EU Corporate Governance

The Ongoing Challenges of the 'Institutional Investor Activism' Conundrum

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Abstract

Institutional investor activism seems to be the ultimate means for steady improvement in corporate governance standards, as well as a powerful tool for refocusing short-term strategies towards more sustainable and viable business projects. Although EU institutions have endeavoured over the past decade to facilitate the exercise of a wide range of shareholder rights, the impact of such regulatory initiatives remains to be seen. This paper challenges the current EU regulatory approach by supporting the idea that, while it has touched upon important topics, such as companies or financial intermediaries, hoping that the investor community will make full use of its discretion and evaluation of these actors, it has avoided resolving another crucial issue, namely, that of investor behaviour. In fact, institutional investors have been partially accused of apathy and contributing indirectly to the EU capital markets crisis. EU law thus needs to find new ways to nurture and maintain an effective willingness to engage in long-term dialogue with companies. It is therefore crucial to reassess all EU initiatives and critically challenge their efficiency in order to propose a way forward to unblock institutional investor activism and establish a veritable alignment of objectives with corporate managers.

Keywords: EU corporate governance, institutional investors, stewardship, shareholders, asset managers.

A Introduction

The global financial crisis in 2007-2008 decisively triggered the re-emergence of the debate around the legitimacy and efficiency of short-term corporate strategies, the relationship of corporate boards with shareholders, as well as the role that national and EU regulators can play to restore the various actors' confidence in the viability and reliability of financial markets. Long-standing views about the benefits of corporate and investor short-termism are now subject to severe criticism, and regulators aim to understand, in a more pragmatic way, the complexities arising from different relationships in financial markets, as well as to channel

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the behaviour of all market participants towards a more responsible conception of their role in the overall investment chain,[1] a vital component of the prosperity of these markets.

The various EU institutions have thus been endeavouring not only to detect and deal with current market practices that contributed to, if not created, the global crisis but also to increase transparency and nurture a different culture in companies with the ambition that investors will be able to benefit from such initiatives and thus opt for much more responsible behaviour. Nevertheless, unlocking shareholder activism and developing a new corporate culture cannot be seen as a fragmented effort at the EU level. Initiatives have to be developed not only towards listed companies but also towards financial intermediaries that act on behalf of investors, such as proxy advisors, as well as institutional investors themselves. Investor behaviour itself cannot be improved and guided towards a much more sustainable path unless EU institutions start targeting the whole investment chain in a holistic perspective.

Unfortunately, this holistic view does not seem to be on the agenda of the EU, which is focused on companies without aiming to use regulatory tools to guide other market actors. Some EU Member States, such as the UK, have already made progress in adopting a wider view as far as enhancing a more sustainable culture is concerned with the 'stewardship' concept. The exercise of stewardship responsibilities by institutional investors has recently been seen as one of the main regulatory tools that can reform investor behaviour. Its most important objective seems to be change in how business is thought of and carried out in order for companies' viability and investors' portfolios to prosper in the long term.[2] For reasons that will be later developed in this paper, the EU has not yet fully used this concept in its regulatory spectrum, remaining limited to some preliminary remarks while showing the intention to deal with shareholder engagement in the future. It is therefore necessary to propose a way for stewardship

1 C. Villiers, 'Has the Financial Crisis Revealed the Concept of the "Responsible Owner" to be a Myth?', *in* I. MacNeil & J. O'Brien (Eds.), *The Future of Financial Regulation*, Hart Publishing 2010, p. 287; *see* also J. Ambachtsheer, R. Fuller & D. Hindocha, 'Behaving Like an Owner: Plugging Investment Chain Leakages', *Rotman International Journal of Pension Management*, Vol. 6, No. 2, 2013, p. 18.

2 In theory, the investor community has the ability to contribute towards such an objective if it engages with companies effectively and achieves sufficient interaction to make more visible concerns about what is expected from the investment and how companies should be managed. The empirical studies are not conclusive as to whether shareholder activism is crucial to improving companies' performance or simply irrelevant. Regardless of the negative or positive effect of this kind of activism, it could be said that in theory it is always better to have a certain amount of indirect pressure from asset managers or the owners of the shares, which will possibly alert the company's management in order to avert certain deficiencies in conducting business: S.L. Gillan & L.T. Starks, 'The Evolution of Shareholder Activism in the United States', *Journal of Applied Corporate Finance*, Vol. 19, 2007, p. 55; I. Demiralp, R. D'Mello, F. Schlingemann & V. Subramaniam, 'Are There Monitoring Benefits to Institutional Ownership? Evidence from Seasoned Equity Offerings', *Journal of Corporate Finance*, Vol. 17, 2011, p. 1340; R. Romano, 'Less is More: Making Institutional Shareholder Activism a Valuable Mechanism of Corporate Governance', *Yale Journal on Regulation*, Vol. 18, 2001, p. 174.

issues to be addressed at the EU level and increase uniformity in the conception of investors' responsibilities.

The EU has not remained completely apathetic to or discouraged by the complexity of the investment chain, with the increasing presence of financial intermediation that makes it even more difficult to bridge the gap between companies and investors. In fact, proxy advisory firms have recently become the subject of a considerable debate as far as their influence on investors is concerned, notably via recommendations in the exercise of their voting rights, as well as the potential introduction of a regulatory framework to ensure the reliability of their services. Taking into consideration the large amount of criticism as to whether such a reform would be appropriate in a sector that has traditionally performed its role without a set of legal rules or principles, the European Securities and Markets Authority (ESMA) recently attempted to encourage the adoption of a Code of Conduct for proxy advisory firms. Although this is an appreciable effort, there are still many obstacles to overcome, which this paper will seek to highlight and propose an alternative regulatory pathway.

As an overall assessment, our study supports the idea that EU law has the potential to enhance communication between companies and investors in a pragmatic way, thus making activism by the latter an essential component for more viable and sustainable markets. This is inevitably a very difficult undertaking because it will require an equal amount of exposure in terms of transparency for a series of market actors. As the current EU framework clearly shows, the EU has so far provided piecemeal solutions and has failed to conceive of shareholder apathy as inextricably linked to the need to communicate with companies based not only on the information received in their corporate governance statements but also with a more independent use of financial intermediation services. EU policies therefore need to be reassessed and a wider framework planned including all relevant parties and avoiding fragmentation in the fields of regulatory intervention.

This paper aims to critically analyse some important EU initiatives in the area of corporate governance which, although trying to achieve harmonisation in how corporate compliance is conceived and applied, still remain disconnected from the investors who are the ultimate beneficiaries of these efforts.[3] Moreover, the paper will aim to project a possible new regulatory pathway affecting financial intermediation and institutional shareholder groups in order to propose an alternative that would have greater potential to drive much more responsible investor behaviour. Part 1 will give a critical review of the current European developments in the area of investee companies and will indicate the problematic issues that have arisen from the use of the 'comply or explain' principle in corporate governance statements. Part 2 will focus on the regulatory efforts to enhance shareholder activism and will critically assess the latest trends in the 'stewardship' movement in the EU, analysing the UK Stewardship Code as a forerunner in the

3 For a general assessment of these gaps, *see* J.M. Mendoza, C. Van der Elst & E.P.M. Vermeulen, 'Entrepreneurship and Innovation: The Hidden Costs of Corporate Governance in Europe', *Lex Research Topics in Corporate Law & Economics*, 2010, Working Paper 2/2010, <http://ssrn.com/abstract=1698352> accessed 30 September 2013, pp. 29-34.

field and proposing its potential adoption at the EU level. Part 3 will touch upon other EU regulatory initiatives that aim to better control some other types of financial intermediaries that are closely linked to shareholder activism, such as the proxy advisory industry, whose role requires it to be more transparent and more thoroughly examined. Part 4 will defend a holistic conception of shareholder engagement with investee companies and the need to adopt an EU regulatory path of wider applicability that would link various market actors in an optimal way. Part 5 will draw conclusions from the above-mentioned issues and reflect upon future EU policies.

B Corporate Governance Codes in the EU and Their Questionable Efficiency

I Flexibility of Soft Law Measures

Corporate governance codes have traditionally been conceived as the most flexible regulatory tool for the issuance of corporate governance statements by companies. These statements give market actors the opportunity to gain insight into the company's profile in order to understand and evaluate in an optimal way the internal management system and the sophistication of different business strategies. Disclosure in the area of corporate governance therefore increases the awareness of a company's profile and enables market actors to exercise their rights on a more informed basis. Bearing in mind that company structures vary considerably, both nationally and internationally, it is believed that it is in the regulators' best interests to develop a framework that encourages transparency in this area without imposing stringent obligations. The prevalence of 'principle-based' standards and soft law measures has fitted elegantly with the need to ensure this kind of regulatory flexibility and has undoubtedly been appreciated by the business community. Nevertheless, the defenders of 'hard law' measures continue to consider the area of corporate governance to be a legitimate area for much more intrusive regulation into companies' lives.[4]

The choice of an optimal regulatory tool in the issuance of reliable and transparent corporate governance statements is a matter of vital importance for the European financial markets especially after the global financial crisis that peaked in 2008 and continues to reveal several stability deficiencies. To overcome the EU crisis and link some of its distinctive features to a failure of modern corporate culture, a balance must be struck between a legitimate regulatory path that respects corporate diversity and the adoption of efficient measures that will not just encourage but actually ensure that companies respect a certain set of rules. The European Union and Member States seem to have better understood the

4 For a discussion on the debate 'soft law v. hard law', *see* R.V. Aguilera, M. Goyer & L.R. Kabbach-Castro, 'Regulation and Comparative Corporate Governance', *in* M. Wright, D.S. Siegel, K. Keasey & I. Filatotchev (Eds.), *Handbook of Corporate Governance*, Oxford University Press 2013, pp. 22-28, <http://ssrn.com/abstract=2071191> accessed 30 September 2013.

need for more control of the information disclosed to the public with regard to corporate governance strategies.[5]

Nevertheless, although the need for more transparency and control is acknowledged, the predominant approach to ensure reliability remains focused on soft law measures and, more specifically, on the ‘comply or explain’ principle, initially introduced in the UK by the Cadbury Report in 1992[6] and later adopted at the EU level with Directive 2006/46/EC.[7] According to this principle, every company is required to comply with the applicable corporate governance code or to explain the reasons it has decided not to do so. Flexibility and openness to different corporate structures are therefore achieved since companies retain the option to deviate from a certain set of standards while explaining the reasons for their non-compliance.[8]

II *The Questionable Efficiency of the ‘Comply or Explain’ Principle and the Lack of Shareholder Engagement*

Despite the unquestionable usefulness of flexibility in the issuance of corporate governance statements, this type of disclosure will only acquire its full potential and usefulness when it reaches and has an impact on different market actors that are interested in evaluating a company’s profile. Although regulators are equally interested in and focused on understanding corporate governance strategies, the crucial recipient of this kind of information, who is expected to base her future investment behaviour upon it, by approving or disapproving the strategy adopted, is the investor community. Although it would be expected that the ‘comply or explain’ principle would be fully used by both companies and investors, it seems that it is not only conceived but also applied in a rather superficial way.

Using as a starting point the companies that are supposed to make use of the principle, it is rather frustrating to note that the level of compliance varies significantly from one European country to the next. Although in some countries compliance is rather satisfactory and highly praised, serving as a legitimate justification for continuing with soft law measures, it seems to be very low in other

5 M. Kort, ‘Standardization of Company Law in Germany, Other EU Member States and Turkey by Corporate Governance Rules’, *European Company and Financial Law Review*, Vol. 5, No. 4, 2008, p. 379.

6 Sir A. Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance*, 1992, para 2.5, p. 14.

7 Directive 2006/46/EC of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions, and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings [2006] OJ L224/7.

8 O. Hart, ‘Corporate Governance: Some Theory and Implications’, *The Economic Journal*, Vol. 105, No. 430, 1995, p. 678.

countries and therefore receives a certain amount of criticism.[9] Regarding countries with a high level of compliance, according to the latest UK annual review,[10] 51% of companies reported full compliance with the corporate governance code, and the remaining 49%, which declared non-compliance, had difficulty in complying with just one or two provisions of the Code. Overall, the level of compliance with the Code's provisions reached 97%. Regarding the explanations provided by non-compliant companies, the report states that 72% gave detailed explanations of non-compliance issues.[11] This percentage allows for a certain degree of optimism but clearly shows that there is room for improvement in terms of disclosing meaningful explanations. In annual reviews of other EU Member States, such as France or Germany, the results regarding the provision of meaningful explanations are much more disappointing, clearly showing a tendency not to engage in honest exposure as far as deviation from the Code is concerned.

Therefore, the 'comply or explain' principle suffers from a superficial use of both of its components, *i.e.* compliance and explanation. Companies that can afford to declare full compliance with a Code demonstrate a tendency to do so in a rather typical way. For companies that declare non-compliance and are supposed to provide meaningful explanations for this deviation, they either face objective difficulties in explaining the reasons for doing so[12] or are tempted to use trivial explanations in order to conceal the true reasons of their non-compliance, which may reflect their unwillingness to adopt certain practices.[13]

As far as investors are concerned, despite their interest in these statements, they seem not to fully appreciate the principle itself since they interpret both the compliance and explanatory parts of the principle in a rather mechanistic way.

9 *See*, for example, the intense debate in Germany in 2010 around the efficiency of the principle itself, questioning soft law measures. The Report was drafted by a Government Commission on the German Corporate Governance Code: Bericht der Regierungskommission Deutscher Corporate Governance Kodex an die Bundesregierung, 2010, <www.corporate-governance-code.de/ger/download/16122010/Governance_Bericht_Nov_2010.pdf> accessed 30 September 2013. The same type of criticism has recently appeared in France, where a Parliamentary report, considering that it is up to the legislator to guide the parties involved in the drafting of soft law measures, has proposed the definition in law of a series of issues that must be included in corporate governance codes: J.-M. Clément & P. Houillon, '*Rapport d'information sur la transparence de la gouvernance des grandes entreprises*', *Assemblée Nationale*, No. 737, 2013, pp. 16-17, <www.assemblee-nationale.fr/14/rap-info/i0737.asp#P222_34062> accessed 30 September 2013.

10 G. Thornton, 'The Chemistry of Governance: A Catalyst for Change', *Corporate Governance Review*, 2012, <www.grant-thornton.co.uk/Global/Publication_pdf/Corporate_Governance_Review_2012.pdf> accessed 15 September 2013.

11 *Ibid.*, p. 8.

12 For an overview, *see* RiskMetrics, 'Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States', 2009, <http://ec.europa.eu/internal_market/company/docs/ecgforum/studies/comply-or-explain-090923_en.pdf> accessed 15 June 2012; A. Keay, 'Comply or Explain: In Need of Greater Regulatory Oversight?' 2012 Working Paper Series, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2144132> accessed 15 October 2013; *see* also M. Moore, 'Whispering Sweet Nothings: The Limitations of Informal Conformance in UK Corporate Governance', *Journal of Corporate Law Studies*, Vol. 9, 2009, p. 95.

13 More generally on this topic, *see* D. Seidl, 'Standard Setting and Following in Corporate Governance. An Observation-Theoretical Study of the Effectiveness of Governance Codes', *Organization*, Vol. 14, 2007, p. 619.

Investors do not always react predictably since they are much more concerned about the financial performance of a company rather than compliance or explanatory issues regarding a specific set of rules.[14] The corporate short-termism and lack of engagement with boards have led shareholders to be much more concerned about profits and the management of their portfolios by financial intermediaries, as we will show later on, than whether the company has made a real effort either to comply with the recommendations of a corporate governance code or to explain in a detailed and substantial way its distinctive features that justify deviation from the Code. This conception of the usefulness of corporate governance statements inevitably creates an almost automatic preference for 'mere compliance' statements in order to ensure that the investee company follows a certain set of recommendations and broadly acceptable principles, without therefore concentrating on the veritable compliance and the subsequent adoption of sound corporate governance practices.

What is even more alarming is that investors tend to start paying attention to compliance or non-compliance issues only when corporate decisions create losses. In other words, as long as the corporate culture adopted proves to be profitable for their investment, they tend to be apathetic even in cases where a non-compliant company does not provide sufficient explanation for its deviation from a corporate governance code.[15] Adding to these worrying signals, the natural preference for 'mere compliance' statements makes non-compliance statements even less attractive and therefore useless for informational purposes. Such non-compliance statements tend to be perceived as a typical declaration about the impossibility of complying with the Code, instead of triggering a further need to understand the overall philosophy of the corporate strategy described in such a statement. In other words, a non-compliance statement, if well justified while providing useful insight into the company's philosophy and the reasons for deviation, should not be considered a failure in terms of the company regulatory approach or compliance.[16]

According to the data collected from interviews conducted with CEOs from amongst the 130 largest listed firms in the UK and Germany, companies in both countries are under constant and increasing pressure to fully conform with all the principles of their national code despite the fact that the 'comply or explain' principle clearly allows them to deviate and provide a meaningful explanation for such a choice. Therefore, even if deviation is essentially 'compliance' with the principle

14 S. Arcot, V. Bruno & A.F. Grimaud, 'Corporate Governance in the UK: Is the Comply or Explain Approach Working?', *International Review of Law and Economics*, Vol. 30, No. 2, 2010, p. 99.

15 *Ibid*.

16 D. Seidl, P. Sanderson & J. Roberts, 'Applying "Comply-or-Explain": Conformance with Codes of Corporate Governance in the UK and Germany', Centre for Business Research, University of Cambridge 2009, Working Paper 389/2009, <www.cbr.cam.ac.uk/pdf/WP389.pdf> accessed 15 June 2013.

itself, in practice this opportunity has been compromised severely since the conception of compliance has remained superficial for both companies and investors.[17]

The most important task for companies to accomplish would therefore be the coherent disclosure of their philosophy which, though possibly not optimal at all costs, provides useful data to investors and allows them to benefit much more from an enriching and understandable statement that targets and analyses deviation from a set of rules. This approach is strongly backed by the Financial Reporting Council (FRC), which has already clarified in the most obvious way that "[w]hilst shareholders have every right to challenge companies' explanations if they are unconvincing, they should not be evaluated in a mechanistic way, and departures from the Code should not be automatically treated as breaches".[18]

As an overall impression, although the adoption of the 'comply or explain' principle at the EU level has clear potential to better connect corporate boards with shareholders, via the provision of a series of information that can give rise to fruitful discussions and mutual understanding of business priorities, it has not yet been perceived as a realistic path of exposure and communication by both companies and investors. A consistent deficiency in the quality of the explanations provided, in a non-compliance scenario, will not only jeopardise the information provided to investors but, most importantly, will harm in its essence and weaken the foundations of the principle itself. As it has been wisely stated, "failure to provide an adequate explanation increases the risk not only of the company being perceived as acting illegitimately but also of the Code being seen as lacking legitimacy".[19]

In order to overcome superficial and merely technical behaviour around the use of corporate governance statements, both companies and investors should start disconnecting their decision-making processes from short-term benefits that seem to be the source of this problematic situation. It would be useful to remember that corporate boards are under constant pressure to deliver results not just according to their own possible short-term targets but, most importantly, the targets fixed by their shareholders, which may demand an even more aggressive decision-making strategy. This phenomenon has been exacerbated by the rise of institutional investor groups and the increasing use of financial intermediaries to represent and exercise their interests. This paper will now focus on these financial intermediaries in order to highlight their interaction with corporate boards and the possible future EU initiatives to guide them in the exercise of their rights in a long-term and more engaged perspective.

17 P. Sanderson, D. Seidl & J. Roberts, 'The Limits of Flexible Regulation: Managers' Perceptions of Corporate Governance Codes and "Comply or Explain"', Centre for Business Research, University of Cambridge 2013, Working Paper 439/2013, p. 19. It is thus essential that this mentality should change towards the full appreciation of the principle and the equal treatment of both possibilities potentially chosen by companies.

18 FRC, UK Corporate Governance Code, September 2012, p. 4, <www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx> accessed 5 October 2013.

19 P. Sanderson, D. Seidl & J. Roberts 2013, p. 6.

C The Disempowered Notion of Shareholder Engagement

I The Incomplete Task of the Shareholder Rights Directive

Apart from making corporate governance strategies much more visible to investors for the sake of optimal regulatory control and increased transparency, there has been a clear agenda to preserve the investor community's confidence in the markets. Indeed, the 'shareholder primacy' principle[20] has been used to ensure a continuous flow of confidence, thereby ensuring market stability and reducing volatility.[21] Apart from aiming to trigger shareholder activism, via the access to corporate governance statements, soft law measures also serve as well as an indirect means of transmitting the message to investors that their opinion is crucial to the company's life and can shape future corporate decision-making.

The EU has endeavoured to ensure that shareholder rights will be exercised effectively by removing several barriers that have traditionally impeded this objective. The Shareholder Rights Directive[22] was undoubtedly a critical point in that sense given the fact that it introduced a series of reforms at the EU level, such as the facilitation of participation in general meetings via electronic means and the exercise of cross-border voting rights, the removal of certain obstacles for the effective exercise of voting rights, and the facilitation of proxy voting. Although these measures were more than needed in order to convey a clear message on the much more democratic and inclusive nature of the voting process, for non-resident shareholders or for shareholders represented by proxy firms, the Directive did not aim to enhance the mentality surrounding this facilitation. This is particularly due to the fact that the Directive was one preliminary step towards the facilitation of the exercise of shareholder rights and the necessity at that time was not to nurture a different investor mentality but to ensure that shareholders would at least have all the means to vote without being dissuaded by certain barriers.

Therefore, these measures have not yet produced the desired outcome of increased shareholder engagement with companies. They have made it easier to exercise voting rights, but this has not come hand in hand with more sophisticated investor behaviour or genuine willingness to better understand corporate culture. The general trend is therefore to exercise shareholder rights more easily, given the improvements brought about by the Directive, but with the same short-term objectives and needs. EU policymakers therefore need to start focusing not

20 For a critical analysis of this focus with regard to the marginalisation of other factors, such as stakeholders, *see* J. Parkinson & G. Kelly, 'The Combined Code on Corporate Governance', *Political Quarterly*, Vol. 70, No. 1, 1999, p. 101. *See* also A. Keay, 'Shareholder Primacy in Corporate Law: Can it Survive? Should it Survive?', *European Company and Financial Law Review*, Vol. 7, No. 3, 2010, p. 369.

21 S. Davis, J. Lukomnik & D. Pitt-Watson, *The New Capitalists: How Citizen Investors Are Reshaping The Corporate Agenda*, Harvard Business School Press 2006; *see* also R.V. Aguilera, A. Cuervo-Cazurra 'Codes of Good Governance', *Corporate Governance: An International Review*, Vol. 17, No. 3, 2009, p. 376.

22 Directive 2007/36/EC of the European Parliament and of the Council of 11 Jul. 2007 on the exercise of certain rights of shareholders in listed companies [2007] O.J. L184/17.

only on how the exercise of those rights will continue to be facilitated in the future but also how investment culture and behaviour can be improved and move towards a much more sustainable framework for the entire investment chain and the prosperity of financial markets.

Educational efforts stemming from regulatory initiatives are crucial to helping investors become aware of the broader challenges they must face. The 'stewardship' concept has evolved in this framework and aims to inspire a sense of responsibility to the investor community for its actions and strategies and to enhance the expression of their views to corporate management about their own agenda and their expectations.[23]

II The Prospects of a Stewardship Trend at the EU Level

Stewardship is an emerging phenomenon that has been partially associated with the current financial crisis both at the EU and international levels. More specifically, it has been conceived as one of the remedies for avoiding other crises in the future as it encourages market participants to adopt a much more active engagement in various investment issues and eventually to react preventively to unreasonably risky strategies.[24] Its core notion is associated with the responsibility of taking care of assets that belong to other parties. As far as institutional investors are concerned, stewardship responsibilities are bestowed upon the trustees of the investor group as well as on the asset managers in charge of monitoring and developing their portfolios. A good steward would therefore be someone who genuinely understands the needs of the ultimate beneficiaries of his/her actions and engages with clients in an effective way in order to manage their financial interests optimally.

According to another definition, "stewardship is responsible and thoughtful ownership. It is synonymous with an ownership mindset and adopts a long-term perspective, but with a focus on value creation [...] It is also a mechanism to ensure the appropriate use of the power vested in institutions to properly and effectively manage the funds, such as savings and pension contributions, entrusted to them by the ultimate investors, the beneficiaries".[25]

The EU has not yet officially adopted any measures on stewardship although, as will be developed later on in our study, this issue is included in the EU policy agenda. Although not the only EU Member State to have dealt with this issue,[26] the UK moved towards adopting the UK Stewardship Code in 2010. This Code contains a series of provisions to be used by institutional investors. To date, it

23 *See* more generally J.H. Marler & C. Faugère, 'Shareholder Activism and Middle Management Equity Incentives', *Corporate Governance: An International Review*, Vol. 18, 2010, p. 313.

24 S.M. Davis, J. Lukomnik & D. Pitt-Watson 2006.

25 Foundation for Governance Research and Education, *An Investigation into Stewardship: Engagement between Investors and Public Companies: Impediments and their Resolution*, 2011, <www.foundationgre.com/Stewardship%20Report%20Final%20-%2022.6.11.pdf> accessed 29 September 2013, 12.

26 *See*, for example, the Dutch best practices for engaged share ownership: <www.eumedion.nl/en/public/knowledgenetwork/best-practices/best_practices-engaged-shareownership.pdf> accessed 25 November 2013.

represents the most sophisticated approach in Europe.[27] It has set a target of increasing awareness of investment-related problematic issues and is trying to change the current short-term mentality in the market.[28]

It is hoped that a viable and continuing dialogue with company management will result from the interaction between companies and institutional investors, and both decision poles will be able to align their incentives and targets. The Code refers to the concept of stewardship as something that "aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole".[29] It goes further by adding that "[f]or investors, stewardship is more than just voting. Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings".[30]

Stewardship thus includes various activities for different actors involved in the investment chain and invited by this regulatory tool, following the 'comply or explain' principle, to adhere to certain standards or to justify their non-compliance. The first issue addressed by the Code is the requirement for institutional investors to disclose information regarding their policies on how they discharge their responsibilities towards their clients. Additionally, they must show how they interact with other service providers in the investment chain, such as proxy advisors or investment consultants, and the responsibilities that arise from these relationships.[31]

The second principle refers to the adoption of a rigorous policy for the management of potential conflicts of interest in the exercise of their duties and the disclosure of this policy.[32] As has been noted on several occasions, institutional investors may face serious difficulties in the effective exercise of stewardship

27 After a consultation period, the UK Stewardship Code was revised in September 2012 and took effect on 1 October 2012: FRC, 'The UK Stewardship Code', 2012, <www. frc. org. uk/ get attachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012. aspx. > accessed 5 October 2013. For an analysis of the Code, *see* A. Reisberg, 'The Notion of Stewardship from a Company Law Perspective', *Journal of Financial Crime*, Vol. 18, No. 2, 2011, p. 126. *See* also I. Hse-Yu Chiu, 'Stewardship as a Force for Governance: Critically Assessing the Aspirations and Weaknesses of the UK Stewardship Code', *European Company Law*, Vol. 9, 2012, p. 5.

28 The short-term strategies and preferences have reached an alarming point where managers had declared that they were willing to sacrifice the company's prospective value in order to satisfy those pressures from their clients: J.R. Graham, C.R. Harvey & S. Rajgopal, 'Value Destruction and Financial Reporting Decisions', 2006, <http:// ssrn. com/ abstract= 871215> accessed 5 October 2013.

29 Stewardship Code 2012, *supra* note 28, p. 4.

30 *Ibid.*

31 *Ibid.*, p. 5.

32 *Ibid.*, p. 6.

responsibilities where conflicts of interest are likely to arise on an institutional, individual, or even group basis.[33]

The Code therefore invites institutional investors to disclose their strategies for dealing with such issues and reminds them of their primary obligation to protect the interests of their clients with regard to any possible situations where conflicts of interest may arise.

Certain educational features also enrich the Code since it provides institutional investors with guidance on how they should monitor investee companies. More specifically, it refers to continuous dialogue with companies, constant updates on a series of critical issues affecting the company's performance, meetings with the chairman and other board members, and attendance of general shareholders' meetings.[34] Moreover, it reminds investors of the importance of fully exploring both aspects of the 'comply or explain' principle when they evaluate corporate governance statements and not to consider a non-compliance statement to be necessarily a failure, as was previously mentioned. Under this perspective, it encourages them to give the company a timely explanation on certain points that a controversial topic may involve and be prepared to engage in a fruitful dialogue with the board.

Institutional investors are also expected to have a clear strategy to influence a company's projects. In that respect, they are expected to disclose certain circumstances that may or may not qualify for active intervention on their behalf and to reassess their strategy on a regular basis. It is thus hoped that their underlying assumptions about the importance of their role in the occasions in which their activism is triggered will come to light not only for their clients but for companies as well. As far as intervention is concerned, the Code proposes a gradual level of actions beginning with a confidential discussion with the company and gradually leading up to demanding a change in board membership at a general meeting.[35]

Another requirement of crucial importance refers to the disclosure of voting policies and requires investors to vote all shares that are held without automatically supporting the board.[36] Indeed, it has been noted that shareholder activism has sometimes been identified as and exercised with a rather simplified approval of corporate strategies that ultimately transforms it into apathy. With special reference to the EU crisis, institutional shareholders have been severely criticised for not having questioned risky strategies in advance and focusing exclusively on the potential profits that could be generated out of short-term goals. The Code invites them to become much more present even if they do not approve the strategies adopted and to engage in an active dialogue with the company instead of just avoiding exercising their rights. They can choose from either registering an abstention or voting against a resolution if the dialogue has not reached a convincing outcome. In both cases, they should inform the company of their inten-

33 For a series of possible conflicts of interest, *see* B. Black & J. Coffee, 'Hail Britannia? Institutional Investor Behavior Under Limited Regulation', *Michigan Law Review*, Vol. 92, 1994, pp. 1997-2068.

34 Stewardship Code 2012, *supra* note 28, p. 7.

35 *Ibid.*

36 *Ibid.*, p. 9.

tions in advance and explain their position. It is clear that this requirement aspires to a much more fruitful shareholder engagement with corporate boards, but it obviously remains to be seen whether this practice will be followed extensively by institutional investors.

From the remaining principles of the Code, particular attention needs to be paid to the requirement to report to their clients on their stewardship activities on a periodic – at least annual – basis. This requirement aims to increase visibility of how the policies adopted are perceived and how they have been implemented throughout the year. Nevertheless, it has to be borne in mind that the Code, as a soft law measure and acknowledging the diversity of expectations and managers' and clients' profiles, leaves it up to them to define the context of information that should be communicated and refrains from intervening into this issue in order to avoid hampering this relationship.

The UK Stewardship Code is not exempt from certain imperfections, such as its territorial effect,[37] its soft law nature, based on the 'comply or explain' principle with its own weaknesses as previously mentioned, and excluding from its scope the potential relationship that can be developed between institutional shareholders and stakeholders. Notwithstanding its 'idealistic' purpose, which seems not to fit perfectly with the ongoing and prevalent short-term mentality of institutional investors, it might constitute a preliminary step at the EU level in order to re-centre the debate on the necessity for genuine shareholder engagement and its benefits for the viability of corporations and financial markets.

In this perspective, it is vital for the EU to take advantage of the UK developments and adopt an EU Stewardship Code applicable to all the market factors in the investment process, ranging from asset owners and asset managers to proxy advisors and investment consultants, as will be shown in part 3. The current EU agenda has included shareholder engagement as one of its distinctive features by conveying the message that this is something that needs to be dealt with at EU level in the future. Apart from the publication of some recent informal discussions with interested parties,[38] the European Commission has expressed its interest in promoting this agenda since the Green Paper on corporate governance in financial institutions and remuneration policies[39] and the Green Paper on EU corporate governance, which received wide support from its respondents.[40] A much more decisive step was reached with the EC Action Plan in 2012, which further clarified the need for much more shareholder engagement at the EU level with

37 Applicable only to UK-based institutional investors.

38 The Commission engaged in informal discussions with stakeholders in early 2013: 'Summary of the Informal Discussions Concerning the Initiative on Shareholders Engagement', Brussels, 17 April 2013 <http:// ec. europa. eu/ internal_ market/ company/ docs/ shareholders/ 120417_ summary-initiative-shareholders-engagement_en.pdf> accessed 25 November 2013.

39 Commission, 'Green Paper: Corporate Governance in Financial Institutions and Remuneration Policies', Brussels, 2 June 2013, COM (2010) 284 final, p. 8, <http:// ec. europa. eu/ internal_ market/company/docs/modern/com2010_284_en.pdf> accessed 15 November 2013.

40 Commission, 'Green Paper: the EU Governance Framework', Brussels, 5 April 2011, COM (2011) 164 final, p. 11, <http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_ en.pdf#page=2> accessed 15 November 2013.

the announcement of an initiative, possibly through modification of the Shareholder Rights Directive, that would deal with the disclosure of voting and engagement policies, as well as voting records provided by institutional investors.[41] It therefore remains to be seen whether the European Commission will promote this agenda and adopt the necessary reforms in order to make disclosure requirements amongst EU Member States converge and to strengthen the overall shareholder engagement trend in a much more realistic way. As previously mentioned, a widely applicable EU Stewardship Code should inevitably include other market actors involved in the investment procedure, such as proxy advisors, whose industry is currently dealt with at the EU level by some ESMA initiatives, as we will see in the next section.

D The Impact of Proxy Advisory Firms on Shareholder Apathy

I The Weakening of Shareholder Engagement through Proxy Services

The facilitation of the exercise of proxy voting services made proxy firms even more powerful in the EU market,[42] thus expanding their predominance in the global market originated by the United States and expressed via other activities as well, such as the provision of proxy advisory services, with Institutional Shareholder Services and Glass Lewis being the most notable examples. The combination of advisory and exercise voting services made proxy firms increasingly popular amongst institutional investors, who prefer to let these firms evaluate corporate decisions and vote accordingly in an ever-accelerating cost-saving framework. Taking into consideration investors' lack of expertise in deciphering complex corporate decisions[43] and their lack of funds that would be needed for thorough research of companies' profiles[44] but, most importantly, the constant pressure of many asset managers and institutional shareholder groups to deliver short-term benefits to their clients,[45] the need for proxy services has become indisputable in the modern investment era.

This over-reliance on proxy services has weakened shareholder engagement even more[46] although these services do offer a rapid corporate assessment along with further recommendations about investment decisions. Therefore, the prob-

41 Commission, 'Action Plan: European Company Law and Corporate Governance – A Modern Legal Framework for More Engaged Shareholders and Sustainable Companies', Strasbourg, 12 December 2012, COM(2012) 740 final, p. 8, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0740:FIN:EN:PDF> accessed 15 November 2013.

42 For example, Ethos, Proxinvest, and European Corporate Governance Service.

43 P.E. Masouros, 'Is the EU Taking Shareholder Rights Seriously? An Essay on the Impotence of Shareholdership in Corporate Europe', *European Company Law*, Vol. 7, 2010, pp. 195, 199.

44 P. Rose, 'The Corporate Governance Industry', *Journal of Corporation Law*, Vol. 32, 2007, pp. 887, 897.

45 D. Krehmeyer, M. Orsagh & K.N. Schacht, 'Breaking the Short-Term Cycle', 2006, pp. 17-18, <www. darden. virginia. edu/ corporate -ethics/ pdf/ Short -termism_ Report. pdf> accessed 10 September 2013.

46 D.M. Gallagher, 'Remarks before the Corporate Directors Forum', 29 January 2013, <www.sec.gov/news/speech/2013/spch012913dmg.htm> accessed 3 November 2013.

lem does not lie in the use of the services but in the over-reliance on them, which makes communication between companies and investors impossible due to the shifting investors' attention away from corporate decisions to the efficiency of proxy services. Since these services will not easily disappear from the market, it is in the best interest of all market actors and regulators to ensure the reliability and transparency of the methods used in their exercise. Under this framework, it is believed that institutional investors will, if not completely disconnected from the recommendations provided by proxy firms, start developing much more independent judgement when they decide when and how to invest their funds. This divergence from over-reliance can also lead to the critical assessment of the services provided and the need to enhance the dialogue with companies in order to have a broader view of a company's profile instead of exclusively voting according to recommendations.

While the EC is currently striving to strengthen investor activism and the efficient exercise of stewardship responsibilities, as previously mentioned, ESMA is in favour of introducing disclosure standards for certain market participants involved in the investment decision in order to ensure that the overall chain becomes at least more visible, if not more sophisticated. It is therefore necessary to reflect upon this policy agenda and critically assess its link with institutional shareholder engagement at the EU level.

II ESMA's Projected EU Code of Conduct

In the Green Paper on corporate governance,[47] the European Commission mentioned the possibility of regulatory intervention in this field. Feedback from stakeholders on the appropriateness of such an agenda[48] was very positive, showing a clear preference for more transparency on the management of potential conflicts of interest, as well as in the overall functioning of the service provided given the absence of a regulatory framework in this field.[49] ESMA subsequently began its own consultation period with various stakeholders and, in February 2013, published its Final Report on the results of the consultation and planning the introduction of an EU Code of Conduct.[50]

The provisions of the Code will be prepared by an industry committee made up mainly of proxy advisory firm representatives. The committee will inform ESMA on a periodic basis of the progress in the preparation of the Code and its

47 Commission 2011, *supra* note 41, p. 14.

48 Commission, 'Feedback Statement: Summary of Responses to the Commission Green Paper on the EU Corporate Governance Framework', 15 November 2011, p. 14, <http://ec.europa.eu/internal_market/company/docs/modern/20111115-feedback-statement_en.pdf> accessed 3 November 2013.

49 Nevertheless, it has to be borne in mind that the UK Stewardship Code is equally applicable to proxy advisory firms and that the French regulator issued recommendations in this respect in 2011: *Autorité des Marchés Financiers* (*AMF*), '*Recommandation AMF n° 2011-06 sur les agences de conseil en vote*', 18 March 2011, p. 3, <www.amf-france.org/documents/general/9900_1.pdf> accessed 3 May 2013.

50 ESMA, 'Final Report: Feedback Statement on the Consultation Regarding the Role of the Proxy Advisory Industry', ESMA/2013/84, 19 February 2013, <www.esma.europa.eu/content/Feedback-statement-consultation-regarding-role-proxy-advisory-industry> accessed 3 November 2013.

application. ESMA will retain a purely symbolic role, for the time being, and will eventually engage with the committee and discuss various topics in order to improve the contents of the Code. ESMA has also mentioned that if this process does not lead to satisfactory results or if market conditions create the necessity for more regulatory intervention, it will proceed to the adoption of more formal measures. Moreover, as recently emphasised by the EC, "[t]he Commission will consider an initiative in 2013, possibly in the context of the revision of the Shareholders' Rights Directive, with a view to improving the transparency and conflict of interest frameworks applicable to proxy advisors".[51]

The Report includes some high-level principles that aim to reflect current areas of concern in this area and that need to be taken into consideration in the preparation of an EU Code of Conduct. The first principle deals with the management of conflicts of interest that may emerge within proxy advisory firms during the course of their duties. Firms need to disclose them, wherever they emerge, and explain their policy for dealing with these kinds of situations. It must be noted that the proxy industry has been criticised on several occasions for continuing to function in the presence of these kinds of conflicts of interest, which severely compromise the reliability and quality of services.[52]

The Report then turns to the need for more transparency of voting methods and policies followed by proxy advisory firms, of the inclusion in their evaluation of local market characteristics, and of their engagement with investee companies. These three pillars of the transparency principle aim to encourage proxy advisors to become much more open to their clients about how they conduct business and how they intend to exercise their role in the investment chain. Therefore, not only their voting policies but also their strategies of evaluation, adapted to each different market, as well as their methods of engaging with companies are crucial elements that they must reflect on and disclose relevant information to regulators and investors.

A special mention deserves to be made with regard to the third component of the transparency principle, which encourages proxy advisors to explain their engagement with companies. The ESMA Report mentions that it is up to the proxy firms to decide whether they wish to establish a dialogue with investee companies. If they wish to do so, they must inform the client accordingly not only of the nature of this dialogue but also of its results. Linking the use of proxy services to shareholder engagement in the scope of our study, it is crucial to understand the usefulness of such a potential disclosure requirement for proxy firms. Extensive contact with corporate managers may give rise to potential conflicts of interest, and, conversely, a continuous reluctance to engage with investee companies might seem to be a less sophisticated and more perfunctory approach. It is therefore vital for the enhancement of shareholder engagement not only to make

51 Commission 2012, *supra* note 42, p. 11.

52 For some current and interesting examples, *see* L. Klöhn & P. Schwarz, 'The Regulation of Proxy Advisors', *Capital Markets Law Journal*, Vol. 8, No. 1, 2013, p. 90 <http://ssrn.com/abstract=2079799> accessed 3 November 2013.

investors much more independent but also to ensure that when they have relied on proxy firms, the latter inform them fully of their engagement with companies.

It is in this kind of framework that shareholder engagement will continue to be present, even in accordance with the use of proxy services, since investors will continue to be informed and may initiate themselves further contacts with companies in order to exert further influence on their agenda. Using this requirement from the companies' perspective, it became apparent from the consultation period that companies would be willing to engage with proxy advisory firms especially in the case of a negative vote. Moreover, companies believe that it would be much more fruitful to initiate a dialogue in order to understand the reasons for which resolutions have been rejected by shareholders and to reply directly to proxy firms if the latter have evaluated them based on incorrect information.[53] This issue will undoubtedly create controversial comments since proxy advisory firms tend to engage differently with each company, and a general disclosure requirement on this issue might be rejected by the industry as inapplicable or time-consuming. Moreover, cultural differences amongst EU Member States[54] might create an obstacle to convergence, and therefore a compromise will have to be achieved in order for this future Code of Conduct to be efficient at the EU level.

Nevertheless, apart from national idiosyncrasies and the need for compromise at the EU level, our study supports the idea that the projected Code of Conduct will only provide a piecemeal solution for proxy advisory firms while separating and isolating them from the rest of the market actors involved in the investment chain, such as asset owners and asset managers. Although a formal Code has been rejected by the respondents to the ESMA consultation, we strongly believe that a soft regulatory tool of this nature, solely applicable to proxy advisory firms, may prove ineffective as it avoids, once again, the shareholder engagement issue to which it is inextricably associated. Combating short-termism cannot result only from the introduction of disclosure obligations applicable to companies or standards applicable to proxy advisors.

E Shareholder Engagement via a Widely Applicable EU Stewardship Code

All the above-mentioned initiatives are vital for the creation of a transparent framework at the EU level, but they might be also perceived by the investor community as an excuse for putting off their responsibilities as investors. It is crucial to understand that sector-centred regulatory agendas, although able to target specific issues, are bound to lose sight of the overarching and wider problem of deficient investment culture. Though they may convey the message to investors that the services that they receive are now reliable, this will not ensure enhance-

53 ESMA 2013, *supra* note 51, p. 19.

54 *See*, for example, the UK approach that lets companies and proxy firms decide how they want to engage, in contrast with the French approach, which is much more detailed, with specific deadlines for the exchange of information and detailed steps that need to be followed in this framework: AMF 2011, *supra* note 50, p. 3.

ment of the critical analysis that investors still need to have with regard to the different service providers upon which they tend to be over-reliant while ignoring the role that they themselves are called to play in the investment process.

If the EU agenda supports the idea that the introduction of disclosure obligations increases investor protection and sophistication, then we have to assume that these requirements need to fulfil a twofold purpose: firstly, ensure the reliability and the provision of high-quality services, and, secondly, nurture a different culture for all market participants and bring about a much more engaged investor community. These two goals will be more easily achieved via a regulatory tool applicable to all parties involved in the investment process.

For future financial and economic crises to be avoided, the entire investment chain – containing a series of market actors that interact with both companies and investors – needs to become more transparent, placing on an equal footing all actors, their roles, and legitimate visibility on their strategies. This is how the educational purposes of the regulatory framework will be unanimously and better understood. Market actors need to become aware of their unique responsibility within this chain in the sense that they manage, influence, represent, and exercise a series of duties and rights that belong to other market actors and that influence companies' projects and culture. This ongoing interaction between market players therefore needs to be dealt with under the same perspective in order for a further symbolic and educational signal to be sent more effectively to all parties involved.

This study proposes the adoption of a holistic approach via the creation of an EU Stewardship Code engaging all market actors involved in the investment chain (asset owners, asset managers, proxy advisors, investment consultants, etc.) to come forward and disclose information on the following areas: their policies; the level of their interaction with investors, other market actors, and companies; and the handling of conflicts of interest. The example of the UK Stewardship Code, although culturally different from other national markets within the EU, needs to be followed and adopted more broadly.

The flexibility of soft law measures will inevitably come into the regulatory framework in order to help market access from other EU Member States to partially comply with the future EU principles and explain their deviation based on the 'comply or explain' principle. Far from being a perfect regulatory pathway or a panacea for the causes of the EU and global crisis, it is a necessary preliminary step to allow all market actors to show how willing they are to engage in this new era of wider participation in corporate governance. In this framework, shareholder engagement will become more vibrant since shareholders will be able to understand better the full spectrum of issues involved in the investment chain, as well as the behaviour that they must adopt not only with regard to corporate boards but also with regard to all the financial intermediaries with whom they cooperate.

F Conclusion

Shareholder engagement has become a crucial issue in the area of corporate governance and, more generally, has been seen as one of the components for the avoidance of future crises, both in the EU and internationally, which are associated with short-term and unsound corporate strategies. The trend for much more active participation in companies' lives has started to make its presence more convincingly and will undoubtedly need a long period of time before becoming unanimously accepted as one of the top future priorities for EU policymakers.[55] The only available option to enhance independent and sophisticated investor judgement would therefore be to encourage both investors and their advisors to assume the same level of exposure at the EU level. All parties would be encouraged to develop a fruitful dialogue with one another and to disclose information about their interactions and the quality of their relationships.

Part 1 endeavoured to point out the problematic issues that have arisen from the use of the 'comply or explain' principle in corporate governance statements. More specifically, it showed that the principle itself has not been sufficiently capable of bringing companies and investors closer in order to guide them towards more fruitful cooperation. Part 2 focused on shareholder activism and critically assessed the latest trends in the 'stewardship' movement in the EU, using the UK Stewardship Code as a starting point. Part 3 critically analysed and challenged ESMA's proposals on the proxy advisory industry, whose role needs to be treated on equal footing with institutional investors at the EU level. Part 4 defended a holistic regulatory conception of shareholder engagement and the need to adopt an EU regulatory path with wider applicability. Although gaining wide acceptance across EU Member States will be difficult, with the necessary amount of compromise, it can contribute to convergence in shareholder engagement practices, giving the investor community the chance to interact with companies in an optimal way.

55 For a recent assessment of global trends in this area, *see* J. Kim & J.D. Schloetzer, 'Global Trends in Board – Shareholder Engagement', <www.conference-board.org/retrievefile.cfm?filename=TCB_DN-V5N20-131.pdf&type=subsite> accessed 7 December 2013.