines the driving forces for ECGR and argues that ECGR has moved from a gradual bottom-up approach based on learning from diversity to an approach that blends into harmonised capital markets regulation at EU level. The gradual bottom-up approach in ECGR was largely due to inconclusive debates regarding the value of comparative corporate governance and its impact on market integration. However, with the advent of overt public interest rhetoric that has paved the way for direct corporate governance regulation of the financial sector post global financial crisis. Elements of corporate governance are now being regarded as suitable for hard harmonised legislation, such as in shareholders' say on pay and (perhaps) the regulation of aspects of shareholder engagement. This article examines the UK's role as norm-pioneer in the developments in ECGR and argues the EU developments on say on pay is still largely couched in the vein of bottom-up development maturing into hard law, and the UK's role as a norm-providing leader in that area has had significant influence. Although the UK's say on pay norms are largely responsive to domestic concerns, the UK's international influence on

171 *de Larosière* and others, Report by the High Level Group on Financial Supervision in the EU (Brussels, 25 February 2009) http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

172 Espírito Santo parent seeks creditor protection, Financial Times (18 July 2014), Portugal pays up for Espírito Santo, Financial Times (4 Aug 2014).

this issue has been possible because of 'fit' conditions at both the micro and macro levels in many jurisdictions. On shareholder engagement, the UK's development of its stewardship concept is largely rooted in its domestic context although the concept has been exported to other jurisdictions. The UK's stewardship concept appears ostensibly to have influenced ECGR in the European Commission's proposals on regulating shareholder engagement. However, the Commission's proposal has arguably upstaged the UK's norm-pioneering leadership as the proposal is more akin to a form of harmonised capital markets regulation. ECGR can be used for extending the scope of securities regulation harmonisation. It is uncertain if such a development is indeed optimal. There are different micro and macro conditions in the capital markets of Member States and it may be inappropriate at this point in time to standardise the norm of shareholder engagement.