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Part I
The Conception, Policy and Expectations of Investment Management Stewardship and Sustainable Finance

Chapter 1

From Universal Owners to Hedge Funds and Indexers: Will Stewardship Drive Long-Termism and Sustainability?

Andrew Johnston

I. Introduction

Policy-makers in the UK have, since the early 1970s at least, sought to encourage institutional investors (IIs) to engage with investee companies. This policy has remained remarkably consistent considering the shifting challenges confronting both corporate governance and wider society, as well as the significant changes in the structure of institutional investment over the last 50 years. If anything, the demands made of shareholders have only increased, with the UK's post-global financial crisis Stewardship Code variously expecting large shareholders to: steer companies towards 'long-term returns to shareholders';[1] 'promote the long term success of companies in such a way that the ultimate providers of capital also prosper';[2] and, most recently, 'create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society'.[3]

In this chapter, shareholder engagement refers to dialogue between shareholders and investee companies, backed by voting and collective action where necessary. The Cadbury Report highlighted that shareholders can make their views known to Boards 'by

[1] Financial Reporting Council (FRC), *Stewardship Code 2010* (July 2010) Preface.

[2] FRC, *Stewardship Code 2012* (September 2012) 1.

[3] FRC, *The UK Stewardship Code 2020* (December 2019) (SC 2020) 4.

communicating with them direct and through their attendance at general meetings'.[4] Shareholder engagement was often referred to as 'activism' before 2008, highlighting that shareholders were pressing for changes intended to enhance shareholder value.[5] After the 2008 global financial crisis, it was rebranded as stewardship, highlighting the 'duty' of institutional investors as a counterpart to their 'significant rights of ownership', which entailed adopting 'a long as well as a short-term horizon'.[6] As such, they were expected to exercise influence through monitoring, meeting with Board members, drawing up intervention strategies and adopting voting policies.[7] Under the influence of the Stewardship Code (and latterly the EU's revised Shareholder Rights Directive), institutional investors are expected to disclose publicly their stewardship and voting policies, and periodically report on their implementation. Stewardship was clearly intended to mark a qualitative change in approach, away from earlier short-term oriented shareholder activism towards an approach that benefits shareholders over the long term and leads to more sustainable economic activity.

As the implications of climate change become clearer, and as it becomes evident that sustainability must be embedded across all areas of policy and regulation, the mainstream belief that it is appropriate to rely shareholder empowerment as the primary means of bringing corporate governance into alignment with sustainability and long-termism is being called into question like never before. Shareholder stewardship as a policy initiative is in the last chance saloon, and if shareholders fail to use their powers to push large businesses to take account of sustainability considerations, then it seems likely that, before long, there will be – as Charkham warned in 1989 – 'political activity to make boards once again more accountable'.[8] There are already signs of this in the EU, which, having mainstreamed stewardship as part of its 2017

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[4] Sir Adrian Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee, 1992) para 6.5.

[5] See eg P Myners, *Institutional Investment in the United Kingdom: A Review* (2001) paras 5.73–5.89; Institutional Shareholders' Committee, *Statement of Principles* (2002).

[6] D Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities*, *Final Recommendations* (26 November 2009) para 5.7. The Walker Review largely eschews discussion of activism in favour of stewardship. In particular, para 5.27 distinguishes stewardship in the form of 'dialogue and longer-term engagement between investors and boards' from 'short-term pressure' involving 'analyst and activist investor argument for short-term initiative'.

[7] ibid at 5.14.

[8] J Charkham, 'Corporate Governance and the Market for Companies: Aspects of the Shareholders' Role' *Bank of England Discussion Paper No 44* (November 1989) 9.

revisions to the Shareholder Rights Directive (SRD II),[9] committed, in its Sustainable Finance Action Plan, to giving serious consideration to using directors' duties to reinforce a corporate obligation to conduct human rights and environmental due diligence. Most recently, the European Commission has published proposals for directives mandating corporate sustainability due diligence and corporate sustainability reporting.[10] This suggests that, if stewardship fails to achieve the goals set for it, then more far-reaching regulation of Boards and senior management is likely in the future.

This chapter sets out to evaluate whether existing efforts to encourage IIs to engage with companies are likely to achieve the goal of steering companies towards long-termism and sustainability. Section II briefly traces the attempts to encourage shareholder engagement, from the Bank of England's efforts in the early 1970s through to the 2008 global financial crisis, and sets them against academic debates at the time, from Useem's 'investor capitalism' to Hawley and Williams' 'universal owners'. Section III examines stewardship as the major corporate governance policy response to the global financial crisis, leading to the UK Stewardship Code and influencing the EU's SRD II. These two sections of this chapter highlight the remarkable consistency of this policy prescription despite far-reaching changes in the world of institutional investment, and different aspirations for what engagement was supposed to achieve. Section IV examines the rapid expansion of activist hedge funds, with academic commentary casting them alternately as 'governance arbitrageurs' or 'predatory value extractors'. Section V then focuses on the implications of the explosive growth, post-2008, of passive investors that track indexes of various kinds, focusing on their 'issue-specific' engagement and asking whether this is likely to drive long-termism and sustainability. In the short conclusion, we highlight that if – as seems likely – the activities of these types of institutional investor fail to steer companies towards a more long-term and sustainable approach on the part of companies, then more company-side regulatory intervention (at least in the EU if not in the UK) will occur, beginning with mandatory sustainability due diligence.

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[9] 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 May 2017 (SRD II).

[10] European Commission, 'Action Plan: Financing Sustainable Growth' (COM(2018) 97 final, Brussels, 8 March 2018), Action 10, which commits to carry out analytical and consultation work on requiring companies to develop and disclose corporate sustainability strategies and possible clarification of directors' duties; for the recent proposals see European Commission, 'Proposal for a Directive on Corporate Sustainability Reporting' (COM(2021) 189 final, 21.4.2021) and 'Proposal for a Directive on Corporate Sustainability Due Diligence', (COM(2022) 71 final, 23.2.2022).

II. The Long-Standing Policy of Encouraging Institutional Investor Engagement

From the early 1970s, the Bank of England sought to encourage IIs to collaborate in order to 'improve efficiency in industrial and commercial companies where this is judged necessary',[11] an initiative which ultimately led to the establishment of the Institutional Shareholders' Committee (ISC).[12] At the end of the 1970s, as institutional share ownership approached 50 per cent of listed UK equities,[13] the Wilson Report concluded that IIs 'generally do have the capacity to exercise the responsibilities of ownership, especially those of fostering efficient management and encouraging development'.[14] It clearly viewed II engagement with companies as crucial, emphasising that those investors 'should be prepared to take a long-term view'.[15] However, whilst it was aware that the ISC was not particularly active, the Report concluded that the ISC 'was adequate for any collective action that may be needed' and that there was no need to strengthen it.[16]

In fact, the activity of the ISC subsequently declined to the point where it was 'virtually inactive'.[17] In the late 1980s, Jonathan Charkham, an adviser to the Bank of England and later a member of the Cadbury Committee, put the issue of II engagement forcefully back onto the

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[11] Bank of England, *Annual Report 1972* 25–26. Whilst its involvement in matters of corporate governance looks surprising today, the Bank of England staged wide-ranging interventions in industrial policy and finance from the 1970s onwards, with one David Walker heading up the Industrial Finance Division from 1980, working on numerous restructurings of failing companies, coordinating refinancing operations by consortia of banks, pushing for management improvements, consulting with shareholders and appointing non-executive directors: see H James, *Making a Modern Central Bank: The Bank of England 1979–2003* (Cambridge University Press, 2020) Ch 9. With the Bank largely working on companies in financial difficulty, it makes sense that they tried to harness institutional investors to improve the management of companies that were not (yet) in financial difficulty. The Bank also played a key role in encouraging companies to appoint non-executive directors and in the establishment of the Cadbury committee, and as we will see below, its former employee and later executive director, David Walker, also wrote the report that led to the Stewardship Code.

[12] 'Institutional Shareholders Committee' (June 1973) *Bank of England Quarterly Bulletin* 148.

[13] P Davies, 'Institutional Investors: A UK View' (1991) 57 *Brooklyn Law Review* 130 at 131; by 1981 institutions owned 54% of UK shares, and pension funds owned 30% of British listed shares by 1984: see Lord Wedderburn, 'Trust, Corporation and the Worker' (1985) 23(2) *Osgoode Hall Law Journal* 203 at 219.

[14] *Committee to Review the Functioning of Financial Institutions* (Cmnd 7937, 1980) (the Wilson Report) para 898.

[15] ibid, para 902. The Report alluded to the necessary reliance of institutions on the work of financial analysts, and that they may be 'more cautious than company managements and less imaginative about long-term investment opportunities', although it was not 'immediately obvious' whether this caution would be beneficial or harmful.

[16] ibid, para 925.

[17] See ISC, 'The Institutional Shareholders' Committee' (24 June 1991), available from the Cadbury archive: http://cadbury.cjbs.archios.info/_media/files/CAD-01221.pdf.

Bank's agenda. He argued that shareholders had to take a more active approach and hold Boards accountable, this time in order to justify shareholder supremacy and head off the danger of regulatory intervention.[18] Again, shareholders were expected, in the event of corporate decline, to 'use their influence and, in the last resort, their powers under the Companies Acts in relation to the composition of the Board to cause remedial action to be taken, rather than simply wash their hands of the whole matter by selling their shares and walking away'.[19] Yet, as the Myners Review highlighted in 2001,[20] the slew of soft law initiatives that followed, from industry-led initiatives such as the ISC to Bank of England-sponsored initiatives such as the Cadbury Report, has failed to reorient institutional investors towards a long-term approach.

How can this ongoing passivity on the part of IIs be explained? As early as 1989, Charkham highlighted one of the main obstacles to institutional investors playing this role: the performance of fund managers was assessed over short time horizons, potentially encouraging a 'trading' approach which runs contrary to the 'longer term view which is concerned with the underlying quality of a business and its management'.[21] As the asset management industry developed from the late 1950s through the 1960s and 1970s,[22] pension funds increasingly rewarded 'the more successful with a greater share of the portfolio management'.[23] Reviewing the role of IIs, the Wilson Report of 1980 did not disaggregate the investment chain, but

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[18] Charkham (n 8 above) 8–9.

[19] ibid 4.

[20] In 2001, Myners expressed particular concern about 'the value lost to institutional investors through 'the reluctance of fund managers to actively engage with companies in which they have holdings, even where they have strong reservations about strategy, personnel or other potential causes of corporate underperformance': Myners (n 5 above) para 79. Myners acknowledged 'considerable movement in recent years' but levels of activism were 'not always sufficient' and 'concerns about the management and strategy of major companies can persist among analysts and fund managers for long periods of time before action is taken': ibid paras 5.73–5.74. Indeed, Myners' threat of regulatory intervention along the lines of the US Department of Labor triggered fresh activity on the part of the ISC. In addition to avoiding confrontation and conflicts of interest, the reasons for the lack of activism and engagement included the same one noted repeatedly over the years: 'current manager selection and performance measurement processes can mean that there is little incentive to adopt activist strategies, which do not deliver the quick results which a perceived focus on quarterly figures tends to demand': ibid para 5.83.

[21] Charkham (n 8 above) 12. A similar point was made by David Walker in 1985 when he drew attention to short-termism in capital markets, as well as increased turnover of institutional shareholdings and 'the increased attention to performance on the part of portfolio managers, which, since it is measured only on a short-term basis, means that they are unavoidably driven to concentrate on the short term rather than long haul'. One of Walker's proposed solutions to the problem of 'shorter horizons militating against long-term investment decisions was the provision of better information about innovation and encouragement of dialogue between executives and IIs, another theme to which corporate governance has returned repeatedly over the years: D Walker, 'Capital Markets and Industry' (1985) Q4 *Bank of England Quarterly Bulletin* 570, 571–72.

[22] For historical background on the development of the asset management industry, see L Hannah, *Inventing Retirement: The Development of Occupational Pensions in Britain* (Cambridge University Press, 1986) 65–78.

[23] ibid 76.

identified a 'lack of industrial, as distinct from financial, expertise' on the part of IIs, so that regular contact with investee companies was 'exceptional'.[24] It also noted that, whilst IIs had formed Investment Protection Committees, they could decline to take part, preserving 'their freedom to deal'.[25] Trading would be key to outperforming peers and increasing assets under management. Indeed, pre-2008 empirical research highlighted that trading was the dominant approach adopted by asset managers.[26] As we will see in the next section, problems arising from the investment chain were highlighted once again in the Kay Review of 2012, and remain a major obstacle to the stewardship agenda achieving its goals.

Much greater academic attention was paid to II engagement in the US than the UK, and expectations and evaluations shifted over time. The reconcentration of the 'ownership' side of corporate governance in the hands of IIs was variously expected to lead to 'pension fund socialism',[27] 'pension fund capitalism'[28] or 'investor capitalism'.[29] In 1976, Drucker was concerned that pension funds would not hold management accountable because they would sell their stock where they were unhappy with the company.[30] As the takeover wave of the 1980s receded, however, and the number of formal resolutions on governance matters, as well as informal contact between investors and managers, increased during the 1990s, Michael Useem referred to the emergence of a kind of joint decision-making in relation to many key corporate

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[24] Wilson Report (n 14 above) 900.

[25] ibid 911.

[26] J Hendry et al, 'Owners or Traders? Conceptualizations of Institutional Investors and their Relationship with Corporate Managers' (2006) 59 *Human Relations* 1101.

[27] P Drucker, *The Unseen Revolution: How Pension Fund Socialism Came to America* (Harper & Row, 1976), referring to workers coming to own the means of production through their pension funds. At the same time, Drucker was one of the first writers to recognise the flaws in the existing model of institutional investment. For example, at 71: 'Pension funds cannot beat the market—they are the market… But because the ability of the asset managers to attract pension fund business heavily depends on their promise to perform such miracles, they tend to concentrate on short-term results: the next ninety days or, perhaps, the next swing in the stock market. Yet, by definition, pensions are long-term. Pension fund management therefore requires long-term strategies for true performance. It is an axiom proven countless times that a series of short-term tactics, no matter how brilliant, will never add up to a successful long-term strategy'; see also P Drucker, 'Pension Fund "Socialism"' (1976) (Winter) *National Affairs* 3, arguing that the growth of pension funds meant that workers were going to own the means of production.

[28] G Clark, 'Pension Fund Capitalism: A Causal Analysis' (1998) 80(3) *Geografiska Annaler: Series B, Human Geography* 139, noting that 'The concentration of financial assets in pension funds coupled with the fact that trustees and their investment advisers have considerable autonomy from plan beneficiaries is analogous to the separation of ownership from control characteristic of modern corporations'. Robert Clark refers to 'the third stage of capitalism' which 'split ownership into capital supplying and investment', describing this separation as 'one of the most striking institutional developments in our century': see RC Clark, 'The Four Stages of Capitalism: Reflections on Investment Management Treatises' (1981) 94 *Harvard Law Review* 561, 564.

[29] M Useem, *Investor Capitalism* (Basic Books, 1996).

[30] Drucker (n 27 above) 82–83.

decisions.[31] Since this was the 1990s, 'Consistent executive reference to "shareholder value" [was] de rigueur',[32] with investors pressing for performance, for strategic change and company restructuring, for changes to the governance system, for information and mutual influence, and insisting that strategy and organisation should be more responsive to investor concerns.[33] At this point, shareholder activism had become a reality, in the US at least, where the threat of a proxy contest created pressure for management to be responsive to shareholder demands for change. In contrast, institutional investors in the UK remained passive, happy to take the 'lazy way out' of waiting for a hostile takeover to come along rather than 'use voice as an instrument for improving poor management'.[34] At the same time, the rise of shareholder influence observed in the US was quite different from the current notion of stewardship, which expects structured dialogue between mainsteam investors and Boards oriented towards the long term. For example, there is no hint in Useem's work that 'investor capitalism' was concerned with anything more than increasing shareholder value and influence.

During this period, Pound influentially argued that a political model of corporate governance had superseded takeovers as a means of protecting shareholder interests and solving the 'oversight problem'.[35] Pound used the term 'political model' to refer to

> an approach in which active investors seek to change corporate policy by developing voting support from dispersed shareholders, rather than by simply purchasing voting power or control. I call it 'political' because this form of corporate governance bears a strong resemblance to the model of governance that we typically associate with the public sector. Within a political model of corporate governance, insurgents use public processes to educate voters and to propose alternatives to the policies of incumbents. This process, and the debate it engenders, promotes an informed, participatory, and substantive approach to oversight of management.[36]

Behind the emergence of the political model was the concentration of institutional ownership, which was 'sufficient to create a wholly different set of market incentives, one that promotes the "political" approach to governance'.[37] As institutional investors responded to

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[31] Useem (n 29 above) 25–28.

[32] ibid 253.

[33] ibid 274–75.

[34] J Charkham, 'Corporate Governance and the Market for Control of Companies', *Bank of England Panel Paper No 25* (March 1989) 11–12.

[35] J Pound, 'The Rise of the Political Model of Corporate Governance and Corporate Control' (1993) 68 *New York University Law Review* 1003, 1013.

[36] ibid 1007.

[37] ibid 1042; see also Useem (n 29 above) 31.

those incentives, they engaged in activism, opting for both informal negotiation and formal voting, with formal proxy voting challenges just the most visible part of the resurgent political model.[38] Pound emphasised that the political model was a more continuous, lower cost, less disruptive and more creative method of corporate oversight than the system of takeovers that it superseded. For example, shareholder activism could result in the divestment of a division rather than a wholesale change of control. There are echoes here of what Charkham was demanding in the UK in the late 1980s and, like Charkham, Pound was focused on shareholder activism as a means to managerial accountability and shareholder value.

After Useem and Pound, a gradual but clear drift beyond a pure shareholder value conception of shareholder activism can be identified, starting with the seminal analysis of Hawley and Williams. They identified an emergent shift to 'fiduciary capitalism', in which well diversified institutions were becoming 'universal owners' more akin to stakeholders because their holdings represent the entire economy. They expected that, as universal owners, institutions would recognise that actions taken at one company can impact on the entire corporate sector and from there to global public goods. Hence this type of investor arguably had a breadth of concern that aligns with the public interest; for example, 'universal owners may have (and indeed they should have) interests in form activities that minimize negative externalities (eg environmental damage) by taking account of them to a greater degree and reducing social, third-party costs for the portfolio as a whole'.[39] Similarly, universal owners should support companies producing positive externalities by investing in education and training, even if they are ultimately unable directly to internalise all the benefits, because it will make the economy more productive. Ultimately they claimed, these investors were increasingly being 'forced to consider issues that can be seen as quasi-public policy in nature'. Even if fiduciary duty requires investors to exclude 'purely' social issues, this distinction becomes fluid because they should focus on 'issues that affect the *economic* return on a portfolio investment'.[40] At this point a concern about social and environmental externalities becomes relevant because these costs impact on the portfolio via their impact on the real economy.

Like Useem, Hawley and Williams recognised that, in the US at least, institutional investors appeared to be moving away from rational apathy. In large part, this was because exit

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[38] ibid 1012.

[39] J Hawley and A Williams, *The Rise of Fiduciary Capitalism* (Pennsylvania University Press, 2000) 4.

[40] ibid 29.

was increasingly blocked, leaving voice as the only solution.[41] They expected that professional shareholders would increasingly monitor their investee companies and communicate with management.[42] But unlike Useem, who assumed that the aim was simply direct increases in shareholder value, and highlighted that low levels of staffing at indexed funds left little scope 'for sustained attention to any company',[43] Hawley and Williams expected that IIs would increasingly take account of wider social considerations as a means of discharging their fiduciary duty to their beneficiaries. In this regard, their work marks the beginning of the (rhetorical) shift from activism to stewardship. Their study highlighted that, although CalPERS' proxy voting guidelines were still dominated by corporate governance issues aimed at 'enhancing shareholder value', they also mentioned a number of 'social issues', in relation to which information disclosure was demanded.[44] Whilst this tendency was clearly still in its infancy, it arguably highlighted an emerging 'awareness that the actions of individual companies can have spillover effects that impact the owner's entire portfolio'.[45] With the benefit of hindsight, Hawley and Williams' expectations were not met, and their argument was perhaps the highpoint of academic belief in institutional investors having incentives to steer companies towards a long-term, sustainable approach, at least until the emergence of recent Panglossian literature (evaluated in section V below) claiming once more that index funds will drive sustainability. Certainly, their analysis highlighted increasing levels of indexation, giving the asset owner an interest in the index as a whole,[46] and foreshadowed more recent

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[41] ibid 125.

[42] ibid 124.

[43] Useem (n 29 above) 61.

[44] Hawley and Williams (n 39 above) 32–40. CalPERS (the California Public Employees' Retirement System) was (and still is) the largest US retirement fund. From 1987, it was a trailblazer among pension funds, taking an activist approach to corporate governance issues. It began by opposing poison pills and staggered Boards that protected against takeovers, then in the 1990s began pushing for improvements among its portfolio companies with poor financial performance: see CalPERS, *Global Governance Principles*, March 2015. Useem noted (at 65) that 'for some investors, the stress on company performance came to displace any concern with governance and related executive practices'. Whilst CalPERS now publicly professes a belief that ESG issues can affect financial performance (*Global Governance Principles* 6), its most recent proxy voting guidelines do not go much further than the 1998 Guidelines discussed by Hawley and Williams, being largely confined to supporting resolutions seeking information disclosure across environmental and social matters: see *CalPERS Proxy Voting Guidelines* (April 2021) 10–12.

[45] Hawley and Williams (n 39 above) 171.]

[46] ibid 7.

commentary about the incentives of index funds to focus on non-diversifiable, 'systematic' risk.[47]

Overall, then, shareholder activism before 2008 was patchy, and was primarily focused on increasing short-term shareholder value, with some IIs beginning to pay attention to what we now know as environmental, social and governance (ESG) issues. In the US, activism served as a substitute for the market for corporate control as takeovers became much harder to carry out from the end of the 1980s. In the UK, policymakers reversed this logic, hoping that IIs would engage more frequently with companies so that there would be fewer takeovers, allowing the end beneficiaries of pension funds to share in the long-term returns that accrue to shareholders in well-run companies. However, there was little evidence of this happening, and as we will see next, shareholder pressure for returns played its part in the run up to the 2008 crisis.

III. The Post-Global Financial Crisis Stewardship Agenda

Given the apparent failure of efforts to encourage engagement, in the UK at least, the 2008 global financial crisis provided a golden opportunity for policymakers to change tack. After all, institutional investors had been identified as one of the drivers of the crisis, chasing returns and pushing for financial institutions to take more – not less – risk in the period leading up to the financial meltdown.[48] Yet, the 2009 review of corporate governance in UK banks, carried out by Sir David Walker, referred to Institutional Investors' 'at least acquiescence in and some degree of encouragement to high leverage'. Walker noted that major fund managers were 'slow to act', and whilst he concluded that they 'could not have prevented the crisis', he also thought the Board-level shortcomings 'would have been tackled more effectively had there been more vigorous scrutiny and engagement by major investors acting as owners'.[49] Walker ultimately recycled Charkham's position from two decades earlier by concluding that, in order to obtain 'at least implicit social legitimacy', 'the larger fund manager' had to be attentive 'to the

[47] See further sectin V below.

[48] J de Larosière, *Report of the High-Level Group on Financial Supervision in the EU* (25 February 2009) 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': Walker Review (n 6 above) para 5.10.

[49] Walker Review (n 6 above) paras 5.10–5.11.

performance of investee companies over a long as well as a short-term horizon'.[50] In converting the ISC's 2009 Code on the Responsibilities of Institutional Shareholders into a Stewardship Code, and encouraging pension funds, insurance companies and the asset managers they hire to comply and disclose an engagement policy or explain their non-compliance, the assumption was that this would call forth the right kind of shareholder engagement from the 'naturally longer-term holders'.[51]

As will be clear from the history set out above, the 2010 introduction and 2012 revision of the Stewardship Code represented a continuation of business as usual, and it is unsurprising that little changed. Echoing Charkham and Walker in the 1980s, the 2012 Kay Review noted the 'short performance horizon' of asset managers,[52] concluding that 'short-termism is a problem in UK equity markets', caused by 'the decline of trust and the misalignment of incentives throughout the equity investment chain'.[53] Research carried out by the Department of Business, Innovation and Skills in 2014 once again highlighted problems in the investment chain, especially a failure to communicate expectations between asset owners and asset managers, leading asset managers to 'over focus on the benchmark and a short-term mindset' because of misunderstandings about time horizons, as well as a lack of clarity as to who is responsible for stewardship.[54] This communication failure is further compounded by the infinite complexity of the investment chain, with huge variety in the extent to which asset owners rely on asset managers, as well as secrecy around mandates,[55] making it impossible for the SC to state clearly whether asset owners or asset managers have primary responsibility for

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[50] ibid para 5.8.

[51] Walker emphasised 'the need for those who are naturally longer-term holders to be ready to engage proactively where they have areas of concern', both to address Board shortcomings and to offset the short timeframe of shareholders such as 'hedge funds with significant stakes': Walker Review (n 6 above) para 5.11.

[52] J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making* (July 2012) para 5.18.

[53] ibid 10.

[54] Department for Business, Innovation & Skills, 'Metrics and models used to assess company and investment performance', *BIS Research Paper No 190* (October 2014). This apparent misunderstanding about the relevance of past performance and short time horizons was identified in the Myners Review of 2001 (n 5 above) paras 5.30 and 5.69, but apparently remains unresolved.

[55] For further discussion of the different (dysfunctional) behaviours that can arise out of the structure of the investment chain, and an argument about the legitimate scope of shareholder engagement, see A Johnston et al, 'Governing Institutional Investor Engagement: from Activism to Stewardship to Custodianship?' (2021) *Journal of Corporate Law Studies* https://doi.org/10.1080/14735970.2021.1965338.

engagement.[56] Stewardship, then, remains at best a hope and an aspiration, making highly questionable the prominent and continued reliance on IIs and private incentives to drive UK companies towards a long-term approach.

Given the UK's sustained failure to nurture significant II engagement with investee companies, it is perhaps surprising that the UK's approach acted as such a powerful influence on the EU's SRD II of 2017. In rolling out obligations analogous to those contained in the UK's Stewardship Code, SRD II added three innovations: engagement policies had to cover ESG matters; the 'comply or explain' obligation on pension funds, insurance companies and asset managers was embedded in law; and these investors were required to report annually and publicly on the implementation of their engagement policy, including disclosure of voting behaviour and how specific votes were cast.[57] With SRD II fully implemented in the UK before Brexit,[58] the 2020 revision to the Stewardship Code (SC 2020) became a best practice document once again, encouraging IIs to identify and respond to market-wide and systemic risks, and to integrate 'material environmental, social and governance issues, and climate change'.[59]

Hence, the response to a financial crisis that was driven at least in part by shareholder pressure for short-term returns, was more shareholder empowerment. That this step was rather illogical was not lost on Bratton and Wachter, who asked:

> Was the crash of financial stocks the result of a system that gave managers too much power, or did it follow from managers catering to stockholders as they expressed their views through stock prices?[60]

They argued that banks came under considerable pressure, as a result of a lagging stock price, to abandon their strict risk management practices as the housing bubble expanded. The way

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[56] The BIS research paper (n 54 above) noted at 28 that asset owners share the responsibility 'through the mandates they give to fund managers and the monitoring of these', which 'can influence behaviour that leads to improved stewardship by fund managers'.

[57] SRD II (n 9 above). For further discussion, see Birkmose, this volume.

[58] See COBS 2.2B.5R and 2.2B.6R (for asset managers); SYSC 3.4.4R and 3.4.5R (for life insurance companies); The Occupational Pension Schemes (Investment) Regulations 2005, SI 2005/3378, reg 2(3)(c) and The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013, SI 2013/2734, Sch 3 (as amended) (for pension schemes).

[59] SC 2020 (n 3 above) Principles 4 and 7.

[60] W Bratton and M Wachter, 'The Case against Shareholder Empowerment' (2010) 158 *University of Pennsylvania Law Review* 653 at 718.

the banks behaved in the lead-up to the crash was shaped by the incentives given to executives, with their decisions validated by shareholder approval as expressed in the share price:

> The financial sector undertook high-risk/high-return strategies to enhance return on equity and raise stock prices. The executives who danced to the rhythm were compensated with stock options and restricted stock in addition to cash bonuses, and so had incentives roughly in alignment with those of their shareholders… Shareholder power was a part of the problem and is not a part of the solution.[61]

This brief history highlights that the corporate governance prescription has remained broadly the same since the 1970s, despite repeated reports that the structure of the investment chain was a key driver of short-termism and despite an enormous financial crisis. Despite decades of failure, there was a clear unwillingness to move beyond soft law and long-standing assumptions that simply empowering shareholders would resolve whatever corporate governance issue was considered most pressing at the time. However, whilst corporate governance policy remained largely unchanged in the aftermath of the global financial crisis, monetary policy did not, and this triggered enormous upheaval in the market for institutional investment, further undermining the assumption that empowered institutional investors would drive more long-term and sustainable behaviour on the part of companies.

IV. The Rise of Hedge Fund Activism

Hawley and Williams did not anticipate (and nor could they have) that the global financial crisis of 2008 would call forth more than a decade of zero interest rates and extraordinary central bank monetary policies (in the form of quantitative easing), forcing institutional investors into a quest for yield in order to meet current liabilities. As Millon makes clear, IIs were forced, in the new era after 2008, to adopt increasingly short-term strategies in order to meet current liabilities fixed on the basis of a now impossible 8 per cent annual return.[62] Indeed, the shift to structurally low interest rates ought to call into question the assumption that most

[61] ibid 723. At the same time, in the UK, it apparently made sense further to empower shareholders by giving them a binding say on forward-looking executive pay policy: see Enterprise and Regulatory Reform Act 2013, s 79(4).

[62] In his examination of the drivers of shareholder short-termism, Millon notes the ‘substantial current obligations’ of pension funds, which creates a ‘need for large amounts of cash on a monthly basis’. In order to meet those obligations, pension funds ‘have historically assumed an annual rate of return of 8%, give or take a half point depending on the plan. This is still largely true in the wake of the 2008 financial crisis, although some plans are considering reducing their assumed rate of return by a point or so’. This pressure for returns is amplified by the enormous deficits being run by many funds. With that level of return being impossible in the current climate, funds have to ‘focus on short-term stock price performance’ by trading, moving into riskier ‘alternative investments’ such as hedge funds or cutting costs through greater reliance on indexing strategies. See D Millon, ‘Shareholder Social Responsibility’ (2013) 36 *Seattle University Law Review* 911 at 930–33.

IIs, burdened by liabilities taken on in an earlier, higher interest rate era, remain capable of acting as long-term providers of patient capital.

Likewise, Duruigbo asked whether long-term investors still existed, noting that:

> Some people that invest for the long-term may be properly characterized as 'short-term investors with long-term interests'… such investors may prefer a series of short-term investments that yield higher returns cumulatively than single investments that are held for longer periods of time but generate lower returns. If that is the case, focusing on the long-term investor's interest clearly misses the point.[63]

In a pre-global financial crisis contribution, Kahan and Rock recognised that hedge funds fall into just this category, holding out exactly the prospect of a series of short-term investments that yield higher returns cumulatively. Kahan and Rock highlighted that hedge funds push for significant changes at target companies, changes which are identified before shareholdings are purchased rather than as a response to underperformance. They also identified a potential divergence of interests between hedge funds and other shareholders, as hedge funds seek short-term payoffs at the expense of long-term profitability.[64] Noting that hedge funds require support from independent directors and other shareholders in challenging management, Kahan and Rock suggested that companies should head off the threat of short-term oriented interventions by 'maintaining regular and close contact with major institutional investors'.[65]

However, with interest rates effectively at zero from the global financial crisis until very recently, hedge funds increasingly came to be viewed as a solution by 'long-term' investors facing ever more expensive liabilities. As institutional investors shifted into 'alternative investments', this increasingly (ought to have) called into question the reliance of policymakers on shareholder engagement as a means to an end of companies adopting more long-term and sustainable strategies. Following the financial crisis, hedge fund activism increased, with Coffee and Palia referring to an 'almost hyperbolic' spike in 2015.[66] Capital flowed into hedge funds, enabling shareholder activism in the US which further reduced barriers to shareholder

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[63] E Duruigbo, 'Tackling Shareholder Short-Termism and Managerial Myopia' (2012) 100(3) *Kentucky Law Journal* 531 at 580.

[64] M Kahan and E Rock. 'Hedge Funds in Corporate Governance and Corporate Control' (2007) 155 *University of Pennsylvania Law Review* 1021 at 1083–84; for further analysis of the implications of diverging shareholder interests, see I Anabtawi, 'Some Skepticism About Increasing Shareholder Power' (2006) 53 *UCLA Law Review* 561.

[65] Kahan and Rock (n 64 above) 1088–1090.

[66] J Coffee and D Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) 41 *Journal of Corporation Law* 545, 548. There were no signs of this abating by 2020: see L Fortado, 'Companies Faced More Activist Investors Than Ever in 2019' (*Financial Times*, 15 January 2020).

influence, as resolutions sought removal of classified Boards and poison pills.[67] In the UK, hedge fund activism was less obvious, partly because the UK Corporate Governance Code and the Takeover Code had long ensured that managers had less insulation from shareholder influence than their counterparts in the US. However, as pension funds and insurance companies sold off their listed UK company shareholdings following the financial crisis, 'other financial institutions', including hedge funds (with investments from those very same pension funds and insurance companies), took up some of those shares.[68] As of 2021, hedge funds and other activist investors were taking advantage of Covid- and Brexit-related uncertainty in the UK.[69]

In the debate about whether hedge funds have a harmful or beneficial effect on companies, on the end beneficiaries of other institutional investors, such as pension funds, and on wider society, Coffee and Palia contrasted two 'polar characterisations': that of hedge funds as natural leaders of shareholders, and that of hedge funds as short-term 'predators, intent on a quick raid to boost the stock price and then exit before long-term costs are felt'.[70]

Gilson and Gordon's hedge fund-friendly model of 'fiduciary capitalism' sees hedge funds acting as 'governance arbitrageurs' who 'identify strategic and governance shortfalls with significant valuation consequences' and present a value proposition, which involves changes to the investee company's strategy or structure, to the other, 'rationally reticent', institutional shareholders.[71] Hedge funds cannot bring about change on their own, and rely on support from more passive institutions, which are trying to produce superior relative performance in order to gain competitive advantage, and do not have the incentive to engage in active monitoring of investee companies. Nor do they have the expertise to do this: as Gilson and Gordon put it, 'institutions can be expected to be skilled at managing portfolios, not at developing more profitable alternatives to a portfolio company's business strategy, creating

[67] S Bainbridge, 'Preserving Director Primacy by Managing Shareholder Interventions' in J Hill and R Thomas (eds), *Research Handbook on Shareholder Power* (Edward Elgar, 2015).

[68] Office for National Statistics, 'Ownership of UK Quoted Shares: 2018', https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2018.

[69] P Hollinger et al, 'Activists Eye Targets in Weak and Vulnerable Corporate UK' (*Financial Times*, 7 January 2021). They were joined in this by private equity firms: see K Wiggins et al, 'Private Equity and the Raid on Corporate Britain' (*Financial Times*, 12 July 2021).

[70] Coffee and Palia (n 66 above) 549.

[71] R Gilson and J Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights' (2013) 113(4) *Columbia Law Review* 863, 896.

better governance structures for the firm, or mastering the skills of governance activism'.[72] Hence Gilson and Gordon present hedge funds as a solution to possible agency problems in the investment chain, setting up intervention proposals that institutional investors can vote on.

In contrast, the critique of hedge fund-led activism is that it demands increased distributions to shareholders in the form of dividends and share buybacks. In their account of predatory value extraction, Lazonick and Shin highlight that activist shareholders, including hedge funds, will seek to influence distribution policies, either working 'harmoniously in looting the corporation' with 'senior executives who have already been incentivized to act as value-extracting insiders',[73] or seeking support from other institutional investors, who also have co-invested in the sense of making an investment into the hedge fund that is pressing for change to the distribution policy.[74] Regardless of who they work with, Lazonick and Shin emphasise that:

> the goal of the hedge fund activist is… *not* to improve a target company's operations or its financial stability. Nor is it to contribute expertise to formulating an innovative investment strategy… Hedge fund activists have neither the abilities nor the incentives to engage in the allocation of corporate resources to innovative strategies, which require massive financial commitments in pursuit of inherently uncertain outcomes combined with an intimate understanding of the company's productive capabilities and competitive possibilities… Their goal is to extract value that was created in the past, not to engage in the innovative strategies that may create value in the future.[75]

Whether increasing the level of payout requires leverage, which in turn increases the riskiness of the firm, or simply involves disgorging cash flow to shareholders rather than investing it in the business, it is likely to entail future cuts to expenditure, whether on R&D and capital assets or on employment, wages and other employee benefits.[76] For example, Coffee and Palia note that 'most studies find that research and development expenditures decline significantly in the wake of hedge fund pressure' and that 'one needs to look beyond the targeted firms and consider the general deterrent impact of hedge fund activism on R&D expenditures across the broader landscape. For every firm targeted, several more are likely to

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[72] ibid 895.

[73] This point reminds us that we should not view the drive for stewardship in isolation from the UK and EU rules giving shareholders a binding 'say on pay'.

[74] W Lazonick and J-S Shin, *Predatory Value Extraction* (Oxford University Press, 2020) 137.

[75] ibid 137–38.

[76] Lazonick and Shin add to this list 'avoidance of corporate taxes, price gouging of customers, sale of corporate assets, and acquisition of other cash-rich companies': ibid 138.

reduce R&D expenditures in order to avoid becoming a target'.[77] Moreover, they say, this may undermine the positive externalities of research, so that 'even if reducing investment in R&D makes sense for an individual company (because it increases its profitability), this reduction in investment likely involves a social cost (as fewer new drugs and products are introduced)'.[78] In this sense, among others, hedge fund activism runs counter to policymakers' expectations that shareholder stewardship would lead to companies taking more long-term, sustainable decisions.

In his 2017 intervention, Strine emphasised the pervasiveness of the disconnect between the short time horizons of hedge funds, asset managers and other actors in the investment chain and the much longer time horizons of end beneficiaries. As he put it:

> If it is the case that these money managers are acting for their own short-term motives and if most hedge funds themselves have no incentive to think long term, that illustrates that we are relying on the law of unintended consequences to drive important elements of decision making in a context critical to human investors' wellbeing.[79]

Strine's contribution highlights the assumption on the part of the authors of the Stewardship Codes that simply encouraging shareholders to engage with companies (and leaving the investment chain unregulated) will necessarily inculcate a longer-term approach on the part of corporate management, 'creat[ing] long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society'.[80] Yet, as Strine puts it, there is simply no reason to assume that 'this debate among those with short-term perspectives' will produce 'optimal policy for human investors with far longer time horizons'.[81] Whilst payouts in the form of dividends and share buybacks are presumably very welcome to the institutional investors and rich individuals who invest in hedge funds, this does leave the 'stuck-in investor' having to figure out where to reinvest the dividends and buyback proceeds, which ultimately 'have to be invested back into the very companies paying them out'.[82]

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[77] Coffee and Palia (n 66 above) 576.

[78] ibid 576–77.

[79] L Strine, 'Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System' (2017) 126 *Yale Law Journal* 1870 at 1907. Along similar lines, Silver emphasises that where companies attempt to boost their share price 'by paying out large dividends or buying back its shares, this would be in the interest of the asset manager, but not in the interest of the ultimate beneficiaries who would want the company to be prospering when they retire': N Silver, *Finance, Society and Sustainability: How to Make the Financial System Work for the Economy, People and Planet* (Palgrave Macmillan, 2017) 118.

[80] SC 2020 (n 3 above) 4.

[81] Strine (n 79 above) 1873–74.

[82] ibid 1939. Silver estimates that the pension fund industry invests less than 4% of its funds in the real economy (that is, new investment), whilst the rest is spent on buying existing assets on secondary markets. As he

Ultimately, with central banks continuing to flood economies with liquidity through quantitative easing and buying up government bonds, the primary problem facing institutional investors, and by implication their end beneficiaries, is not a shortage of liquid assets, but a shortage of places to put their money where it can generate a return.

Moreover, there is a real question about the legitimacy of hedge fund interventions into areas currently reserved for managerial prerogative. As Anabtawi and Stout put it, there is 'a new genre of public company shareholder that is aggressive, wealthy, and eager to play a role in setting corporate policy'.[83] Not only do these shareholders not face liability where they engage in self-interested behaviour and other forms of rent-seeking, there are also serious questions as to their competence to dictate matters of strategy to incumbent management. Indeed, the 2020 iteration of the UK Stewardship Code invites institutional investors to intervene in a range of issues, including diversity, remuneration and workforce interests, environmental and social issues and compliance with covenants and contracts, which in law fall within the scope of the managerial prerogative, and in relation to which there is no reason to believe the investors have any expertise, yet for which IIs are very unlikely to bear any legal responsibility.[84] Lazonick and Shin point out that advocates of agency theory, such as Bebchuk, 'do not explain how public shareholders, who merely buy and sell shares on the stock market, could and would make contributions to "long-term value" if they could exercise more power over management'.[85] Strine adds that even those who are optimistic about hedge fund interventions recognise that they tend to focus on matters of corporate finance. For example, Brav admits that:

> many of the hedge funds in our sample are not experts in the specific business of their target firms. Focusing on issues that are generalizable to other potential target firms helps hedge funds lower the marginal cost of launching activism at a new company.[86]

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emphasises, payouts that boost the share price serve the interests of asset managers, but does not serve the interests of long-term end beneficiaries who want investee companies to make long-term investments in productivity: Silver (n 79 above) 113.

[83] I Anabtawi and L Stout, 'Fiduciary Duties for Activist Investors' (2008) 60 *Stanford Law Review* 1255, 1279.

[84] For further discussion of the legitimate scope of intervention, see Johnston et al (n 55 above) 35–37.

[85] Lazonick and Shin (n 74 above) 160.

[86] Strine (n 79 above) 1940; A Brav et al, 'Hedge Fund Activism, Corporate Governance, and Firm Performance (2008) *Journal of Finance* 1729, 1754–55. The recent successful proxy fight, which resulted in Engine No 1, a provider of index funds, having three nominees appointed to the Board of Exxon Mobil on the back of a very small shareholding ,has been called a game changer, although more sceptical commentators such as Sharfman highlight the absence of concrete transition proposals from the insurgent, as well as the huge marketing boost it obtained: see BS Sharfman, 'The Illusion of Success: A Critique of Engine No 1's Proxy Fight at ExxonMobil' *George Mason Law & Economics Research Paper No 21-20*.

Those who support hedge fund activism claim that forcing payouts through activism helps to resolve 'the agency problem of free cash flows, such as relatively low dividend yield and diversifying investments… that might not be in the best interest of shareholders'.[87] For them, these 'investment-limiting' interventions move companies towards an optimal level of long-term investment, correcting for the tendency of management to build empires and 'pursue projects without the discipline generated by having to raise outside financing'.[88] However, increasing payouts to shareholders through share buybacks and dividends is not only a corporate finance issue; it also constrains the range of options open both to management teams facing hedge funds acting as 'governance arbitrageurs', and to other management teams that experience the 'governance externalities' of these activities, and feel obliged to increase payouts to shareholders in order to avoid attracting attention from hedge funds.

Ultimately, this debate comes down to a question of whether capital should be allocated by corporate management under the oversight of the general meeting (as company law expects) or by institutional investors following distributions from companies (as shareholder primacy advocates increasingly claim).[89] Besides a lack of clarity as to who is actually supposed to be taking decisions on behalf of the company, and a concern about whether the distributions are primarily used to further bid up the price of existing assets, there are significant doubts about whether hedge fund activism is compatible with the goals of stewardship, that is, long-term and sustainable decision-making producing benefits for shareholders and wider society. Whilst some might say that this does not matter, because shareholder engagement is simply about resolving the 'agency problem', this is not what policymakers are claiming. After the 2008 global financial crisis, they sought legitimacy for their continued reliance on shareholder engagement by referencing wider social benefits that went beyond shareholder value. As such, it is submitted, whether or not engagement drives long-term and sustainable decision-making is fundamental to any assessment of the success or failure of the stewardship agenda.

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[87] Brav et al (n 86 above) 1755.

[88] L Bebchuk et al, 'The Long-Term Effects of Hedge Fund Activism' (2015) 115(5) *Columbia Law Review* 1085, 1135–36.

[89] Indeed, Lazonick and Shin (n 74 above, 162) express some doubt as to whether, 'after a quarter century of embracing MSV ideology, incumbent directors and executives of US business corporations have the incentives, or even the abilities, to make resource-allocation decisions consonant with "the long-term success of the business enterprises" over which they exercise strategic control'.

Ultimately, as I have argued elsewhere, the legitimate scope of shareholder engagement needs to be more clearly delineated than it is at present if it is to achieve these goals.[90]

V. The Rise of Passive or Index Investors

A. Background to the Rise of Indexers

Alongside the growth of hedge funds discussed in the previous section, the other critical development since 2008 has been the massive growth in indexed funds (or 'indexers') as retail and institutional investors alike have switched from active to passive management,[91] driven by lower fees and by the ongoing failure of many higher cost, actively managed funds to outperform the market benchmark.[92] This section explores the implications of this shift, asking whether it is likely to drive long-termism and sustainability.

A passive or index fund is a pool of assets, normally set up as a separate legal entity by a sponsoring company within the same corporate group, with administrative, advisory, engagement and stewardship services delegated to other companies within that corporate group. They may take the form of exchange traded funds (ETFs), the shares of which can be bought and sold on a stock exchange, or a mutual fund, which can be bought and sold based on a daily valuation.[93] These types of funds commit to tracking a particular index, whether a mainstream index such as FTSE100 or a more bespoke index, for example focusing on ESG-screened companies, created for them by an index provider. These funds are therefore 'locked in' to their shareholdings, which must mirror the index on a weighted basis, and are unable simply to sell shares in response to events within investee companies. When the various funds

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[90] Johnston et al (n 55 above) part five.

[91] In the EU, passive equity funds grew from 15% of investment fund assets in 2007 to 30% in 2017; in the US passive funds controlled 43% of total equity fund assets in 2018; and in the UK, passive funds account for about one-third of total assets managed by members of the investment association: see K James et al, 'Does the Growth of Passive Investing Affect Equity Market Performance?: A Literature Review' *FCA Research Note* (February 2019) 6.

[92] V Sushko and G Turner, 'The Implications of Passive Investing for Securities Markets' (2018) *BIS Quarterly Review* 113, 117.

[93] Secondary market trading means that ETFs are more frequently traded than mutual funds, especially in times of market turmoil: see ibid 123–26. Mutual funds may also be active funds, buying and selling shares in an effort to outperform other active funds as well as passive funds in order to increase assets under management. Anabtawi points out that the combination of investor liquidity in mutual funds, 'coupled with widespread availability of information on fund performance, has led to pressure on mutual fund managers to maximize short-term returns at the expense of any longer-term focus in order to attract and retain investors': Anabtawi, (n 64 above) 579–80.

managed under a single corporate group are considered together, that group is normally among the largest shareholders on the register of every listed companies, giving it considerable influence over whether resolutions are approved, and greater weight with Boards than the highly fragmented institutional investors of the past. At the same time, they attract investors by charging low fees, so clearly face constraints on their capacity to process firm-specific information and engage with investee companies. This combination of factors means that the engagement behaviour of indexers will be absolutely crucial in determining whether stewardship achieves its goals of long-termism and sustainability.

The sector is dominated by a handful of large corporate groups, with BlackRock and Vanguard the largest, whilst State Street, LGIM and others are smaller but still very large. These corporate groups offer a whole suite of passive funds to their investors, as well as a variety of active funds. For example, Vanguard primarily offers passive funds to its investors, whilst two thirds of BlackRock's assets are in passive funds. The majority of BlackRock's customers are institutional investors,[94] whilst Vanguard is more focused on retail investors.[95] Other groups, such as Fidelity, are more focused on actively managed funds.[96] The higher costs of active funds will normally be reflected in higher fees, although Fidelity, for example, offered fee-free passive funds in order to attract new investors and new assets, highlighting the potential for cross-subsidisation between funds.[97]

Unlike the funds, which are locked into holdings, the fund's investors have liquidity and can sell their shares or units at any time and receive the net asset value. One result of this is that competition to attract new investors and retain existing ones is fierce. The normal business model of these groups is to maximise revenue across the whole range of funds, with revenue coming from the fees they charge their investors as well as from other activities such as

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[94] BlackRock, Inc's SEC Form 10-K filing of February 2022 discloses that, as of December 2021, $5,694,080m out of total $10.01 trn of AUM were institutional, the remainder divided between retail (S1.048,709m) and ETFs ($3,267,354m).

[95] As of June 2022, Vanguard managed £7.5trn of assets on behalf of more than 30m investors across 411 funds see https://corporate.vanguard.com/content/corporatesite/us/en/corp/who-we-are/sets-us-apart/facts-and-figures.html. Vanguard's origins lie in providing services to retail investors, and this is where its focus remains: see A Massa, 'Vanguard Makes Rare Retreat as Price War It Started Takes a Toll' (*Bloomberg*, 7 December 2020), https://www.bloomberg.com/news/articles/2020-12-07/vanguard-makes-rare-retreat-as-price-war-it-started-takes-a-toll.

[96] J Fisch et al, 'The New Titans of Wall Street: A Theoretical Framework for Passive Investors' (2019) 168 *University of Pennsylvania Law Review* 17, 28–29.

[97] Fisch et al (n 96 above) 24.

securities lending.[98] The fees which come into the group will increase as assets under management increase, so groups compete to increase investment and reduce costs in order to increase returns to their own shareholders. Vanguard is an important exception to this as its mutual funds are the shareholders of the company which provides asset management services to them at cost.[99]

The rise of passive funds over the last decade has given rise to much debate about their contribution to stewardship, both about whether they will engage in activism and about the orientation of their contribution (especially whether it will be focused on individual companies or the index as a whole). This section sets out to evaluate whether – and if so, how – indexed funds are likely to make a significant contribution to the stewardship goals of long-termism and sustainability.

B. What Kind of Stewardship Activities Are Indexers Expected to Conduct?

Sceptics and optimists alike recognise that indexers have little or no incentive to improve performance of individual companies in their portfolio.[100] Among sceptics, Lund argues that indexers lack firm-specific information acquired through the process of trading, and may also lack governance expertise (although she accepts that there may be some information sharing within big investors).[101] As such, they may either fail to engage with management or intervene to demand low cost, one-size-fits-all measures, normally following the recommendations of proxy advisers.[102] Lund highlights the 'lock-step consistency of voting across funds', with very few funds not following standard, proxy-adviser given guidelines.[103] Moreover, she claims that indexers are less likely than active institutional investors to act as a 'keel' to hedge fund activism, which, she says, evaluate proposals and block them where they are not in the interests of their long-term shareholders.[104] Lund is concerned about convergence on a particular model

[98] ibid.

[99] For a history of Vanguard see J Bogle, *Stay the Course: The Story of Vanguard and the Index Revolution* (Wiley, 2019).

[100] Sushko and Turner (n 92 above), for example, note at 119 that 'passive portfolio managers have scant interest in the idiosyncratic attributes of individual securities in an index'.

[101] D Lund, 'The Case against Passive Shareholder Voting' (2018) 43 *Journal of Corporation Law* 493, 495.

[102] ibid 495 and 516.

[103] ibid 517.

[104] ibid 520.

of corporate governance (which increases Board independence, removes takeover defences and eliminates dual class structures) that pays little heed to firm-specific circumstances. Indeed, there is some evidence that, for example, innovative activity increases as non-index fund ownership increases, and that companies with a higher proportion of passive shareholders invest less and pay out more.[105]

Bebchuk and Hirst's main concern is that indexers defer excessively to managers.[106] Whilst they publicly claim to be maximising the long-term value of their portfolios, index fund managers have incentives which give rise to agency costs: the private interest of the fund manager in fees prevails over the investor interest in stewardship.[107] Moreover, they have private incentives to be excessively deferential, including business ties and fear of a potential regulatory backlash if they intervene in matters conventionally reserved to management.[108] They lament that indexers do not intervene in ways that link pay to performance, eliminate takeover defences and monitor and if necessary remove CEOs for underperformance.[109] Competition for assets does not solve this problem because passive funds which commit more resources to stewardship will have a higher cost base than other passive funds tracking the same index, which will free ride on their efforts.[110] Likewise, if they do succeed in bringing about improvements in portfolio companies, this will benefit those actively managed funds that are overweight those companies.[111]

Perhaps because they have been written in a US context, and are therefore grounded in an agency approach, these accounts pay less attention to stewardship activities aimed at ESG matters, which are treated as extraneous to the core task of producing shareholder value. Bebchuk and Hirst view indexer claims in this regard merely as an effort to distract attention away from their growing power and the agency costs they impose on their investors,[112] whilst

[105] See sources cited in James et al (n 91 above) 9–10.

[106] L Bebchuk and S Hirst, 'Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy' (2019) 119 *Columbia Law Review* 2029.

[107] ibid 2048–55.

[108] ibid 2060–70.

[109] ibid 2068.

[110] ibid 2057.

[111] ibid 2059.

[112] Bebchuk and Hirst (n 106 above) note at 2073 that some investors might choose indexers on the basis of their non-financial preferences for stewardship quality, giving indexers 'an incentive to emphasize their commitment to stewardship in their public communications. This might also lead index fund managers to take positions on

Lund appears to view claims to ESG activism as advertising aimed at attracting additional assets by appearing to meet investor preferences.[113]

More optimistic accounts similarly focus on engagement to improve corporate governance, such as supporting 'higher quality financial reporting' or 'better-functioning audit committees',[114] but again, perhaps reflecting their US origins, pay little or no attention to issues like long-termism and sustainability. Fisch et al emphasise the highly competitive nature of the market for passive investment creates incentives to improve the governance of investee companies.[115] Passive funds are competing with an enormous array of other investment alternatives, and need to attract investors, increasing assets under management, and deter outflows, allowing the corporate group to achieve its goal of maximising revenue. The key question is how much scope these considerations leave for stewardship activities. Fisch et al argue that passive funds have an incentive to focus their efforts on improving corporate governance across their portfolio as a whole, rather than on firm-specific improvements. Where 'a passive investor can identify governance "best practices" that are likely to reduce the risk of underperformance with little firm-specific information', that approach 'can be deployed across a broad range of portfolio companies'.[116] Combined with their scale, passive investors have 'a comparative advantage in using voting and engagement to address issues such as corporate governance'. While their holdings generate significant fees and hence resources for engagement, the cost of engagement is likely to be low, 'especially if a fund sponsor supports a particular governance reform across its entire portfolio', and given that 'passive investors are likely to be pivotal voters', this will allow them to exercise informal influence in many cases.[117]

Kahan and Rock agree that passive funds have very strong incentives to increase 'corporate value' through informed engagement and voting.[118] The primary incentive is direct:

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subjects that they expect to appeal to such investors, such as gender diversity on boards and climate change disclosure'.

[113] Lund (n 101 above) 525.

[114] Fisch et al (n 96 above) 37.

[115] ibid 30–32.

[116] ibid 37.

[117] ibid 38–40.

[118] M Kahan and E Rock, 'Index Funds and Corporate Governance: Let Shareholders be Shareholders' (2020) 100 *BU L Rev* 1771, 1779. The fund is an entity to which management is provided by an external adviser, normally identified with the fund family, and which hires portfolio managers. The investment adviser will normally make all voting decisions, even in active funds, and this function is normally centralised in an in-house stewardship or proxy voting group.

higher share prices lead to higher returns to portfolios which brings in more assets under management which produces higher fees. Since indexers hold large numbers of shares, they have a good incentive to cast informed votes, knowing that they are likely to influence investee companies. The costs of becoming informed will be met out of the additional fees that flow from higher portfolio value. Moreover, with very large shareholdings and with customers who hold for long periods of time, these higher fees will be received over a long period of time.[119] However, like Fisch et al, they recognise that passive investors who hold shares in multiple companies are likely to focus on 'issue-specific' rather than 'company-specific information', because a focus on the former will allow them to enjoy 'economies of scope', as they will already have considered particular issues in relation to other portfolio companies. This, they say, 'may explain why some investment advisers have developed detailed voting guidelines on many recurring issues',[120] and their lack of company-specific focus is confirmed by evidence on voting which 'suggests that it is often governed by published policies that apply equally to all companies'.[121]

The literature highlights three main areas in which passive funds might engage with investee companies: system-level issues, specific externalities and, as we have just seen, corporate governance.

i. System-level Issues

In arguments echoing Hawley and Williams two decades earlier, Condon claims that passive funds are no longer 'rationally reticent'; instead, they put forward proposals with the aim of improving returns across the whole portfolio by addressing systemic risk (in the climate context, this includes transition, physical and liability risks) that the investor cannot avoid through diversification. Climate risk 'is substantially generated by the publicly traded companies within institutional investors' own portfolios', and so is a systemic risk over which investors 'can uniquely exercise control'.[122] Gordon, too, argues that index funds ought to focus not on firm-level engagement but on actions that seek to 'mitigate systematic risk, which

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[119] ibid 1787–88.

[120] ibid 1800–1801.

[121] ibid 1797.

[122] M Condon, 'Externalities and the Common Owner' (2020) *Washington Law Review* 1 at 18.

most notably would include climate change risk, financial stability risk, and social stability risk'.[123]

However, whilst indexers might support firm-specific activism on climate matters (led by others), and might also take part in collective action to push for appropriate regulation, most of their activities in this area involve pushing companies to disclose information, including compliance with private standards such as those produced by the Sustainability Accounting Standards Board and Taskforce on Climate-Related Financial Disclosures (TCFD).[124] So the big indexers are very publicly putting pressure on companies to comply with TCFD,[125] and putting pressure on governments to require companies to carry out environmental and human rights due diligence.[126] What explains this strategy of focusing on information production and disclosure?

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[123] J Gordon, 'Systematic Stewardship' *ECGI Law Working Paper No 566/2021*. In modern portfolio theory, systematic risk is risk that cannot be diversified away, contrasted with firm-level, idiosyncratic risk, which can.

[124] For an overview of TCFD, see A Johnston, 'Climate-Related Financial Disclosures: What Next for Environmental Sustainability?' *University of Oslo Faculty of Law Research Paper No 2018-02*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3122259.

[125] The largest indexers, along with many other institutional investors, have expressed their support for the TCFD Recommendations: see https://www.fsb-tcfd.org/supporters/. For example, BlackRock asked companies to report under TCFD and SASB in January 2020, and notes that 'it seeks to understand how a company's strategy, operations and long-term performance would be affected by the transition to a low-carbon economy'. It adds that 'all investors need a clearer picture of how companies are managing sustainability-related risks and opportunities'. In 2020, it flagged up 244 companies as making insufficient progress on climate risk, whether in terms of their business models or disclosures, voting against 53 (22%) of them and putting the remaining 191 on watch: BlackRock, *Our Approach to Sustainability: BlackRock Investment Stewardship* (July 2020) 4, 7 and 17. In November 2020, the Investment Association, which represents investment managers with £8.5 trillion AUM, reaffirmed its position that FTSE-listed companies should report in line with TCFD, committed to engaging with them to improve the quality of their disclosures, and called on the government to amend company law to require all large UK incorporated companies, whether public or private, to report in line with TCFD: see The Investment Association, 'Investment Association Position on Climate Change' (11 November 2020) 6–7. The UK Treasury has published a 'roadmap' towards mandatory TCFD-aligned disclosures, which would apply to companies as well as asset managers, life insurers and pension schemes: see HM Treasury, 'A Roadmap towards mandatory climate-related disclosures' (November 2020). In December 2020, the FCA announced that the UK Listed Rules (9.8) would require premium listed companies to include a statement in their annual financial report setting out whether and where they have made TCFD-compliant disclosures, and if they have not, explaining why and setting out a time frame for doing so. These rules will apply to accounting periods beginning on or after 1 January 2021, so the first annual financial reports including disclosures should appear in Spring 2022: see FCA, 'Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations' *Policy Statement PS20/17* (December 2020).

[126] See eg Investor Alliance for Human Rights, 'The Investor Case for Mandatory Human Rights Due Diligence', https://investorsforhumanrights.org/sites/default/files/attachments/2020-04/The%20Investor%20Case%20for%20mHRDD%20-%20FINAL_3.pdf, signed by 105 institutional investors with US$5 trillion of AUM calling on 'all governments to develop, implement, and enforce mandatory human rights due diligence requirements for companies headquartered or operating within their own jurisdictions or, where appropriate, to further strengthen these regulatory regimes where they already exist'.

Condon advances a number of possibilities, all of which would benefit a passive investor with a portfolio focus: it might encourage governments to regulate when they see company projections; it might enable firm-specific targeting by climate activists; it may lead to 'regulation by revelation' (elimination of undesirable practices by disclosure alone); or 'disclosure may lead to a decline in the value of fossil fuel industry stock, which in turn will limit present capital expenditures on the exploration and development of reserves'.[127] Others, such as Gordon, argue that sustainability disclosures 'lead to better capital market pricing of the risks in question, which is both informative and disciplinary, and deepens the fund's ability to evaluate systematic risk associated with a particular company's activities'.[128]

However, sustainability disclosure regimes such as TCFD are at a comparatively early stage in their development, and, to the extent that it is being disclosed, scenario analysis is a long way from being comparable and capable of being used to price shares.[129] Moreover, whilst actively managed funds within the same corporate group might be able to make use of and profit from the information, it is unclear why passive funds would want to contribute to assisting third party active shareholders to contribute to the public good of more accurate share prices and engagement aimed at greater sustainability. One possibility is that passive funds desire to avoid the disorderly transition which would occur if climate risks were suddenly priced in (this was one of the goals of the drafters of TCFD), leading to gyrations in asset prices and outflows that significantly reduce fee income. Yet it is also far from clear that active funds will actually make use of this information in their share trading and activism, as hedge funds continue to prioritise short-term shareholder value as discussed above, whilst active funds are

[127] Condon (n 122 above) 39.

[128] Gordon (n 123 above) 9.

[129] In *The Green Swan*, 'the development of forward-looking approaches grounded in scenario-based analyses' is described as an 'epistemological break' within the financial community, as it is increasingly recognised that backward-looking risk assessment models cannot address future systemic risk of climate change, not least because 'physical and transition risks… interact with complex, far-reaching, nonlinear, chain reaction effects'. It recognises the limits of scenario analysis arising out of 'the deep uncertainties involved' (hence the notion of Green Swan or 'climate black swan') so that 'no single model or scenario can provide a full picture of the potential macroeconomic, sectoral and firm-level impacts caused by climate change'. See Bank for International Settlements, *The Green Swan* (January 2020) 1, 3 and 10. *The Green Swan's* pessimistic conclusion about scenario analysis is that 'although the generalised use of forward looking, scenario-based methodologies can help financial and economic agents to better grapple with the long-term risks posed by climate change, they will not suffice to "break the tragedy of the horizon" and induce a significant shift in capital allocation towards low-carbon activities'. Whilst they might be useful for firms to explore their underlying vulnerabilities, they can become operational only in the context of a system-wide transition: ibid 23–24.

being squeezed by indexers, potentially leaving a significant stewardship gap in relation to sustainability.

This leaves one last explanation for passive investor activism in relation to sustainability disclosures: it brings these issues more forcefully to the attention of the regulatory authorities, and so acts as a complement to collective demands for regulators to implement legally enforceable due diligence regimes or TCFD compliance obligations. This makes sense from three perspectives. First, passive investors are exposed to high levels of climate-related risk which 'remain unhedgeable as long as system-wide transformations are not undertaken'.[130] Hence, passive investors need to put pressure on governments to change the whole system in order to ensure the long-term viability of their investment model. Secondly, this type of action might enhance their reputation with certain types of investors, especially millennials who are viewed as a key future market,[131] and create a 'halo effect' by engaging on ESG matters.[132] Thirdly, and more cynically, activism in relation to disclosure standards is akin to the CSR activities of companies, creating the impression that these investors are fulfilling their social responsibilities, potentially heading off the threat of regulatory action to limit their power[133] as debate increases about the deleterious effects of common ownership on competition.[134]

ii. Specific Externalities

Another parallel to Hawley and Williams' universal owner approach can be found in Enriques and Romano's argument that portfolio value maximising indexers might press for emissions reductions, making their efforts as visible as possible in order to improve the group's reputation, potentially attracting investors and assets.[135] Condon goes further, arguing that indexers tracking an entire market rather than just one industry should rationally act to internalise intra-portfolio negative externalities, provided that its share of the costs to the externality-creating firms is lower than the benefits that accrue to its entire portfolio from the

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[130] *The Green Swan* (n 129 above) 4.

[131] M Barzuza et al, 'Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance' (2020) 93 *Southern California Law Review* 1243.

[132] P Jahnke, 'Ownership Concentration and Institutional Investors' Governance through Voice and Exit' (2019) 21(3) *Business and Politics* 327, 341.

[133] Bebchuk and Hirst (n 106 above) 2073.

[134] For a recent overview of the anticompetitive effects of common ownership, see M Schmalz, 'Recent Studies on Common Ownership, Firm Behavior, and Market Outcomes' (2021) 66(1) *Antitrust Bulletin* 12.

[135] L Enriques and A Romano, 'Rewiring Corporate Law for an Interconnected World' *ECGI Law Working Paper No 572/2021* 23–25.

elimination of the externality.[136] In other words, indexers should engage with companies with the aim of protecting and enhancing the value of the portfolio in the long term by forcing companies to reduce carbon emissions. In support of her argument, she cites recent examples of climate change activism, with asset managers acting collectively, for example, to outline expectations that portfolio companies should not lobby against carbon regulation[137] and to use private persuasion to induce major oil companies to set targets to reduce total emissions impact and to link executive pay to these targets.[138]

Such activism is no doubt welcome, but is there potential for indexers to go further on externalities? After all, reducing externalities is a major way in which companies can become more sustainable, and so contributes to the goals of the stewardship agenda. Enriques and Romano are doubtful, noting that, despite very wide diversification, 'institutional investors only have stakes in one subset of the economy. Thus, they do not internalize the losses imposed on non-portfolio companies, final consumers, and others'.[139] Even this may be expecting too much of indexers: will cost-constrained parent groups spend money trying to identify and distinguish which externalities should be discouraged, because they impact on portfolio valuations, and which fall on consumers and citizens, who likely would never have been savers in the first place? Even at the more enlightened end of indexing, where companies are encouraged to mitigate certain impacts, there is no obvious focus on intra-portfolio externalities as opposed to negative externalities more generally.[140] Condon highlights that passive investors do not have sufficiently large stewardship and engagement teams realistically to be able to track and quantify intra-portfolio externalities, so it makes more sense to focus on issue-specific engagement that can be scaled up.[141] This means that, headline issues like oil firms' carbon emissions aside, firm-specific externalities are likely to remain the preserve of active

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[136] Condon (n 122 above) 6.

[137] ibid 7.

[138] ibid 20–21.

[139] Enriques and Romano (n 135 above) 27. Condon (n 122 above) also notes (at 68) that the incentive to internalise is limited to costs that affect portfolio value, and does not extend to costs that affect others.

[140] For example, in its April 2022 'Global Corporate Governance and Responsible Investment Principles' at 31, Legal & General Investment Management (LGIM) calls for investee companies to carry out a 'dynamic risk-mapping exercise' in relation to environmental and social risks, and then disclose policy statements which commit to managing and mitigating 'risks [that] have been identified for the business'. That holistic approach should cover 'business operations that either can be considered exposed to environmental and social-related risks, and/or that may produce negative externalities'.

[141] Condon (n 122 above) 69.

investors, corporate social responsibility initiatives, or, where regulation is lacking, be left where they fall.

iii. Corporate Governance

In their public communications, the large indexers emphasise that they 'advocate for robust corporate governance and the sound and sustainable business practices core to long-term value creation for our clients'[142] or 'speak with thousands of executives and board members each year to understand how they intend to deliver enduring value to investors'.[143] So how does this commitment to 'long-term' or 'enduring' value creation translate into engagements on corporate governance matters?

Numerically, BlackRock's ESG engagements are dominated by 'governance' engagements,[144] and if we look at its proxy guidelines for Europe, we find a large investor committed to most, if not all, of the conventional shareholder value mechanisms commonly associated with short-termism and social and environmental externalities. Only a brief flavour can be given here. It begins by noting that the 'majority of our equity investments are made through indexed strategies, so our clients are going to be invested as long as the companies are in the index'.[145] As for takeovers, which will normally lead to companies being removed from the index, BlackRock is clear that it does not support anti-takeover defences,[146] but does not otherwise mention its approach to takeovers. On remuneration, BlackRock supports linking it to 'strategy and long-term value creation', assessed over a three- to five-year horizon, but is hardly encouraging of ESG-linked incentives. It notes that, if they are used, ESG-type criteria should be linked to material issues, and be quantifiable, transparent and auditable. Moreover, companies should offer an explanation if financial issues make up less than 60 per cent of performance measures.[147] Finally, BlackRock 'usually approves' share repurchases on the basis that they are 'generally supportive of the share price'.

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[142] BlackRock, *Investment Stewardship Annual Report* (September 2020) 2.

[143] Vanguard, *Investment Stewardship 2020 Annual Report* 1.

[144] BlackRock reports 1,230 environmental engagements, 870 social engagements and 2,835 governance engagements in 2020: see BlackRock, *Our Approach* at 8.

[145] BlackRock, *Proxy voting guidelines for European, Middle Eastern, and African securities*, effective as of January 2021, 3.

[146] ibid 9.

[147] ibid 11–15.

Vanguard's European proxy voting policies are not dissimilar. Its policy on mergers and acquisitions is more detailed, with funds voting on a case-by-case basis, albeit that financial and market considerations weigh very highly.[148] On remuneration, alignment of pay with performance is 'mainly assessed through analysis of three-year total shareholder return', whilst structurally pay 'should be aligned with the company's long-term strategy and should support pay-for-performance alignment'.[149] Long-term performance is assessed 'ideally for a period of three years or more',[150] with relative performance in terms of TSR strongly emphasised.[151] Finally, on share repurchases, Vanguard states that funds will typically vote to authorise share repurchases.[152]

C. The Implications of the Rise of Indexers for Long-Termism and Sustainability

Overall, then, as we saw in sections V.Bi and iii, these indexers very visibly press for sustainability-related disclosures, but when it comes to engaging with companies on matters of governance, their approach tends very strongly towards shareholder value. Where takeovers are proposed, it seems likely that BlackRock, which lacks company-specific information, will simply accept any bid that offers a significant premium over market price, even if the effect is to remove companies from the index. This may deliver a short-term gain for BlackRock's 'long-term' indexed investors, but, as Strine highlights, the money still has to go somewhere.[153] In the case of an index fund, it will simply be reallocated across the recomposed index, regardless of whether the change of composition of the index presents a better or worse prospect for the long-term investors. Vanguard's position is slightly more nuanced, but beyond a reference to taking account of 'effect on stakeholders, if relevant to long-term value', there is no evidence of considering wider social costs or other externalities which might impact on

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[148] Vanguard, 'Summary of the proxy voting policy for UK and European portfolio companies', effective 1 December 2020, 11: 'The strategic, operational and financial benefits (and drawbacks) of the transaction are evaluated based on a number of criteria, including… Board and management oversight of the deal process; Valuation; Prospects for long-term enterprise value under a standalone/alternate scenario; Market reaction; The surviving entity's governance profile; Fairness opinions from independent financial advisers; Effect on stakeholders, if relevant to long-term value'.

[149] ibid 14.

[150] ibid.

[151] ibid.

[152] ibid 22.

[153] Strine (n 79 above).

the portfolio over the longer term. On remuneration, BlackRock hardly looks like an investor committed to incentivising management to pursue long-term social and environmental sustainability. Its focus on a 3–5 year time horizon is a purely conventional shareholder value approach and is also likely to undermine the quality of its much-trumpeted support for TCFD disclosures: incentivising executives in investee companies to keep the share price high during that time period makes it less likely that they will disclose scenarios that will lead to significant (negative) share repricing to reflect physical and transition risks. Likewise, there is no real pressure from BlackRock for companies to link executive pay to issues identified in their sustainability strategies, whilst Vanguard does not encourage aligning pay with anything other than relative total shareholder return.[154]

We might wonder whether the priority given to shareholder value governance by these two institutions can be explained by reference to their American origin. UK and Ireland-based LGIM is committed to 'inclusive capitalism' and promises that its index funds will benefit from 'meaningful dialogue with corporate boards and executives on matters that impact long-term financial returns'.[155] In 2021, it managed £1.3 trillion of assets on behalf of individuals and institutions, of which around £430bn was indexed. Like Vanguard and BlackRock, its 'statement of principles' places emphasis on gender and racial diversity on the Board, and it demands TCFD and other sustainability disclosures from investee companies.[156] However, it goes further than its US counterparts in a number of respects. First, and this may be driven by the recent evolution of the UK Corporate Governance Code, it encourages investee companies to 'embrace the value of their workforce' and establish an 'appropriate structure' for employee voice.. Going further, it encourages all companies to pay employees a living wage; to ask their suppliers to do the same; and to make annual disclosures about how employees are treated and whether all are offered the opportunity to elect to work at least 15 hours per week. Secondly, it encourages companies 'that are exposed to high levels of… ESG risks [to] include relevant and clearly measurable targets that focus management on mitigating these risks' in the annual incentive part of their remuneration arrangements. Thirdly, it encourages dynamic risk-mapping of sustainability risks and opportunities as mentioned above.[157] At the same time, large swathes of its policy remain straightforward demands for shareholder value – long-term

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[154] ibid 15.

[155] See https://www.lgim.com/uk/ad/capabilities/index-funds/#esg-integration.

[156] See LGIM (n 140 above) 34.

[157] Ibid 5, 14, 20-21 and 31.

incentive plans should have a minimum three year assessment period making up at least 50 per cent of executive pay, with 'at least one measure that is linked to shareholder returns' alongside Board-determined KPIs that 'reflect the company's ESG risks as well as target opportunities'; [158] share buybacks are viewed as 'a flexible way to return cash to shareholders';[159] M&A proposals will be supported where they 'create value for investors over the long term';[160] and it is opposed to poison pills that 'protect the company from market pressures, which is not in investors' best interests'.[161] LGIM, then, tempers its pursuit of shareholder value with some stakeholder and sustainability demands, bringing it more into line with the European discourse around corporate governance and sustainability. At the same time, whilst its demands are welcome, it is difficult to see them leading to wholesale transformation in the way large companies are governed.

VI. Conclusion

As we saw in section I above, the policy of relying on institutional investors to solve the corporate governance problem of the day has been remarkably consistent, as has the failure of the policy to reorient corporate governance. The focus is now on institutional investors to steer companies towards prioritising long-termism and sustainability. Whilst there was a period of optimistic commentary about their potential contribution, as we saw in section II, along with a gradual ramping up of pressure and legal obligations with the post-global financial crisis introduction of the Stewardship Code and SRD II, as seen in section III, there is little evidence that these measures have been effective in steering companies towards more long-termism and sustainability. The pressure for short-term returns, identified in section IV, has led to rapid expansion of flows into hedge funds and greater activism aimed at short-term shareholder value. Meanwhile, the exponential growth of indexers described in section V is unlikely to contribute to this goal either, as they push for sustainability disclosures that they cannot act on, but otherwise largely support conventional shareholder value, itself a key driver of unsustainability.

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[158] Ibid 22.

[159] Ibid 28.

[160]Ibid.

[161] Ibid 29.

The polarisation of institutional investment between activist funds that push for higher payouts and passive funds that compete on cost and engage in an issue-specific way across their portfolio seems likely to continue. The result is likely to be indexers trying to ensure that sufficient sustainability-related information is available so that active investors can incorporate it into the share price. Yet this is likely to fall on deaf ears as hedge funds focus on helping their clients meet their short-term financial obligations.

Both the Financial Conduct Authority (FCA) and the Financial Reporting Council (FRC) appear to have a good understanding of the implications of the rise of indexers. An FCA research note recognises that, although it has not been conclusively proven either way, the massive growth of passive investment may reduce the amount of informed trading, which in turn may affect market quality, especially as regards pricing. Likewise, it recognises that 'the growth of passive investing may shift shareholder monitoring towards routine engagement and away from deep engagement'.[162] That certainly appears to be borne out by our brief exploration in the final section of the proxy voting policies of BlackRock and Vanguard, which are highly generic. The FCA cites evidence that the routine engagement that characterises indexers may lead to increases in firm value, something which is unsurprising, as all the proxy voting policies are straight out of the shareholder value playbook. However, there is much more doubt about whether this 'routine engagement', combined with encouragement to comply with disclosure regimes such as TCFD, will steer companies towards long-termism and sustainability, which are the stated goals of the SC 2020. In a joint paper, the FRC and FCA note that there is value in both routine engagement and the 'idiosyncratic issuer-specific' focus of actively managed funds, but note that 'the balance of engagement strategies observed may influence overall market quality'.[163] There is no reference in this discussion paper to whether the balance of engagement strategies might impact on the goals of the Stewardship Code, something for which the FRC is responsible.

It is clear that SC 2020 strives to accommodate indexers and their issue-specific engagements by expecting signatories to 'identify and respond to market-wide and systemic risks to promote a well-functioning financial system'.[164] This is a long way from the original conception of stewardship, as evident in the Walker Report and SC 2010 and 2012, which

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[162] James et al (n 91 above) 9.

[163] FRC and FCA, 'Building a Regulatory Framework for Effective Stewardship' DP 19/1 (January 2019) para 5.21.

[164] SC 2020 (n 3 above) Principle 4.

focused on the role of IIs in ensuring the quality of the leadership team and giving 'broad endorsement of the company's principal strategies and objectives'.[165] The SC 2020 also expects signatories to 'systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change'.[166] Here again, the expansion beyond the original corporate governance focus of Walker and the early iterations of the Stewardship Code is clear, as is the influence of SRD II. However, early evidence is that signatories tend simply to 'list collaborative initiatives to which they are signed up', whilst 'many reports fell short of meeting the requirements of the Code' in relation to the integration of sustainability or responsible across 'the organisation as a whole'.[167]

In many ways, the disappointing effect of SC 2020 only serves to highlight the limits of soft law, even where the 'comply or explain' obligation is embedded in law, as it has been since SRD II. As climate change becomes an ever more pressing issue, and as institutional investors continue to fail to play their part in steering companies in that direction, regulatory intervention becomes more likely, as Charkham recognised so clearly in the 1980s. The continued failure of stewardship is likely to see greater attention being paid to other, company side reforms (at least in the EU, even if not in post-Brexit UK). As noted in the introduction, this process is already under way, with the recent publication of proposals for EU directives mandating corporate sustainability due diligence and corporate sustainability reporting,[168] two instruments that have significant potential complementarities.[169]

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[165] See Walker Review (n 6 above) para 5.30.

[166] SC 2020 (n 3 above) Principle 7. For further discussion of SC 2020, see Chapter 3 below, by Chiu.

[167] See FRC, 'The UK Stewardship Code: Review of Early Reporting' (September 2020) 21 and 28.

[168] See n 10 above.

[169] For recommendations as to how due diligence could usefully be linked to the development and implementation of a sustainability strategy, see A Johnston et al, 'Corporate Governance for Sustainability' (January 2020) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3502101.