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Shareholders in the United Kingdom

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Abstract

This paper, a version of which will appear in Research Handbook on Shareholder Power (Randall Thomas & Jennifer Hill eds, forthcoming 2015) analyses the extent of shareholder power in the United Kingdom. In part, it confirms the generally held view of institutional dominance of the share registers of listed companies and the consequent capacity of institutional shareholders to influence the 'rules of the game' as they relate to shareholder influence over management. This is especially true for rules set by subordinate rule-makers (ie not by the legislature directly) or self-regulatory bodies. However, institutional shareholder influence has always been more extensive in relation to rule setting than with regard to interventions to alter managerial policy at portfolio company level, a disparity which is attributed mainly to free-rider problems and conflicts of interest.

However, the paper argues that the standard account of institutional shareholder influence in the UK is likely to be significantly affected for the future by four developments. First, the proportion of the overall market for listed shares held by UK institutions, especially insurance companies and pension funds, has declined this century to the point where it is little or no higher than it was in the 1960s. Second, their place has been taken foreign investors, predominantly US or continental European institutional investors. Third, government is no longer content to leave the level of portfolio company intervention to be decided by the institutions in their own interests but, through the imprecise notion of 'stewardship', generates some pressure on institutional shareholders to intervene, to combat 'short-termism'. Fourth, hedge fund activism, although less developed than in the US, is a distinct feature of the current market.

The combined result of these factors for institutional activism, at both 'rules of the game' and portfolio company level, is uncertain. UK institutions may have a lesser capacity to intervene in view of their lower overall holdings, whilst foreign institutions may be less motivated to do so. The coordination costs of both types of investor may increase. This does not bode well for the stewardship policy. On the other hand, the crucial matter for intervention, at least in the medium-term, may not be the concentration of share ownership but the concentration of share management. There is some evidence that investment in the UK market continues to be concentrated in the hands of UK-based managers, even whilst institutional shareholding has become less concentrated. Finally, the coordination costs of institutional shareholders, domestic and foreign, may be reduced by hedge fund activism.

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Shareholders in the United Kingdom

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The influence exercised by shareholders over the running of the companies in which they are invested varies from jurisdiction to jurisdiction. An extended analysis of that influence in a single jurisdiction – the United Kingdom in this case – therefore requires some justification. From a comparative perspective, it is suggested that there are a number of reasons why such an analysis may be of interest to scholars whose primary concern is not with the UK.[1]

Like the United States, the UK displays a pattern of dispersed share-ownership in publicly traded companies, in contrast to the dominance of controlling shareholders in many other advanced economies. In a dispersed shareholding environment, the agency costs of the shareholders as a class are potentially high. They have been extensively analysed in the literature. (Armour, Hansmann and Kraakman, 2009) However, it would be wrong to equate the UK pattern of shareholding with a fully atomised dispersal in which, for example, the largest shareholder typically holds no more than 1% of the voting rights. A distinct feature of the UK system, at least since the 1960s, has been the ability of (semi) dispersed shareholders (primarily pension funds and insurance companies) to achieve a sufficient level of coordinated action to be able to influence the environment in which their investee companies operate. At least in certain conditions, significant but non-controlling shareholders have been able to coordinate their actions so as to do two things: the first is to influence the management of portfolio companies directly and, second, to influence the setting of the rules which determine the mechanisms of accountability of management to shareholders. It is arguable that, to date, they have been more active and more successful in the second role than the first. From the perspective of a comparison with US, the interesting feature of the emergence of a 'semi-dispersed' shareholding environment in the UK is that the process has been in advance of a similar development in the US by some two or three decades.

A further question is whether the reduction by dispersed UK shareholders of their agency costs through coordinated action was simply a function of the partial re-concentration of shareholdings.[2] It seems likely that this development was facilitated in part by a legal framework in the UK which traditionally has put fewer barriers in the way of shareholder coordination than has the US and in part by lobbying on behalf of the new category of shareholders for shareholder-friendly governance arrangements (Black and Coffee, 1997).

[1] The UK consists of three separate legal jurisdictions: England and Wales; Scotland; Northern Ireland. The Companies Act 2006, however, applies in a largely uniform manner to all three jurisdictions and the relevant common law is also similar. Where there are differences, references to the law in this paper are to the law of England and Wales.

[2] In fact, the empirical evidence is unclear on the question of whether a full-scale Berle & Means dispersion of shareholdings occurred in the UK in the period between the First and Second World Wars (Cheffins 2008, ch 8.III.B). If it did, 'partial re-concentration' is the appropriate term; if it did not, it would be more accurate to say that in the UK shareholdings became only partially dispersed.

Even if the rise of institutional shareholders was driven predominantly by developments outside the corporate law system (as will be argued below), a pro-shareholder corporate law system may increase the impact on management of the partial re-concentration process as compared with a corporate law system which aims to insulate management from direct shareholder pressure. Corporate law rules which facilitate shareholder coordination or which generally promote managerial accountability to shareholders may thus bring about, for any particular level of shareholding concentration short of a controlling shareholder, a greater reduction in shareholders' agency costs than would be the case for less shareholder-friendly rules. It will be argued below that the relevant UK rules are significantly pro-shareholder.

If, from a US comparative perspective, UK shareholders have appeared active earlier than their US counterparts for much of the last half century, from the point of view of a comparison with a controlling shareholder system, the low level of shareholder activism in the UK is notable. This raises the question of the strength of the incentives for UK shareholders to coordinate to exercise their shareholder powers, especially in the case of direct intervention in the management of portfolio companies, even in the presence of a shareholder-friendly set of governance rules. Even when the legal framework facilitates intervention, institutions may not see it as in their interests to take up all the intervention opportunities available to them.

To the extent that the role of shareholders in the UK turns on the decisions of institutional shareholders, the intensity of shareholder influence on management can be expected to be sensitive to changes in the composition of the institutional shareholder body and to changes in investment goals. The initial pattern (Davies 1993, Stapledon 1996) was a predominantly domestic institutional shareholder body with a high commitment to equity investment. With the removal of restrictions on capital movements, the domestic institutions have shifted a significant proportion of their equity investments out of the UK, whilst non-UK institutions now hold nearly half the UK market for public shares. At the same time, the maturity of pension schemes and an era of low inflation have pushed UK pension schemes to re-weight in favour of bonds and out of equity (Cheffins 2008, ch 11). These developments militate in favour of less institutional shareholder activism in relation to UK companies. On the other hand, the growth of activist hedge-funds, with intervention strategies which are not purely defensive, raises the prospect that institutional intervention will be facilitated because the activists reduce the costs of intervention by the long-only institutions (Armour and Cheffins 2012). The overall implications of these two contrasting developments are not yet clear.

Finally, there is the question of whether public policy should welcome or discourage activism, whether by the traditional institutions or by the more recently-arrived activist hedge funds. In the initial period of the rise of institutional shareholders in the UK, government did not seek strongly to influence the extent to which the institutions sought to exercise their formal governance rights or, by contrast, simply exited investee companies with whose management they were dissatisfied. From the early days, however, there were influential voices who argued that it would be better for those with the ultimate economic interest in the shares (ie, pensioners, policy-holders) if institutional shareholders replaced failing management themselves rather than leaving it, for example, to a takeover bidder (Charkham

1989). From the beginning of the 21st century, however, government began to put non-legislative pressure on institutional investors to be more active (Myners 2001) – at precisely the time that their capacity for action was arguably reducing. By 2010 this pro-intervention perspective was embodied in the (quasi-official) Stewardship Code, enforced on a 'comply or explain' basis. Institutional shareholder activism has thus become defined as a desirable activity in public policy terms and a number of legislative initiatives (such as 'say on pay') assume its existence. Whether activism can bear the weight placed upon it is not year clear.

The rest of the paper is organised in the following way. Section 1 analyses the rise and fall of institutional ownership of the public share market. Section 2 analyses the private incentives and disincentives for institutional shareholder activism. Section 3 deals with the public policy debate over activism and links that emerging changes in the incentives to activism which are analysed in Section 2. Section 4 deals with a minor, but significant, qualification to picture presented above of the absence of controlling shareholders. In recent years a number of foreign-incorporated companies have accessed the London capital markets by listing on the London Stock Exchange. Some of them have controlling shareholder structures familiar outside the UK and the US. The question has thus arisen of how well adapted to majority shareholder agency problems the UK corporate governance system is, given its concentration since the Second World War mainly on reducing management agency costs. Section 5 concludes.

I. Institutional Shareholder Ownership of the UK Public Share Market

[Table 1 here]

A. Who holds listed shares in the UK?

Table 1 sets out the data produced by the Office of National Statistics' surveys of the beneficial ownership of listed UK equities, which it has been running since 1963. 'Shareholder of record' data is freely available, but tells one little because many investors hold their shares in nominee accounts, so that one needs to go behind the share registers to establish beneficial ownership This exercise is bedevilled by the problem of identifying the beneficial ownership of shares held in pooled nominee accounts (ie where a custodian holds shares on behalf of a number of different investors in a single account). It is generally accepted, including by ONS itself (ONS 2012a), that a methodological change introduced after the 1997 survey failed to capture the distribution of ownership across different types of beneficial owners, until it was corrected for the 2010 and 2012 surveys. The effect of methodological failings was, in the 2001, 2004 and 2008 surveys, to overestimate the holdings of pension funds and insurance companies and to underestimate the holdings of mutual funds, 'other financial institutions' and 'rest of the world'.

Despite these limitations, Table 1 allows certain broad conclusions to be drawn about the development of institutional shareholding in the UK. In general it is two-period story, with the second period beginning somewhere around the turn of the century.

- For individuals, including controlling family shareholders, there has been a secular decline in their direct holding of shares – a process which got under way before the period covered by the official surveys. This decline continued despite the privatisations of the nationalised utilities during the 1980s during which the shares in the former state-owned enterprises were heavily marketed to the general public. During this century, however, the percentage held by individuals has levelled out. Table 1 shows that institutional holdings exceeded individual holdings by the middle of the 1970s, something that occurred in the US only at the end of the century (Armour & Skeel, Figure 1).
- Domestic insurance companies moved from one tenth to one fifth of the market between 1963 and 1981 and remained there until this century when a decline began to (now) below the 1963 percentage.
- Pension funds reached their high point slightly later than insurance companies and began to decline somewhat earlier, so that they too now hold a percentage which is lower than in 1963.
- Open and closed-end mutual funds have become significant holders of equities in this century, becoming the largest category of domestic holder.
- Overseas holders began to acquire a higher percentage of the market only in the late 1980s, rose steadily thereafter and now have reached over half the market.
- The proportion of the market held by 'other financial institutions' has fluctuated over the past 50 years, but it is difficult to know what significance to attach to this since the category contains a wide variety of types of financial institution. (ONS 2012b)[3]

A further problem with the ONS data relates to the categories used. The two residual categories have become much more important over time, but detailed data about their constituents is lacking. We have already mentioned this problem in relation to 'other financial institutions', which contains both activist hedge funds and sovereign wealth funds, about which separate information would be desirable. The other, egregious, example is 'rest of the world' which category now holds the owners of more than half the market. Not only is this category not further broken down, but its defining feature is different from that used for all the other categories, ie the geographic location of the owner, not the nature of the owner's business. In the 2012 an effort was made to correct for this. We now know that over half of the overseas holdings are in the hands of North American institutions and over a quarter are held by (non-UK) European institutions (ONS 2012b) Moreover, Figure 1 shows that the breakdown by business type adds to the strong position of mutual funds in the market as a whole and increases the weight of pension funds somewhat. One can guess that the category 'public sector' is substantially populated by sovereign wealth funds, but their exact weight is unclear.

[Figure 1 here]

[3] "This [category] includes market participating holdings such as clearing accounts, market makers, stock lending and collateral accounts. This also includes funds such as index funds, exchange traded funds, hedge funds, socially responsible and ethical funds." (ONS 2012b at 29)

B. The drivers of change

The reasons for the shift of shareholdings from individuals (including controlling families) to institutions (in the first period identified above) have been studied by Cheffins (2008). On the 'sell-side' the main driver was the post-war punitive tax regime relating to investment income, which at times was near 100%. There were no changes in corporate law in the period which made private benefits of control harder to obtain. Consequently, law did matter on the sell side, but it was tax law rather than corporate law which was significant. On the buy-side, both insurance company and pension fund expansion was driven by savings for retirement (Davies 1993), since the tax system encouraged the use of both vehicles for this purpose. The incentive for individuals to participate in retirement saving schemes arose from the fact that the state pension (funded on a pay-as-you-go basis out of taxation and part of the post Second World War welfare state reforms) was deliberately set at a low level in order to encourage supplementary private saving. The incentive for employers to offer occupational pensions was to attract and retain good staff (substantial financial penalties in terms of pension loss were suffered if a person left an occupational pension scheme before retirement age), but the tax regime strongly encouraged pension liabilities to be funded and the fund to be held outside the corporate entity (in a separate pension trust). For a mixture of tax and path-dependency reasons, those for whom no occupational pension scheme was available would save for retirement through 'with-profits' insurance policies rather than through individual retirement savings accounts, which became available only in this century. Thus, insurance companies were initially much more important vehicles for retirement savings than mutual funds, but the position has reversed in this century. The incentive for both pension fund trustees and insurance companies to invest employer and employee contributions in equities rather than the more traditional bonds was provided by the high rates of inflation experienced by the UK in the post-war period. The start of the move out of bonds was symbolised by the decision of the Imperial Tobacco pension manager, Ross Goobey, in the middle 1950s to move that scheme's assets entirely into equities.

The 'second period' decline in the holdings of the domestic institutions is partly the reverse story of the above, at least in relation to employers' incentives. Employers were less likely in the 21st century to want to maintain large and stable UK workforces, the tax regime for pensions became less favourable, and mark-to-market accounting and other regulatory changes reduced the incentives for institutions (and pension funds in particular) to hold equities (Haldane 2014). The long-term incentives for individuals to save against retirement remained, but their short-term incentives decreased: membership of occupational pension schemes became voluntary, employers increasingly replaced defined-benefit with less attractive defined contribution schemes (because the investment risk was thrown onto the employee), and governmental policy encourage individual saving for retirement.[4] Overall, the growth in retirement-driven saving slowed. (DWP 2012; ONS 2013b) In addition, as pension funds became mature, the attractions of bonds to meet known liabilities returned to some extent.

[4] Some institutions, eg mutual funds, benefitted from these changes.

A new factor, however, was the removal of exchange controls in 1979, which led over the course of the succeeding years to a geographical diversification of UK institutions' equity, away from UK-listed companies, and a corresponding increase in the percentage of the UK market held by 'the rest of the world'. The capital controls, which fixed exchange rates entailed, had artificially constrained the diversification policies of institutional investors and their removal demonstrated the extent of that pent-up demand. In recent years the value of overseas equities held by UK institutions has come to exceed the value of their domestic equities (ONS 2013). However, overseas equities may be managed from the UK, whether held by UK or non-UK institutions. According to the 2013 survey of its members by the Investment Management Association (IMA – the trade association for UK-based fund managers), UK equities represented only a little over one third of equities managed from the UK (IMA 2013a, Chart 13).

Overall, the rise in the proportion of UK listed equities held by UK institutions and the consequent impact on the dispersion of shareholdings in UK public companies was a residual effect of important changes taking place outside the sphere of corporate law. Whilst the rise of the institutions was to have a profound impact on how corporate law and governance operated in the UK (see Section II below), the primary drivers of the rise (and then partial decline) of the UK institutional shareholders as holders of UK equities were the governmental decision not to throw the main burden of pension provision onto the taxpayer but to encourage private saving to provide an income in old age, the incentives (or lack of them) for employers to build up a core stable workforce, and the breakdown of the Bretton Woods system of fixed exchange rates which permitted both UK and foreign institutions to diversify their equity holdings on a world-wide basis.

II. The Incentives and Disincentives to Shareholder Activism

So far, we have uncritically equated the rise in the percentage of the UK market held by institutions (whether domestic or foreign) and the decline in the proportion held by individuals with a description of shareholdings in the UK as only 'partially dispersed'. This assumption now requires some further analysis, distinguishing between concentration at the level of the market as a whole and concentration of shareholdings within particular companies. It will be seen that institutional shareholders have been able (or incentivised) to exercise influence more extensively at the level of the market as a whole than in relation to investee companies.

A. Market level influence

Although no single type of institution ever reached the proportion of the market held by individuals in 1963 (over half), they were in a better position to exercise market-level influence than individual shareholders for three main reasons. First, there were fewer institutions engaged in equity investment than there were individuals. Second, the institutions were geographically concentrated – in the City of London and, to some lesser extent, in Edinburgh. This facilitated both formal and informal communication amongst the institutions

and both formal and informal communication between the institutions and, on the one hand, those acting for corporate clients (for example, the merchant (later investment) banks) and, on the other, regulators. Third, the investment goals of the institutions were more homogenous than those of the individual shareholders, who ranged from small retail investors to controlling families whose focus was normally on the business performance of the company they controlled rather than on the rights of shareholders. Those rights, given their holders' majority position, were fully secure and the holding itself was illiquid.

The institutions thus had lower coordination costs than individual shareholders. In some cases, coordination of the institutions' market practices was sufficient to give them what they wanted. (A good example is the institutions' aversion to non-voting shares, discussed below, which led to the virtual disappearance of offers of non-voting shares and the enfranchisement of existing non-voting shares. In consequence, the US dual class recapitalisation debate largely passed the UK by.) More often, the institutions needed to influence corporate governance regulation by others. In either case, the influence was exercised predominantly through the trade associations which they had established, in particular, the Association of British Insurers and the National Association of Pension Funds. With regard to regulation, the institutions were fortunate that important elements of corporate governance regulation were set in this period, not by the legislature through the companies legislation, but were either left to self-regulation by the City or delegated by the legislature to City-based statutory agencies. These approaches to rule-making reflected the government's then view that this area of regulation was not politically salient and was to be regarded as a largely technical matter. Lobbying by the institutions collectively in the context of self- or delegated regulation was likely to be more effective than if the subject-matter for regulation had been seen as politically charged and been dealt with directly through the Parliamentary process. In particular, employees and other non-shareholder stakeholders were not well placed to access this technical discussion and management bodies had less scope to present themselves as proxies for these interests (Culpepper, 2011).

From the late 1960s onwards the institutions had substantial success in pushing market practice and self-regulatory law in a shareholder friendly direction (Stapledon 1996, ch 4). This was in sharp contrast to perceptions of shareholders' lack of influence which were dominant only a decade earlier. The leading Labour Party politician and theoretician, Anthony Crosland, argued in the 1950s against an extension of the Party's post-war programme of nationalisation of private industry on the grounds that dispersed shareholders had little influence over managerial policy. The most important influences, he argued, were the government through the residue of its war-time controls over the economy and the trade unions via collective bargaining, so that expulsion of the private shareholders would achieve little (Davies 2003).

Among the most notable of the pro-shareholder (but non-legislative) changes to which the institutional shareholders contributed were the following.

(a) The adoption in the self-regulatory City Code on Takeovers and Mergers of a pro-shareholder approach to takeover bids (tender offers). The decision on the acceptance

of the offer was firmly placed in the hands of the shareholders through a board neutrality rule prohibiting unilateral defensive action by management; and target shareholders were protected against opportunistic conduct by the bidder through elaborate equality rules (Davies 2002), including a mandatory bid rule which gave shareholders an exit right on attractive terms upon a change of control, even if that change was achieved through a private purchase. At least at the level of the formal rules the contrast between the City Code and the Delaware rules on takeovers is pronounced (Armour and Skeel 2006; Davies and Hopt 2009)

(b) The institutions successfully lobbied for an amendment to the Listing Rules – at that stage a self-regulatory matter for the London Stock Exchange[5] – in the early 1970s which subjected all economically large corporate transactions to prior shareholder consent. Although the common law and the companies' legislation required shareholder consent in some cases of self-dealing transactions, there was no requirement for prior approval simply on the grounds of the size of the proposed transaction. The institutions had pressed for this change following a takeover which substantially changed the nature of the business of the *offeror* company (Stapledon 1996, p 60). It is significant that a governmental report in 1962 on changes to the companies' legislation had recommended against such a reform (Jenkins 1962, para 118) on grounds of difficulty of implementation and that, even today, the Companies Act 2006 does not contain this requirement.

(c) The introduction in the 1950s, again in the Listing Rules, of a default pre-emption option for existing shareholders on an issue of new shares for cash and the subsequent development by the institutions of strict (but informal) guidelines on the circumstances in which they would be willing to waive their entitlements under default rule. Although statutory pre-emption was introduced in 1980 upon the transposition in the UK of the Second Company Law Directive of the European Community, the Listing Rules and the Pre-emption Guidelines have continued to reinforce the statutory rules. The Guidelines still determine the rigour of the pre-emption default (though their policy on waiver) and the Listing Rules in effect require the pre-emption rights to be tradable (not a statutory requirement) if the discount from the market price is substantial (Davies and Worthington 2012, paras 24-13 and 24-14). These supplements to the statutory requirements are seen as (i) protecting shareholders against financial loss on existing holdings when there is a further, deeply discounted, issue and (ii) giving institutional shareholders a powerful governance lever when management decides to raise external finance following sub-optimal corporate performance (Myners 2005). It has been argued that the providers of new finance to financially constrained companies has been in the UK the most effective

[5] When the Exchange de-mutualised, it abandoned responsibility for the Listing Rules, which passed to the Financial Services Authority (now Financial Conduct Authority). Since the FCA, although statutory, is a delegated regulator based in the City, the institutions continued to be well-placed to influence its rule-making.

means of replacing poorly performing management (Franks, Mayer, Renneboog, 2001).

(d) Leading the opposition to non-voting, restricted voting or multiple-vote shares in favour of the principle of one share, one vote. As with the requirement for shareholder approval of significant changes in the company's business, the governmental committee in 1962 recommended (by a majority) against legislative change (Jenkins 1962, para 136). Nor were the Listing Rules amended so as to require one share, one vote. However, through market pressure (ie the refusal to buy such shares or to subscribe to regular issues of new shares unless voting inequalities on existing shares were removed) such shares ceased to be a significant feature of companies quoted on the London market.

(e) Promoting a greater role for non-executive directors on corporate boards and on board committees. The initial version of the UK Corporate Governance Code (CGC) (Cadbury, 1992) reflected the prior views of institutional shareholders and the institutions have been successful in influencing the subsequent development of the Code in a pro-shareholder direction. Since the Code is enforced via a 'comply or explain' mechanism (the 'hard' obligation to either comply or explain is contained in the Listing Rules), the burden of taking action in the case of unsatisfactory explanations lies with the shareholders. The high degree of compliance on the part of companies with the recommendations of the UK CGC is a piece of indirect evidence about the influence of institutional shareholders on governance practice.

There are three features of the UK CGC (Financial Reporting Council 2012) which strengthen its pro-shareholder orientation. First, the recommendation that half the board should be independent is joined with the recommendation that a substantial proportion of the board should be executive directors. In other words, the Code's ideal is the board equally divided between executive and independent non-executive directors (not a board consisting wholly or mainly of non-executive directors which, to UK eyes, turns the board into a pure supervisory mechanism). Second, the Code recommends a division of function between the chair of the board and the CEO: as is often said, the latter runs the company but the former runs the board. Third, the Code recommends the appointment of a 'senior independent director' who "should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or other executive directors has failed to resolve or for which such contact is inappropriate". All three mechanisms are designed to enhance the influence of the independent directors and their accountability to the shareholders.

B. <u>Investee Company Influence</u>

Despite the clear evidence of institutional shareholder influence on the setting of the 'rules of the game' in the UK, most public policy debates over institutional shareholder activism focus on direct influence over the managerial policies of individual investee companies. Here the crucial initial question is the degree of shareholding concentration at the level of individual companies, not at the level of the market as a whole. Clearly, for prudential and portfolio management reasons, most individual institutions will hold a relatively small share of any single company's equity. In the early 1990s the median size of the largest voting block in UK listed companies was 9.9%, with the second largest at 6.6% and the third at 5.2% (Becht and Mayer 2001).[6] In the same period Stapledon carried out a more detailed investigation into the holdings of institutional shareholders in UK listed companies (Stapledon 1996, Table 5.6). He found that the mean collective holding of the six largest institutions was 20% in the largest listeds, 30% in medium-sized listeds and 36% in small listeds. (He also provided data for one to five institutions.) Although this data is not current, it is unlikely that recent changes in the composition of institutional shareholders have led to an increase in concentration at investee company level.

Non-routine intervention by shareholders in the management of investee companies thus requires the construction of a coalition of institutions to be effective. That coalition need not hold a majority of the voting rights in the company, but probably needs something around the one quarter mark in order to carry the day at a general meeting against board opposition. The crucial questions thus relate to the determinants of effective coalition building amongst institutional shareholders. Two main influences have been identified: the extent to which corporate law encourages or discourages shareholder coalitions to influence management and structural incentives or disincentives on institutions to combine to achieve common goals.

(i) Corporate law and shareholder coalitions

UK corporate law has retained to a remarkable degree the classical features of its origins in the middle of the nineteenth century. The company was then conceived of predominantly as a private association, founded and subsequently controlled by its members, who, in the case of a commercial company, were the shareholders. Despite the development of welfarist and social democratic characteristics in British society, notably the periods immediately before the First World War and immediately after the Second, the fundamental character of British corporate law changed rather little. Social solidarity expressed itself in the creation of state bureaucracies to administer welfare and the nationalisation of what were regarded as the 'commanding heights' of the economy rather than, as in Germany (Dukes 2011), through the democratisation or constitutionalisation of the corporation itself. In consequence, UK corporate law provides strong governance rights for shareholders as against management and the UK scores high on comparative 'anti-director' indexes (Lele and Siems 2007; Siems 2008). To this extent, the legal path open to the institutional shareholders was a clear one.

It is worth stressing, however, that this pro-shareholder law derived from successive Companies Acts rather than from the common law. Whilst the common law retained control

[6] By contrast, the median for the largest block on the NYSE was 5.4% and on NASDAQ 8.6%, but in both cases the second and third largest blocks were smaller – less than 5%.

over important areas of company law, notably (until 2006) directors' duties, the common law was much less favourable to shareholder activism than the legislation. Whilst an elaborate structure of substantive law on directors' duties was built up by the courts, by analogy with the duties applicable to trustees, the courts placed difficulties in the way of the enforcement of those duties by individual shareholders (Armour 2008). Enforcement of directors' duties thus tended to be the province of liquidators in insolvency or new boards of directors suing their predecessors, often in an attempt to reduce the price paid for the acquisition of the company. The institutions were pushed to intervene in management decisions via the exercise of statutory governance rights rather than the enforcement of common law liability rules.

The common law enforcement difficulty derived from the limited standing rules for the prosecution of derivative claims.[7] Compendiously referred to as the 'rule in *Foss v Harbottle*' ((1843) 2 Hare 46), English law denied standing to bring a derivative claim if (a) the directors' wrong was capable of being ratified (approved) by an ordinary majority of the shareholders (whether it had actually been ratified or not) or (b) in the case of a non-ratifiable wrong, the alleged wrongdoers did not control the general meeting of the shareholders. (English law never took the step taken in Delaware of equating wrongdoer control with control of the board.) The underlying thrust of the rule was to push decisions about ratification/suit into the hands of the general meeting. However, if the institutional shareholders had to operate via the general meeting, then, as we shall see below, their governance rights were likely to be more attractive to them than the initiation of suit.

The rule in *Foss v Harbottle* was abolished in the Companies Act 2006 and replaced by a judicial filter system for bringing derivative claims (Davies and Worthington 2012, ch 17), but for all but a small part of the period under discussion the *Foss* approach determined this question. In the early 1980s a major UK institution, the Prudential Assurance Co Ltd, made a big push to obtain through litigation an amelioration of the then standing rules for the derivative action in a case involving an egregious self-dealing transaction between an investee company and another company in which the chairman and chief executive of the investee company had a substantial financial interest. At trial the Prudential was successful and judge propounded a novel interpretation of the *Foss* case-law, which was favourable to minority shareholders (*Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257). This was too much for the Court of Appeal which re-asserted orthodoxy, castigated the Prudential for its conduct of the case and hinted that it would award very substantial costs against it ([1982] Ch 204). Not surprisingly, the institutions made no further attempts to use the litigation route to secure rulings favourable to intervention, but instead confined themselves to their well-established statutory governance rights. Whether the 2006 reforms will encourage greater use of the litigation route remains to be seen. The courts are still developing their approach to the broad discretion invested in them.

By contrast to the litigation route, the structure of the UK companies' legislation is favourable to the exercise by the institutions of their governance rights. In this respect it is

[7] Financing the litigation, by contrast, was not a major issue after the courts decided in the 1970s that, assuming standing, the company would normally carry the costs of the litigation, even if it were unsuccessful.

also in contrast to the traditionally more restrictive stance of US law (Hill 2010). The following aspects of UK law are to be noted.

(a) The Act has always left the scope of the board's powers to be determined by the company's articles of association rather than determining them in the Act itself. The articles of association are wholly under the control of the shareholders: the articles are specified by the initial shareholders on formation and can be altered subsequently at any time (by supermajority decision) by the shareholders, whether the board supports such a change or not. The board's powers are thus derived from the shareholders, not from the legislation. For this reason, there is no doctrine in UK law that shareholders' resolutions can be excluded from being put to the meeting because they conflict with the statutory grant of powers to the directors nor therefore is it necessary to frame the resolution in precatory form in order to avoid this difficulty.
However, there is a significant question about what size of majority is needed for shareholders to give instructions to the board. For obvious efficiency reasons, in practice the articles of publicly traded companies confer extensive powers on the board. After some debate the courts have concluded that a supermajority vote (equivalent to that required to change the articles) is needed if shareholders wish to give instructions to the board, if that instruction conflicts with the grant of powers to the directors in the articles (Davies and Worthington 2012, para 14-5ff). (There was a period in the nineteenth century when the dominant view was that the articles circumscribed the powers of the board but not of the shareholders, who therefore could give instructions to the board on any matter by simple majority vote.)

(b) The discussion in the previous paragraph was rendered somewhat academic by the inclusion in the Companies Act 1948 (and all subsequent Companies Acts) of a power for the shareholders to remove all or any of the directors at any time for any reason by ordinary majority vote (subject to corporate liability for breach of service contract). Now, the instructions normally come via a threat to remove if the desired course of action is not adopted by the board. The 1948 Act thus in effect restored the nineteenth century position. Interestingly, it did so at a time when social democracy was at its height in terms of influence over governmental policy. The committee which recommended this change put the whole of its justification into this single sentence: "It seems to us desirable to give shareholders greater powers to remove directors with whom they are dissatisfied than they have at present." (Cohen, 1945, para 130).

(c) Governance rights which turn on shareholder-initiated resolutions are effective only if shareholder meetings can be summoned by minorities. Under the current 2006 Act 5% of the shareholders have the right to requisition an (extraordinary) meeting or to add an item to the annual general meeting agenda – though before 2009 the required percentage for an extraordinary meeting was 10%. The system of attendance at meetings via proxies had been removed from managerial control through a combination of stock exchange rules and statutory reform by the time the institutions

became active. For example, management must provide two-way proxies (giving the shareholders the option to vote against), if they solicit proxies at all. However, the incumbents have a cost advantage in any battle for a majority of the votes in that they may use the corporation's assets to fund their side of the battle of words, whereas the challengers have limited circulation rights at the company's expense. Modern methods of electronic communication may have reduced that managerial advantage. (The shareholder register is a public document.)

(d) For some issues, management must summon a shareholders' meeting to seek approval for a proposed course of action, so that the burden of convening a meeting falls on the board. UK company law contains the standard European list of matters (somewhat wider than the US list) upon which shareholders have veto rights (Rock et al, 2009). In addition, this catalogue is supplemented by Listing Rules. Besides the large transaction requirements, noted above, the Rules contain a set of related party transaction requirements which go beyond the Act, mainly by requiring shareholder consent where the Act is content with independent board approval. Since 2002 the Act has contained a 'say-on-pay' requirement, ie a requirement for an annual vote of the shareholders on the company's remuneration policy and actual payments during the year under review. Initially advisory, the vote has recently become binding as far as remuneration policy is concerned (Davies 2013, 3.1.5). The UK Corporate Governance Code has recommended since 2010 that the directors of the 350 largest listed companies should submit themselves to annual re-election. Thus, in relation to both remuneration policy and continuation in office, the burden of action to secure shareholder consent lies with the board rather than the shareholders.

(e) In addition to these statutory rights, the 'comply or explain' recommendations of the UK Corporate Governance Code are likely to have made boards with substantial independent director representation sensitive to the interests of the shareholders (Guo and Masulis 2012; Masulis and Mobbs 2013) and to have provided an effective channel of communication between institutions and boards.

(f) Finally, the board neutrality rule of the Takeover Code (above) constitutes a potentially powerful and low-cost rule for making boards sensitive to the interests of shareholders. Boards which ignore shareholder interests will be unlikely to retain shareholder support in a takeover battle, whilst the prospect of a bid operates ex ante as a continuous incentive for management not to ignore those interests.

(g) There are two main *legal disincentives* to coalition building, neither of which is likely to be substantial provided the coalition is not seeking continuing control of the board. Shareholders who come together to change managerial policy may be treated as 'acting in concert' for the purposes of the statutory disclosure rules (on share ownership) and, more worryingly for them, for the purpose of the mandatory bid rule of the Takeover Code. The prospect of becoming subject to an obligation to offer to buy out all the others shareholders would likely chill institutional intervention. The

Takeover Panel has taken steps to reduce the significance of this latter threat (Davies 2013). The mandatory bid obligation is not triggered simply by the coming together of shareholders who hold 30% or more of the voting rights but by the acquisition by any member of the coalition of further shares in the company. Thus, combining institutions can avoid the mandatory bid rule by remaining below the 30% threshold or by sacrificing liquidity – including the chance to increase their gains from intervention by increasing their holdings. More important, the Panel applies the MBR only to those acting in concert who seek to obtain control of the board. Simply proposing or supporting change of executive directors (or of managerial policy) does not necessarily amount to board control, in the absence of evidence of a wish to exert continuing control of the board. In effect, one-off interventions, even a series of episodic interventions, do not constitute board control in the eyes of the Takeover Panel. By contrast, disclosure of the collective beneficial holdings of the coalition is less costly for them and may even further the coalition's ability to influence management by providing verification of the size of the coalition's joint holdings – although it may also encourage free-riding by other institutions which are being pressed to join the coalition.

(ii) Disincentives to the exercise of governance rights

Overall, the governance provisions of UK company law, the Corporate Governance Code, the Takeover Code and the Listing Rules provide effective mechanisms for institutional investors to intervene in the management of investee companies. The next question is how willing the institutions have been to avail themselves of these opportunities. The answer for the second half of the 20th century was that substantial disincentives to intervention existed alongside some incentives to intervene. The overall result was characterised as one where the glass (of intervention) was only 'half full' (Black and Coffee 1997). This characterisation was meant to convey that the UK institutions achieved a higher level of intervention at investee company level than might be expected from fully dispersed shareholders but did not achieve the level of intervention which they were probably capable of reaching and that the actual level of intervention was sub-optimal from the point of view of the institutions' beneficiaries (pension plan members and insurance policy holders).

The incentives for intervention were that, when some institutions acquired relatively large blocks of shares in companies, the traditional exit route where management was underperforming (sale in the market) was difficult to effect without driving down the market price, at least if a rapid exit from the share was desired. Equally, the alternative exit route of waiting for a takeover bidder and then selling out was not reliably available, since takeover incidence displayed a wave-like quality and in any event bids for truly underperforming companies were often not forthcoming even in takeover booms (Franks and Mayer 2002). On the positive side, an institution with a substantial stake in the company stood to gain significantly if intervention led to improved corporate performance, and without sharing those gains with a takeover bidder.

However, the disincentives to intervention were also strong. Those disincentives fall into three groups: the costs of intervention as against its potential benefits, free-rider problems and conflicts of interest (Cheffins 2008, ch 10.V). By contrast, market level intervention through trade associations to influence governance rules does not raise these problems in an acute way. Costs are spread over all the members of the association, all institutions have strong incentives to be members of the trade association even if they do not value highly the rule-setting role of the association, and conflicts of interest are not acute, since the rules create opportunities for intervention but do not require it in any particular situation.

When considering the balance of incentives to intervention at investee company level, it is important to note that not all institutions make investment decisions in-house. In particular, pension funds commonly delegate investment decisions to outside fund managers and, along with the investment mandate, grant them the power to exercise governance rights in investee companies, whilst insurance companies are more likely to keep that function in-house (IMA, 2013a, p 43). Consequently, the incentives of outside fund managers are important as well as the incentives of the institutions themselves.

The costs of intervention are of two sorts. First, there are the out-of-pocket and managerial time costs of intervention. The business models of some institutional investors are very sensitive to even moderate costs of this type (Çelik and Isaksson, 2013). Examples are exchange traded funds which charge no fees and earn revenues solely from lending out shares or index tracker funds which invest in an extremely wide portfolio of stocks and whose promise to the investor is to provide exposure to the index at a very low cost. In these cases the product which is offered to investor is one which implicitly excludes intervention as an investment technique.

Even when the investment proposition is not so constrained, the costs of intervention can be substantial if the incumbent board does not respond to informal, behind-the-scenes expressions of disquiet and a public exercise of governance rights has to be organised. Consequently, there is a disincentive to take issues beyond the informal stage unless the likely benefits of public action seem large and obtainable. If the intervention decision is in the hands of a fund manager, the incentives to intervention may be even more muted. Most fund managers are remunerated by a small percentage (1-2%) of the funds under management. Their remuneration will thus increase by only a very small proportion of the gain to fund value resulting from the intervention, whilst they may carry all or a substantial part of the costs of intervention.

Second, neither institution nor fund manager may be expert in the development of managerial (as opposed to investment) strategy, so that effective intervention may involve a substantial investment of resources in acquiring this particular strategic capacity. Good returns can be earned by funds which make this investment (Becht et al 2009), but the patient institutional settings which support such investment may not often be available. The best-known example of such investment, Hermes Focus Asset Management (studied by Becht et al) was eventually sold by its pension-fund owners to a hedge-fund in 2012 (Financial Times September 18, 2012).

Building a coalition of investors is important to successful public intervention (where control of the majority of the votes at a general meeting may be needed) and will also operate to reduce the financial costs of intervention of any one shareholder. However, this process is subject to free rider problems and incentives to exit. Whilst it is to the benefit of all institutions to mount a successful intervention, each institution maximises its wealth by not participating in the intervention (provided the others go ahead). Since this is true for all potential participants, obtaining and holding commitment to the intervention by the requisite number of institutions in an environment of competition amongst fund managers for business may be difficult. Alternatively, an institution approached to participate may regard this as a signal that the lead institution has non-public and adverse information about the investee company and so decide that its interests will be best served by exiting the company rather than joining the coalition. This may be a particular issue with institutions with relatively small holdings in the investee company but whose participation is needed to give the coalition the necessary overall voting strength.

Conflicts of interest affect both institutions and fund managers, but especially the latter, where they are part of financial conglomerates. A fund manager part of an investment bank might feel constrained from taking action against the management of a company to which the corporate finance arm of the bank is providing – or seeking to provide – its services. Evidence of such conflicts is necessarily difficult to obtain but a corporate reform body established by the government thought the informal and anecdotal evidence of such conflicts was convincing (CLRSG 2001, 6.19ff)

Overall, then, whilst levels of institutional shareholder activism increased in the last two decades of the last century, and especially in the final decade, it was clear that institutions often felt that the incentives not to intervene outweighed the incentives to do so. Measurement of the level of institutional investor firm-level activism is, however, somewhat imprecise, because it takes place to some significant degree behind closed doors. The traditional institutions and their fund managers will normally seek reliable commitments to joint action from other institutions before they act, in order (a) to have confidence that the out-of-pocket costs of intervention will be spread across a number of institutions and (b) to maximise the chances of the management of the investee company conceding the institutions' argument at an early stage, thus reducing the costs of intervention. Consequently, much early-stage intervention is unobservable by outsiders (unlike in the case of hedge-funds, considered below, where publicity for the demands made on management is part of the process of building support for them among other types of shareholder).

III The future of shareholder activism: public policy and hedge funds

The previous section discussed the institutions' incentives to intervene in the management of portfolio companies from an entirely private point of view: would an institution, considering solely its own interests, be in favour of intervention or not? Even in this analysis public policy necessarily performs an important background role: tax law favoured retirement

saving; corporate law maintained a stance which facilitated shareholder intervention; and the government in effect delegated important areas of rule setting (takeovers; listing rules) to quasi-governmental organisations which were particularly open to collective institutional influence. It seems improbable, however, that the policy-makers in these disparate areas of governmental action realised that, combined, their initiatives might promote firm-level intervention by institutional investors. Yet, once this activity had established itself securely, even if at a sub-optimal level, public policy began to adopt at the turn of the century a more positive stance towards institutional shareholder activism. With the final abandonment in the 1980s of nationalisation as a politically viable means of expressing public policy in relation to large companies and with the limited successes which economic planning had achieved in the 1960s and 1970s, governments wishing to influence management strategy at a micro level were left with the shareholders as their preferred channel of influence.

There are two central issues about governments' recent promotion of institutional shareholder activism. The first is whether governments wish the institutions to become more active because they consider that the private goals of the institutions coincide with public policy or because they seek to modify those private goals so as to align them better with government's conception of public policy. This is an easy enough question to formulate but difficult to answer because of ambiguities about the time-frame over which either private or public policy objectives are to be measured. Second, there is the question whether changes in the composition of the institutional investor body have rendered the institutions as a whole more or less capable of responding to governmental pressure to intervene.

(a) Governmental policy

A major governmental push to get the institutions to be more activist at investee company level was signalled in 2001 when a government-commissioned review on institutional investment reported (Myners, 2001). The report in many ways reflects the tension between governmental and institutional interests. The review was set up in response to a publicly articulated view on the part of the government that the range of asset classes considered by the institutions for investment was too narrow. In particular, institutions were said to disfavour private equity investments. The implication was that the UK economy was held back by this narrow view of appropriate investment opportunities. The Report, however, specifically rejected the proposition that institutions "have some public interest responsibility to invest in particular ways". The Report focussed instead on structural and procedural issues relating to investment decisions by the institutions. One of structural recommendations was that the institutions should be more active at investee company level because that was in the best financial interests of the institutions' beneficiaries (current and future pensioners; policy holders etc). Seeking to explain why such intervention was not already at its optimum level, the Report suggested that the main explanation lay with institutions' practice of reviewing fund managers' performance at short intervals (quarterly), which discouraged managers from taking decisions which might bring about significant short-term diversion from what other managers were achieving (herding). As Keynes once put it: "it is better for reputation to fail conventionally than to succeed unconventionally." (Keynes 1936) Thus, the reform proposals were framed in terms of freeing institutions or their fund managers from the

competitive pressures which inhibited long-term investment styles. Less clearly addressed was the argument that non-intervention was a central ingredient of some low-cost and highly diversified investment products, perhaps because the report focussed on the traditional institutional investors (insurance companies and pension funds). Was the implication that such investment strategies were to be discouraged?

The Myners' solution was to propose that institutions include in their mandates with fund managers an obligation (or at least an encouragement) to intervene and 'in due course' the government should incorporate this principle into law. The institutions sought to head off legislation by up-dating their own voluntary code on intervention of a decade earlier (ISC 2002), which committed them publish policies on active engagement, to monitor the performance of investee companies, and to intervene actively where necessary, whilst preserving the right to sell out when this was the most 'effective' response to their concerns. Coupled with the new legislation on 'say-on-pay' of 2002[8] and a further pro-activism governmental report in the wake of Enron (Higgs 2003, ch 15), the Myners Report produced a temporary flurry of public interventions by the institutions. Within a couple of years, however, that activism had dissipated itself, as both institutions and corporate management found the resulting public conflict difficult to handle (Cheffins 2008, ch 10).

In the wake of the 2007/8 financial crisis, the now established pattern repeated itself: governmental reports supportive of greater activism, a ratcheting up of the soft-law provisions, and more displays of institutional activism whose duration and impact was uncertain. Now, intervention was often called for in the name of 'sustainability' but the ambiguities remained. Was sustainability in the financial interests of the beneficiaries in the long term or were they being called on to make financial sacrifices in the interests of other groups in society? And how did one set about answering that question? Post the crisis, the institutions lost control of the content of their voluntary code and, whilst that content did not become mandatory, it did become subject to a mandatory 'comply or explain' rule, in the same way as the UK CGC. And the same body, the Financial Reporting Council, as was responsible for the Corporate Governance Code became responsible for the shareholder code – now re-named a Stewardship Code (FRC 2010) – an idea now being promoted at European Union level by the European Commission. It contained no definition of stewardship and so was ambiguous as to whether it was confined to securing good corporate governance in investee companies or extended to intervention to secure changes in managerial policy. Principle 1 of the revised 2012 version of the SC made it clear the extended meaning was intended (FRC 2012b).

The 'comply or explain' obligation of the SC is formally binding only on fund managers, who need the authorisation of the Financial Conduct Authority to act as such. The FCA's rules contain the hard 'comply or explain' obligation for asset managers just as they contain

[8] Provisions now contained in the Companies Act 2006. 'Say-on-pay' is the core example of the migration of a UK CGC recommendation into mandatory legislation – reflecting the political salience of this topic. Legislative support for stewardship is otherwise rather light: the Companies Act (ss 1277ff) contains fall-back powers under which the government can require institutions to disclose their voting rights and the allocation of voting rights in mandates, but the SC envisages stewardship as going beyond voting.

the same rule for listed companies in relation to the CGC. Given, however, the level of governmental influence over the financial industry, a significant number of institutions have also committed themselves to the code and their names are published on the FRC's web-site – thus generating the potential for some reputational harm if they do not adhere to the SC. The new code led to another flurry of institutional shareholder activism, mainly directed at levels of remuneration in banks and some non-financial companies. As we have noted, legislation requires companies to provide an annual opportunity for shareholders to vote on remuneration, so that this form of activism was made available to the institutions at low cost.

Perhaps fearing that these pro-activism recommendations would not produce long-lasting change in institutions' behaviour, the government commissioned an overall report on the functioning of the UK equity market (Kay 2012). This wide-ranging and, on the surface, radical report identified lack of trust as the crucial ingredient lacking in equity market relationships. As far as institutional investment was concerned, lack of trust between institutions and fund managers showed itself through too frequent assessment by asset owners of the performance of their managers; and between asset managers and investee companies, through a focus by managers and owners on trading rather than investment strategies. However, by focussing on trust as the central form of behaviour which needed to be fostered, Kay was led to downplay regulation as a significant instrument for producing behaviour change. The main instruments of change were to be voluntary 'good practice statements' promulgated with government encouragement by the relevant trade associations and the formation of an 'investor forum' to facilitate engagement with particular investee companies. Whilst one might agree with the content of the proposed statements (see box 1) it is wholly unclear what was being relied upon to induce behavioural changes in the desired direction – other than the educative impact of the statements themselves.

Asset Managers Good Practice Statement

Box 1

Asset Managers Good Practice Statement

Asset managers should . . .

7. prioritise medium to long-term value creation and absolute returns rather than short-term returns from market movements when making investment decisions.
8. build an ongoing relationship of stewardship with the companies in which they invest to help improve long-term performance – recognising that engagement goes beyond merely voting.
9. make investment decisions based on judgments about long-term company performance, informed by an understanding of company strategy and a range of information relevant to the specific company (including relevant environmental, social and governance issues), and avoiding reliance on single measures of performance.
10. be prepared to act collectively to improve the performance of their investee companies.

Asset Holders Good Practice Statement

Asset holders should . . .

4. be proactive in setting mandates for asset managers based on open dialogue about agreed investment objectives.
5. set mandates which focus managers on achieving absolute returns in line with beneficiaries long-term investment objectives, rather than short-term relative performance benchmarks.
6. recognise that diversification is the result of diversity of investment styles.
7. review performance no more frequently than is necessary, and with reference to long-term absolute performance.
8. encourage and empower asset managers to engage with investee companies as a means of improving company performance to deliver investment returns.

Source: Kay Review, pp 53 and 56

As to the investor forum, asset owners and fund managers agreed in 2013 to set up such a body (IMA 2013b). Funded by the industry and supported by skeleton secretariat, the central idea behind the forum is to facilitate ad hoc engagement with individual investee companies in cases of dissatisfaction with their governance or performance. Typically, the forum would coordinate interaction on the part of a small group of concerned shareholders with investee management through the formation of an ‘engagement action group’ for each instance of concern as it arose. Participation in the group would be voluntary on the part of the shareholders. Although the membership of the forum is broadly conceived – it is open to

foreign owners and sovereign wealth funds, for example, as well as to UK institutions - and so reflects the changes over recent decades in the ownership of UK equities, the notion of having an institution to facilitate ad hoc engagement with under-performing or otherwise concerning companies is by no means novel. As early as the 1970s the various trade associations representing domestic asset owners or asset managers were in the habit of establishing such 'case committees' or 'investment protection committees'. Indeed, the umbrella organisation, the Institutional Shareholders Committee, was created in 1973 with the establishment of case committees as one of its main objectives (Stapledon 1996, pp 135-138). However, this activity proved not sustainable, probably because of the disincentives to participation identified in II.B.ii above. It is far from obvious how the new forum will address these issues.

In many ways the up-shot of Kay was a set of prescriptions similar to those which had emerged from Myners – more detailed certainly and backed by an overall critique of equity markets which Myners lacked, but also without the implicit threat of legislation which Myners retained. In particular, it is difficult to believe that the new regime will achieve anything of substance in the absence of some amendment of the liberal UK regime for takeovers, which induces corporate management to focus on the current share price and provides episodic but substantial pay-offs to shareholders. Whereas the Kay Review's focus is on maintaining managerial accountability to shareholders, already strong in the UK (above), whilst altering the goals of investors and their agents, no consideration is given to the alternative, or even complementary, strategy of providing a degree of insulation for management from the share markets. Whilst recognising in chapter 1 that many of the 'bad decisions' that the management of large British companies made over recent decades were enthusiastically supported by the shareholders and in fact were driven by them, the Review did not consider latter strategy. As such, the Review sits in the mainstream of the UK corporate governance tradition.

(b) Foreign institutions and hedge funds

As we noted in Section II, there are grounds for thinking that the present level of intervention is sub-optimal because of free-rider and conflicts of interest problems. A case might thus be made for the view that governmental pressure to intervene is justified on the grounds that it will move the institutions towards the optimal level of intervention. However, for this policy to be effective, asset owners and asset managers must be susceptible to pressure from the UK government. The increasing proportion of UK equities now held by 'the rest of the world' (Table 1) constitutes an obvious difficulty for UK government. Foreign owners are likely to be less susceptible to governmental influence than domestic ones. Indeed, the growth of foreign ownership has been described as the Achilles heel of the SC (Cheffins 2010). The weakness of the government vis-à-vis foreign owners arises out the exit rights foreign owners have: they may exit the UK market or they may exit from UK-based fund managers (whilst remaining in the UK market). There are some limits on these options. Exiting the UK market may not be attractive if it significantly reduces diversification and no substitute market can be found. Not using UK managers may be an easier option. It is true that, currently, some foreign owners use managers based in London (and that some 40% of the assets managed by

IMA members are managed on behalf of foreign investors (IMA 2013a, p 79)).[9] UK-based fund managers, whether domestically or foreign-owned, are subject to the FCA rules and thus subject to the SC on a comply or explain basis. However, it is not a pre-requisite for investing in the UK market to have a fund-manager located in the UK, nor are asset managers obliged to locate the management of non-UK assets in London.[10] Thus, the SC could lead to a decline in the of UK-based fund managers (to the detriment of that area of UK-based activity) if they were seen to be subject to regulation which was not in the interests of owners. Perhaps for this reason the FRC only 'hopes' that investors based outside the UK will commit to the Code (FRC 2010 para 25).

Whilst one may doubt whether the soft-law approach of Kay and the Stewardship Code will produce a significant increase in institutional intervention in the face of the disincentives to activism (identified above), at least in the absence of continuous political pressure sustaining intervention, it is possible that a market solution will emerge. Institutional shareholder activism is traditionally defensive, ie it is a response to adverse developments in the investee company which were not anticipated when the investment was made (Armour and Cheffins 2009). By contrast, offensive activism, associated predominantly with activist hedge funds, involves the acquisition of a non-controlling stake in a company in order to increase the value of the company's shares by seeking a change in management or its policy.

Offensive activism has become a feature of UK institutional activity in the 21st century (Cheffins 2008, ch 11.II). Whether it will develop into the dominant mechanism for producing change remains to be seen. Because of the non-controlling stake held by the activist, the success of its proposals depends on their attracting the support of the non-activist institutions. Hence, the desire of hedge funds to make 'noisy' interventions which alert other investors to their intentions. The attraction to the traditional institutions – both domestic and foreign – of producing management change via hedge funds is that two of the disincentives to intervention on the part of long-only investors are removed. The costs of intervention are borne by the activist whilst the activist specifically invites the institutions to free-ride on its efforts – at a minimum requiring only voting support. "The role of a new entrant into the governance story, the activist shareholder, is to increase the value of the vote held by the institutions by teeing up the intervention choices at low cost to the institutional owners." (Gilson & Gordon 2013)

Why are hedge funds better incentivised to intervene in portfolio companies than the traditional institutions? As far as their managers are concerned, they are more strongly incentivised towards intervention because their remuneration arrangements (notably carried interest) enable them to capture a higher percentage of the up-side of intervention. As to the fund itself and the investors therein, since the costs of intervention to the activist are substantial, the incentives to the activist turn in large part on its ability to acquire a shareholding at a price which does not reflect the expectation of successful intervention.

[9] This figure refers to assets managed from the UK, whether those assets are in the UK or not.
[10] Çelik and Isaksson (2013, Table 1) point out that only one of the world's twenty largest asset managers is UK-based/

However, the UK disclosure rules do not facilitate the acquisition by the activist of shares at an 'uncontaminated' price. The standard disclosure threshold for beneficial shareholdings is low (3%); disclosure must be made quickly (within two days of the threshold being reached); and purely economic interests in shares held through contracts for differences (equity swaps) count towards the threshold.

The concluding feature of activist hedge funds' intervention is selling out as soon as the intervention is successfully achieved and reflected in the share price, thus crystallising the gain and freeing the capital deployed for use in other situations. (This is not to say that hedge funds might not hold stakes for a significant period whilst pursuing the changes they think desirable.) Without quick exit, the activist hedge fund would not be able to shoulder the costs of intervention. Although the most recent empirical data roundly rejects the proposition that this business model encourages activists to propose changes that pay off in the short-term but are damaging to the company in the long-term (Bebchuk et al 2013), it is far from clear that public debate views activist intervention as being benign. Governmental concern with corporate governance is driven by the political salience of the topic: lack of appropriate investment (Myners 2001); the Enron scandals (Higgs 2003); the financial crisis. Like takeovers, activist intervention often causes immediate detriment to the interests of non-shareholder stakeholders, as businesses are split up or more leverage is taken on. In other words, there is a risk that government may perceive the long-term economic success of companies as implying the absence of sudden shifts that are painful to non-shareholder interests. In this situation, the market mechanism for overcoming the disincentives to institutional shareholder activism may not be developed to the full (for example, because tough disclosure rules on share ownership are kept in place). Governments may end up liking 'active' investors (ie those who take problems off the government's plate by dealing with failing companies) but disliking 'activist' ones (ie those who create problems for governments by seeking out companies to effect changes where such change is not obviously necessary).

Nevertheless, recent research supports the argument that activist hedge funds are effective interveners. Filatotchev and Dotsenko (2013) studied 270 public manifestations of activism (by all classes of shareholder) in the UK, targeting 217 companies, over the period 1998 to 2008. Their results show an increasing trend in public interventions, from 10 per year in 1998 to 42 in 2007. In terms of impact on firm value, they find, as in many US studies, that overall the interventions had no positive impact. However, the picture changed when the interventions were divided by reference to type of intervention, type of intervener and type of demand made.

- They divided the types of intervention into (essentially) public campaigns/debate and shareholder proposals. (A third strategy, litigation, was also identified but, in line with the analysis of litigation above, this was deployed in only 1% of interventions.)
- Public debate (just over half of interventions) showed no short-term positive gains and a somewhat negative impact on firm value in the medium term. The authors interpret this as the market regarding public debate as both ineffective in producing change and as a signal/confirmation that the company is underperforming. Pension funds and

insurance companies in this period confined their interventions almost entirely to public debate, whereas both investment managers (presumably sometimes acting on behalf of institutional investors) and hedge funds were likely to move to a resolution if public debate failed.

- The most commonly found types of shareholder resolution concerned board membership (proposals to elect or remove named persons) (35% of proposals); remuneration (22%); business strategy (21%); governance (10%); and capital structure (9%).
- Activists tended to target underperforming companies. Shareholder proposals (just under half of interventions) had a positive impact on firm value in both short and medium term. This effect was more pronounced in the case of board membership and corporate strategy resolutions (in contrast, for example, to governance or remuneration resolutions). Resolutions put forward by hedge funds (as opposed to asset managers) had a positive effect in the short term but a diminishing effect in the medium term.

These findings support the arguments that strong shareholder resolution rights facilitate activism; that an institutional investor committed to activism can act as a catalyst for institutional intervention generally; but that, given the declining impact on firm value of hedge fund activism in the medium term, the debate about the long-term impact of hedge fund activism is not conclusively resolved. The fact that remuneration resolutions are a significant proportion of shareholder resolutions, despite their lack of impact on share price, may reflect political pressures on shareholders to be active in this area – pressures which have only increased in the post-research period. The lack of impact of public debate not supported by a resolution proposal does not necessarily indicate that informal pressure is ineffective. The market may assume that, in the case of traditional institutions, the public campaign has been preceded by 'behind closed doors' dialogue, which has failed, whereas private debate which has been successful in changing managerial behaviour did not show up in the research because it led to no public intervention.

IV Controlling shareholders and UK corporate governance

The above account has been entirely concerned with the coordination problems of (semi) dispersed institutional shareholders, whose rise to dominance began in the 1960s. The other great theme of corporate governance, the agency costs of non-controlling as against controlling shareholders, has been completely absent from this piece. Of course, this theme is not absent from UK company law across the board, for much of the law about private companies revolves around that issue. For publicly traded companies, however, the dominant theme of the past half century has been that analysed above. However, controlling shareholders are not unknown even in listed UK companies, and their number has increased somewhat in recent years with the listing of resource extraction companies on the Main Market of the London Stock Exchange. These companies may be foreign incorporations, will certainly have predominantly foreign operations and often are controlled by a foreign shareholder. The UK attracts them for capital raising, not operational, purposes. It has been

estimated that some 50 of the FTSE 350 companies would fall within the proposals discussed below as having a controlling shareholder as there defined. (Slaughter and May 2013).

As a result of conflicts in these companies between controlling and minority shareholders, the minority protection provisions of the Listing Rules have been reviewed. The rules for a premium listing[11] on the London Stock Exchange already contained some minority protections, notably a 'majority of the minority' approval requirement for self-dealing transactions (which apply to a 10% shareholder). The reforms build on these existing provisions of the Listing Rules via a requirement (a bit like the German 'contract of domination') that a controlling shareholder (holding, with associates, 30% or more of the voting rights) enter into a written and legally binding agreement with the company in which the controlling shareholder gives three central undertakings. These are (a) not to take any steps to prevent the company from complying with its obligations under the Listing Rules; (b) to ensure that transactions with the controlling shareholder are at arm's length and on normal commercial terms; and (c) not to propose shareholder resolutions which will subvert the operation of the Listing Rules. This reform is not intended to exclude the controlling shareholder from all participation in the day-to-day running of the company at board level (FCA 2013).

Monitoring of the agreement once concluded is in the hands of the independent directors, whose appointment is recommended by the UK CGC.[12] They must state each year in the company's annual report whether they agree with the statement to be required of the controlled company that it has entered into a control agreement with the controlling shareholder and that the controlling shareholder has abided by its terms during the year. If the independent directors do not concur (or if the controlling shareholder has not entered into an agreement) the sanction is that the related party transaction rules apply to the company without qualification until the situation is rectified. This means that the normal exemptions from the requirement for independent shareholder approval in the case of small related-party transactions and transactions in the ordinary course of business will not apply, thus giving the non-controlling shareholders greater opportunities to influence managerial policy. This is likely to be an effective sanction.

Finally, in order to ensure the monitoring and sanctioning regimes operate effectively, the appointment or annual re-appointment of an independent director will require the separate approval of the non-controlling shareholders (failing which there is a 90-day delay before a nomination may be considered by all the shareholders on a simple majority basis). In addition, in order to avoid manipulation of the shareholder vote it will be required that the voting rights of all the shares in any class of premium-listed shares be equal and that the voting rights of different classes of premium listed shares be proportional to the interest of each class in the company's equity. These last two changes will apply to all premium-listed

[11] A premium listing is optional (issuers can choose a standard listing instead) but the premium listing brings with it access to the FTSE indexes and, therefore, greater liquidity and a lower cost of capital.

[12] An earlier FCA proposal that the election of independent directors in a controlled company should be mandatory has been dropped.

issuers, whether they have a controlling shareholder or not. Thus, for the first time, the UK will introduce a mandatory enactment of the 'one share, one vote' principle in this segment of the market.

V Conclusion

This analysis of the UK framework for shareholder governance rights can be said to demonstrate that:

1. shareholder monitoring of management is intensely sensitive to the dominant form of shareholding in a company;
2. some significant level of monitoring is achievable by coalitions of large shareholders who, individually, do not have a controlling stake;
3. the maximisation of monitoring by such coalitions is unlikely to be achieved in the current structure of asset owner and asset manager relations;
4. changing these relations is a challenging task and is likely to be achieved only through sustained political pressure or the encouragement of activist hedge-funds.

TABLE 1: BENEFICIAL OWNERSHIP OF LISTED UK EQUITIES

Beneficial Owner	**1963**	**1969**	**1975**	**1981**	**1989**	**1993**	**1997**	**2001**	**2004**	**2008**	**2010**	**2012**
Individuals	54	47.4	37.5	28.2	20.6	17.7	16.5	14.8	14.1	10.2	10.2	10.7
Insurance companies	10	12.2	15.9	20.5	18.6	20	23.6	20.0	17.2	13.4	8.8	6.2
Pension funds	6.4	9.0	16.8	26.7	30.6	31.7	22.1	16.1	15.7	12.8	5.6	4.7
Other financial institutions*	11.3	10.1	10.5	6.8	1.1	0.6	1.3	7.2	8.2	10.0	12.3	6.6
Unit and investment trusts	1.3	2.9	4.1	3.6	7.5	9.1	5.4	2.9	3.9	3.7	10.9	11.4
Banks	1.3	1.7	0.7	0.3	0.7	0.6	0.1	1.3	2.7	3.5	2.5	1.9
Rest of the world	7.0	6.6	5.6	3.6	12.8	16.3	28.0	35.7	36.3	41.5	43.4	53.2

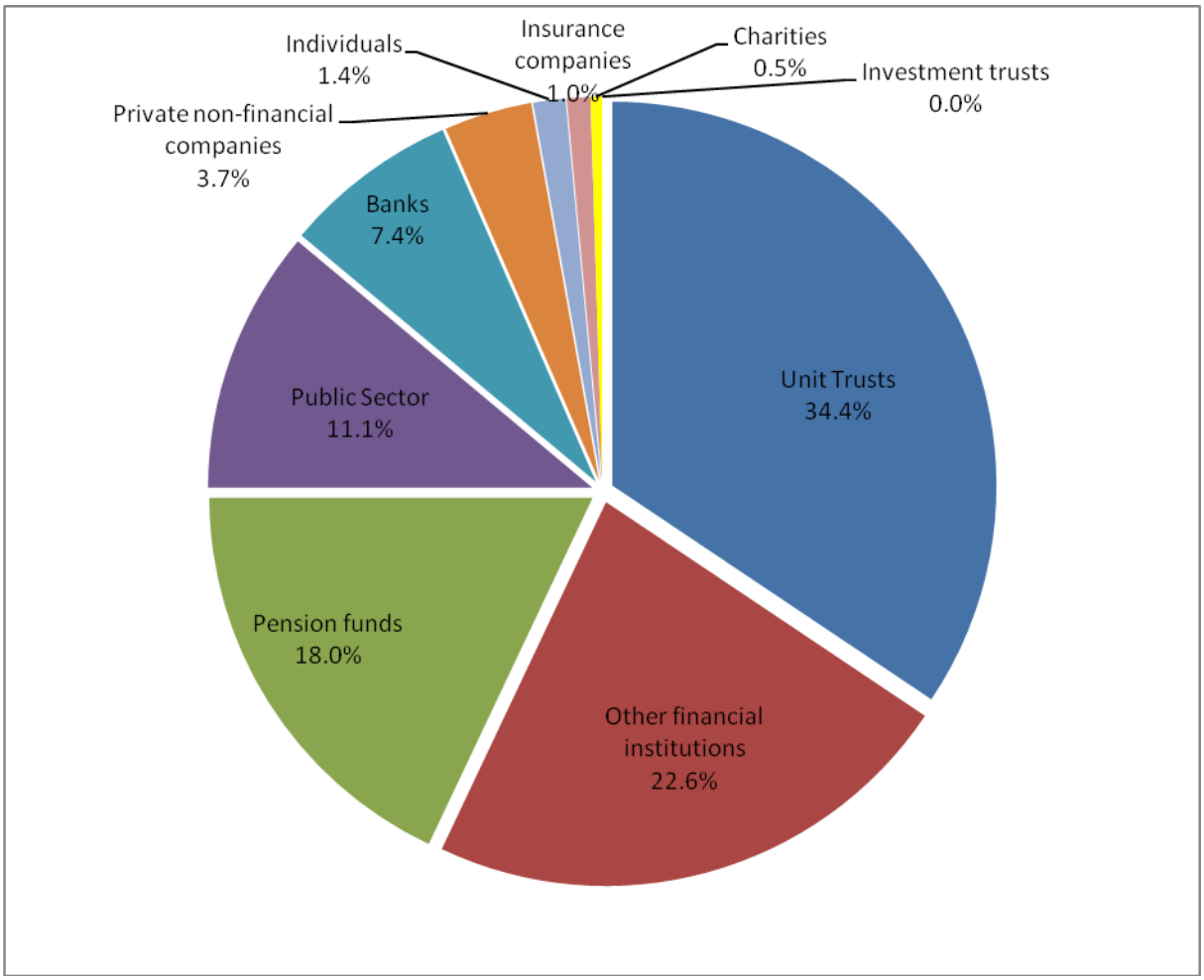
*Includes hedge funds

Notes (1) totals do not sum to 100 because some minor categories of holder omitted. (2) 2001, 2004 and 2008 Numbers not strictly comparable across years because of methodological changes after 1997 and again after 2008.

Source: Office of National Statistics, *Ownership of UK Quoted Shares 2012* (2013)

Figure 1

'Rest of World' by Beneficial Owner 2012



Source: ONS 2012b

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