THE UK STEWARDSHIP CODE 2010-2020
From Saving the Company to Saving the Planet?

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March 2020

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University of Oxford and ECGI

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The United Kingdom introduced a Stewardship Code in 2010, followed by a slightly revised iteration in 2012 (the “first version” of the SC). It was premised upon the corporate governance advantages of engagement between institutional investors and corporate boards and was designed to redress what were perceived to be the weaknesses in the model of the monitoring board as revealed during the financial crisis. In short, the institutions were to monitor the monitor. The first version was officially branded as ineffective in a government appointed reviews at the end of 2018. It was recommended that the first version should either be abandoned or revised so as to focus more on the results of engagement. Surprisingly, the Financial Reporting Council chose not only to revise the SC in the hope of making it effective within the engagement framework, but also to expand the Code’s concept of stewardship so as to embrace environmental, social and governance matters (including climate change). This “second version” came into effect at the beginning of 2020.

The purpose of this paper is to assess the chances of the second version being more successful than the first. It begins by examining the most plausible reasons for the failure of the first version, by reference to the capacity and the incentives of institutional investors to discharge the engagement function which the first version cast upon them. It concludes that the incentives and capacities were weak. Turning to predictions for the second version, it concludes that, in relation to engagement as envisaged in the first version, the second version has not effectively addressed the causes of the weakness of the first version. However, in relation to ESG factors, especially climate change, there are reasons to expect a more positive impact from the second version, mainly because governmental policy has increased the reputational incentives for institutions to exercise stewardship in this area. These reputational incentives may also be supported by changes in investors’ preferences. Overall, the second version may turn out to operate ing along the same lines as other changes in society rather than as an isolated reform, as with the first version. However, this optimistic prediction is conditional upon the continuance of the governmental policy and social changes which support the second version of the SC.

Keywords: stewardship, institutional shareholders, engagement, reputational incentives, shareholder capacity, environmental impact

JEL Classifications: L20, K22, K32, M14 and M48

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CONTENTS

1. Introduction

The UK adopted a Stewardship Code (SC) in the wake of the financial crisis of 2007-2009, as a result of a recommendation in the Walker Review.[1] The first version of the Code, which appeared in 2010, was hastily put together by the Financial Reporting Council (FRC), the quasi-governmental agency which Walker recommended should take charge of the drafting and implementation of the SC. It was very substantially based on the "statement of principles" which the representative body of the institutional shareholders itself had produced nearly twenty years earlier and had revised at various times subsequently.[2] The 2002 version of this statement had constituted a temporarily successful, but ultimately unavailing, manoeuvre on the part of the institutional shareholders to head off an earlier proposal for an official SC made by the Myners Review.[3] Perhaps because of its origins the 2010 SC was quickly revised in 2012, with substantial detail added, but in a way which did not alter its fundamental orientation.[4] These two iterations of the SC are referred to in this chapter cumulatively as "the first version" of the UK SC.

There was no further version of the SC until the current ("second") version which came into force at the beginning of 2020.[5] Given that its companion, but longer established, Code - the UK Corporate Governance Code (CGC) - was revised from its 2012 version three times in the same period, the longevity of the first version of the SC is, perhaps, surprising. As we shall see below, the FRC appears to have devoted its efforts during this period to an ultimately unsuccessful attempt to make the first version "work". In December 2018 the Kingman Review of the FRC concluded that the Code was "not effective in practice"[6] The FRC was criticised

*Senior Research Fellow, Commercial Law Centre, Harris Manchester College and Professor of Corporate Law Emeritus, both University of Oxford, and ECGI. I am grateful for their comments to the participants in the Commercial Law Centre/National University of Singapore conference on corporate externalities, held in January 2020, and in particular to Professor Arad Reisberg for very helpful follow-up from this conference. An edited version of the paper will be published as a chapter in *Global Shareholder Stewardship: Complexities, Challenges and Possibilities (Dionysia Katelouzou and Dan W Puchniak (eds) , Cambridge University Press, forthcoming).*

[1] David Walker, *A review of corporate governance in UK banks and other financial industry entities*, November 2009.

[2] Institutional Shareholders' Committee, *The Responsibilities of Institutional Shareholders in the UK*, 2009, originally published in 1991.

[3] Paul Myners, *Institutional Investment in the United Kingdom: A Review*, 2001.

[4] "This edition of the Code does not change the spirit of the 2010 Code." (FRC, *The UK Stewardship Code 2012*, p 2).

[5] FRC, *The UK Stewardship Code 2020*.

[6] FRC, *Independent Review of the Financial Reporting Council*, 2018, Summary, paras 12 and 13. The Review was critical of the FRC as a whole and proposed that it be replaced by standard, statutory regulator, which is likely to happen in 2020. At the time of writing the FRC is still a hybrid, originally established by the accounting and auditing professions as a private body, the government now appoints its Chair and Deputy Chair and its powers are largely derived from delegation to it by the government. The FRC is funded by the audit profession, who are required to contribute under the provisions

for focussing its compliance efforts on assessing the quality of the stewardship policies, which signatories to the SC are required to produce, whilst passing lightly over the implementation of those policies by the asset owners and asset managers which signed up to the Code. It concluded that if a change of focus towards outcomes and effectiveness "cannot be achieved, and the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition."

Given its reputational investment in the SC, it is perhaps not surprising that the FRC did not choose the abolition option. The second version of the Code gives full weight to the Kingman Review's criticism about effectiveness. The "Guidance" which surrounded the Principles in the first version has been replaced by, often very detailed, "Reporting Expectations", designed to reveal what signatories have done by way of stewardship. However, there is a more significant contrast between the first and second versions of the SC than the addition of outcomes to the FRC's assessment exercise. The second version contains a much broader concept of stewardship and of the techniques to be deployed to further it than does the first version. In effect, the FRC doubled down on its bets: it is now committed to producing a code which operates not only effectively but also over a much broader set of stewardship goals than previously. Given the acknowledged failure of the first version, the question this chapter seeks to address is whether the second version is likely to fare better. However, it is necessary first to put some detail on the contrast between the goals of the first and second versions.

2. The goals of stewardship in the two versions

The first version of the SC can be seen best as an adjunct to the CGC. Since its introduction in the wake of the Cadbury Committee Report of 1992[7] the CGC had been based on the model of a "monitoring" board, as shown by the increasing emphasis over the various versions of that Code on the role and functions of independent non-executive directors (NEDs). Their role was to ensure the loyalty of the executive management of the company to the shareholders' interests, not only in the obvious sense of handling overt conflicts of interest, but across the general management of the company.[8] However, the Walker Review concluded in 2009 that in

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of the Companies Act 2006 and, with the agreement with HM Government, by other groups subject to, having regard to, or benefiting from FRC regulation." See, https://www.frc.org.uk/about-the-frc/funding. This funding arrangement is likely to continue in place under the new arrangements.

[7] *Report of the Committee on the Financial Aspects of Corporate Governance* (London, Gee Publishing) 1992.

[8] Ibid, paras 4.4 - 4.6. "Non-executive directors have two particularly important contributions to make to the governance process as a consequence of their independence from executive responsibility … The first is in

the run up to the financial crisis, NEDs had failed. Their performance was assessed as "seriously inadequate". The Review identified "above all the failure of individuals or of NEDs as a group to challenge the executive."[9] The implication of this analysis for shareholders was stated to be that "the board and director shortcomings discussed in the previous chapter would have been tackled more effectively had there been more vigorous scrutiny and engagement by major investors acting as owners."[10] For its concept of "engagement" the Walker Review relied on the institutional investors' statement of principles. Engagement procedures would involve arrangements "for monitoring investee companies, for meeting as appropriate with a company's chairman, SID [senior independent director] or senior management, a strategy for intervention where judged appropriate and policy on voting and voting disclosure"[11] So, engagement was a strategy based on "voice"; in fact, "exit" was not thought to count as engagement. Selling shares might send a signal to management, "but in many cases such a signal may be disregarded or will be relatively ineffective as an influence. Even if it is seen as conveying a strongly negative message, it is more likely to be a blunt instrument than one targeted at a specific change in company leadership or direction . . . a situation in which the influence of major shareholders in their companies is principally executed through market transactions in the stock cannot be regarded as a satisfactory ownership model."[12]

Walker was a review of the governance of financial institutions, but his recommendations were applied across the board, as he apparently expected, even though the evidence suggested that non-financial corporate governance had performed moderately well in the crisis.[13] Accepting this extension, it was not surprising that the engagement approach was carried through into the first version of the Code. The first sentence from the Preface of the 2010 SC stated: "The Stewardship Code aims to enhance the *quality of engagement* between institutional investors and companies to help improve long-term returns to shareholders . . .", whilst the second sentence defined engagement as "pursuing purposeful dialogue on strategy, performance and the management of risk." The high expectations held of engagement were revealed especially in the Guidance to Principle 3 ("Institutional investors should monitor their investee

reviewing the performance of the board and of the executive. . . . The second is in taking the lead where potential conflicts of interest arise."

[9] Above n 1 at 4.1 and 4.3.

[10] Ibid, 5.11. There were many board-centred reform recommendations as well, most of which found their way into the CGC.

[11] Ibid. 5.14.

[12] Ibid. 5.6-5.7.

[13] Brian Cheffins, "Did Corporate Governance "Fail" During the2008 Stock Market Meltdown? The Case of the S&P 500" (2008) 65 *The Business Lawyer* 1.

companies") in the 2012 iteration of the first version: "Institutional investors should endeavour to identify at an early stage issues that may result in a significant loss of investment value." Engagement was clearly expected to be more than a reaction to problems which were already well developed and would require continuous, close monitoring of the company's development, at least at a high strategic level. The first version could as well have been called an Engagement Code as a Stewardship Code, as is recognised in the Directive amending the Shareholder Rights Directive, which was heavily influenced in the stewardship area by the first version. The Amending Directive[14] uses the term "stewardship" only once (in a recital) whereas the words "engage" or "engagement" appear 18 times in the recitals and 11 times in the body of the Directive.

The second version of the SC clearly moves away from an almost exclusive focus on engagement as the recommended version of stewards. A glance at the structure of the 2020 Code (as it applies to asset owners and asset managers)[15] shows a significant development. The second version has four sections, of which only one is labelled "Engagement" (Principles 9-11). There are two substantial new segments labelled "Purpose and Governance" (Principles 1-5) and "Investment Approach" (Principles 6-8). Even if we throw the fourth section ("Exercising Rights and Responsibilities" with a single Principle 12) in with the Engagement Section, on the grounds that for asset managers and owners it principally involves voting, which was covered in the first version of the SC, non-engagement principles now outweigh the engagement principles by 8 to 4. Something is clearly going on beyond the initial concept of stewardship as engagement.

The techniques of stewardship are now defined in a more expansive way, so that, although engagement is still given emphasis, it is only one among a number of recommended procedures: "Stewardship activities include investment decision-making, monitoring assets and service providers, engaging with issuers and holding them to account on material issues, collaborating with others, and exercising rights and responsibilities."[16] In particular, buy and sell decisions ("investment decisions") are given apparently equal weight with engagement, so that monitoring may be done as much for this purpose as for engagement. The same point

[14] Directive (EU) 2017/828. On the other hand, it is perhaps equally disingenuous to place these shareholder obligations in a Shareholder *Rights* Directive.
[15] The 2020 Code now has a separate, and shorter, set of principles for "service provides" (for example, proxy advisers and investment consultants), which I ignore in this chapter. It also now covers investments in "fixed income, bonds, real estate and infrastructure". I shall ignore this extension also.
[16] 2020 Code p 7.

emerges from the very first sentence in the 2020 SC: "Stewardship is the responsible allocation, management and oversight of capital . . ." If engagement is one technique for responsible management and oversight of capital, entrance and exit decisions are another, whilst allocation seems to refer primarily to entrance and exit decisions.

Equally significant is a shift of focus so as to embrace, not just the fortunes of individual investee companies, but the share market as a whole. "The Code also recognises that asset owners and asset managers play an important role as guardians of market integrity and in working to minimise systemic risks as well as being stewards of the investments in their portfolios."[17] Principle 4 puts this introductory statement in normative form: "Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system."[18]

It is suggested that what is driving the above developments is the heavy emphasis placed on environmental (especially climate change), social and governance factors (ESG) in the second version as compared with the first version. The 2012 SC contained a fleeting reference to ESG factors, but most people would probably have missed it.[19] By contrast, the second version insists that "Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities" and that "Signatories should explain how information gathered through stewardship has informed acquisition, monitoring and exit decisions . . ."[20] The aim is clearly to mainstream ESG factors into stewardship, not simply to present them as an add-on. The same can be seen in the definition of market-wide factors. The definitions attached to Principle 4 mention specifically that systemic risks include "climate change".

The references to climate change are particularly important in explaining the development of the second version. Achieving climate change goals is likely to require a concerted effort by businesses across the economy, so that co-opting institutional investors to support market-wide standards is likely to be as important as a focus on individual companies. Of course, the businesses of some types of company are likely to be particularly threatening from an environmental perspective, but engagement may not be the optimum strategy for moderating that threat. The result may simply be to reduce the financial attractiveness of those businesses.

[17] SC 2020, p 4.
[18] Though, following modern fashion, the SC uses the indicative rather than the imperative mood.
[19] It was to be found at the end of the final sentence of the first paragraph of guidance to Principle 4.
[20] Principle 7 and Reporting Expectation – Outcome.

From the point of view of those entrusting their savings to asset owners and asset managers, it is not ideal to encourage investment in those companies in order to bring about their full or partial demise. Not investing, by contrast, may put pressure on those companies by raising their cost of capital, without involving financial sacrifice of the hard-earned savings of potential or actual pensioners. Pace Walker, non-engagement stewardship strategies may be preferable here.

Having set out an analysis of the origins and aims of the two versions of the SC, I now turn to the central question of the likelihood of the second version achieving its goals. I approach this question in two stages. First, an analysis of the reasons for the failure of the first version. Second, taking account of the reasons for that failure, an assessment of whether the second version is likely to fare better.

3. The failure of the first version of the SC

What underlay the Kingman Review's assessment of the ineffectiveness of the first version was the view that the level of engagement on the part of institutional investors with portfolio companies had not significantly increased since 2010. This view was widely shared among those knowledgeable in the field, though it has to be said that Kingman carried out no empirical studies which might have tested the truth of the underlying proposition. What it focussed on instead was the FRC's inability to demonstrate that levels of engagement had increased since 2010, because it focussed its assessments on signatories' engagement policies rather than their reports of the outcomes of engagement. Given the lack of FRC assessment, these reports were characterised as "boilerplate". While it is not completely clear what the Review meant by this term, it seems to indicate that Kingman thought the reports on stewardship activity contained only generalisations, which gave little detail about the interventions actually undertaken or their results. In that sense, the reports were boilerplate in the sense that they needed little amendment from year-to-year. In defence of the FRC, it has to be said that assessment of outcomes is a less straightforward task than Kingman presented it to be. The Walker Report itself stated that "It is not the role of institutional shareholders to micromanage or "second guess" the managements of their companies. Indeed, the dispersed ownership model relies on the appointment and performance of high quality directors who enjoy substantial autonomy in discharge of their obligations without need for detailed oversight by dispersed owners, at any rate in "normal" situations."[21] It is perhaps too much to expect Walker, the FRC and Kingman to solve one of the most debated issues in corporate law, namely, the appropriate balance between autonomy and accountability for the board, but it might have been sensible for them to recognise that their views on the issue were opaque and so the implications of the SC for the optimal level of engagement by institutional investors was uncertain. Asset owners and managers could well conclude that they had a large measure of discretion under SC as when they should engage and even to conclude that limited engagement was in line with best practice.

Given the widespread and probably correct view that levels of engagement had not significantly increased over the decade, how might this be explained?[22] It has to be said at the outset that what the SC was seeking to achieve was more demanding than what the CGC aimed at, contrary to the view of Myners Review.[23] The CGC contained a set of structural recommendations for the board and its committees, emphasising in particular the role of NEDs and the chair of board. It was, therefore, fairly straightforward for companies to work out how to implement the recommendations and for investors to see whether those recommendations had been complied with. Certainly, compliance with the recommendations was expected to alter corporate behaviour (and the extent to which this has happened has been a controversial topic for research ever since) but at the level of applying the Code, this issue did not concern either investors or companies, except perhaps where the company advanced an argument for non-compliance with the Code's recommendations.

By contrast, the SC was concerned with changing behaviour directly, not via structural changes in the governance system. Both the behaviour of institutional investors as against investee companies and the behaviour of investee companies, for example, in relation to their business strategies were aimed at. However, the appropriate behavioural changes were inherently firm-specific and fact-dependent, since the business models and environments of investee companies were many and various. Certainly, Principle 4 of the SC 2012 listed the tools

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[21] Above, n 1, p 5.30. See also the marvellously incomplete statement in the SC 2012 at p 1: "In publicly listed companies responsibility for stewardship is shared. The primary responsibility rests with the board of the company, which oversees the actions of its management. Investors in the company also play an important role in holding the board to account for the fulfilment of its responsibilities."

[22] I will take for granted that neither lack of legal powers for shareholders nor the coordination costs of institutional investors play a significant role in the explanation. On both these points see Paul Davies, "Shareholders in the United Kingdom" in J Hill and R Thomas (eds) *Research Handbook on Shareholder Power* (2015). For an earlier and penetrating assessment of the first version of the SC see A Reisberg, "The UK Stewardship Code: On the Road to Nowhere?" (2015) 15 *Journal of Corporate Law Studies* 217.

[23] It argued that, since the UK Corporate Governance Code had been "on any reasonable analysis" a success, a comply-or-explain SC could be expected to be as well. Above n 3, p 3.

available for engagement, for example, voting on resolutions put forward by management at shareholder meetings, private meetings with corporate management or the chair of the board, or proposing shareholder motions at general meetings to change policy or remove directors. And it required a commitment from shareholders and asset managers to use these tools, as and when appropriate. But the SC had little to say about the identification of the "as and when". The appropriate occasions and the appropriate tools for particular occasions were not, and could not be, identified ex ante in the SC itself. The SC contained only high-level engagement recommendations, not specific ones equivalent to the structural recommendations of the CGC.

Somewhat disingenuously the SC tried to push the formation of ex ante engagement rules onto the institutions themselves, through the obligation to establish a stewardship policy, as. Principle 1 of the first version required. Under Principle 4, if the board proved unresponsive to initial approaches: "Institutional investors should establish clear guidelines on when and how they will escalate their activities . . ." However, institutional investors with a diversified portfolio of investee companies are hardly in a better position to work out, ex ante, when and how they would or should intervene than were the drafters of the code. The correct response is still highly fact- and case-specific and incapable of ex ante generalisation, whether it is a regulator or an investor seeking to develop a portfolio-wide policy. The policies developed by investors turned out, not surprisingly, to consist only of generalities, just like the SC itself. For example, M&G, a long-established and well-respected fund manager, stated in the 2018 version of its policy:

> As a general policy, we are supportive of the management of the companies in which we invest. However, when companies consistently fail to meet our reasonable expectations, we will actively promote changes. These changes might range from the formulation of a new strategy to the appointment of new directors."[24]

This embodied eminent good sense but did not convey any information which probably would not have been found on M&G's web-site even if the SC had never been adopted.

In a behavioural setting where firm guidance is lacking, the issues of capacity and incentives of institutional investors to engage move centre-stage. These issues provide two plausible explanations why the expectations generated in some quarters by the Walker Review and the

[24] M&G Investments, *M&G Equities' Approach to Responsible Investment*, March 2018.

first version of the SC failed to materialise. Did institutional shareholders possess the capacity to devise effective engagements, even if they had the legal capacity to engage and could overcome their coordination issues? Did asset owners and asset managers lack the incentives to engage in the desired way, even if they have both the legal and factual capacity to do so? We will look at each question in turn.

A. Shareholders' functional capacities

The first question is whether and in what circumstances institutional shareholders (and asset managers acting on their behalf)[25] have the knowledge and understanding to improve the quality of corporate decisions. Is more engagement by them likely to produce worse corporate decisions rather than the better ones anticipated by the Walker Review? The view that shareholders engagement should be kept at a low level in the interests of good decision-making (even at the level of choosing strategy) is not implausible, was partially accepted by the Walker Review[26] and is advocated by some academics.[27] However, even jurisdictions which are protective of management as against shareholders, for example Germany and, traditionally, Delaware, follow the general approach of corporate laws around the world and accept the proposition that for some corporate decisions shareholder involvement is mandatory.[28] In these cases, at least, the involvement of the shareholders must be thought likely to improve the quality of corporate decisions. The question, then, is whether, beyond this limited, mandatory list of decisions, shareholders should be permitted and encouraged to insert themselves into the management of the company and whether such engagement is likely to be fruitful.

When exploring this issue, it is useful to keep in mind that the answers to the question may differ according to the investment strategy followed by the asset owner or manager and according to level or type of engagement which is contemplated. There are two principal types of investment strategy – index tracking and stock picking – though some hybrids exist and the stock picking strategy obviously covers a wide range of investment philosophies. However, at least as a first cut, one can say that an index tracker makes no decision as to which shares to

[25] It is conventional, and helpful, to distinguish between 'asset owners' and 'asset managers', provided one remembers that a single entity may perform both functions. Thus, a large pension fund (asset owner) may manage a large part of its investments (thus acting as asset manager as well) whilst a smaller fund may contract out most or all of the management function to a fund manager. Equally, a mutual fund (unit trust, investment trust, exchange traded fund, UCITS) may manage its funds as well as gather in contributions and deal with redemptions, but it may contract out the management function to a third party.

[26] See text attached to n 21.

[27] S Bainbridge, "Director Primacy and Shareholder Disempowerment" (2005-6) 119 *Harvard L. Rev*. 1735.

[28] See E Rock et al, "Fundamental Changes" in R Kraakman et al (eds), *Anatomy of Corporate Law* 3rd ed, 2017.

invest in or about the weight of the investment in any particular stock. Once the tracker has chosen the index it will track, the buy and sell decisions then follow automatically. What the index tracker offers is diversification at a lower price than a stock picker will charge, and it must be capable of tracking the chosen index with only a very small "error" factor.

Functional capacity to engage also varies from engagement strategy to engagement strategy. For example, voting on a proposal put forward by management (or an activist hedge fund) for consideration by the shareholders requires less in the way of knowledge and insight on the part of the shareholders than does participating in an initiative to change the company's business strategy against the wishes of the incumbent management. Even with a significant managerial resolution, for example, a proposal to dispose of or acquire a substantial business, index investors may be as well placed as anyone else to evaluate its impact upon firm value. Management will have devoted substantial time and resources to developing the proposal and will be obliged to disclose most, if not all, of their rationale for the proposal, because the rules surrounding shareholder meetings require it and because the management will wish to do so to maintain or increase the market price of the company's equity. Naturally, management disclosures will stress the advantages of their proposal, but, in the case of large publicly traded companies, analysts who follow the company will provide an assessment from an external viewpoint and that assessment will become known to the shareholders, indirectly (via its impact on the share price) or directly (for example, because the analyst releases the assessment publicly or the financial press picks it up). So, a lot of the work (and cost) of gathering information and analysing it is taken out of the hands of the shareholders in this case and even index-trackers, who will have good market intelligence, will be well-placed to respond to it.

The point, therefore, is not that all forms of effective engagement are beyond index funds. In fact, in the case of management or hedge fund proposals, the functional capacity of institutional shareholders, even index funds, to engage appears not to be a serious cause for concern. The point rather is that "reactive" voting is not the type of engagement which the first version of the SC appeared to advocate most strongly. Over the past thirty years, levels of institutional voting on resolutions put before them, typically by management, have been on the increase.[29] Since this type of institutional engagement was already in place, the SC's contribution to

[29] The Myners Review, above n 3, p 91, n 24, noted that in 1999 about half of shareholders voted on resolutions, the figure having been about 20% a decade earlier. By 2005 the figure was reported to be 58%: C Mallin, "Trends in Levels of Voting and Voting Disclosure" (2006) 14 *Corporate Governance* 73. Given that retail shareholders show a lower propensity to vote, this implies a rather higher level of voting by institutional shareholders than the headline figures would suggest, especially, perhaps, on non-routine resolutions.

promoting stewardship must be assessed by reference to engagement beyond reactive voting. What is the functional capacity of shareholder in respect of these more demanding forms of engagement?

As far as index managers are concerned, it is unlikely that their capacity is high. Their business model does not call for them to employ analysts to develop insights into the business potential of particular companies or to identify and correct strategic mistakes by management before damage is done. Their expertise lies in tracking an index with minimum error and minimum cost. Irrespective of their incentives to engage deeply with portfolio companies (which we discuss in the following section), there is little reason to have confidence that business policy initiatives which index trackers might decide to take would be well chosen.

However, this is not to argue that all non-reactive voting by index funds is unreliable. When they vote on the application of market-wide codes (notably corporate governance codes) to investee companies, for example, their views are deserving of as much respect as those of stock picking managers, since they are as likely as stock pickers to be in a position to observe which structural governance provisions are important and in which situations. However, in the core area for the SC, of shareholder-initiated fundamental change, the index funds do not appear as reliable initiators. Whilst it may be clear to an index-tracking manager that a company is underperforming and whilst the tracker may respond by voting for the strict application of market wide codes to that company or against particular executive directors (or their remuneration), that is not the high-level engagement response envisaged by Walker. As Rock and Kahan have pointed out, "to develop more precise measures, a more detailed analysis is required. Without such analysis, it is hard to pinpoint the cause for low performance and to recommend specific changes."[30] This is the typical predicament of the index tracker. The implication of the analysis is that the SC is misguided to push for pro-active engagement on the part of partly incompetent index-tracking funds to bring about changes in investee companies' business strategies, and that self-aware trackers are unlikely to want to participate in this form of engagement.[31]

[30] E Rock and M Kahan, *Index Funds and Corporate Governance: Let Shareholders be Shareholders,* 2018 (ssrn.com/abstract=3295098). The focus of their, highly sophisticated, analysis is a rebuttal of the proposition that index funds should be deprived entirely of their voting rights. Their aim is thus to identify classes of case where index fund voting is reliable – or no less reliable than stock pickers' votes - rather than to identify types of engagement activity (beyond voting) where index funds might perform poorly.

[31] Over 50% of equities managed by UK fund managers are managed on a passive basis: Investment Association, *Asset Management in the UK 2017-2018*, p 50.

By contrast, stock pickers appear better placed to engage in proactive engagement. Their business model requires them to acquire an understanding of a potential investee company's strategies and of their strengths and weaknesses. If an investment is made, the company's performance will be closely monitored and, if it is regarded as unsatisfactory, that understanding is available to inform proposals for change. This argument carries greatest conviction in the case of a fund whose strategy is to invest in only a small number of companies. Its focus on that small number is likely to generate a high level of understanding of the company's potential and capacities. By contrast, some funds present themselves as stock-pickers (and charge the appropriate higher fees), but invest widely, whilst avoiding a commitment to any particular index. A generalist stock-picking fund may be in little better position that an index tracker to identify appropriate changes of policy within particular companies. Overall, the extent of the functional advantage of stock pickers over index funds turns on the nature of the stock picker's strategy and those strategies are, in principle, many and various. Nevertheless, it is reasonable to suppose that, overall, stock pickers are better placed to implement the engagement strategies promoted by the SC than are index funds.

B. <u>Asset Owner and Asset Manager Incentives</u>

Even if it were clear that institutional shareholders had the capacity to engage beyond reactive voting, there is a further question about the strength of their incentives to engage. The analysis of incentives needs to distinguish carefully between (i) financial incentives related to the immediate value of the fund and the remuneration of asset managers and (ii) reputational incentives for owners and managers to engage even in the absence of immediate financial benefit.

(a) Financial incentives of asset owners and managers

It will be suggested below that, just as index tracking funds have limited capacity to engage, so also do they have limited financial incentives to do so. In fact, their capacity and their financial incentives seem to line up quite well. This is a desirable outcome, since an actor with strong incentives to intervene but little capacity to judge which interventions will be successful could bring about substantial wealth destruction. By contrast, stock pickers have greater capacity and incentives to engage, but, even then, those features are unlikely to apply uniformly across the whole of the investment portfolio.

The argument for the limited financial incentives of index trackers to engage is well established in the literature and does not need to be considered in detail.[32] Even assuming the engagement is successful in financial terms, the fund's attractiveness to investors is likely to be improved only marginally, if at all. The fund will still have achieved only the goal of tracking the chosen index and all its competitors will have done the same, so that intervening fund will not be comparatively better off. Few investors will notice that the level of the index has been affected in an upwards direction by the actions of the particular intervening fund. Even worse, since the benefit of the upward impact will accrue to all funds tracking the relevant index, the intervening fund will not be able to recoup from its investors the costs of intervention, which its competitors will not have borne, for fear of causing them (or new investors) to move to the competitors.

However, this does not mean index trackers will not engage at all. They will have a financial incentive to do so if the engagement proposed is low cost and that cost will probably be covered (at least across a series of engagements) by the likely increase in remuneration for the fund, even when that remuneration is based on receiving only a modest percentage, for example, less than 1%, of the assets under management (AUM), especially if that increase in the value of the investee company is likely to continue into future years.[33] In this analysis it is irrelevant that other, non-voting index trackers may reap the same monetary benefit. In fact, however, the incentives to engage in thoughtful, low-cost engagement will apply to competitors as well, so that fears of giving competitors a comparative advantage by voting when they do not are likely to be subdued. However, the typical form of engagement which this argument promotes is, once again, voting on a resolution put forward by management or another shareholder, because voting is a low-cost (though not costless) activity. As already indicated, the SC is aimed at promoting pro-active engagement by institutional shareholders on a much wider (and more expensive) basis than thoughtful voting on resolutions put forward by others. The view that index trackers have limited incentives to initiate high-cost engagement to change management strategy remains untouched by the arguments about their reactive voting incentives.

It is sometimes argued that index funds are incentivised to engage because they are locked into the index they have chosen to track. This is a non-sequitur. The fact that one is trapped in some particular situation does not answer the question whether it is worth one's while to try and

[32] See L Bebchuk and S Hirst, "Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy" (2019) 119 *Columbia L R* 2029.

[33] These cases are discussed in some detail in Rock and Kahan, above n 30.

change it or some feature of it, as Shakespeare recognised.[34] The answer depends on the costs and benefits of the change which is contemplated, which brings us back to the capacity and incentive analysis above.

Does the matter stand differently in relation to stock-pickers? In some cases it is likely that it does. Although some funds are closet index trackers, as noted above, whose incentives are not much different from transparent trackers, genuine stock pickers may choose to be overweight in a particular stock and see benefits from engagement (beyond voting), even if there are (non-overweight) competitors present on the same share register. The asset manager will benefit directly from the AUM formula, whilst out-performance on the part of the fund will attract new investors, thus increasing AUM again. But there are constraints on the amount even an over-weight fund will devote to engagement (beyond voting). The return to high-level engagement must provide (on a probabilistic basis) a higher return to the fund than alternative courses of action, such as doing nothing or divesting and investing the proceeds elsewhere. When assessing the probabilities, engagement beyond voting starts with a handicap, since its likely costs (firm-specific investigation and firm-specific activism) will be higher than those of the alternatives, whilst its returns may be uncertain, though potentially large.

This argument does not mean that stock pickers will not participate in routine interactions with investee companies. Analysts employed by fund managers inevitably meet with investee companies on a regular basis, because they hope to gain insights relevant to trading decisions, and corporate governance teams, generally less well-resourced and meeting less frequently, do so as well. However, both sets of meetings tend to concentrate on the short-term – short-term financial projections in the former case, the up-coming annual general meeting in the latter. Strategic issues, likely to be relevant to the SC, take very much a second place in both types of meeting, especially in meetings with corporate governance teams.[35]

Even when the corporate governance team flags up a set of concerns, an enhanced level of engagement with the investee company appears not to be the exclusive response on the part of the fund manager. There is a recent study, admittedly of a single fund manager,[36] Aberdeen,

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[34] "To die, to sleep,/To sleep, perchance to Dream; ay, there's the rub,/For in that sleep of death, what dreams may come,/When we have shuffled off this mortal coil,/Must give us pause." (*Hamlet*, Act 3, Scene 1)

[35] Investor Forum, *The Four Dialogues*, 2019, ch 3.

[36] M Becht, J Franks and H Wager, *Corporate Governance through Voice and Exit*, ECGI Finance Working Paper 633/2019. For the operation of this strategy in relation to a particular investee company, see House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees, *Carillion*, HC 769, May 2018, ch. 2, Table 1.

which shows that adverse reports by the governance team trigger not only increased interventions with the management of the company but also sale decisions by the investment team. This suggests that the fund manager was hedging its bets with problem companies, devoting some resources to engagement but also reducing the fund's exposure to that particular company. If this is a general approach on the part of funds, it will reduce the incentive to expend resources on deep engagement.

Overall, genuine stock pickers are likely to have greater incentives than index trackers to engage at a high level and, as we saw in sub-section A, their capacity to engage is likely to be greater than in the case of index funds. Nevertheless, that incentive is not without limits related to the costs of intervention nor is it likely to operate across the whole of the stock-picker's portfolio, for example, where the stock picker has an underweight holding in a particular company.

(b) Reputational incentives

Consequently, the picture that emerges is one in which both index funds and stock pickers have only limited financial incentives to engage beyond voting or the enforcement of market-wide best practice. Do reputational incentives change the picture? There is some evidence that reputational incentives are at work in this area to encourage adherence to the SC. The Kingman Review found that in 2018 the SC had 278 signatories, of whom some 100, mainly asset owners, were (at that time) under no obligation to adhere to it.[37] Equally, to encourage higher levels of commitment to the SC, the FRC introduced a public tiering system, based on an assessment of the quality of the signatories' engagement policies. There were no overt sanctions for an institution which failed to achieve the top tier, but many did. The obvious incentive operating here was to avoid governmental action which might turn a comply-or-explain Code into more intrusive regulation.

There is also some evidence that reputational incentives have influenced institutions' voting patterns. Thus, in relation to executive remuneration – a long-standing headache for government - recent research has shown that institutions voted against the company's pay proposals in 8% per cent of cases (the average across all management proposals being just over 2%) and pay votes showed the lowest similarity with the recommendations of the two largest

[37] Kingman, above n 6, 2.80-2.83. At that time only asset managers were required under Financial Conduct Authority (FCA) rules (COBS 2.2.3) to disclose whether they were committed to the SC and the extent of that commitment. After the enactment of the Amending Directive a similar requirement was extended by the FCA to pension funds and insurance companies.

proxy advisers.[38] Both facts suggest thoughtful voting on remuneration on the part of the institutions and their asset managers. However, there appears to be no evidence that, in relation to the first version of the SC, reputational incentives encouraged engagement activity beyond voting on low-cost and politically salient issues.

C. Collectivising engagement

The incentive problems discussed above could be addressed by collectivising engagement. Collectivisation would spread the costs of engagement across participating institutions, thus facilitating some of the high cost versions of this activity, and reduce the free-rider problem. It might also serve to reduce the capacity issues, for example, where the collective body employed its own specialists. Following the Kay Review[39] an initiative was undertaken in this direction. The Investor Forum, funded by its institutional members, provides a mechanism to facilitate engagement by those members who wish to take an issue forward. However, over its first five years the Forum initiated only a modest number of engagements (32 in total). Two aspects of its functioning suggest that it has not fully overcome the collective action problems of the institutions. First, an almost equal number of engagements was proposed by members (25), but these proposals were not taken forward because of their failure to attract support from a sufficient number of other members. Second, engagement is defined by the Forum as the robust presentation of investor views to the board about the problems the company faces, but it equally stresses discretion. It operates therefore in private, though its interventions are reported once concluded. It appears never to have conducted a public battle with an intransigent board. In addition, robust presentation of investor views does not typically extend to the formulation of strategies for dealing with the problems raised. This justified on the basis that it is not the role of the investors to devise solutions; that is for the company.[40]

An alternative, market solution to the collectivisation issue is the activist hedge-fund. As we have seen, the incentives to engagement on the part of institutional investors are low mainly because of their cost and the difficulty of spreading those costs over all competing institutions,

[38] S Gomtsian, *Shareholder Engagement by Large Institutional Investors*, Tilburg Law and Economics Center Discussion Paper, 2019-014, p 37 and Figure 9.

[39] *The Kay Review of UK Equity Markets and Lotsianng-Term Decision Making, Final Report*, July 2012

[40] The Investor Forum, *Review 2018*, January 2019 and *Review 2019*, January 2020. Many of its engagements are driven by concerns arising under the CGC rather than the SC. On the potential for third-party facilitators of this type see G Balp and G Strampelli, "Institutional Investor Collective Engagements: Non-Activist Cooperation vs Activist Wolf Packs" *14 Ohio St. Bus. L.J.* (forthcoming). The Investor Forum is in many ways a recreation of the 'case committees' run by the trade associations of the institutional investors in the 1970s to 1990s, which eventually faded for lack of enthusiasm on the part of the members: G P Stapledon, *Institutional Investors and Corporate Governance* (Oxford, 1996) 135-138.

whilst capacity constraints derive from the fact that their business models do not reliably capture all the relevant firm-specific information and understanding necessary for successful engagement. An activist hedge fund presents a solution to both those problems, by reducing the required engagement on the part of traditional institutional shareholders to voting on propositions others have developed and promoted or other low-cost expressions of support for or opposition to the activist.[41] The activist hedge fund has itself deployed the resources necessary to work out whether a change of strategy and/or management on the part of the company would improve its value, so that this task no longer falls on the institutions.

The hedge fund is able to discharge this function because its business model is different from that of the "long-only" institutions, whether index trackers or stock pickers. Even for stock pickers, a company which requires high-level engagement represents a failure: the investment choice is made on the basis that the company already has a good strategy and management team in place and is in a position to adapt successfully to changes in the business environment. By contrast, a hedge fund operates on an investment model which requires it to have the capacity and the financing to seek out companies where a change in strategy or management is likely to bring about an increase in its share price. Typically, these are companies whose performance prior to the intervention has fallen below that of others in the same market segment. However, provided change is likely to improve the share price, an activist hedge fund may intervene to produce change even in a successful company. For example, a successful company may become more so if merged with a competitor, a step which the incumbent management may resist if it means a complete or partial loss of control to the merger partner. Having made a substantial, but non-controlling, investment in the company's shares, the activist agitates for the proposed changes, attempts to secure other investors' support for its proposals and moves on once the changes have been implemented and the share price increased.

The value or otherwise of the changes brought about by activist hedge funds is one of the most hotly debated topics in current corporate law. It is not necessary to comment on that debate here, except to make two points. First, activist hedge funds do not rely on the SC for their effectiveness, except perhaps to give themselves some marginal ideological support. They are most prominent – indeed have their origins in – the United States, which has no SC. What the hedge fund relies on is its capacity to (threaten to) put pressure on management when it has the

[41] See Balp and Strampelli, previous note, and R Gilson and J Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights" (2013) 113 *Columbia L R* 863.

support of other major investors. This means that the corporate governance rights of shareholders (rather than their duties) are central to their strategy. These are generally to be found in corporate law (for example, the right easily to remove members of the board and rules facilitating inter-shareholder communication) though soft law may sometimes be helpful (for example, the presence of a senior independent director as a channel for shareholder communication). Thus, if activist hedge funds are the answer to the engagement problem, there is no need for a SC to provide it and the FRC can devote its resources to something else.

Second, however, it is clear that the Walker Review did not think activist hedge funds were the answer, because it took the view that their goals were short-term whilst the purpose of the SC was to promote the long-term value of companies. As the Review put it, "Differentiation is needed between the motivation behind the proposals . . . for enhancing dialogue and longer-term engagement between investors and boards and increased shareholder pressure on boards to perform in the short term. Before the recent crisis phase, such short-term pressure involved analyst and activist investor argument for specific short-term initiatives such as increased leverage, spin-offs, acquisitions or share buybacks, with the result in some cases of a stronger stock price and higher short-term earnings. . . The focus in what follows is on dialogue and engagement between investors and companies where the investors are likely to be relatively long-term holders for whom divestment in potential problem situations comes to be seen as a last rather than first resort."[42] On this analysis, the SC recovers its role but cannot rely on activist hedge funds to rescue it from ineffectiveness. On either analysis of hedge funds, the first version of the SC is open to a futility assessment: it is either unnecessary or impotent.

4. The second version of the SC

A. <u>Engagement</u>

It seems unlikely that engagement, as envisaged by the Walker Review, will occur on a more significant level under the second version of the SC than under the first. This prediction is made on the basis that the capacity and incentive problems identified above have not been addressed effectively in the second version – and possibly are incapable of comprehensive remedy.[43] As noted above, the second version addresses the Kingman ineffectiveness critique by enhancing

[42] Above n 1, para 5.27. For scepticism on this point see A Christie, "The new hedge fund activism: activist directors and the market for corporate quasi-control" (2019) 19 *Journal of Corporate Law Studies* 1.

[43] Below I take a more optimistic view about ESG engagement and it is possible that there will be some spill over from ESG engagement to Walker-style engagement.

the reporting requirements for SC signatories in relation to their engagement outcomes. In relation to Engagement (Principles 9-11), besides disclosing their engagement strategy (including its escalation if the initial engagement is unsuccessful), the SC 2020 requires signatories to disclose "the outcomes of engagement that is ongoing or has concluded in the preceding 12 months", including the outcomes of any collaborative engagement or escalated engagement. Although the annual[44] reporting requirement is an obvious way of keeping up the pressure on signatories to the Code, it is not clear that it is an appropriate one. Of course, many institutions already produce annual reports on their stewardship activities of a fairly general kind, for example indicating, anonymously, concerns raised with some investee managements. It seems that the 2020 SC is designed to generate more detailed reporting than this. The question is whether detailed annual reporting of engagement outcomes will undermine the Code's commitment to the improvement of the long-term value of companies. The risk with a detailed annual reporting requirement is that it will generate activity, which may or may not enhance the long-term value of investee companies, but will certainly generate reportable events. It would be an ironic outcome if the revised reporting requirements reduced the time-scale for engagement pay-offs.[45]

Ironically, signatories may perform better on the traditional engagement metric under the second version than the first, not because they engage more, but because the Code's expectations of engagement (now only one part of the SC, as we have seen) have been reduced. This argument is somewhat speculative but there are hints to this effect in the second version. First, the Guidance attached to Principle 3 of the SC 2012 encouraging "early intervention" by institutional investors to avoid loss of value[46] is not repeated in the second version. Second, escalation of engagement, where management is initially resistant to the initial (and usually private) approaches of investors, is perhaps the acid test of commitment to engagement. The first version set out the techniques of escalation, including various public actions, such as making a public statement in advance of general meetings of shareholders, submitting resolutions and speaking at general meetings, and requisitioning a meeting, in some cases proposing to change board membership.[47] Under the second version, escalation still merits a

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[44] Curiously, the SC 2020 does not explicitly require a report to be made annually, though it seems that this is the FRC's expectation. See n 66.

[45] It is recognized on p 6 that outcomes may take more than a year to achieve, but, even then, 'progress' during the year is required to be reported. This risk is heightened because the assumption that the long-term is easy to identify is misplaced: see M King and R Kay, *Radical Uncertainty* (2020).

[46] See above, text adjacent to n 13.

[47] SC 2012, Guidance to Principle 4.

separate Principle (11) but the techniques of escalation are no longer laid out, perhaps suggesting that the limited form of escalation practised by the Investors' Forum is acceptable. Third, with the expansion of stewardship techniques to give equal weight to buy/sell decisions and engagement, an institution could improve its stewardship score without a higher level of engagement. Thus, the "outcome" to be reported under Principle 7 (the first Principle in the "Investment Approach" section of the SC 2020) is defined as follows: "Signatories should explain how information gathered through stewardship has informed *acquisition*, monitoring *and exit* decisions . . ." (emphasis added).

Against this, the requirement under Principle 4 to address market risks includes in this category "the failure of a business or group of businesses", which suggests a renewed emphasis on engagement, though this statement is not to be found in the Engagement section of the Code. What might be required of institutional investors in this context is not clear. In the recent collapse of Carillion plc most of the public blame was apportioned to the board and the company's auditors. The institutional investors, holding some third of the companies' equity, had not gone beyond private meetings with the board (and in some cases votes against the remuneration policy) but had steadily sold down their shareholdings in the period before the collapse. The Parliamentary investigation put the blame for this low level of engagement squarely on the board since "effective stewardship by investors depends in large part on the availability of trustworthy financial reporting and on honest engagement with board members in response to the raising of concerns." In this case, where these features were lacking, "investors were left with little option other than to divest."[48] Nevertheless, the prospect of public scrutiny of collapsed companies may induce some greater commitment to engagement on the part of asset owners and managers in relation to potentially failing companies.

B. <u>Social and Environmental Issues</u>

As we noted in section 2, the stewardship goals of the second version are defined more broadly than in the first version. Intervention to reduce over risky business strategies, as with the pre-crisis banks or Carillion plc, or to modify strategies that are failing in market terms, no longer captures the range of the second version's ambitions for stewardship. Systemic risks are expected to be addressed by institutional investor and climate change is expressly included within that category (Principle 4). Principle 7 requires systematic integration of ESG factors

[48] Above n 36, paras 111 and 113. There was no adverse comment on BlackRock, holding nearly 9% of the equity at one stage, whose shareholdings reduced automatically as Carillion sank in the relevant index and which engaged with the company apparently only over its remuneration proposals.

into institutional investors' acquisition, monitoring and exit decisions. Are these provisions likely to be more successful than the engagement model of the first version? It will be suggested below that reputational incentives may in fact operate more effectively in relation to ESG factors, including climate change, under the second version of the code than they did in relation to the first version. However, before turning to that argument, it is necessary to look at the force of the argument that companies with high ESG scores perform better than companies with lower ones. If this is the case, then the case for ESG investing will fit easily with the standard business models of both index tracking and stock picking funds, without the need to identify reputational incentives to add to the business model incentives.

(a) Performance

It is often argued that the financial performance of firms which adopt strong ESG policies is superior to those which do not.[49] This is the classic "doing well by doing right". Unfortunately, the empirical evidence for the proposition is at best mixed. There is evidence that the volatility of the share prices of companies with high ESG disclosures is less than that of companies which are not in this category. This is probably because a higher level of ESG disclosure gives analysts and thus investors more information about the company, so that its share price is less often subject to correction as unexpected information emerges. So, the purchase of such shares is, along this dimension, less risky. But it is difficult to find a statistically significant link between ESG disclosures and firm performance, adjusted for risk, except in the US, where ESG disclosure is not mandatory and so voluntary disclosure may act as a proxy for superior performance.[50]

The point is important because investor or beneficiary welfare is still the goal of stewardship in the second version of the Code. Asset owners and managers are not expected to push for the adoption of ESG policies by investee companies where the financial interests of beneficiaries will suffer. The draft of the second version suggested differently, ie that it aimed to promote benefit to society at least in some cases independently of the benefit of those who provide the funds for investment, with the implication that in some cases sustainable benefit for society might come at the expense of beneficiaries' financial returns. Thus, the draft stated: "Stewardship is the responsible allocation and management of capital across the institutional

[49] See, for example, the speech by the Governor of the Bank of England, *TCFD: strengthening the foundations of sustainable finance*, 8 October 2019.
[50] F Lopez-de-Silanes, J A McCahery, and P. Pudschedl, *ESG Performance and Disclosure: A Cross-Country Analysis*, ECGI Law Working Paper N° 481/2019.

investment community to create sustainable value for beneficiaries, the economy and society."[51] There was push-back from some asset owners and managers against this proposal and in the adopted version a more conventional statement appears: "Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries *leading to* sustainable benefits for the economy, the environment and society."[52] Thus, it would seem, the benefits to the economy, the environment and society are expected to flow from the creation of long-term value for investors, not independently of investor value.

The revised approach aligns the normative structure for investment intermediaries under the SC with that for directors under s 172 of the Companies Act 2006. More influential was probably the work done by the Law Commission on the application of fiduciary law to pension fund trustees,[53] later adopted by the relevant government department (Department of Work and Pensions (DWP))[54] and referred to in an Annex to the SC 2020. The DWP/Law Commission work endorses, not surprisingly, the view that pension fund trustees must take ESG factors into account when they are relevant to the value of a proposed investment and engage with investee companies on the same basis. Those factors may have positive or negative implications for investment. Taking climate change as an example, it is likely to render investment in a vineyard in Southern England more attractive than previously, whilst consumer or governmental reaction to climate change is likely to do the same thing for investment in the manufacture of some component vital for electrically propelled cars. On the other hand, ESG consideration are likely to render investment in a petrol distribution business less attractive. This is entirely straightforward and one would expect such assessments to be carried out by corporate boards and asset managers, whether there was a hard or soft law requirement for it or not.

Where the ESG factor is not financially relevant, the Law Commission's analysis is permissive, not mandatory, and the permission is subject to significant caveats. Trustees may take into

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[51] FRC, *Proposed Revision to the UK Stewardship Code*, January 1919, p 2.

[52] SC 2020, p 4 and Principle 1. Some sense of the push-back is provided in FCA, *Building a regulatory framework for effective stewardship Feedback to DP19/1*, Feedback Statement 19/7, October 2019, paras 3.7ff.

[53] Law Commission, *Fiduciary Duties of Investment Intermediaries*, Law Com 350, 2014; *Pension Funds and Social Investment*, Law Com 374, 2017. Some trust lawyers regard the Law Commission's approach as too lax in its permitted departures from purely financial benefit. See, for example, P Bennett, "Must an occupational pension scheme take into account ESG factors even if there is a risk of financial detriment to the pension fund?" (2019) 32 *Trust Law International* 239.

[54] DWP, *Consultation on clarifying and strengthening trustees' investment duties*, June 2018; The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018/988.

account members' views which favour financially disadvantageous investments, but are not bound to do so. Crucially, that permission is subject to the conditions (i) that the weight of those views is in favour of a particular policy – a condition, it is said, not likely to be met in the case of controversial policies[55] and (ii) even then, the financial disadvantage to the fund should not be significant.[56] Although the Law Commission's work was the result of its analysis of what trust law requires and not all contributor/institution relationships are based on trust law, its more general influence on the SC is probably explained by the consideration that the SC could hardly advocate a version of stewardship which was unlawful for one significant sub-group of asset owners.[57]

The bite of the Law Commission's binary analysis depends heavily upon the determination of which limb is applicable. Under the first limb, taking ESG factors into account is mandatory; under the second it is permitted but subject to tight constraints. Given the uncertainties surrounding the empirical data, it is likely that pension fund trustees (and other asset owners subject to similar duties) will have a significant discretion in this area, provided they act in good faith and remain within conventional views about the financial value of pursuing ESG policies. This is not an issue, it may be noted, on which the SC itself gives any fine-grained guidance.

The determination of the applicable limb is likely to be sensitive to the time-scale of the investment. For example, the benefits of carbon emission reduction and the costs of not reducing them are likely to show over a period of decades. On this basis it is sometimes suggested that pension funds and other retirement-based savings mechanisms should be more open to ESG factors than, say, a mutual fund where the average holding period by investors in the fund is less than five years. However, even this rule of thumb is not as obvious as it seems. The position of a new entrant to a pension scheme, contemplating retirement in forty years, may indeed fit this analysis, but a person near retirement or with a pension in payment will have a stronger financial interest in the fund having enough cash to meet its payment obligations over a much shorter period.

Overall, it seems likely that asset owners (and their investment advisers) will have significant leeway in determining the extent to which they will take into account ESG factors, whilst still

[55] "These proposals are not intended to give any support to activist groups for boycotts or disinvestment from certain assets" (DWP, para 26).
[56] Ibid, paras 24-25.
[57] Similar, if less easily definable, issues arise in relation to contract-based investment in any event: Law Com 350 (above n 52) ch 8.

remaining within the applicable legal rules. Thus, we come back to the question of their incentives to take a broad or a narrow view of their powers in relation to ESG factors.

(b) Incentives

The above argument suggests one can identify one significant continuity between the first and second versions of the SC, despite the expanded scope of the latter. The SC still seeks to change the behaviour of asset owners and asset managers but without precise guidance as to what should be done in any particular case. So, the issue of the incentives remains central for how owners and managers are likely to react to the second version of the SC. The difference between the first and second versions is the possibility that the incentive structure is significantly different in the two versions, because reputational incentives will operate more strongly in relation to the second version of the SC.

Reputational incentives here are conceptualised as the incentive to maintain a good name with somebody which has the capacity to inflict harm on you if you lose that good name or to promote your interests as long as the good name is maintained. This is not the same as the warm glow a person may experience from knowing others think well of him or her – though the creation of that warm glow could operate in some contexts as an incentive. Asset owners' and managers' stance on ESG matters is required to be disclosed under the SC, not only as a result of reporting under Principles 4 and 7, discussed above, but also from reporting under Principle 1. This requires reporting of "signatories' purpose, investment beliefs, strategy, and culture" and how, via long-term value for beneficiaries, they lead to "sustainable benefits for the economy." Thus, asset owners and managers which pay little attention to ESG matters cannot hope that this fact will remain hidden.

The most obvious wielder of reputational sanctions in the ESG context is the government, through its control of the legislative and regulatory framework through which the asset management industry operates. This is no theoretical possibility. In the run-up to the second SC, the FCA (the rule-maker for companies listed on the Main Market of the LSE) and the FRC issued a joint discussion paper on the balance between regulation and soft law in promoting stewardship.[58] It its feedback on the responses, the FCA concluded that, given the imminent arrival of the second SC, it should not introduce additional regulatory requirements at this stage, but it added that "We will consider the need for any further actions as the new Code takes effect, so that the regulatory framework continues to support effective

[58] FRC/FRC, *Building a regulatory framework for effective stewardship*, DP 19/1, January 2019.

stewardship."[59] As the Investor Forum politely put it in its 2019 Report,[60] referring to the recently revised CGC and SC: "If market participants step up to deliver and demonstrate effective outcomes . . . regulators and supervisors can focus on incentivising positive behaviour rather than enforcing prescribed rules."

The government, via the FCA, has thus shown general support for the SC. Within that general support, there is particular emphasis on climate change.[61] The UK government, as a signatory to the Paris climate change accords, is committed to policies of carbon dioxide emission reduction and, in particular, to achieve a net zero carbon economy by 2050 (though this is a time-table which is too slow for some). Some important steps toward this goal are achievable by regulation outside corporate law, such as the phasing out of coal-fired power stations or the prohibition of the sale of new non-electrically propelled cars or environmental standards for new housing. However, fine-grained carbon reduction activity by individual businesses (and, indeed, non-businesses) is thought to be necessary for the goal to be achieved, and this activity is not susceptible to ex ante specification across the board through regulatory rules. Thus, it is necessary, in the government's eyes, to co-opt corporate managers and those in a position to influence them in the pursuit of environmental targets. The FRC, a quasi-regulator, is one obvious channel towards this co-option and the SC one obvious instrument available to it.

Two examples, relevant to investor incentives, can be given of government interest in carbon reduction initiatives. First, the DWP, despite its formal adherence to the Law Commission's guidelines, gives pension fund trustees a heavy steer that climate change considerations should be given significant weight when assessing both the financial returns to an investment or engagement action and the views of the scheme's members.[62] The resulting regulations include ESG factors within the definition of factors which trustees must take into account under their statement of investment policy when they consider them financially material, but only climate

[59] Above n 52 at 1.9.

[60] Above, n 39 at 10.

[61] A similar story could be told about the proportion of women on the boards of publicly traded companies, where the official policy, developed outside the FRC, is for one third of board members of FTSE 350 companies to be women by 2020. This policy has more relevance to the CGC, which stresses diversity at board level, than the SC. Some asset managers have expressly taken up this point in their governance interactions with companies. LGIM, a large UK index tracker, has a policy of voting against the board chair where female directors do not constitute one quarter of the board (the original target). See Gomtsian, above n 38, p 5.

[62] Above n 54 , ch 2, paras 17 ("The UK's commitment to the Paris Agreement on Climate Change demonstrates the Government's view that climate change represents a significant concern.") and 28 ("Trustees may therefore use knowledge of broad public opinion or ratification of relevant treaties by the UK Government to draw conclusions about members' views.")

change is specifically mentioned as an ESG item.[63] The Department is clearly unwilling to leave an important government policy in the entirely unfettered hands of the trustees. Second, the FRC, whilst eschewing general stewardship regulation in the immediate aftermath of the introduction of the second version of the SC, as we have seen, nevertheless does propose to introduce rules requiring regulated asset managers and life insurers to enhance their disclosure of matters relevant to climate change.[64] In this case, therefore, the regulator of the capital markets is not prepared to leave disclosure wholly in the hands of those who have signed up to the SC.

These indications of the government view of the importance of climate change for investment decisions underline the reputational risk for signatories of the SC if they do not respond fully to the Code's climate-change provisions, which, as we have seen, identify the issue as a 'systemic' risk. Signs are already emerging that asset owners and managers can see the writing on the wall. The Investor Forum's Report for 2019 states that "Asset managers are re-designing investment approaches to meet client interest in ESG factors"[65] while individual asset owners, especially those holding assets acquired from outside the private sector, have publicly announced a change of focus towards more emphasis on climate change.[66] A fuller picture will emerge when the first reports from signatories to the new Code become available, which will probably be in the spring of 2021.[67] The FRC has already announced that it will pay particular attention to climate change when assessing these first reports.[68]

We argued above that index trackers had very limited incentives to take robust action under the first version of the SC. By contrast, index funds may be more open to reputational incentives, driven by fear of adverse governmental action, than stock pickers. First, the adverse

[63] Occupational Pension Schemes (Investment) Regulations 2005.3378, reg 2(3)(b)(vi) and (4) (as amended).
[64] Above n 52 at 4.41.
[65] Above n 40 at p 4. See also a recent blog on the Chartered Financial Analyst Institute's web-site: https://blogs.cfainstitute.org/investor/2019/09/05/the-seven-asset-owner-approaches-to-esg/.
[66] For example, "Church of England joins passive push with climate index", *Financial Times*, 30 January 2020, reporting that "The Church of England Pension Board, overseer of the £2.8bn retirement savings pot for the Anglican clergy, will on Thursday launch a passive index aligned with the Paris climate goals on the London Stock Exchange"; "Top UK pension scheme threatens managers over climate risk", *Financial Times*¸27 January 2020, reporting that "One of Britain's largest pension schemes has given its 130 asset managers a two-year deadline to reduce their exposure to climate change or risk being fired."
[67] "Organisations wanting to become signatories to the Code will be required to produce an annual Stewardship Report explaining how they have applied the Code in the previous 12 months. The FRC will evaluate Reports against our assessment framework, and those that meet the reporting expectations will be listed as signatories to the Code. To be included in the first list of signatories, organisations must submit a final report to the FRC by 31 March 2021." (https://www.frc.org.uk/investors/uk-stewardship-code).
[68] www_frc_org_uk_news_february_2020_1_frc_assesses_company_and.pdf

financial consequences for beneficiaries of ESG investing (in so far as they exist) are not a major competitive concern for index funds, since they will exist also for their competitors, provided they are subject to the same incentives to move in the same direction. Of course, index trackers need an ESG index to track and it may be that ESG indexes will fare worse than non-ESG indexes.[69] However, index trackers can hedge against this risk by offering both types of fund and seeing what choices investors make. Stock pickers may be unwilling to abandon particular profitable investments on ESG grounds, but they too could hedge the risk by offering both types of fund. Hedging can be identified in a recent strategic change by BlackRock, which will both increase the number of ESG index-tracking funds on offer and enable clients to remove certain types of company from its active funds, though there will also be an apparently across-the-board removal of its investments in companies which derive more than 25% of their revenues from thermal coal production.[70] Here, therefore, reputational incentives are supported potentially by changes in investor preferences. If beneficiaries change their preferences in favour of ESG, the investment models of the institutional investors will adjust accordingly, whether or not a SC recommends this course of action – though the SC may operate indirectly on institutions by supporting the change in beneficiaries' preferences.

As to capacity to pursue ESG goals and climate change targets in particular, the second version of the SC appears less likely to require asset managers to expend resources on acquiring in-depth firm-specific knowledge than the first. As we have noted, the second version gives equal weight to capital allocation and engagement as ways of pursuing stewardship, capital allocation being an inherent function of asset management. It appears to be open to stock-pickers to rely mainly on buy or sell decisions to implement ESG policies and deploy engagement only where it appears appropriate to them to do so. Moreover, moves are underway to improve the climate change reporting by companies, both in terms of detail and commonality across companies.[71] To the extent that these moves are successful, they will reduce analysts' costs in the same way that mandatory, uniform financial reporting has long done, especially if the information revealed is aggregated by service providers. In this way the costs of making allocation decisions

[69] It is also an open question how far ESG indexes (or the exclusion of particular types of company from active funds) encourage investee companies to change their policies so as to secure inclusion. See P Brest, R Gilson and M Wolfson, *How Investors Can (and Can't) Create Social Value*, ECGI Law Working Paper N° 394/2018.

[70] *Sustainability as BlackRock's New Standard for Investing*, BlackRock Client Letter 2020, available at www.blackrock.com/corporate/investor-relations/blackrock-client-letter.

[71] See n 49 above and FCA, *Proposals to enhance climate-related cisclosures by listed issuers*, cp 20/3, March 2020.

which are responsive to climate change factors are reduced and such reporting may also reduce the costs of engagement by owners and managers on climate-related issues.

5. Conclusion

The Stewardship Code can be said to have had a remarkable escape from its condemnation in the Kingman Review as ineffective. None of the plausible reasons to explain the reluctance of asset owners and asset managers under the first version of the Code to engage with investee companies have been addressed in the second (2020) version. Instead, the focus of the Code has pivoted away from the performance of individual companies towards the impact of companies on society. Obviously, the two are connected, but there has been a change of emphasis from a narrow conception of stewardship as engagement (first version) to a broader concept of stewardship (second version) or, as Peter Montagnon has put,[72] a shift from a purely inward approach to stewardship to one which put as much, if not more, emphasis on the outward impact of companies on society.

Will the second version of the SC be more successful than the first? It has been argued in this paper that it is possible to construct a plausible argument in favour of a positive answer to this question, despite the bolder goals contained in the second version. This argument turns on the identification of a new and more forceful set of incentives for asset owners and managers to comply with the second version, together with a greater capacity to do so. The first version failed because engagement was not well aligned with the financial incentives and capacities generated by the business models of asset managers and asset owners. The second version, in addition to placing capital allocation decisions on a par with engagement, creates a new set of incentives for compliance with the SC. Asset owners and managers, it is argued, will want to keep regulation at bay in order to protect their business models and that will require doing enough in relation to ESG considerations to keep the government happy. Whether asset owners and managers, individually, are on the side of Extinction Rebellion or of President Trump and the Prime Minister of Australia does not really matter, because they are likely to share a common concern to keep government regulation of investment intermediation to a minimum.

The argument developed above is thus based on the idea of soft law operating in the shadow of regulation, much as in its early days the non-statutory UK Takeover Code secured the

[72] See also Peter Montagnon, *Stewardship in a Stakeholder World* (Corporate Governance Forum, Stockholm, 2019), welcoming the 'outward facing' qualities of the second version, but regretting its more prescriptive approach. This was his final public address before his untimely death.

support of the investment banks, in order to discourage the government from legislating on takeovers. This prediction that the second version will have a significant impact does depend, therefore, on the shadow of regulation continuing to loom over asset owners and managers in this area. This does seem a reasonable prediction in relation to climate change, given the UK government's commitment to achieving a carbon neutral economy over the next thirty years. In relation to other ESG elements, especially the social elements, it is less clear how strong and sustained the government's policy commitments will turn out to be.

However, the incentive argument can be refined here in terms of a more general incentive to reduce the threat of regulation. It is widely accepted that since the financial crisis of 2007 to 2009 public confidence in the private sector of the economy has fallen significantly and not just in the financial sector. Big companies and their investors thus have an interest in restoring the legitimacy of capitalist organisation, so as to ward off public support for measures such as the nationalisation of industries or the compulsory transfer of shares to state or employee funds.[73] Thus, the second version of the SC can claim to be aligned with broader concerns in UK society in a way that the first was not.

It is also significant that climate change and restoration of the legitimacy of big business are not parochial UK concerns. Climate change and business legitimacy are pressing issues across the developed world. Thus, BlackRock has made a major change on ESG investment, as we have seen above, and other non-UK managers have voiced similar concerns. The chief executives of Fidelity International (a US global asset manager) and Allianz Global Investors (a German global asset manager) have recently called for more focus on sustainability, even suggesting that economic growth and investor returns need to be sacrificed to this end.[74] Although different jurisdictions will deal with ESG and climate-change issues in different ways, a broadly shared view of the underlying problems is an important element in the potential support of the SC in a world in which equity investment takes place across borders. It appears that the SC requires signatory asset owners and managers to report on stewardship activities in relation to foreign equities which they own as well as in relation to domestic equities.[75] Equally, cross-border ESG concerns may encourage foreign investment managers based in the UK to

[73] Both items appeared in the manifesto of the Labour Party for the 2019 general election: Labour Party, *It's Time for Real Change*, 2019.
[74] *Financial Times*, November 15, 2019.
[75] For example, under Principle 7 signatories are asked to report "how integration of stewardship and investment has differed for funds, asset classes and *geographies*" (emphasis added).

sign up to the SC and those based outside the UK to follow at least some parts of the SC in relation to their UK equity holdings.[76]

Whatever one may think of the value of ESG developments within corporate law to society as a whole, they probably represent good news for the second version of the SC, since they suggest that the new SC is cutting with, not across, the grain of more general, if incipient, changes in society. It is not too hard to discern a symbiosis between the SC and these broader changes. It is likely that the SC will be more a reflection than a driver of social change, but that is perhaps the role which all sets of rules most comfortably fulfil. Conditional upon these changes continuing and receiving political backing, the second version of the SC may turn out an unlikely success story. We shall see.

[76] Contrast Cheffins' view that the foreign holdings were the Achilles' heel of the first version of the SC because of its parochial focus: Brian Cheffins, "The Stewardship Code's Achilles' Heel" (2010) 73 *Modern Law Review* 1004.

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