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GOVERNING INSTITUTIONAL INVESTOR ENGAGEMENT: FROM ACTIVISM TO STEWARDSHIP TO CUSTODIANSHIP?

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ABSTRACT

Institutional investor engagement with companies is a long-standing goal of UK policymakers. This article evaluates whether the UK's corporate governance regime is likely to orient institutional investor engagement towards the long-term, as policymakers hope. After reviewing the historical development and shifting goals of policymakers in encouraging engagement, it notes that in practice, institutional investors have considerable discretion in whether and how they engage with companies. Three existing forms of engagement behaviour (termed agency, trusteeship and ownership) are identified, and the article examines how far these are promoted or discouraged by the current regulatory and soft law regimes. It notes the danger of all three form of engagement behaviour degenerating into passivity, short-term share trading or 'bad activism' focused on short-term value maximisation. This may satisfy the financial demands of all the actors in the investment chain, but it contradicts the aims of the stewardship agenda. The article then suggests that the goals of stewardship would be more likely to come to fruition if the regulatory and soft law regimes articulated a clearer vision of the different roles of shareholders and company management. In order to fill that gap, it offers a custodianship model of engagement that balances managerial autonomy and accountability.

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1. INTRODUCTION

Encouraging shareholder engagement has long been an important part of corporate governance policy in the UK, but the justifications for it have changed over time. Shareholder engagement was commonly referred to as 'activism' before 2008,[1] as shareholders sought to put pressure on managers to make changes to strategy or financial structure in order to increase shareholder value. Following the 2008 financial crisis, engagement was rebranded as 'stewardship' and advanced as a solution to the problem of short-termism, whilst the 2017 revisions to the EU Shareholder Rights Directive aimed for 'sustainable shareholder engagement' to 'improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors'.[2] The 2020 iteration of the UK's Stewardship Code aims for 'long-term value… leading to sustainable benefits for the economy, environment and society'.

This article asks whether the UK's current regulatory and soft law regimes are adequate to ensure that institutional investor engagement is directed towards long-termism and sustainability. It notes that institutional investors have wide discretion in terms of the scope and content of their engagement with companies, creating space for a number of patterns of behaviour to emerge, not all of them compatible with the goals of stewardship. We examine three existing patterns of behaviour, which we term agency, trusteeship and ownership. We explore how each of these patterns of behaviour is addressed by the UK's current regulatory and soft law stewardship regime, and highlight the danger of each of them degenerating into passivity (which lowers costs), short-term share trading (in pursuit of capital gains), or, most damagingly, 'bad activism' focused on short-term shareholder value maximisation. These degenerate forms of behaviour might satisfy the immediate financial priorities of all actors in the investment chain, but they contradict the explicit aims of the stewardship agenda. We argue that stewardship would be more likely to achieve its goals if policymakers delimited more clearly the legitimate scope of shareholder activism, and, in particular, its relationship to the managerial prerogative.

In order to flesh out this argument, we develop Belinga's novel 'custodianship' model of shareholder engagement, in which shareholders give managers space and time to develop and implement a sustainable and long-term strategy, but hold them accountable for achieving that strategy.[3] In doing so, we build on the recommendations made in the post-financial crisis Walker Review, but supplement them with insights from the management literature. Institutional investors who exhibit custodianship behaviour in relation to companies recognise that their activities are a complement to, rather than a substitute for, management. Their function is to ensure that management is discharging its functions in a responsible manner, taking account of environmental, social and governance (ESG) issues and the long-term, so producing sustainable returns for the institutional investors' clients and beneficiaries, whilst meeting the expectations of stakeholders by ensuring that the enterprise is successful. This approach to engagement fits better with the basic division of powers and responsibilities within company law, and arguably has greater potential to ensure that the stewardship agenda achieves its

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[1] See e.g. Institutional Shareholders' Committee, *Statement of Principles* (2002), para 5; John Hendry, Paul Sanderson, Richard Barker and John Roberts, 'Responsible Ownership, Shareholder Value and the New Shareholder Activism' (2007) 11(3) *Competition and Change* 223; Stuart Gillan and Laura Starks, 'Corporate Governance Proposals and Shareholder Activism: the Role of Institutional Investors' (2000) 57 *Journal of Financial Economics* 275.

[2] SRDII, preamble para 14.

[3] The 'custodianship model' of shareholder engagement was first developed by Rachelle Belinga in *L'engagement actionnarial: de l'industrialisation de l'actionnariat à l'expression de nouvelles responsabilités,* (2018) Doctoral dissertation, MINES ParisTech - PSL Research University.

stated goals. However, it is also fragile, being vulnerable to opportunism on the part of either shareholders or management, and so, we argue, requires policymakers to nurture a careful balance between managerial autonomy and accountability to shareholders.

The paper is structured as follows. In the next section we look at the emergence of shareholder engagement as a policy goal, its rebranding as stewardship, and the gradual shift from encouragement to soft law and finally on to harder law. In part three we briefly highlight how the law gives wide discretion to both asset owners and asset managers.[4] This leads into a discussion in part four of three patterns of institutional investor behaviour and the ways those behaviours are governed by regulation and soft law. Finally, we develop the notion of 'custodianship' behaviour as a way of setting an appropriate boundary between shareholder activism and managerial prerogative. A brief conclusion follows.

2. HISTORICAL EVOLUTION OF SHAREHOLDER ENGAGEMENT

Shareholder engagement has long been a goal of UK policymakers. From the Cohen Committee Report of 1945, through the Cadbury Report of 1992, right up to the 2020 Stewardship Code, it has been thought essential that shareholders should exercise the rights given to them by company law to hold directors accountable. In 1945, data about the separation of ownership and control in the UK showed that shareholder control was 'illusory', with growing numbers of small shareholders failing to use their powers at meetings to 'exercise control over directors'.[5] However, by 1962, the separation of ownership and control was already beginning to narrow in the UK, with the Jenkins Report stating it was 'perhaps now something of an overstatement' to describe shareholder control as 'illusory', because institutional investors, who were rapidly expanding their shareholdings, were 'not likely to submit to any major abuse of power by the directors'.[6] It was only after the end of the takeover boom of the 1960s that attention turned back to institutional investors. At the instigation of the Bank of England, an Institutional Shareholders' Committee (ISC) was set up in June 1973,[7] whose members would work together to coordinate their 'existing investment protection activities'.[8]

By the end of the 1970s, institutional investors owned a majority of the shares in UK listed companies. Reviewing the ISC, the 1980 Wilson Report concluded that the ISC 'was adequate for any collective action',[9] and that institutional investors 'generally do have the capacity to exercise the responsibilities of ownership, especially those of fostering efficient management and encouraging development.'[10] At the same time, it noted that, where management is lacking solutions, investors cannot provide them.[11] Institutional investors were not to interfere in day-to-day management decisions and were expected to be slow to voice their own judgement even on major policy decisions. Their role was to ensure that boards included sufficient non-executive directors,[12] to express their views at the AGM, and if

[4] Throughout the article we use the term 'institutional investors' to refer to asset owners and asset managers collectively; where we distinguish between them, we refer specifically to 'asset owners' or 'asset managers'.
[5] *Report of the Committee on Company Law Amendment* (1945, London: HMSO), paras 7(e) and 125.
[6] *Report of the Company Law Committee* (1962: London, HMSO), para 106.
[7] 'Institutional Shareholders Committee', *Bank of England Quarterly Bulletin* June 1973 at 148.
[8] 'Industrial management and the institutional investor' *Bank of England Quarterly Bulletin* March 1973 20.
[9] Para 925.
[10] Ibid, paragraph 898.
[11] Ibid, paras 913-914.
[12] Para 917.

dissatisfied, use their voting powers, especially in relation to the appointment of non-executive and other directors.[13]

Jonathan Charkham put the issue back onto the Bank of England's agenda, arguing that in the UK context, there was 'no alternative' to 'active shareholding' because company law had made shareholders 'technically supreme', yet shareholders had 'all but abdicated', doing little more than deciding on the success or failure of takeover bids.[14] Moreover, continued passivity would call into question the legitimacy of the system of 'shareholder supremacy' created by the law, potentially triggering 'political activity to make boards once more accountable.'[15] At the same time, Charkham highlighted barriers to engagement, particularly the short time horizons forced upon fund managers by performance assessment regimes, which prevented them from taking a long-term view and establishing relationships with companies in their portfolio.[16]

Charkham's paper is fundamental because it identifies for the first time that the investment chain might induce a 'trading' approach on the part of institutional investors at the expense of building long-term relationships with investee companies. It is now more than thirty years since he wrote his paper, and highlighted that 'remedial action' might be needed, but, as we discuss in part 4.1 below, empirical evidence suggests that trading is still the dominant approach. What followed instead was a steady stream of soft law initiatives seeking to head off regulatory intervention.

The ISC was reactivated in 1989 and in 1991 issued a statement on the 'Responsibilities of Institutional Shareholders in the UK', which committed to bringing about change in companies and was endorsed by the Cadbury Committee in 1992.[17] However, nearly a decade after the Cadbury Report, the Myners Review concluded that engagement was still insufficient.[18] Indeed, Myners emphasised that a lack of clarity as to timescales had 'the potential to encourage fund managers to adopt an investment approach which does not reflect either their clients' wishes or their long-term interests'.[19] Publication, in 2002, of the ISCs revised 'The Responsibilities of Institutional Shareholders and Agents – Statement of Principles', once again headed off the threat of regulatory intervention .

It was only after the financial crisis, which laid bare that shareholders had actually been pushing for financial institutions to take more risk,[20] that claims began to be made to the effect that shareholder engagement would result in companies taking a longer-term and more sustainable approach. The ISC's 2009 *Responsibilities of Institutional Shareholders* called for 'collaborative engagement' and rebranding shareholders' role as one of 'stewardship' (a term which Cadbury had originally used to describe the role of directors). Shortly afterwards, the Walker Review recommended that the ISC Code should become the 'Stewardship Code', be sponsored by the FRC giving it a status similar to the UK

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[13] Para 923.

[14] Jonathan Charkham, 'Corporate Governance and the Market for Companies: Aspects of the Shareholders' Role' *Bank of England Discussion Paper No44*, November 1989 at 4-6.

[15] ibid at 8-9.

[16] ibid at 12.

[17] Adrian Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance*. (1992, Gee: London) paras 6.9- 6.11.

[18] Paul Myners, *Institutional Investment in the United Kingdom: A Review* (2001); John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making*, July 2012, paras 56-7.

[19] Kay Review, para 53.

[20] Jacques de Larosière, *Report of the High-Level Group on Financial Supervision in the EU,* 25 February 2009 at 10; Walker referred to 'widespread acquiescence by institutional investors and the market in the gearing up of the balance sheets of banks (as also of many other companies) as a means of boosting returns on equity': David Walker, *A Review of Corporate Governance in UK banks and Other Financial Industry Entities – Final Recommendations*, 26 November 2009, para 5.10.

Corporate Governance Code, and elevated to 'comply or explain' status.[21] For Walker, steering institutional investors towards 'ownership' behaviour was viewed as 'a matter of public interest… not least given the limited liability that shareholders enjoy.'[22]

The first iteration of the Stewardship Code (SC 2010), issued in July 2010, viewed enhancing the quality of engagement as a way 'to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities'.[23] The SC 2010 was primarily addressed to asset managers, who were expected to comply with the terms of their mandates, but were expected by the FRC to publicly disclose how they had applied the Code. The FRC also encouraged asset owners 'to report if and how they have complied with the Code', whether by direct action or through the mandates they give to their agents. Compliance would primarily consist of publishing a policy on how stewardship responsibilities would be discharged (the reward for which would be being listed on the FRC's website), and explanations for any non-compliance were also encouraged. From November 2010, the FRC's expectation that asset managers would comply was reflected in a legal obligation that they, as part of their authorisation to provide financial services, disclose the nature of their commitment to the SC, or explain their alternative investment strategy.[24] As was noted at the time, the limited reach of SC 2010 was its primary weakness: this obligation could not be extended to overseas asset managers (who were not subject to FSA authorisation). Likewise, compliance by UK-based asset owners remained entirely voluntary, whilst the FRC could only 'hope' that overseas asset owners, who by 2008 owned 42% of publicly traded shares of UK companies, would comply.[25]

In the 2012 version of the Stewardship Code (SC 2012), the rationale for stewardship had evolved to become 'promot[ing] 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.'[26] Compliance with the Code remained effectively voluntary for asset owners, although, in an effort to improve quality of reporting and maintain the credibility of the Code, the FRC in 2016 began tiering signatories according to the quality of their reporting.

Whilst share prices had recovered from the financial crisis, largely driven by extraordinary monetary policy, there was little evidence that the new Stewardship Agenda was bringing about a longer term approach. Echoing Charkham and Myners in earlier decades, the 2012 Kay Review noted the 'short performance horizon' of asset managers,[27] whilst research by Tilba and McNulty (discussed further below) found little evidence of direct stewardship activities by large pension funds.[28] Reviewing the law in this area, the Law Commission was told that, in practice, investors 'will satisfy their stewardship responsibilities through their investment managers. This might include terms in the investment manager's mandate, communication of stewardship policies to investment managers, and by holding

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[21] Walker, ibid, Recommendation 17 and paras 5.36 to 5.39.
[22] Ibid, para 5.7.
[23] FRC, *The UK Stewardship Code*, July 2010, preface.
[24] COBS 2.2.3R introduced by Conduct of Business Sourcebook (Stewardship Code) Instrument 2010, FSA 2010/57, 10th November 2010.
[25] Brian Cheffins, 'The Stewardship Code's Achilles Heel' (2010) 73(6) *Modern Law Review* 985 at 1015-1018. In fact, the main global asset management companies do comply with the Stewardship Code; a list of asset managers that published a statement of compliance with SC 2012 can be viewed at https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements/asset-managers.
[26] FRC, *The UK Stewardship Code*, September 2012 at 1.
[27] Kay Review at 5.18.
[28] Anna Tilba and Terry McNulty, 'Engaged versus disengaged ownership: the case of pension funds in the UK' (2013) 21(2) *Corporate Governance: An International Review* 165.

investment managers to account for their stewardship activities.'[29] However, it concluded that investment managers 'may receive conflicting instructions from among their clients, leading to a "lowest common denominator" approach to stewardship'.[30]

At the European level, it appeared that corporate governance might go in a different direction. In 2010, the European Commission stated in a Green Paper that 'confidence in the model of the shareholder-owner who contributes to the company's long-term viability has been severely shaken, to say the least.'[31] However, by 2014, conventional wisdom had regained the upper hand, with the European Commission proposing to amend the existing Shareholder Rights Directive in order to achieve the 'overarching objective' of 'contribut[ing] to the long-term sustainability of EU companies' by 'increas[ing] the level and quality of engagement of asset owners and asset managers with their investee companies'.[32] As enacted, the revised Shareholder Rights Directive (SRDII) requires Member States to impose a 'comply or explain' obligation on institutional investors (defined as pension funds, insurance companies and asset managers), requiring them to develop and disclose an engagement policy (an obligation which largely mirrors that included in the SC) or to disclose 'a clear and reasoned explanation why they have chosen not to comply'.[33] Whilst the comply or explain obligation to disclose a policy was familiar to UK institutional investors, SRDII framed stewardship more broadly than SC 2012. For example, SRDII requires the engagement policies disclosed to include information on how institutional investors monitor investee companies on matters such as non-financial performance, social and environmental impact and corporate governance.[34] The aim is for these shareholders to play a part in improving the 'financial and non-financial performance of companies, including as regards environmental, social and governance factors'.[35] Institutional investors will also be required to report annually and publicly on the implementation of their engagement policy, including disclosure of voting behaviour and how specific votes were cast.[36] This latter obligation represents a major juridification of the approach to stewardship, especially in the UK, with these rules implemented by the FCA[37] to cover life insurance companies and asset managers, and by the Department of Work and Pensions to cover pension fund trustees.[38]

So how far do the SRDII-derived obligations attach to the owners and managers of UK listed equities? UK-based asset owners caught by SRDII and required to make disclosures are now relatively minor players: UK pension funds hold around 3% of UK quoted shares, whilst UK insurance companies (a category wider than the life insurance companies caught by SRDII) own around 4% of UK quoted shares. However, asset managers that provide portfolio management services to asset owners are also caught by SRDII, as are alternative investment fund managers, UCITS management companies

[29] Law Commission, *Fiduciary Duties of Investment Intermediaries*, Law Com No 350, 2014, para 5.86.
[30] Ibid, para 5.91.
[31] European Commission, *Corporate governance in financial institutions and remuneration policies* COM(2010) 284, June 2010 at 8.
[32] COM(2014) 213 final at 2.
[33] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, new Art 3g(1)(a).
[34] Ibid, new Art 3g.
[35] Ibid, preamble para 14.
[36] Ibid, new Art 3g(1)(b).
[37] See FCA, *Shareholder Rights Directive (Asset Managers and Insurers) Instrument 2019* (FCA 2019/68).
[38] The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019 (SI 2019 No 982).

and UCITS funds without external management.[39] This means that SRDII also applies to those managing unit trusts, which own around 10% of UK listed shares, as well as those managing many of the 'other' financial institutions (a category including index funds, exchange traded funds, hedge funds, socially responsible and ethical funds) that own around 8% of quoted shares.[40] The vast majority of the remaining quoted shares are beneficially owned by the rest of the world (54.9%) and UK-based individuals (13.5%); SRDII will only apply where these shares are managed on behalf of the beneficial owners by UK-authorised asset managers.

One effect of SRDII is that the recently published Stewardship Code 2020 (SC 2020), which aims 'to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society' is once again a pure best practice document.[41] Whether caught by SRDII-derived obligations or not, institutional investors may choose to apply SC 2020 and explain their approach to stewardship in more detail than SRDII requires. SC 2020 will steer these institutional investors towards further disclosures on a wider range of topics, including, intriguingly, 'market-wide and systemic risks'.[42] As we will see in part 4.1.1 below, the FCA hopes voluntary application of SC 2020 might be driven by a 'market for stewardship'.

3. WIDE DISCRETION OF ASSET OWNERS AND ASSET MANAGERS

The previous section showed how policymakers have long sought to encourage institutional investor activism, on the assumption that it would lead to more efficient management and so to better returns for savers and beneficiaries, but also on the basis that it would have wider societal benefits, whether 'development' in 1980, a 'long-term' approach in 2010 or 'sustainable benefits for the economy, the environment and society' in 2020. At the same time, that history highlights the long-standing tendency on the part of institutional investors to revert to passivity and simply sell their shares where they are dissatisfied. In this section we argue that one important reason for this is that shareholders have very wide discretion in law as to whether and, if so, how they engage with companies and exercise the decision-making rights they hold. That discretion in many ways mirrors the discretion given to directors and managers. Just as the law protects honest decisions of directors which are intended to serve the interests of the company (or promote the success of the company in the UK's more recent reformulation), so the law rarely if ever intervenes in the discharge by institutional investors of the fiduciary duties which they owe to their end beneficiaries and clients.[43]

Asset owners such as pension funds can, in principle, decide that the financial interests of end beneficiaries would be best served by acquiring, divesting and managing assets in house or by contracting those functions out to a professional asset manager. In the latter case, which covers about

[39] UCITS are Undertakings for Collective Investment in Transferable Securities, regulated by Directive 2009/65/EC. UCITS compliant funds can be marketed to retail investors across the EU.

[40] ONS, Ownership of UK quoted shares: 2018 (https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2018)

[41] FRC, *The UK Stewardship Code 2020*, December 2019.

[42] Ibid, Principle 4.

[43] The analysis in this section focuses on asset managers and asset owners that operate on the UK market and may be subject to fiduciary duties under English law.

two thirds of assets,[44] the owner will, following a tender process which takes on average ten months,[45] engage an asset manager under an investment management agreement (IMA). The IMA will specify whether the assets are segregated or pooled (they are commonly segregated in the 'traditional institutional market'[46]) and may also make detailed provision in relation to voting and other forms of activism, meeting – in theory at least – the asset owner's preferences as to how far and on what matters the manager should engage with companies, or may simply incorporate one of the asset manager's standard engagement policies. The terms on which the assets are managed will depend on the relative bargaining power of the owner and the manager, the fees which are going to be paid and the size of the assets in question. So, where an asset owner invests in a pooled fund, they will have to take (or leave) the standard mandate that applies. If they invest in a segregated fund, the asset owner may have more bargaining power and be able to negotiate (and pay for) a mandate that better matches their preferences as to engagement. However, in 2018-19, only 15% of the segregated mandates favoured by large institutional investors include some kind of sustainability or responsibility element,[47] with almost all of that 15% doing so by integrating environmental, social and governance (ESG) factors into traditional financial analysis. ESG integration is, of course, not the same as stewardship (although presumably IMAs that impose clear stewardship obligations on the asset manager are included in the ESG total). Hence, it is likely that considerably fewer than 15% of IMAs make any reference to stewardship.

That references to stewardship are largely missing from IMAs is supported by evidence from the asset owner side: it is clear that they do not emphasise long-termism and ESG when they select managers. A survey of procurement questionnaires carried out for the Department of Business, Innovation & Skills (BIS) found no questions relating to the long-term approach of asset managers, whilst on average only 5% of weighting was assigned to stewardship and ESG questions (and these were 'conformance driven, closed-end rather than open-end').[48] Nor are asset managers entirely clear about what asset owners want, piecing together what is expected of them from a whole mosaic of communications rather than just from formal IMAs. Asset managers may be comfortable with this ambiguity in some cases, which allows them to conclude that asset owners place less weight on outperformance than on underperformance, and that underperformance would be more likely to influence asset owners' decisions whether to hire, renew or terminate an asset manager. While mandates normally have a three year duration, they can all be terminated immediately,[49] with asset managers commonly believing termination would follow two years of underperformance.[50] This leads asset managers to an 'over focus on the benchmark and a short-term mindset' as they believe that asset owner time horizons are shorter than asset owners 'believe they are suggesting'.[51] Further confusing matters, the complexity and variability of these relationships means that there is a lack of clarity as to who ultimately is responsible for stewardship, with experts telling BIS that asset owners should collaborate more with asset managers on issues of stewardship.[52]

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[44] BIS, 'Metrics and models used to assess company and investment performance', *BIS Research Paper No.190*, October 2014 at 19.
[45] Ibid.
[46] Investment Management Association, *Investment Management in the UK 2018-19*, September 2019 at 41; almost two thirds of third party institutional mandates were managed on a segregated basis: see ibid at 51.
[47] Ibid at 32-3.
[48] BIS, 'Metrics and Models' at 24.
[49] Ibid at 25. There is no publicly available information on how often mandates are actually terminated.
[50] Ibid at 22.
[51] Ibid at 23.
[52] Ibid at 29. Whilst paragraph 2 of the 2012 SC did state that 'institutional investors [asset owners and asset managers… cannot delegate their responsibility for stewardship', this relates to external service providers and

This is by no means a new problem. From Charkham to Myners to Kay, the short time horizons used to assess asset manager performance have been repeatedly noted. Where expectations remain unclear, short-term financial performance can allow all concerned to meet their targets. However, the short-term focus of the investment chain takes on new significance when policymakers are relying on shareholder activism to become 'stewards' and steer companies towards long-term sustainability and success.

Fiduciary duty does not play a meaningful role in regulating the terms of delegation and does not solve the problem of time frames. In principle, actions taken in the discretionary space in which asset owners and managers operate are subject to fiduciary duties. However, a 2014 Law Commission report highlights that the law is unclear, and that, in those rare cases where a legal challenge is launched, litigation can be long and drawn out.[53] It is clear that asset owners will owe a fiduciary duty to their beneficiaries (if they are a trust-based pension fund) or 'fiduciary-like' duties requiring them 'to act honestly, fairly, and professionally in accordance with the best interests of its client' (in the case of contract-based pensions[54] and life insurance companies[55]). The position of asset managers is much less clear. Investment managers to whom decisions have been delegated by pension trustees will, along with the trustees themselves, be required to follow the Occupational Pension Schemes (Investment) Regulations 2005, which require assets to be invested 'in the best interests of members and beneficiaries', and powers of investment 'must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole'.[56] They probably[57] also owe fiduciary duties and a duty of care to the pension trustees who have given them a mandate,[58] and may, in some cases, even owe fiduciary duties to the end beneficiaries.[59]

Beyond legal uncertainty, litigation is rare and the courts will not judge trustees' decisions with the benefit of hindsight.[60] This would apply to asset manager decisions as well, with the courts very unlikely to impose liability unless a particular decision either was clearly incompatible with the investment mandate (such as where the mandate specifically asked for stewardship activities), or

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does not – and indeed, could not, since it is a question for the mandate – allocate responsibility between owners and managers.

[53] Law Commission, 'Fiduciary Duties of Investment Intermediaries', LC 350, para 11.5: 'Very few cases are brought' in relation to breach of fiduciary duty in fast-moving financial markets, and there are often long delays between the actions complained of and the court ruling.

[54] Law Commission, para 8.49, referring to COBS 2.1.1R, which can be enforced by a person who has suffered loss under s138D of the Financial Services and Markets Act 2000.

[55] COBS 1.1R General application, applying COBS to 'long term insurance business in relation to life policies'.

[56] SI 2005 No 3378, Regulations 4(1), (2) and (3).

[57] There is some doubt here because, as the Law Commission pointed out in its initial consultation, the courts are also often reluctant to impose fiduciary duties within an arms' length commercial relationship where the parties have opportunity to define their obligations and have contractual remedies open to them. Law Commission, *Fiduciary Duties of Investment Intermediaries, A Consultation Paper*, No 215 (2013) at 11.15. In its final report (above n53), the Law Commission concluded at 10.47 that fiduciary relations may arise in commercial relationships, but that 'a party claiming that a fiduciary relationship has arisen may face a more difficult task when the relationship is a commercial one, at least where the relationship in question is not one that is considered to be clearly or traditionally fiduciary.'

[58] The Law Commission recognised that 'there is no authority directly on point', but referred to two UK cases in which courts assumed that asset managers with discretionary powers would owe fiduciary duties and a duty of care to their clients and a Canadian case which stated that this situation would 'frequently' give rise to fiduciary duties (LC 350 above n53), paras 10.22-10.23).

[59] *Ibid*., paras. 10.27-10.28, citing *Australian Securities Commission v AS Nominees Limited* (1995) 62 FCR 504, but noting that this is 'far from certain'.

[60] LC 350 at 3.81 and 5.56.

(improbably) there was clear evidence that it was shaped by a conflict of interest or motivated by an improper purpose. Hence, it would be virtually impossible for a hypothetical asset owner or end beneficiary to challenge an asset manager's decision to sell a shareholding, with a view to booking an immediate profit, or simply to do nothing, free riding on the efforts of other investors, rather than engaging in costly stewardship activities, at least in the absence of an explicit and applicable mandate for the manager to take an activist approach in relation to that particular holding. Moreover, any decision to spend resources on highly uncertain litigation against an asset manager would itself have to comply with the asset owner's clear fiduciary duty to its end beneficiaries,[61] with the costs of challenge likely to exceed any remedy available for a decision made in relation to a single investment. As for end beneficiaries, they are largely passive, and even rare active beneficiaries will be very unlikely to know about any of these events. At best, there will be some public and end beneficiary scrutiny of more high profile pension fund trustees, potentially leading them to put pressure on asset managers to be more transparent, especially about voting policies.[62]

Overall, then, the common law in this area is not well developed and certainly does little to interfere with the beliefs of both asset managers and owners that, as long as they deliver short-term financial returns that keep everyone happy, then they are discharging their fiduciary duty. This means that the corporate governance system, and the Stewardship Code and SRDII in particular, have a critical role to play if stewardship is to amount to anything more than another mechanism for short-term shareholder value maximisation.[63]

4. THREE PATTERNS OF INSTITUTIONAL INVESTOR BEHAVIOUR AND THEIR GOVERNANCE BY REGULATION AND SOFT LAW

In this section we suggest that the discretion available to institutional investors has led to the emergence and institutionalisation of three broad patterns of behaviour, which we refer to as agency, trusteeship and ownership to identify the interests that they serve. These behaviours overlap and can degenerate into the 'lowest common denominator' of passivity, short-term share trading or activism aimed at short-term value maximisation. In each case, we consider the extent to which regulation and soft law attempt to govern these forms of behaviour, whether by encouraging or discouraging them, and evaluate the likelihood of success.

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[61] NAPF guidance on 'Securities Litigation – Questions for Trustees' states that in relation to securities class actions against companies or their directors, or aimed at changing corporate governance practices, trustees should 'at the very least not neglect opportunities to recoup losses, where the cost and effort are commensurate with the expected return'. Similar advice would presumably apply for clear cut breaches of duty by asset managers.

[62] A. Tilba and A. Reisberg, 'Fiduciary Duty under the Microscope: Stewardship and the Spectrum of Pension Fund Engagement' (2019) 82(3) *Modern Law Review* 456 at 476-7.

[63] Hendry et al's interviews in the early 2000s found institutional investors claiming that their activism was aimed at shareholder value, but also noted that institutions' own profit maximisation pushed them to compete for mandates. One way of doing this was emphasising in their pitches to clients that they had capacity for corporate governance and activism, even though they assumed that their clients were only preoccupied with these matters out of a desire for political correctness (mandates did not require activism, and clients put little pressure on their managers to actually engage in activism): see J. Hendry et al (2007) above n1 at 232-5.

4.1. Agency behaviour

'Agency' behaviour describes asset owners engaging (or failing to engage) with companies so as to serve the wider financial or business interest of the corporate group of which they are a part rather than their end beneficiaries, or asset managers acting in ways which serve the interests of the company that employs them and its shareholders, rather than their clients.[64] We use the term 'agency' here in its economic sense, to express the idea that asset owners and managers are, in line with conventional corporate governance prescriptions, encouraged to act in the financial interests of their principals (the company which employs them, the wider corporate group and, ultimately, its shareholders). As such, the financial interest of their principals may conflict with the interests of their beneficiaries, customers and clients, which as we shall see, may or may not be adequately captured in the mandate.[65]

In a narrow sense, agency behaviour may manifest itself in a reluctance to challenge corporate management in the hope of gaining further business from the company. In a wider sense, agency behaviour might encompass a long-term approach if that is what the principals want, but might also motivate passivity (which reduces costs compared to rivals), a trading approach (in search of capital gains), or 'bad activism'[66] (pushing for short-term shareholder value maximisation). Whether agency behaviour focuses on the long-term or degenerates into short-termism will depend in part on the incentives and in part on the mandates given to those acting on behalf of asset owners or managers.

As regards incentives, an asset management firm might, for example, remunerate its employees for increasing market share; rolling over or retaining asset owner mandates; or producing better short-term returns relative to its competitors. These practices are intended to increase assets under the firm's management, but 'in many cases, the consideration of improving relative performance would not provide any incentives to improve stewardship decisions'.[67] The result may be greater passivity, which reduces costs, or efforts to increase short-term financial returns through trading or 'bad activism'. Asset management firms are effectively caught between corporate governance pressures to serve their own shareholders by increasing revenues or reducing costs, and the (rarely if ever enforced) contractual and fiduciary duties they owe to their clients and end beneficiaries. Whilst the latter may require actions to promote the interests of clients and their end beneficiaries, actions intended to improve short-term returns or reduce costs relative to competitors will hit internal targets and it is difficult to argue that they are not in the best financial interests of clients and beneficiaries. Those pressures are increasing as a result of the inexorable rise of index funds, which have ultra-low costs in relation to corporate governance, and so ramp up the pressure on active funds either to lower costs by becoming more passive or to increase short-term financial returns through trading or 'bad activism'.

The primary constraint on asset managers adopting passive or short-term approaches will be the mandate they receive from their client. We do not have a great deal of information about the

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[64] See for example Lucian Bebchuk, Alma Cohen and Scott Hirst, 'The Agency Problems of Institutional Investors' (2017) 31(3) *Journal of Economic Perspectives* 89.

[65] In the US context, Sharfman notes that the absence of guidance as to the fiduciary objective of shareholder voting, 'institutional investors may be tempted to utilize shareholder voting for their own purposes (enhancing the welfare of the institutional investor or its managers)': see Bernard Sharfman, 'The Risks and Rewards of Shareholder Voting' 73(4) *SMU Law Review* 849.

[66] Jennifer Hill, 'Good Activist/Bad Activist: The Rise of International Stewardship Codes' (2018) 41 *Seattle University Law Review* 497.

[67] Bebchuk et al, above n65 at 97-8.

mandates given by investors to managers,[68] but as we saw above, IMAs give asset managers considerable 'slack', which is essential to allow them to manage investments, but also creates a broad discretionary space for managers. That 'slack' can be exploited by asset managers to do whatever is needed to demonstrate 'good' performance according to both the internal criteria against which their performance is assessed and their understanding of what asset owners 'really' want. Again, the simplest way to square these various circles is to increase short-term financial returns or reduce costs relative to competitors.

A trading approach, whereby asset managers buy and sell shares rather than engage with companies, is one hallmark of agency behaviour that has degenerated. Trading is much cheaper than engagement, and lower costs will improve performance relative to peers, whilst engagement benefits all shareholders, regardless of whether they have incurred the costs of getting involved.[69] Hence, trading furthers the interests of the asset manager and its shareholders of increasing market share by outperforming competitors in the short-term, and so attracting more business from asset owners. There is evidence of asset managers preferring trading over engagement: Hendry et al's interviews with senior fund managers (admittedly carried out before the 2008 financial crisis and the Stewardship Code) found that their position relative to the index was critical to determining whether activism occurred.[70] Trading was the dominant approach, with activism only seen as justifiable where a fund was overweight relative to an index. In contrast, there was little evidence that asset managers framed themselves as the agents of asset owners in law, or that they were holding company management to account for their clients' end beneficiaries. Instead, fiduciary duty was 'an ideal description of the system' rather than 'a real description of the situation with which actors are in practice faced.'[71]

More recent interviews carried out in 2011 by Tilba into the behaviour of pension fund trustees found that around two thirds of pension funds surveyed 'do not have direct relationships with their investee companies, nor do they seek to influence their fund managers in any way when it comes to corporate governance or ESG issues'.[72] Performance is appraised by reference to benchmarks, and fund managers are encouraged to exit rather than exercise voice where corporate performance is poor. This data, which was gathered after the Walker Review and the first iteration of the Stewardship Code, demonstrates that pension fund trustees are happy with – or at least unwilling to complain about and seek to change – the trading approach taken by asset managers. Pension funds in this group viewed trading as compatible with fiduciary duty because it results in financial performance allowing them to

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[68] House of Commons Business, Energy and Industrial Strategy Committee, *Executive Rewards: Paying for Success*, Eighteenth Report of Session 2017-19, HC 2018, 26th March 2019 at 30: 'these mandates are rarely made public, and it is therefore extremely difficult for asset owners to be held to account for the way in which they direct our savings to be invested'.

[69] Edmans argues that trading can also act as discipline on management, solving the problem of a myopic focus on short-term stock price leading to underinvestment. Where a blockholder incurs costs and acquires information about whether weak earnings are caused by low quality management or long-term investment, they can profit from that information by trading or holding respectively, driving the stock price towards fundamental value. By not carrying out the threat of exit, the blockholder induces long-term investment. However, where share ownership is truly dispersed, this leads to myopia (the 'separation of ownership from information'). See Alex Edmans, 'Blockholder Trading, Market Efficiency and Managerial Myopia' (2009) 64 *Journal of Finance* 2481. Of course, trading has never been ruled out by any of the ISC instruments or the SC ('does not… preclude a decision to sell'), so presumably policymakers take the view that UK and EU markets do not have sufficient suitable blockholders to steer companies towards long-term sustainability.

[70] John Hendry, Paul Sanderson, Richard Barker & John Roberts, 'Owners or traders? Conceptualizations of institutional investors and their relationship with corporate managers' (2006) 59 *Human Relations* 1101–1132.

[71] Ibid at 1121-1122.

[72] Tilba and Reisberg above n63 at 471.

meet their future liabilities and does not entail spending resources on engagement that may not further the financial interests of beneficiaries. In any event, asset managers were better equipped to make decisions on engagement. The minority of pension funds who did put pressure on fund managers to engage with investee companies on their behalf were trustees of local authority and occupational pension funds. They require engagement 'because they themselves are under public scrutiny' and therefore 'demand greater transparency, particularly when it comes to disclosing voting policies'.[73] This pressure could lead them to specify voting guidelines or research the manager's voting policies and corporate governance activities before appointment. Finally, two pension funds engaged directly with investee companies, including acting collectively through the Local Authority Pension Fund Forum, with a view to creating and maintaining long-term relationships with the companies.[74]

4.1.1 How is agency behaviour regulated?

With litigation about fiduciary duties in the investment chain virtually unheard of, does regulation prevent agency behaviour degenerating into a short-term approach? The UK's Financial Conduct Authority (FCA) may impose fines on asset managers, as regulated firms, for breach of relevant regulations, including for example failure to manage conflicts of interest fairly.[75] However, there is no evidence of the FCA taking enforcement action against asset managers for taking a short-term approach to investments. Market forces might act as a greater constraint if asset owners who are dissatisfied with the short-termism of their managers reassign the mandate to another asset manager (say, that has a clearer and stronger approach to ESG activism), or carry out more asset management internally. Indeed, the FCA has noted its desire to create a market for stewardship,[76] and threatened more forceful 'regulatory intervention' in the event that some investors 'free-ride' on the stewardship efforts of others or otherwise underinvest in stewardship, undermining the quality of the market.[77] At the same time, the research discussed above[78] highlights the ongoing trading mentality of most asset owners and managers, whilst others have noted that, without additional measures such as tax expenditures, the prospects for market-driven stewardship appear dim.[79]

This leaves the SC and SRDII as the primary mechanisms to prevent agency behaviour degenerating. There are provisions aimed at resolving conflicts of interest, which may arise where the institutional investor also has another relationship with investee companies (such as managing the investee's own pension fund), potentially making the institutional investor less willing to take an adversarial approach to company management. The SC 2012 required public disclosure of 'a robust policy on managing conflicts of interest in relation to stewardship'.[80] It explained that conflicts of interest will 'inevitably arise' and 'may include when voting on matters affecting a parent company or client'. The policy

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[73] Ibid at 477

[74] Ibid at 478

[75] See 'FCA fines Aviva Investors £17.6m for systems and controls failings that led to its failure to manage conflicts of interest fairly', https://www.fca.org.uk/news/press-releases/fca-fines-aviva-investors-%C2%A3176m-systems-and-controls-failings-led-its-failure.

[76] FRC and FCA, 'Building a regulatory framework for effective stewardship', DP 19/1, January 2010 at 3.11: 'Transparency of firms' stewardship activities should help to develop a competitive market for stewardship in the interests of consumers. When working well, financial services firms would compete with each other to deliver high-quality investment decision-making'.

[77] Ibid at 5.6.

[78] Hendry et al, n1 above and Tilba and Reisberg, n63 above.

[79] Dionysia Katelouzou and Eva Micheler, 'The Market for Stewardship and the Role of the Government', October 2020 draft available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3704258.

[80] Stewardship Code 2012, Principle 2.

should disclose how conflicts are identified and managed with 'the aim of taking all reasonable steps to put the interests of their client or beneficiary first'. Following the lead of the SC 2012, SRDII aims to address 'particular situations in which the institutional investors or asset managers and their affiliated undertakings have significant business relationships with the investee company'.[81] It requires that the engagement policy of the institutional investor or asset manager should explain how they 'manage actual and potential conflicts of interests in relation to their engagement'.[82] This has now been implemented as 'comply or explain' obligation for pension funds, insurance companies and asset managers.[83] The inclusion of these matters within the engagement policy will at least draw more attention to the issue, although there must be doubts as to how many asset owners will monitor asset managers in relation to this, and whether they will change managers as a result.

As for encouraging stewardship behaviour as an alternative to passivity, short-term share trading or 'bad activism', SRDII requires the asset owner to disclose the following aspects of their arrangements with asset managers, or give a clear and reasoned explanation of why their arrangement does not contain these aspects: 'how the arrangement with the asset manager incentivises the asset manager to align its investment strategy and decisions with the profile and duration of the liabilities of the institutional investor, in particular long-term liabilities'; how it 'incentivises the asset manager to make investment decisions based on assessments about medium to long-term financial and non-financial performance of the investee company and to engage with investee companies in order to improve their performance in the medium to long-term'; how the method and time horizon of evaluating asset manager performance align with profile and duration of the asset owner's liabilities, and take absolute long-term performance into account; how portfolio turnover costs are monitored and how it defines a targeted portfolio turnover; and how long the arrangement lasts.[84] Pension fund trustees are now required to include these matters in their Statement of Investment Principles (SIP) or explain the reasons why these matters are not set out.[85] An equivalent requirement is also imposed on insurance companies.[86]

These new provisions should elicit more publicly available information about the mandates that are given to asset managers than is available at present, as well as increase the pressure on asset owners to address explicitly how far asset managers are expected to engage with investee companies: if an asset owner does not incentivise an asset manager 'to engage with investee companies' in order to improve medium- to long-term performance, it will (in the case of insurance companies) have to disclose why it does not do this, or (in the case of pension funds) not make any disclosure in relation to this, and explain why it has not made disclosure. Whilst some asset owners might admit in private that they are happy not to engage with investee companies and for their asset managers to do the same,[87] that is very different from announcing this publicly to the market and to their beneficiaries. At the same time, we should be careful not to overstate the potential of this approach: pension funds can satisfy regulatory requirements by making bland statements in public documents (like the SIP)

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[81] SRD, Preamble, para 17.
[82] Art 3g(1)(a).
[83] This was implemented via SYSR 3.4.5R and COBS 2.2B.5R, and via an amendment to the 2005 Regs by SI 2019/982, Reg 4.
[84] Art 3h(2)(a) to (e).
[85] SI 2019 No 982, Reg 2 inserting these rules in to Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), as Reg 2(c)3(d).
[86] SYSC 3.4.9R (1). It is worth noting that, where the arrangement with the asset manager 'does not contain one or more such elements', the insurance company is required to 'give a clear and reasoned explanation why this is the case': see SYSC 3.4.9R (2).
[87] As they did to Tilba: see Tilba and Reisberg, n63 above.

about their stewardship approach, and they could adopt the same approach to these new rules implementing SRDII. Going further, trustees could simply decline to make disclosure, stating that they make different arrangements with different asset managers and that these are commercially confidential.[88]

These disclosures may give regulators better data about the extent to which the investment chain is making provision for stewardship. This might motivate further action on the part of regulators such as the FCA to create a market for stewardship as discussed above. At the same time, the rapid growth of index funds will continue to pose a challenge for market-based solutions, and so raises the possibility of further juridification of stewardship obligations.

Finally, it should be noted that the SC 2020 requires signatories to explain how 'performance management or reward programmes have incentivised the workforce to integrate stewardship and investment decision-making'.[89] This will potentially allow asset owners to identify whether staff working for asset managers have incentives to increase short-term returns through trading and/or passivity. Asset owners that focus on the long-term financial interests of their beneficiaries would oppose measures that encourage agency behaviour and so could choose explicitly to mandate asset managers to incentivise their employees to pursue long-term returns. Asset owners would then be exhibiting 'trusteeship' behaviour, the type of behaviour to which we now turn.

4.2 Trusteeship behaviour

Where asset owners create a portfolio of investments of one or more types that they consider will further the financial interests of their beneficiaries over an appropriate time frame, the asset owners are exhibiting 'trusteeship' behaviour.[90] Likewise, asset owners may exhibit trusteeship behaviour where they give mandates to asset managers which demand and assess performance over relatively long time frames that match their liabilities to end beneficiaries and clients. In order to steer the portfolio towards sustainable long-term returns, mandates might also require asset managers to: take account of ESG factors in selecting investments and carrying out financial analysis; have voting policies which will be applied across the portfolio; and perhaps even to engage with companies where this will produce better long-term financial returns than divestment. In turn, asset managers will be exhibiting trusteeship behaviour where they take decisions as to whether and how to engage with portfolio companies based on what they consider the best long-term interests of the asset owners and their end beneficiaries or clients requires.

Unlike the agency behaviour described in the previous section, trusteeship behaviour should be encouraged. However, as the BIS research discussed above shows, communication failures in the delegation process – particularly over the time frames used for performance assessment – can result in trusteeship behaviour degenerating into passivity (lower costs), short-term share trading (higher

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[88] If this type of response becomes more common, then policymakers may put more emphasis on the quality of explanation: see for example Commission, *Recommendation on the quality of corporate governance reporting ('comply or explain')*, OJ L 109/43, 12.4.2014, paragraph 8.

[89] SC 2020, Principle 2.

[90] Lounsbury contrasted the 'trustee logic' of portfolio-focused firms with the 'performance logic' of more speculative firms that sought to outperform rivals in the short-term: see Michael Lounsbury, 'A tale of two cities: Competing logics and practice variation in the professionalizing of mutual funds' (2007) 50(2) *Academy of Management Journal* 289–307.

returns) or even 'bad activism'.[91] Moreover, unlike ownership behaviour, which we discuss in the next section, trusteeship behaviour focuses on the performance of the portfolio, which works against engagement at the level of individual companies. Hence, engagement will only occur where this is clearly better for the performance of the portfolio than lower cost passivity or higher return share trading. Even then, there is a danger of that engagement degenerating into 'bad activism' in pursuit of short-term financial returns.[92]

In this section, we look at the ways in which pension fund trustees are regulated when they delegate to asset managers, focusing in particular on how far regulation requires trustees to articulate and transmit to managers their expectations as to portfolio-level ESG integration, voting policies and engaging with companies. We then turn to look at the way in which asset managers and life insurance companies are regulated under the rules that implement SRDII and evaluate how far they encourage these actors to exhibit trusteeship behaviour.

4.2.1 Pension fund trustees

Pension fund trustees, relying on advice from investment advisers or consultants, delegate extensively to asset managers, often on the basis of a number of single-asset, 'specialist' mandates.[93] We saw above that fiduciary duty cases rarely come before the courts, although trustees do bear it in mind when they make decisions about delegation.

Regulation is a more important constraint, and indeed, trustees of occupational pension schemes often avoid the need for FCA authorisation (and the associated regulation) by delegating all 'day-to-day' decisions to asset managers, leaving the trustees dealing only with 'strategic' decisions, including drafting the SIP (something on which they should take written advice from a suitably qualified person), drafting a general asset allocation policy, changing the balance between income and growth and the initial appointment of asset managers.[94]

[91] When the focus is on the portfolio as a whole, institutional investors' disincentive to be well informed about individual companies becomes particularly pronounced, leading them to rely on one-size-fits-all, low cost proxy advice that lacks nuance. As Sharfman notes, this can create an externality for companies and so for end beneficiaries and clients as shareholders drive shareholder wealth maximization as 'a kind of lowest common denominator solution to their inability to coalesce around other objectives': see Sharfman above n66 at 868, citing Sean Griffith, 'Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority' (2020) 98 Tex.L. Rev. 17-18.

[92] Gordon argues that index funds and other widely diversified investment vehicles have a powerful incentive to focus on corporate behaviour that produces 'systematic' effects and therefore impacts on the value of their portfolio via an impact on the real economy (or natural environment). Gordon argues that such investors should develop guidelines that push portfolio companies to make disclosures that allow their risks to be priced, support firm-specific activism on climate matters that they believe will create value for their beneficiaries and act collectively to push for appropriate regulation. At the same time, he recognises that index funds may go along with conventional shareholder activism because activism (at least on managerial insulation and board level diversity) increases expected returns across the portfolio: see Jeffrey Gordon, 'Systematic Stewardship' *ECGI Law Working Paper* No 566/2021.

[93] Investment Association 2019 at 59.

[94] Law Commission at 4.13-4.16, referring to PERG 10.3, Q8 (FCA guidance to occupational pension scheme trustees). FCA guidance is that a non-authorised trustee is precluded from making buy, sell or hold decisions in relation to particular securities (PERG 10.3, Q9). However, exercising voting rights in relation to a takeover, board appointments or rights issues would not amount to day-to-day to management because they would not involve acquiring or disposing of investments, or in the case of the takeover, would be regarded as a strategic decision (PERG 10.3, Q16). It is notable that, despite being revised in April 2019, the FCA guidance does not mention stewardship or activism explicitly.

As we saw above, asset managers will be appointed under an investment management agreement (IMA). The NAPF notes that a schedule normally sets out the trustees' investment objectives, the strategy to achieve them and any restrictions that the manager must adhere to.[95] Trustees are advised to make provision in the IMA for liability, obliging managers '(as a minimum standard) to act in good faith and with reasonable skill and care' and to 'retain liability for the acts of any delegates'.[96]

However, it is the SIP which is the critical document from the point of view of transmitting engagement and stewardship obligations from trustees to the managers they hire. Under s35 Pensions Act 1995, trustees of a trust scheme (which includes both defined benefit schemes and different optional plans under defined contribution schemes) are required to produce a SIP. Under s36(5) Pensions Act 1995, the trustees, or the investment manager to whom any discretion has been delegated, must exercise their powers of investment in accordance with the SIP in 'so far as reasonably practicable'. It is probably also common to refer explicitly to the SIP in the IMA.[97] This means that the contents of the SIP as they relate to policies on ESG integration, voting and engagement where necessary will be critical in terms of the trustees ensuring that the asset managers will adopt a trusteeship approach rather than degenerating into passivity or trading, or even pushing for short-term value maximisation.

Yet before 2018, and despite the prominence of the Stewardship Code as a response to the financial crisis and the problem of short-termism, there was little prescription as to the contents of the SIP. Delegated legislation required the trustees to include in the SIP, inter alia, 'their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments'.[98] As such it was open to pension funds to have no policy on exercising voting rights, to leave it to asset managers, or to delegate it to a third party; in 2015, the National Association of Pension Funds advised trustees to decide:

> 'what role they want the manager to play in relation to voting and corporate actions. Are they happy following the managers' normal voting policy, in which case the manager should be required to provide a copy of its policy? If not, do the trustees want to impose some or all of their own corporate governance policies on the manager or use a third party to deal with corporate governance?'[99]

Even then, it noted, 'some managers are more flexible than others', and willingness to move away from normal policy 'may depend on the bargaining strength of the relevant trustees'. Hence, including a strong prescription in relation to voting rights, ESG integration or engagement in the SIP would have restricted many trustees' choice of asset managers (and so could certainly be viewed by trustees as contrary to the fiduciary duty to promote the best financial interests of beneficiaries).

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[95] NAPF, *The NAPF Guide to Investment Management Agreements*, March 2015 at 2.1.

[96] NAPF at 3.3 and 3.6. This is presumably intended to give the courts sufficient contractual provisions so that they do not have to entertain complex legal questions about whether more far-reaching fiduciary duties are owed.

[97] For example, in clause 21.1(e) of the Investment Association's (May 2018) Model Discretionary IMA, the institutional investor (client) warrants to the manager that any restrictions to which the client is subject and the level of risk to be reflected in the manager's exercise of discretion, whether from legislation, governing documentation, SIP or otherwise are set out in the Guidelines in Annex 2. However, inclusion does not have legal consequences: notes to Annex 2 suggest considering including details from the SIP, but also note the statutory requirement on managers of pension scheme assets to invest broadly in accordance with the SIP.

[98] Regulation 2(3)(c) of The Occupational Pension Schemes (Investment) Regulations 2005 (2005 No 3378).

[99] NAPF 2015 at 3.12.

In 2018, following a recommendation of the Law Commission,[100] the relevant delegated legislation was amended to require the SIP to make more explicit reference to stewardship. In addition to stating their policies in relation to exercising the rights attaching to shares, pension fund trustees are now required to disclose:

> 'their policy in relation to… undertaking engagement activities in respect of the investments (including the methods by which, and the circumstances under which, trustees would monitor and engage with relevant persons about relevant matters).' [101]

The government explained that its intention was to:

> 'reassure trustees that they can (and indeed should) … fulfil the responsibilities associated with holding the investments in members' best interests – whether directly or by others on their behalf – not just through voting, but the full range of stewardship activities, such as monitoring, engagement and sponsoring or co-sponsoring shareholder resolutions'.[102]

In addition to these changes to SIP requirements in the UK, SRDII then added a requirement for pension funds, life insurance companies and asset managers to report publicly on the implementation of their engagement policy, as well as how they have cast votes on significant matters in companies in which they have significant shareholdings.[103] In relation to pension funds, this has been implemented by an amendment to the relevant disclosure regulations.[104] Pension funds must provide, on request and free of charge, a statement setting how 'how, and the extent to which, in the opinion of the trustees, [the engagement policy] has been followed during the year' and describing 'the voting behaviour by, or on behalf of, trustees (including the most significant votes cast by trustees or on their behalf) during the year'.[105]

These SRDII-inspired changes mark the first time that an institutional investor has been required to disclose voting behaviour under UK law.[106] There is no doubt that a lot more stewardship—and responsible investment-related material—is now being published by pension fund trustees. However, as always with information disclosure, the question is whether the addressee will act on it where it is considered unsatisfactory. If end beneficiaries continue to be passive, to worry about the deficit that their pension fund is running or simply crave yield during a period of structurally low interest rates,

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[100] DWP June 2018 at 26, referring to Law Commission report 'Pension Funds and Social Investment', LC374, June 2017.

[101] The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018 (2018 No 988), reg 4 inserting the amendment into the OPS Regulations 2005, and coming into force on 1st October 2019. 'Relevant persons' is defined as including but not limited to 'an issuer of debt or equity, an investment manager or another holder of debt or equity', whilst relevant matters' is defined as including but not limited to 'matters concerning an issuer of debt or equity, including their performance, strategy, risks, social and environmental impact and corporate governance'.

[102] DWP, 'Consultation on clarifying and strengthening trustees' investment duties', June 2018, at 10.

[103] Art 3g(1)(b).

[104] The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013.

[105] Reg 3(4) of SI 2019/982 inserting paragraph 30(ca)(i) and (ii) into Schedule 3 of The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013.

[106] There is an unused power in s1277 CA 2006 allowing the secretary of state to make regulations requiring certain types of institutional investor to disclose information about their exercise of voting rights attaching to shares.

there is no guarantee that all this disclosure will result in pressure on pension fund trustees to embed stewardship obligations more firmly in their activities and mandates.[107]

4.2.2 Asset managers and life insurance companies

Before the implementation of SRDII, and from shortly after the introduction of the SC 2010, FCA-authorised asset managers were only required to disclose either the nature of their commitment to the Stewardship Code or their alternative investment strategy.[108] This was intended by the FCA to encourage best practice when there were no other FCA rules on stewardship.[109] In contrast, life insurance companies were under no obligation to make public statements about stewardship, although they could, of course, become voluntary signatories to the SC. Moreover, unlike pension funds, whose engagement policies are binding on asset managers where they are included in the SIP, life insurance companies' engagement policies (as well as those of other asset owners outside the scope of SRDII) will only bind asset managers where they are incorporated into the mandate by which those managers are engaged. Incorporation of a demanding stewardship mandate ought to be possible, but insurance companies may decide not to do so for various reasons, including cost and not limiting their choice of investment managers.

Following implementation of SRDII, the stewardship disclosures required of asset managers and life insurers are much more closely aligned with those of pension funds. FCA rules now require both life insurers and asset managers to develop and disclose various aspects of their engagement policies as required by SRDII, or explain why they have not made such disclosure.[110] They are also required to publish an annual report on the implementation of their engagement policies, including (self-defined) significant votes, or an explanation of why they have not made such disclosure.[111] In terms of the effect of the disclosure rules, the customers of life insurance companies are likely to be even less engaged than their pension fund counterparts. In contrast, disclosure will enable asset owners to assess the extent to which asset managers have been engaging in stewardship and voting, and assess whether (in the event that the SIP or the IMA impose sufficiently specific obligations) they have been complying with their mandates. We would not expect this to lead to a surge in litigation, but asset owners who have a strong and genuine commitment to stewardship may reallocate asset management mandates to asset managers whose disclosures indicate more engagement and a long-term oriented approach.

4.3 Ownership behaviour

The third possible pattern of behaviour involves investors acting as 'real owners'[112] and pursuing the long-term success of the companies in which they have invested. Whereas trusteeship behaviour entails a focus on producing the best financial outcome for clients or beneficiaries across multiple assets in an investment portfolio, ownership behaviour involves acting alone or in collaboration with other shareholders to produce the best long-term financial outcome for an individual investee

[107] For a wide-ranging discussion of ways in which stewardship obligations could be enforced, including by clients and end beneficiaries, see Dionysia Katelouzou and Konstantinos Sergakis, 'Shareholder Stewardship Enforcement', *ECGI Law Working Paper No 514/2020*, May 2020.
[108] COBS 2.2.3R.
[109] See CP19/7, para 3.19.
[110] See COBS 2.2B.5R and 2.2B.6R (for asset managers) and SYSC 3.4.4R and 3.4.5R (for life insurance companies).
[111] See COBS 2.2B.7R (for asset managers) and SYSC 3.4.6R (for life insurance companies).
[112] Andreas Jansson, '"Real owners" and "common investors": Institutional logics and the media as a governance mechanism' (2013) 21(1) *Corporate Governance: An International Review* 7–25.

company, which in turn delivers benefits for all shareholders in proportion to their shareholdings, and from there to the beneficiaries which stand behind them. The Walker Review clearly expected the Stewardship Code to shift the focus of investors away from indices or relative performance of a whole portfolio towards an ownership approach. Following its recommendations, investors would engage with companies 'as a means of increasing absolute returns by addressing issues in the company in a timely and influential manner and thus improving long-run performance.'[113] Walker also expected that asset managers who publicly disclosed their commitment to stewardship would attract new mandates from asset owners.[114] Institutional investors displaying ownership behaviour would act – collectively where necessary – to express concern about their investee companies' economic sustainability, and also with environmental and social issues, at least where they consider that these – directly or indirectly – will impact on the economic sustainability of the investee company.[115] However, as we argue in the final section on 'custodianship' behaviour, the principal-agent approach adopted by Walker means that, even if the barriers to ownership behaviour can be overcome, the approach taken in the UK's Stewardship Code (and also SRDII) focuses primarily on accountability and does not adequately insulate managerial prerogative from shareholder interference.

Those who reject the claim that shareholder value corporate governance leads to short-termism often assume that shareholders will display ownership behaviour on the basis that they are, with only unimportant exceptions, 'fundamentally unified behind the goal of maximizing the value of the equity'.[116] In this view, conflicts among shareholders are rare, as they push for measures which will enhance long-term value, with long-term investors opposing and outweighing short-termists.[117] In this approach, the problem remains the classic one of shareholder weakness resulting from the separation of ownership and control, which allows managers to impose agency costs on them. The solution is further shareholder empowerment,[118] which will necessarily promote the long-term success of investee companies.[119]

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[113] Walker, above n20, para 5.7.

[114] Ibid, para 5.9.

[115] As noted above (n93), Gordon argues that managers of highly diversified portfolios have powerful incentives to focus on ESG issues, at least where they consider that this will produce better outcomes across the portfolio, whether through 'governance externalities' or through more accurate pricing of shares. For a discussion of how company law could provide greater support to allow 'portfolio value-maximising' institutional investors to realise their preferences in relation to companies that create systemic externalities, see Luca Enriques and Alessandro Romano, 'Rewiring Corporate Law for an Interconnected World', ECGI Law Working Paper No 572/2021.

[116] George Dent, 'The Essential Unity of Shareholders and the Myth of Investor Short-Termism' (2010) 35(1) *Delaware Journal of Corporate Law* 97 at 105.

[117] Ibid at 125 and 133. Walker is more hesitant in this regard, noting the importance of 'those who are naturally longer-term holders' being ready to engage proactively, given that 'the shareholder population includes holders such as hedge funds with significant stakes who may be ready to exit the stock over a relatively short timeframe': Walker above n20 at 5.11.

[118] Ibid at 130.

[119] Barzuza and Talley take a different approach, arguing that shareholder short-termism might in practice operate as an 'institutional brake on at least certain forms of long-termist overinvestment' arising out of excessive managerial optimism about the prospects of long-term projects. In their view, measures to address shareholder short-termism that do not also address excessive managerial long-termism might be misguided. See Michal Barzuza and Eric Talley, 'Long-Term Bias', *ECGI Working Paper Series in Law No 449/2019*, May 2019. In response to this, Bainbridge notes that managers could equally, for a variety of reasons, be excessively short-termist; we simply do not know. Bainbridge concludes that the board of directors is the actor best placed to rein in either managerial myopia or hyperopia, and, indeed, this is the task given to directors by corporate law: see Stephen Bainbridge, 'Long-Term Bias and Director Primacy' *UCLA Law & Economics Working Paper No 20-04*, November 2020. Our contention in this paper is that managers need to be given the discretion

These assumptions are simply not borne out by the history of efforts to encourage shareholder engagement, or by the various reviews and research discussed above. Two main barriers to shareholders displaying ownership behaviour and engaging with companies for the long-term can be identified.

First, as was discussed in the previous section, the strategy of relying on various forms of disclosure leaves wide discretion to the various actors in the chain of intermediaries that runs from end beneficiaries to companies. Ownership behaviour may be desired, but as with trusteeship behaviour, intermediaries may use the discretion available them opportunistically to cut costs by remaining passive, or increase short-term shareholder value by share trading or even engaging in 'bad activism'. Provided they produce returns that satisfy everyone, it is unlikely that anyone will question their approach to ESG or the long-term prospects of a single investee company.

Second, ownership behaviour will become less attractive as asset owners and managers diversify. Diversification inevitably moves the focus of both owners and managers away from the performance of individual companies and towards the performance of the portfolio or index as a whole. This of course creates potential for trusteeship behaviour, but it also implies that the best financial interests of beneficiaries are no longer served by expending too many resources on improving the performance of a single company within the portfolio. Hence, increasing diversification suggests that trusteeship behaviour is likely to trump ownership behaviour, before potentially degenerating into passivity, trading or 'bad activism'. As suggested above, the rise of index funds is likely to amplify the pressure to cut costs or increase performance.

As for whether asset owners are displaying ownership behaviour in practice, recent evidence is scant and somewhat contradictory, with some studies suggesting pension funds are acting as 'engaged and active owner[s]' whilst others 'create an impression of pension funds operating very much as distant holders of shares'.[120] In order to fill this gap, Tilba and McNulty carried out a series of interviews with trustees of large pension funds in 2008-9. They found that a small minority of engaged funds have in-house investment management resources and therefore capacity to 'exhibit a more engaged ownership stance', holding relatively large corporate shareholdings and a strong ethos of responsibility towards both beneficiaries and society.[121] Perhaps most significantly for our purposes, Tilba and McNulty found that these responsibilities were not viewed as externally imposed by soft law but rather 'embedded in the investment management philosophy and connected to the overall in-house investment decision making.'[122] The mandates given by these large pension funds to investment managers were, Tilba and McNulty found, 'overwhelmingly oriented towards generating investment

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to put in place a long-term strategy that is sustainable in the sense of taking account of all impacts on stakeholders, rather than one that simply produces acceptable short-term or long-term financial returns, and that shareholders (and NEDs) should contribute to that by holding managers accountable for achieving the agreed strategy (see discussion of custodianship behaviour in the final section).

[120] See Tilba and McNulty above n28 at 168.

[121] Tilba and McNulty at 172. McNulty and Nordberg discuss this last factor in terms of psychological ownership, where investors have a degree of loyalty towards the company, and so are more likely to exercise voice and engage 'directly with management in a process that involves challenge and change of mutual benefit or at least accommodation': see Terry McNulty and Donald Nordberg, 'Ownership, Activism and Engagement: Institutional Investors as Active Owners' (2016) 24(3) *Corporate Governance: An International Review* 346 at 352. For further discussion of psychological ownership, see Katarina Sikavica and Amy Hillman, 'Combining Financial and Psychological Insights for a New Typology of Ownership' in Maria Goranova and Lori Ryan (eds), *Shareholder Empowerment* (2015, Palgrave Macmillan, Basingstoke).

[122] Tilba and McNulty at 173.

performance, rather than attending to matters of corporate governance'.[123] This research suggests that asset owners adopting an ownership style are a small minority, and that agency behaviour in its trading form prevails over trusteeship behaviour.

As regards the behaviour of asset managers, Hendry et al's research, discussed above, found fund managers resisting the idea that they could play a firm-specific 'ownership role', something they considered 'should be left to pension fund trustees, acting directly through the non-executive directors rather than through the fund managers'; there was also a degree of lip service on the part of these fund managers when claiming to act as 'owners' under client or government pressure, because they viewed themselves as stock pickers rather than corporate advisors.[124] Whilst this evidence contradicted the notion that fund managers were equipped, or even willing, to play an 'ownership' role, it should be emphasised that these interviews took place in 2002-3. The development of the stewardship agenda after 2008, followed by the more prescriptive rules introduced by SRDII, might put pressure on asset managers to adopt an ownership style when they engage with companies. Whether this occurs will depend on asset owner priorities as well as whether those priorities make their way into IMAs and other mandates in ways that influence asset manager behaviour.

Finally, the increasing concentration of the asset management industry creates a danger that asset managers will display trusteeship or agency behaviour, rather than focus on firm-specific improvements more in line with an ownership approach. Reviewing the literature on 'common institutional ownership', Posner and Weyl highlight that concentration of asset management can have harmful effects on competition, investment, innovation and wages.[125] Large asset managers such as Blackrock or Vanguard are normally the largest shareholders in listed companies, holding significant stakes in several companies that are competing in the same sector. This may lead them to focus on the aggregate performance of a sector rather than making improvements at the level of individual companies. For example, asset managers that are in a dominant position may want management to take account of their decisions on other companies in which they also own shares,[126] push for the use of remuneration packages which reduce the incentive to compete against rivals, or otherwise act to reduce the impact of one firm on its competitors. One way of doing this is to align incentives with absolute rather than relative performance, so that higher profits across a whole sector will increase returns to both managers and large shareholders who have diversified across that sector. The overall effect is that increasingly oligopolistic asset managers are more likely to focus on the whole sector or the whole portfolio, rather than on individual companies,[127] resulting in agency or trusteeship rather than ownership behaviour. There is also a danger that engagement degenerates into pressure for short-term financial value maximisation across the portfolio if asset owners do not have the bargaining power to give asset managers clear mandates and insist that they are followed.

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[123] Ibid at 173.

[124] Hendry et al above n71 at 1111-1112.

[125] See Eric Posner and Glen Weyl, *Radical Markets: Uprooting Capitalism and Democracy for a Just Society* (Princeton University Press, 2018), Chapter 4.

[126] Xavier Vives, 'Common Ownership, Market Power, and Innovation', IESE Business School Working Paper, January 2019 at 3-4.

[127] Large asset managers such as Blackrock, which holds 90% of its equity portfolio through index funds, claim that where indexing rules out divestment, they 'engage with [investee companies] to evaluate how they manage the material sustainability-related risks and opportunities within their businesses, and encourage them to adopt the robust business practices consistent with sustainable long-term performance.' See Siobhan Riding, 'Capital and Blackrock under fire for backing Brazil's JBS', *Financial Times*, 23rd September 2019.

4.3.1 What steps have been taken to promote ownership behaviour?

The above discussion highlights that ownership behaviour – that is institutional investors acting individually or collectively to drive improvements in some aspects of an investee company's performance – is precisely the type of behaviour that the drafters of the Stewardship Code and SRDII were hoping to encourage, but also that we are a long way from the general adoption of an ownership approach in which shareholders act individually or collectively to engage with companies. Whilst we support the goal of steering companies towards long-term success, we do not consider that encouraging ownership behaviour on the part of shareholders is the best way of achieving this. The stewardship regime may fail, with institutional investors reverting to passivity or trading, or worse, engagement may degenerate into 'bad activism' and short-term value extraction. In what follows, we ask what the various 'stewardship' instruments do to promote ownership behaviour, and to ensure that it does not degenerate.

SRDII is certainly motivated by fostering an ownership approach, with the preamble referring to asset owners and managers playing 'an important role in the corporate governance of [listed] companies, but also more generally with regard to their strategy and long-term performance.'[128] In particular, the rules requiring asset managers to be more transparent about implementation of their engagement policy and exercise of voting rights may help asset owners identify managers whose behaviour is likely to be aligned with their own.[129] However, this will not necessarily change the incentives of asset owners, and there will be no guarantee that owners will be willing to pay the higher fees demanded by asset managers who display ownership behaviour in relation to individual companies. At a time of low yields, asset owners will be looking to cut costs to meet liabilities premised on higher returns. 'Free riding' on the part of asset managers that adopt a more passive approach will make it more difficult for their activist counterparts to compete for investments or mandates as they will have higher costs. Passivity on the part of institutional investors has been an issue ever since policymakers first sought to encourage greater engagement. In the period leading up to Walker's recommendation that the ISC Principles become the Stewardship Code, Lord Myners famously referred to institutional investors behaving as 'absentee landlords' during the period before the crisis, and (once again) urged greater involvement with investee companies.[130]

One attempted solution has been to promote collective action. Since the SC 2010, collective engagement on the part of investors has been encouraged, but the SC 2012 appeared to view it as exceptional, highlighting that 'collective engagement may be most appropriate at times of significant corporate or wider economic stress, or when the risks posed threaten to destroy significant value'.[131] In that situation, institutional investors should act collectively to protect their common financial interest. SRDII goes further, requiring asset owners and managers, on a comply or explain basis, to include in their engagement policy a description of how they 'cooperate with other shareholders'.[132] This expectation that institutional investors will act collectively, at least in a defined range of circumstances, is mirrored in the UK's 2020 Stewardship Code which refers to 'collaborative engagement to influence issuers', at least 'where necessary', and requires signatories to report where

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[128] SRD Preamble Para 15.

[129] Preamble paras 17 and 18 and new Article 3g.

[130] Kate Burgess, 'Myners lashes out at landlord shareholders', *Financial Times*, 21st April 2009.

[131] Guidance to Principle 5 of Stewardship Code 2012. In the proposed draft 2019 SC, signatories are required to disclose 'the extent to which they participate in collaborative engagement' with other investors or market participants.

[132] Art 3g(1)(a) implemented by: Reg4(2)(b) of SI 2018/988 defining 'relevant persons' with whom pension funds should disclose engagement as including 'another holder of debt or equity'; COBS 2.2B.6R(5); and SYSC 3.4.5R (5).

they have collaborated with other investors to engage a company 'to achieve a specific change' or with stakeholders on a thematic issue and the outcome of that engagement.[133]

Whilst many institutional investors are likely to address working with others in their engagement policy, actual cooperation will hinge on communication, as well as a harmony of interests, between different types of investor. Whilst the Investor Forum established following the Kay Review may help, it is difficult to share Dent's confidence that the short-term shareholders will always be outvoted by the long-term shareholders.[134] It seems at least plausible to argue that any equilibrium achieved among these different groups of shareholders will be oriented towards the lowest common denominator of short-term shareholder value. In other words, even if the tendency towards passivity and trading can be overcome, collective ownership behaviour may degrade into simple short-term shareholder value maximisation ('bad activism') more in line with the outcomes of agency or dysfunctional trusteeship behaviour.

Overall, then, there is little evidence of ownership behaviour, whether individual or collective. For example, the Ownership Commission referred to research showing that 'there is often very little scrutiny of the long-term business rationale for managerial decisions… so long as it appears to be promoting shareholder value.'[135] When they place investments with either UCITS or 'other' financial institutions, pension funds and life insurance companies will have little or no influence over these investors' stewardship policies: they will have to take them or leave them. As the Ownership Commission put it, 'financial intermediaries… dominate their relationships with their clients… [and] are generally able to dictate the terms of these relationships to their own advantage… intermediaries are uninterested in the stewardship of the assets underlying the transactions (even though good stewardship is in their clients' interests).'[136] Even where pension funds and life insurance companies give clear mandates for ownership behaviour to those who manage their investment portfolios, their managers' voices are likely to be outweighed by those of UCITS and 'other' financial institutions. It is far from clear that these other groups will take a long-term approach: some hedge funds will be taking high frequency trading strategies, whilst others will be leading 'wolf packs' and looking to put pressure on companies to restructure.[137] Others, such as index funds and ETFs, have few resources to devote to stewardship.[138] It therefore seems likely that institutional investors will only display individual or collective ownership behaviour as a response either to a crisis of short-term shareholder value or to an opportunity to increase short-term shareholder value.

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[133] FRC, Stewardship Code 2020, Principle 10.

[134] The Ownership Commission was more neutral in this regard, simply noting that 'Corporate owners will be both committed, long term owners and transactional short term owners': see The Ownership Commission, *Plurality, Stewardship and Engagement*, March 2012 at 18.

[135] Ibid at 32.

[136] Ibid at 37.

[137] Coffee and Palia define a 'wolf pack' as 'a loose network of activist investors that act in a parallel fashion but deliberately avoid forming a "group"' under the Securities Exchange Act 1934: see John Coffee and Darius Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) 41 *Journal of Corporation Law* 545 at 562. Similar concerns will arise in relation to UK and EU Takeover Regulation. However, there is anecdotal evidence that, rather than being explicitly coordinated, campaigns spearheaded by one or more activist hedge funds 'often receive implicit support from fellow investors – both hedge funds and other institutional investors – with smaller stakes… The phenomenon is fairly widespread': see Alon Brav, Amil Dasgupta and Richmond Mathews, 'Wolf Pack Activism' *ECGI Finance Working Paper* No 501/2017, March 2018 at 2-3.

[138] Ibid at 33.

5. CUSTODIANSHIP BEHAVIOUR

The analysis above highlights that institutional investors may comply with the various regulations and soft law instruments discussed above, yet still behave in ways which frustrate policymakers' assumptions that shareholder engagement will lead to more long-termism and sustainability on the part of investee companies. Agency behaviour may be characterised by excessive trading or simply by passivity, whilst trusteeship behaviour might have a longer-term orientation, but is also likely to focus on financial returns across the portfolio as a whole, leading to divestment and passivity rather than efforts to improve individual companies. Either may degenerate into 'bad activism', particularly if an activist investor with short time horizons takes the lead.[139] Of the three patterns of behaviour we have considered, ownership behaviour comes closest – in theory at least – to investors steering companies towards the pursuit of long-term value, but faces considerable barriers. There is also a further issue: there is little or no discussion of the appropriate scope and content of shareholder intervention in the instruments under consideration in this article. This creates scope for ownership behaviour – where it occurs – to degenerate into short-term value maximisation as investors engage in activism which intrudes on managerial prerogative.[140] In this section we develop the notion of custodianship behaviour, which, we argue, is legitimate behaviour on the part of institutional investors, is in line with the goals of stewardship, and so ought to be explicitly encouraged by instruments such as SRDII and the Stewardship Code.

Investors who display custodianship behaviour in relation to companies recognise that their activities ought to be complementary to, rather than a replacement for, those of management. They accept that it will sometimes be appropriate to exhibit trusteeship behaviour and sometimes ownership behaviour, working individually or together with co-shareholders to influence management. But they also accept that when they engage with companies, they should seek to further their interests indirectly, by focusing on whether management is discharging its functions in a responsible manner, taking account of ESG and the long-term, and so producing sustainable returns for all shareholders and their beneficiaries, whilst meeting the interests of most stakeholder groups by ensuring a successful enterprise. This does not entail leaving management unaccountable; on the contrary it involves shareholders offering constructive challenge to executives in much the same way as non-executive directors (NEDs) do, whilst leaving managerial prerogative intact.

The role of institutional investors should be more limited than that of NEDs, in part because they do not bear the legal responsibilities of directors in the normal course of events. Whilst this may be a fine line, they should offer constructive challenge to the arrangements that the board and management have put in place, but they should not try to rewrite or influence those arrangements. They should at least be very reticent about telling the board and management how to run the company. For example, they should not intrude on the board's competence to determine matters of long-range strategy and key business decisions, including the internal allocation of capital. They should be satisfied that the company's business model pays adequate attention to economic, social and environmental sustainability; that remuneration includes appropriate performance criteria to incentivise long term

[139] Gilson and Gordon see hedge funds acting as 'governance arbitrageurs', presenting value propositions to 'rationally reticent' institutional investors: Ronald Gilson and Jeffrey Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights' (2013) 113(4) *Columbia Law Review* 863-927. Critics contend that that activist shareholders engage in 'predatory value extraction', with support from incentivised executives or other institutional investors, who may have co-invested in the hedge fund: William Lazonick and Jang-Sup Shin, *Predatory Value Extraction* (OUP, 2020) at 137-8.

[140] Gilson and Gordon highlight the role of activist shareholders in presenting 'concrete proposals for business strategy' which are 'more profitable alternatives to a portfolio company's business strategy' (above n142 at 867 and 895).

and sustainable behaviour; and that statements of corporate purpose put forward by the board align all of the company's activities so as to deliver an acceptable balance of the various competing interests. This description of appropriate custodianship behaviour reflects the fact that shareholders are not NEDs, are not executives or managing directors entrusted with running the enterprise, and do not owe duties to the company or face other accountability mechanisms (beyond the mandatory information disclosure requirements discussed above).

Policy intervention to encourage custodianship behaviour, and with it a clearer division of responsibility between shareholders and managers, can also be justified within the existing corporate governance literature. The important work of Goshen and Squire highlights that, as shareholders exercise control, 'principal costs' will rise, and that optimal governance will reduce the sum of principal costs and agency costs.[141] Principal costs include, firstly, competence costs, with shareholders lacking expertise and the incentive to incur the opportunity cost of obtaining skills and information, a set of costs which becomes even more dangerous where multiple and dispersed shareholders are invited to intervene in areas of managerial competence. Secondly, they also include conflict costs arising out of 'investor self-seeking' of various forms, including rational apathy and reticence, costs which also become more significant where shareholders are dispersed and ultimately only the agents of end beneficiaries. Where the aim is to promote the long-term success of the company, custodianship behaviour is to be encouraged. It reduces principal and conflict costs by delineating a legitimate space of management authority and control but still gives shareholders a role in holding management accountable. Custodianship behaviour recognises that shareholders have a role in ensuring accountability, but also that, if management is chosen for its competence to run the business, then it needs leeway to balance competing interests, enhancing the commitment of the different stakeholders and so increasing long-term corporate value.

At the same time, striking a workable balance between holding managers accountable and giving them discretion to take the enterprise forward is no easy task.[142] The analysis above shows that it certainly will not be achieved merely by encouraging more engagement on the part of shareholders. We begin by noting that, when stewardship was becoming a major policy initiative, key actors acknowledged the outer limits of institutional investor engagement. For example, just as the 2002 iteration had, the ISC's 2009 Code stated that it did not 'constitute an obligation to micro-manage the affairs of investee companies'.[143] Walker repeated that 'it is neither the role nor within the competence of fund managers to "micro-manage" companies in which they have significant stakes', and that this was not the aim of his proposal for a Stewardship Code.[144] Nor would they 'second guess' management, because shareholders are not equipped to 'identify and assess specific business risks'. Nevertheless, limited liability and 'significant rights of ownership' bring with them, for larger fund managers at least, 'a reciprocal obligation involving attentiveness to the performance of investee companies over a long as well as a short-term'.[145]

Instead, and in line with the ISC's stated approach since 1991, Walker expected institutional investors to focus on ensuring the quality of the leadership team and that board composition is satisfactory; understanding and giving 'broad endorsement of the company's principal strategies and objectives';

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[141] Zohar Goshen and Richard Squire, 'Principal Costs: A New Theory for Corporate Law and Governance' (2017) 117 *Columbia LR* 767.

[142] Bainbridge draws on the work of Kenneth Arrow to emphasise that authority and accountability cannot be reconciled: you cannot have more of one without having less of the other: Bainbridge supra n120.

[143] ISC at 1.

[144] Walker Review, above n20 at 5.7.

[145] Ibid.

and appraising management's performance in delivering the agreed strategy.[146] Walker expected that a 'more productive and informed relationship' with shareholders would 'help directors in better management of the company's affairs.'[147] At the same time, he assumed that high-quality directors would 'enjoy substantial autonomy in discharge of their obligations without need for detailed oversight by dispersed owners, at any rate in "normal" situations'.[148]

We suggest that the limits identified by the ISC and Walker provide a solid foundation for 'custodianship' behaviour. However, Walker's approach remains too grounded in a principal-agent account of the relationship between 'owners' and 'managers',[149] so that he has no clear positive conception of the function of management beyond generating financial returns for their principals, and therefore does not discuss ways in which that function can be supported within a framework of managerial accountability. Below we supplement Walker's approach with some insights from the management literature. Moreover, some of the nuances of the ISC's Guidelines and Walker's expectations appear to have been lost in the transition to the Stewardship Code. Its first iteration, published in 2010, duly stated that 'compliance with the Code does not constitute an invitation to manage the affairs of investee companies',[150] whilst the SC 2012 offered more detail, with stewardship responsibilities shared between the board, which is supposed to oversee management, and investors, who are supposed to hold the board to account for its responsibilities.[151] Investor stewardship involves monitoring and engagement in the form of 'purposeful dialogue' on matters such as strategy, performance, risk, capital structure and corporate governance.[152] Again, the Code did not 'constitute an invitation to manage the affairs of the company', although already there was some slippage as investors were invited to engage on matters of capital structure, which would tend to be considered as falling within managerial prerogative. This could potentially open the door to 'bad activism' aimed at short-term value extraction.

Likewise, SRDII broadly followed the UK's approach, defining 'engagement' as 'monitor[ing]… on relevant matters', including strategy, performance, and risk, capital structure, social and environmental impact and corporate governance, 'conduct[ing] dialogues', voting, cooperating with relevant stakeholders and managing conflicts of interest.[153] With binding obligations imposed on some asset owners and asset managers pursuant to SRDII to make disclosure about engagement so defined, the SC 2020 adopts a broader approach. It encourages signatories to disclose issues they have prioritised in making decisions to buy, hold and monitor or sell, methods of engagement and outcomes and examples of collaborative engagement and escalation. The 2020 Code makes no mention of management, and signatories are encouraged to consider a wide range of issues such as diversity, remuneration and workforce interests, environmental and social issues and compliance with covenants and contracts, matters which arguably previously fell within the scope of the managerial prerogative.

Overall, then, the various instruments that have emerged and developed since 2009 have not delineated any clear space within which management prerogative could operate. The 2020 Stewardship Code in particular encourages investors to engage on such a wide range of matters that

[146] ibid at 5.30.
[147] ibid at 5.28.
[148] ibid at 5.30.
[149] ibid at 5.2.
[150] SC 2010 at 1.
[151] SC 2012 at 2.
[152] SC 2012 at 1.
[153] New Art 3g.

it looks very much like an invitation to 'micro-management'. Even if they do not actually do this, the mere threat that shareholders might end up 'selecting, evaluating and if necessary, removing' management, this will arguably put them 'in a position to define the premises, or the boundaries, within which managerial decision making will occur'.[154] Either way, there is a danger that the expanding scope of the stewardship agenda encourages behaviour which impinges on managerial prerogative, creating greater pressure for short-term shareholder value maximisation as agency, trusteeship or ownership behaviour degenerates. We suggest that more clarity is required as to the areas where investor engagement is legitimate and therefore expected, and the areas where it is not legitimate – because it intrudes on managerial prerogative – and therefore management should be left alone.

In their discussion of managerial stewardship, Davis et al emphasise that if shareholders and managers choose to form a 'mutual stewardship relationship', this will 'maximize the potential performance of the group'. However, this is fragile, and it can be damaged by shareholders or managers acting opportunistically and pursuing their self-interest, or it can be replaced by a 'mutual agency relationship' which seeks to minimise potential costs. However, where shareholders treat managers as though they are agents, the lack of trust may deny them the opportunity to act as stewards, leading them to engage in 'antiorganisational behaviors'. Likewise, in reverse, opportunistic behaviour on the part of management is likely to result in anger and betrayal on the part of the shareholders. Davis et al's key point is that an agency relationship is the inevitable choice of two individualistic parties, and the only way to move to a stewardship relationship is 'when both parties subordinate their personal goals to that of the collective', 'evaluate the joint utility and mutually choose a stewardship relationship.'[155] So the question is how institutional investors can give managers sufficient autonomy to act as stewards, but still exercise oversight to ensure that that autonomy is being used in a pro-organizational way. We would suggest that policymakers should begin by specifying more clearly the legitimate scope of engagement, aligning it more closely with custodianship behaviour.

First, we would suggest beginning with what Walker envisaged, namely that institutional investor engagement with companies under a stewardship regime ought to be confined to: checking that the board is appropriately constituted and has put in place a competent team of executives and managers; checking that those executives and managers have – with input from the NEDs – established a strategy which will plausibly produce sustainable returns; and assessing periodically whether the strategy is delivering what it promised. Such restrictions on the scope of engagement not only fit better with the structure and responsibilities of company law by preserving managerial prerogative; they also support the development of a 'mutual stewardship relationship' between shareholders and managers, which Davies et al claim will 'maximize the potential performance of the group'. Such a relationship requires that 'both parties subordinate their personal goals to that of the collective'.[156]

Second, and going beyond Walker's agency theoretical framework to draw on the management literature, policymakers should encourage asset owners and asset managers to ensure managers are

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[154] Mark Mizruchi, 'Who Controls Whom? An Examination of the Relation between Management and Boards of Directors in Large American Corporations' (1983) 8 *Academy of Management Review* 426 at 429. Mizruchi's argument was intended to show that the mere prospect of intervention put boards in control of management; we submit that the same argument can be made in relation to potential interventions by shareholders into the domain of management.

[155] James Davis, David Schoorman and Lex Donaldson, 'Toward a Stewardship Theory of Management' (1997) 22(1) *Academy of Management Review* 20 at 39-40.

[156] ibid

acting as 'pro-organisational stewards'[157] and that boards are acting as 'mediating hierarchs'[158] and taking account of 'the firm's value-adding, unique risk-taking constituents'[159] when they take decisions that relate to the organisation. Both boards and managers have to deal with diverse and at times contradictory interests, reconciling them in the way they consider will best serve the interests of the organisation. For asset owners and asset managers who are behaving as custodians, the goal of engagement is therefore to satisfy themselves that the strategy, the board and the management team adequately balance shareholders' and stakeholders' different interests, including environmental and social concerns. This division of responsibilities should at the very least be set out clearly in the Stewardship Code in place of the current, very broad invitation for shareholders to intrude on a range of matters which ought to fall within managerial prerogative.

Finally, it may be desirable to move beyond soft law and lock in this division of responsibility between shareholders, boards and managers at the level of the company's constitution. Following the example of the recent French company law reform (*loi Pacte*),[160] policymakers could invite shareholders to define the purpose or *raison d'être* of the company, and related long-term and sustainability goals, in the company's constitution. In this way, rather than leave the interests of the company undefined, the constitution provides a clear and binding statement of corporate purpose. In this context, the role of custodian shareholders becomes much clearer to all concerned: they should ensure that boards and managers make decisions that further this purpose. This heads off the risk of conflating the interests of the company with the short-term financial interests of the shareholders, whilst ensuring that managers are held accountable for their decisions.

Once these matters have been established, and subject to regular monitoring to ensure that decisions are in line with the stated purpose, shareholders should leave managers to get on with managing.

6. CONCLUSION

This article has shown that policymakers have long sought to encourage engagement on the part of institutional investors, originally to improve the quality of management and drive development and more recently to steer companies towards a longer-term and more sustainable approach. Despite a shift from encouragement to soft law to harder law, there is little sign that institutional investors are playing the role expected of them. We identified three existing forms of behaviour. 'Agency behaviour' should be discouraged where it takes the form of passivity, trading or 'bad activism', but this is easier said than done, in large part because it serves the short-term financial interests of all concerned. Trusteeship and ownership behaviour should be encouraged, but the complexity of investment intermediation chains and the wide discretion available to all actors means these behaviours may similarly degenerate into passivity, trading or bad activism aimed at short-term value extraction. We then suggested that one way forward would be to clarify the legitimate scope of shareholder

[157] ibid

[158] Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247.

[159] Allen Kaufman and Ernie Englander, 'A team production model of corporate governance' (2005) 19 *Academy of Management Perspectives* 9 at 10.

[160] *Plan d'Action pour la Croissance et la Transformation des Entreprises* (2019) (https://www.gouvernement.fr/action/pacte-le-plan-d-action-pour-la-croissance-et-la-transformation-des-entreprises).

engagement, explicitly limiting shareholder engagement to custodianship behaviour, which requires them to hold management accountable for putting in place and carrying out a long-term and sustainable strategy. Further research is needed on the best way regulation and soft law might be used to steer institutional investors towards custodianship behaviour.